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Rebalancing Bosnia and Herzegovina

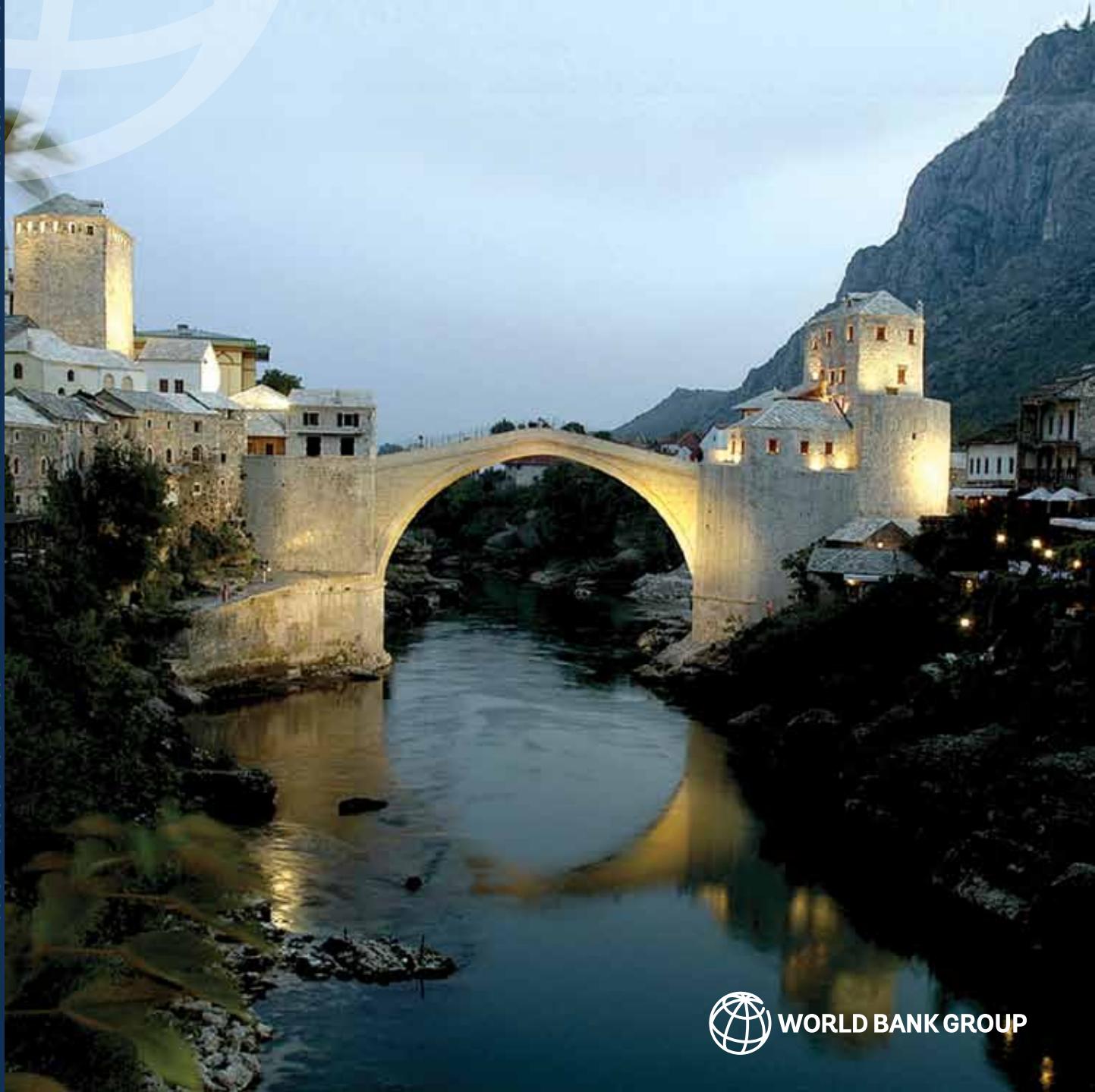
A Systematic Country Diagnostic

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WORLD BANK GROUP

Europe and Central Asia Region

Rebalancing Bosnia and Herzegovina

A Systematic Country Diagnostic

November 2015

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ABBREVIATIONS

ALB	Albania	GBD	Global Burden of Disease
ALMPs	Alternative Labor Market Policies	GCI	Global Competitiveness Index
ARM	Armenia	GDP	Gross Domestic Product
AROPE	At Risk Of Poverty or Exclusion	GEF	Global Environment Facility
B40	Poorest 40% of the population	GEO	Georgia
BAM	Bosnia-Herzegovina Convertible Mark	GFCF	Gross Fixed Capital Formation
BCG	Bacillus Calmette–Guérin (inoculation against TB)	GNI	Gross National Income
BD	Brcko District	GNP	Gross National Product
BEEPS	Business Environment and Enterprise Surveys	GSP	Gross Social Product
BG	Bulgaria	GWh	Gigawatt hour
BH	Bosnia and Herzegovina	HA	Health Assessment
BHAS	BiH Agency for Statistics	HBS	Household Budget Survey
BiH	Bosnia and Herzegovina	HDI	Human Development Index
BLSE	Banja Luka Stock Exchange	HH	Households
CAD	Current Account Deficit	HIF	Health Insurance Fund
CAGR	Compound Annual Growth Rate	HRZ	Croatia
CIT	Corporate Income Tax	HS	Harmonized Standards (trade data)
CPF	Country Partnership Framework	HTA	Health Technology Assessment
CPIA	Country Policy and Institutional Assessment	HUN	Hungary
CVD	Cardio-Vascular Diseases	IBHI	Institute for Better and Humane Inclusions
DB	Doing Business	ICT	Information and Communications Technology
DPT	Diphtheria, Polio, Tuberculosis vaccination	IDA	International Development Association
DSA	Debt Sustainability Analysis	IFC	International Finance Corporation
DSL	Digital Subscriber Line	IFOR	Implementation Force
DTF	Distance to Frontier	ILO	International Labour Organisation
EBRD	European Bank for Reconstruction and Development	IMF	International Monetary Fund
EC	European Commission	IPA	Instrument for Pre-Accession
ECA	Europe and Central Asia	ISO	International Organization for Standardization
ECAPOV	ECA Poverty Database	ITA	Indirect Tax Authority
ECD	Early Childhood Development	KM	Convertible Marks
ECE	Early Childhood Education	KOS	Kosovo
EE	Estonia	KWh	Kilowatt hour
EHBS	Extended Household Budget Survey	LFS	Labor Force Surveys
ENVSEC	Environment and Security (Initiative)	LGBT	Lesbian, Gay, Bisexual and Transgender
ERASMUS	European Community Action Scheme for the Mobility of University Students	LITS	Life in Transition Surveys
EU	European Union	MCO	Micro Credit Organization
EU-CEE	European Union-Central and Eastern Europe	MICS	Multiple Indicator Cluster Survey
EUR	Euro	MKD	FYR Macedonia
FACE	Fiscal Accounts for Country Economists	MNE	Montenegro
FAO	Food and Agricultural Organisation	MoF	Ministry of Finance
FAOSTAT	Food and Agricultural Organisation Statistics	MoH	Ministry of Health
FBiH	Federation of Bosnia and Herzegovina	MW	Megawatts
FDI	Foreign Direct investment	NANFA	Net Acquisition of Non-Financial Assets
FM	Family Medicine	NATO	North-Atlantic Treaty Organization
FSAP	Financial Sector Assessment Program	NCDs	Non Communicable Diseases
FSC	Forest Stewardship Council	NEET	Not in Education, Employment or Training
FYR	Former Yugoslav Republic	NER	Net Enrollment Rate
FYROM	Former Yugoslav Republic of Macedonia	NHA	National Health Accounts
		NOAA	National Oceanic and Atmospheric Administration

NORC	National Opinion Research Center	SRB	Serbia
NPLs	Nonperforming Loans	SSC	Social Security Contributions
OHR	Office of the High Representative	T60	Wealthiest 60% of the population
OLS	Ordinary Least Squares	TAAG	Tax At A Glance
OOP	Out Of Pocket	TB	Tuberculosis
OPEC	Organization of Petroleum Exporting Countries	TEN-T	Trans-European Networks
PCF	Per Capita Financing	TFP	Total Factor Productivity
PE	Population Equivalent	TIMSS	Trends in International Mathematics and Science Study
PEFA	Public Expenditure and Financial Accountability	TPP	Thermal Power Plant
PER	Public Expenditure Review	TU	Turkey
PES	Public Employment Services	TVET	Technical and Vocational Education and Training
PGI	Political Economy, Governance, Institutional	UIC	University of Illinois at Chicago (Urban Transportation Center)
PHC	Primary Health Care	UK	United Kingdom
PIAAC	Programme for the International Assessment of Adult Competencies	UN	United Nations
PIC	Peace Implementation Council	UNCCD	UN Convention to Combat Desertification
PISA	Program for International Student Assessment	UNDP	United Nations Development Programme
PIT	Personal Income Tax	UNEP	UN Environmental Program
PM	Particulate Matter	UNESCO	United Nations Educational, Scientific and Cultural Organization
PN	Poland	UNICEF	UN Children's Foundation
PPP	Purchasing Power Parity	UNODC	UN Office of Drugs and Crime
PSD	Private Sector Development	UNPOP	United Nations Population Department
PWC	Price Waterhouse Coopers	UNPROFOR	UN Protection Force
RCA	Revealed Comparative Advantage	UNW-DPC	UN Water
RHS	Rural Household Survey	US	United States
RO	Romania	US\$	United States Dollar
ROSC	Reports on Observed Standards and Codes	USD	United States Dollar
RS	Republika Srpska	VAT	Value Added Tax
SAA	Stabilization and Association Agreement	WBG	World Bank Group
SASE	Sarajevo Stock Exchange	WDI	World Development Indicators
SBA	Stand-By Arrangement	WEF	World Economic Forum
SCD	Systematic Country Diagnostic	WEO	World Economic Outlook
SEE	South East Europe (ALB, BiH, KOS, MKD, MNE, SRB)	WHO	World Health Organization
SILC	Survey on Income and Living Conditions	WMO	World Meteorological Organization
SLV	Slovenia	WPS	Working Paper Series
SMEs	Small, and Medium Enterprises	WTO	World Trade Organization
SO	Stunting and Overweight	WWII	Second World War
SOEs	State-Owned Enterprises		
SP	Social Protection		



EXECUTIVE SUMMARY

Twenty years after the end of the war, Bosnia and Herzegovina (BiH) has yet to achieve shared prosperity for its citizens and approach European living standards. The country has been at peace since the end of 1995, but its development model needs adjustment if it is to join the ranks of prosperous European economies. BiH has a disproportionately large public sector that dates back to Yugoslav times and has only been partly reformed since, and the constitutional arrangements under the Dayton and Washington Agreements had as their aim the cessation of war rather than the explicit goal of building a viable and efficient state. Financial inflows, particularly aid and remittances, have been fueling consumption-based economic growth. These inflows were important in post-war recovery, and propelled the country back to middle-income status. However, reaching high levels of income, creating prosperity and eliminating poverty will only happen if BiH shifts toward an economic model that builds on international integration, especially with the EU, BiH's most important trading partner and anchor of institutional reform.

In principle, BiH has a number of strengths it could leverage. The country is located next to the EU, the world's largest economic bloc. It has achieved macroeconomic stability with low fiscal deficits and moderate debt levels. The large diaspora is doing well and transfers an estimated 10-11 percent of GDP back to the homeland. If BiH would reach the same volume of trade with its neighbors as it had during the time of Yugoslavia, its exports would triple. Leveraging these strengths could make it a vibrant economy with dynamic entrepreneurs leading a catch up with wealthier countries in Europe.

The average BiH residents cannot expect to live a prosperous life. Measured by the World Bank's poverty methodology, poverty was at 15 percent in 2011 (latest available data), and around half of the population still live in a precarious situation.¹ Poverty declined from 20 percent (2001) to 14 percent (2007) but has reversed modestly since the global crisis. Poverty levels are similar in both Entities (Federation of Bosnia and Herzegovina, FBiH and Republika Srpska, RS) and, as in many other countries, poverty is higher among the rural population. The most critical agenda is job creation since unemployment is closely linked to poverty and only about one in three working-age adults in BiH has a job (and only one in four has a formal job). Much of the population lives from informal activities, remittances from relatives, or social welfare. If the country does not create more jobs, many Bosnians will grow old in relative poverty.

Social and economic imbalances are acute. BiH society is split into a relatively small active part that earns a regular salary (often abroad) and a large group which depends on transfers from the government or relatives. Many of these welfare dependents live in rural parts of the country. Despite higher rates of poverty among those who live in rural areas (and those who work in agriculture), the rural population has hardly declined as a share of total population since the war. Rural life, with reasonable access to many public services, remains the better alternative for many

¹ Defined as being at-risk-of-poverty-or-social exclusion (AROPE), a headline indicator of the Europe 2020 strategy.

Bosnians who do not have jobs and cannot afford the higher cost of living in cities. Other populations are also overly impacted by poverty including children and Roma populations. Indeed, over 40 percent of Roma area estimated to be poor. In addition one in five adult Roma are considered to be illiterate (compared with close to full literacy among the rest of the population) and over half are malnourished.

BiH needs to rebalance its development model in two fundamental ways in order to succeed. First, it needs to unleash the potential of the private sector while reducing the footprint of the very large public sector. Second, the economy needs to shift from an inward focus driven by local consumption and imports to the potential of international integration through investments and exports. To achieve this the country needs more (and larger) companies, vibrant small and medium sized enterprises and a business environment that allows them to grow and expand output, employment, and exports.

Currently, incentives are misaligned for embarking on this new development model. Most policies support those who already have a job and benefit from a consumption-based and state-dominated economy. For example, high social protection spending benefits the wealthy almost as much as the poor, state-owned companies (SOEs) that no longer operate continue to keep people on their payroll (building up large arrears in unpaid social contributions), and a large tax wedge swallows over a third of even the lowest paid workers' salaries, making it almost impossible for employers to create formal jobs for lower-skilled workers. These imbalances have been difficult to correct because they are deeply rooted in the country's history and institutional structures from the former Yugoslav Federation. At the same time, if BiH wants to eliminate poverty, create shared prosperity and eventually become a high-income country, it will need to break with the present state of affairs and find a new and more effective development path.

The rebalancing of BiH's social and economic model is also made difficult due to the country's demographic challenges and unique institutional set-up. At 3.8 million inhabitants, the population of BiH is already relatively small. Yet it is among the fastest shrinking and aging populations in the world, which creates challenges for service delivery, especially in rural areas. Unlike many other emerging economies, BiH cannot reap a demographic dividend as it reorients its economic model. In addition, the country's institutional fragmentation makes economic policymaking more challenging. The complex institutional structure established by the Dayton Agreement ending the war has a negative impact on the efficiency of decision-making processes and results, at times, in unnecessary and expensive duplication.

Box ES.1: Social and economic development in Bosnia and Herzegovina—Key facts

- Per-capita income is US\$ 4,700, which is less than half the global average and only 26 percent of the average income in the European Union.
- Poverty is at 15 percent at around \$5 per day per person and is evenly distributed across both Entities. The poverty rate has risen modestly since 2007.
- BiH has a poor track record in governance. In SEE, only Albania and Kosovo are ranked as more corrupt than BiH by Transparency International. Most people in BiH believe that the current institutional structures are reinforcing poor governance and make reform difficult.
- Unemployment is over 27 percent and labor force participation is extremely low at only around 50 percent. Youth and long-term unemployment are of particular concern, as is extremely low female participation in the labor force.
- When the economy grew, the bottom 40 percent (B40) benefitted disproportionately. This reflects the pattern of job creation and large government redistribution.
- The public sector is by far the bigger player in the economy. National, sub-national and local government expenditures account for approximately 50 percent of GDP, not including SOEs.
- Only one out of three BiH working-age adults has a job and one out of four has a formal job. Almost half of these formal jobs are in the public sector.
- Population is declining rapidly because of low birth rate and sizable outward migration. Since 1995, the BiH population has shrunk from 4.5 million to an estimated 3.8 million today and there will only be around 3.5 million people living in BiH by 2020, if the trend continues.
- BiH is one of the least urbanized countries in Europe with some 60 percent of the population living in rural areas.

Source: BiH SCD team

A turbulent past

BiH has a special place in the history and development of Europe. One hundred years ago, the assassination in Sarajevo of the heir to the Austro-Hungarian throne, Franz Ferdinand, triggered the outbreak of the First World War. Twenty-five years ago, after the fall of the Berlin Wall and the subsequent disintegration of Yugoslavia, BiH was again the powder keg of the region. The atrocities and devastation of the war in BiH in 1992-1995 are well documented and still explain some of its development challenges 20 years later.

In the 1990s, BiH suffered one of the largest economic contractions in modern history, estimated at close to 90 percent. Following a decade of economic stasis during the 1980s, Bosnia and Herzegovina—already one of Yugoslavia's poorer republics—suffered during the collapse of communism in Eastern Europe, the disintegration of Yugoslavia and then war in BiH. By many measures, no country in Eastern Europe was hit harder.

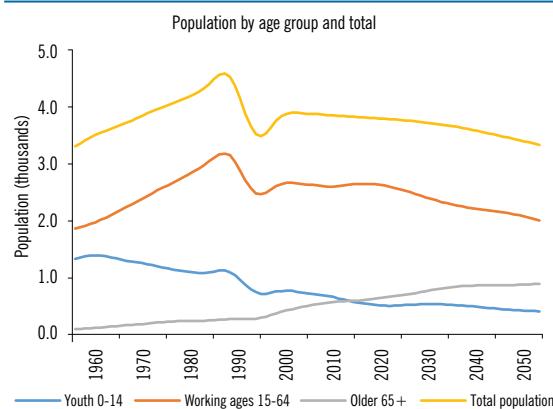
The decline of the country's population has been dramatic. Before the war started, BiH had an estimated 4.5 million people. Today there are only around 3.8 million people living there. This trend will persist due to continued emigration and low fertility: by 2020, BiH will likely be home to only 3.5 million people. Since 2014, the number of old people exceeds the young, meaning that reforms need to happen at a time of demographic decline (Figure ES.1).

The Dayton Agreement of 1995 restored peace but constrained effective governing of the country. The Agreement divided the country administratively into a weak central government and two Entities: the Federation of Bosnia and Herzegovina and Republika Srpska,² with FBiH further divided into ten cantons. The sub-national levels of government were given considerable power. This institutional structure resulted in significant fragmentation and duplication of public services and decision-making. Two extreme examples of such fragmentation are the existence of 11 ministries of health in FBiH alone, reducing the quality of health care and increasing its costs; and different train companies in RS and FBiH, requiring a change of locomotives when each train enters the other Entity. An international oversight organ was established known as the Office of the High Representative (OHR). A central bank and a local currency, pegged to the Deutsche Mark (later the Euro), were established and they provided one of the main anchors for the new country.

International donor resources flooded in to help the country rebuild after the war. Aid averaged 26 percent of GDP between 1996 and 1999. Today, the institutional structures established twenty years ago remain largely unchanged. While the currency board (now pegged to the Euro) has been the bedrock of broad macro-stability in BiH, the public sector has become one of the largest in the world. Aided by the establishment of the Indirect Tax Authority (ITA), BiH has become one of the most successful tax collectors in the region, collecting the equivalent of 45 percent of its GDP in revenue. The large public sector is similar in size to Scandinavian countries, yet the availability and quality of BiH's public services are not reflective of the large tax contributions.

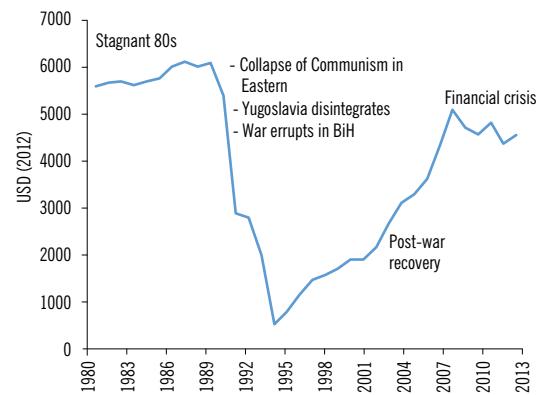
A person who is 50 years old today—born in the mid-1960s—has lived in a country beset by economic turmoil for most of his or her adult life. The 1980s were a decade of economic hardship when the Yugoslav economy stagnated and inflation reached up to 70 percent per year. In the first half of the 1990s an average BiH citizen experienced territorial disintegration and war. After more than a decade of post-war reconstruction, the country, by some measures, never quite reached pre-war living standards, before falling back into economic stagnation brought on by the global economic crisis (Figure ES.2).³

Figure ES.1: BiH's demographic challenges:
Shrinking and aging



Source: World Bank staff estimates, based in UN Population Prospects, 2012

Figure ES.2: BiH's recent economic history: Collapse, recovery and stagnation
GDP per capita



Source: World Bank staff estimates based on WDI, measured in 2012 USD; data prior to the war are rough estimates

² In addition, the Brcko District is an autonomous self-governing administrative unit.

³ Note that in Euro terms the per-capita increase from 2000-2008 was substantially lower due to a 40 percent appreciation of the Euro compared to the USD.

BiH has many similarities with neighboring countries and a few important differences. The similarities build on its history as part of Yugoslavia for most of the 20th century. The key traits are a dominant role of the state, weak economic integration (internal and external), an aging population and a high level of perceived corruption. The main differences are the extent of destruction and trauma from the war, which resulted in one of the most extreme declines of economic activity in modern history. The Dayton Agreement still dominates the social and political systems today, and has exacerbated and enshrined many social and economic weaknesses of the state-led system. This institutional architecture also strengthened vested interests in opposing institutional and economic reforms.

Neither rich nor extremely poor

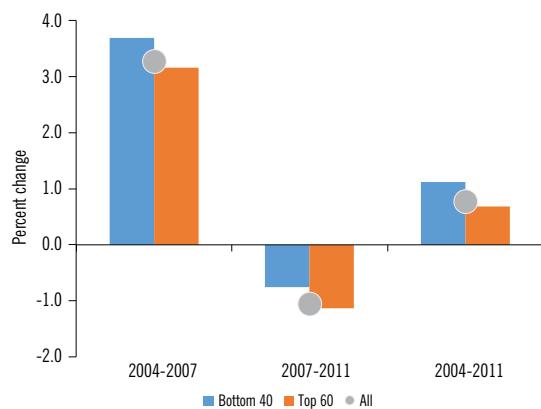
BiH is an economy relying on its domestic market. With consumption averaging over 100 per cent of GDP between 2010 and 2013, BiH is one the world's most consumption-driven economies. The model is fueled by a large public sector, which favors recurrent spending over investments and is fostered by the prevalence of remittances. A credit boom after the end of the war supported the economic recovery until 2008 but the country failed to integrate internationally and to start its export engine.

BiH citizens' average income has reached US\$ 4,740 (US\$ 8,800 in PPP). However, since the global crisis incomes have stagnated, which means that incomes are about a quarter of the EU average and 15 percent lower than its non-EU neighbors in South-East Europe (SEE). Incomes are relatively evenly distributed compared to other European countries, and past growth has particularly benefitted the poorest percent of the household income distribution (B40).

Poverty remains significant in both Entities, while it declined in Brčko District (BD). From 2007 to 2011, poverty increased slightly at the national level from 14 to 15 percent (although the change is not statistically significant), primarily due to an increase of poverty in FBiH, now projected to be at the same level as in RS (Table ES.1).⁴ In BiH, poverty is a predominantly rural phenomenon where people are twice as likely to be poor as in urban areas. This presents a particular challenge as BiH, which, unlike other emerging economies, remains majority rural (60 percent of the total population); unfavorable demographics combined with lack of labor market opportunities in cities create incentives for out-migration from the country rather than urbanization momentum.

Growth has been good for the poor via both labor income and social transfers. Over the last decade BiH has become a more equal country. From 2004-2011, (the period for which household data is available), the household expenditures of B40 have grown at about half a percent higher level than the B60 (Figure ES.3). This reflects the strong growth and employment performance in areas such as agriculture, manufacturing and construction during the pre-crisis period—sectors which employ many of those in the B40. The income-source decomposition of income changes during the 2004-2007 period suggests a third of the overall growth in incomes of the B40 during this period to be due to the growth in labor earnings. During the 2004-2007 period, almost half of the overall income growth of the B40 group was due to social assistance transfers—a more important contribution than that of labor earnings. This safety net would not have been possible absent strong economic growth in BiH.

⁴ The statistical significance of the increase in the poverty headcount in FBiH is somewhat sensitive to the choice of poverty threshold.

Figure ES.3: BiH Growth has been good for the poor

Source: World Bank (2014) EHBS 2011 data

Table ES.1: Poverty in BiH is mainly rural, 2007-2011

	2007	2011	Change
National	14.0	15.0	0.9
Urban	8.2	9.2	1.0
Rural	17.8	19.0	1.2
Entity			
FBiH	13.4	15.1	1.8
RS	15.0	14.9	-0.2
BD	18.8	10.4	-8.4

Source: World Bank (2014) EHBS 2011 data

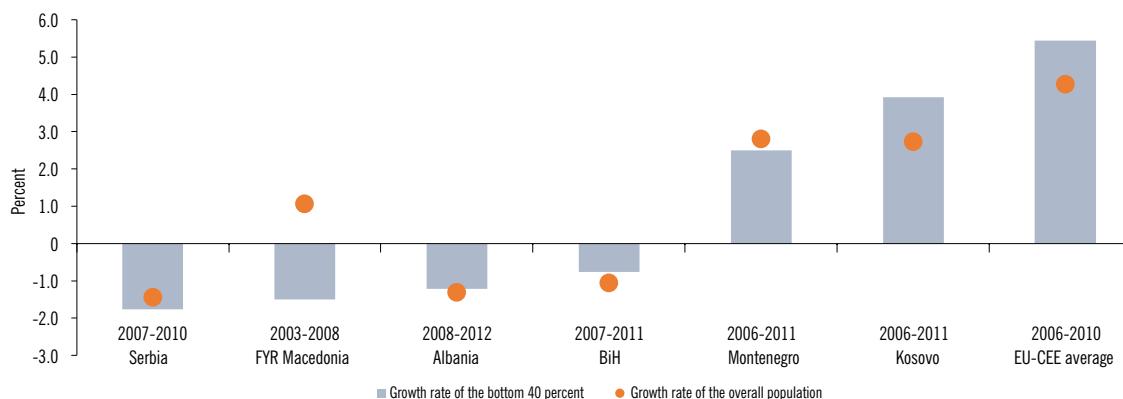
At the same time, public transfers are often poorly targeted and do not sufficiently cover the poor.

The nature of redistributive fiscal policy is unsustainable and often poorly targeted, benefitting the rich almost as much as the poor. The targeting of social benefit spending is inefficient, with just 37 percent being received by the poorest 20 percent and 56 percent by the B40, significantly worse than any other country in SEE. At the same time, over 12 percent of public spending on social benefits reaches the wealthiest 20 percent of the population. While BiH spends around 4 percent of GDP on non-contributory social assistance (the highest in SEE), but less than 10 percent of social assistance transfers are means-tested. The poorest population quintile receives only 17 percent of non-contributory benefits, while the wealthiest quintile receives 20 percent. As a result, the contribution of social assistance to poverty reduction is therefore considerably less than it could have been with a more effective social protection system.

Between 2007 and 2011, conditions of the B40 of the population remained precarious. However, in relative terms, the B40 did better than the rest of the population during a difficult period; their consumption level declined by 0.8 percent, compared to 1.1 percent decline for the wealthiest 60 percent of the population (T60).⁵ In comparison, the poor in Kosovo and Montenegro still experienced an improvement in their living standards during the crisis, while the B40 in Serbia were hit harder than the average. In Albania, the impact of the crisis on the poor was similar to BiH (Figure ES.4). In BiH, much of the support through the crisis period came via pensions rather than social assistance. The income source decomposition of income changes during 2007-11 shows declines of salaries and self-employment incomes of the B40 during this period, which were partially counterbalanced by the positive growth of social assistance transfers, and in particular of pensions (overall, not just in the B40 group). However, the T60 benefited even more than did the B40 from increased pensions and assistance during 2007-11.

⁵ Note that the shared prosperity analysis is based on harmonized ECAPOV consumption aggregates.

Figure ES.4: Shared prosperity in the Western Balkans



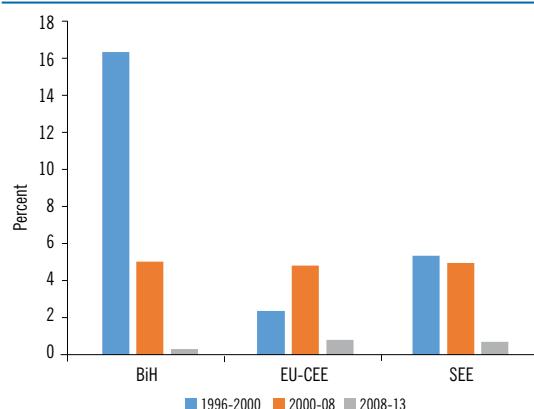
Source: National Statistical Offices and World Bank staff estimations

The B40 percent of the population have difficulty finding stable and high-quality employment that could boost their income generating capacity. The B40 tends to have larger households to care for, lower levels of education and training and other assets. In addition, the B40 has lower employment rates, particularly among women, and especially high unemployment rates among young people. Moreover, a higher share of those who are employed have temporary jobs or no contracts, and they are also much more likely to be in occupations and sectors of activity that rely on unskilled labor. The ability to find employment is key in determining whether someone is likely to be in the B40.

A landlocked island

After the end of the war, BiH experienced more than a decade of economic recovery from 1996 to 2008. This recovery had two phases. First, in the direct aftermath of war (1996-99), BiH experienced a bounce back, with growth rates in excess of 10 percent per annum driven by a large inflow of aid, which averaged 26 percent of GDP per year. Post-war return migration meant that GDP per capita growth was slightly lower than total GDP growth. In the second phase (2000-08), aid fell to below 10 percent of GDP,⁶ and average annual per capita growth dropped to 5 percent, but was still in line with the SEE regional average (Figure ES.5).

Figure ES.5: Stable growth in the 2000s, stagnation since the crisis



Source: WDI and staff calculations

⁶ Aid averaged 8 percent of GDP between 2001 and 2005 and 4 percent between 2006 and 2008.

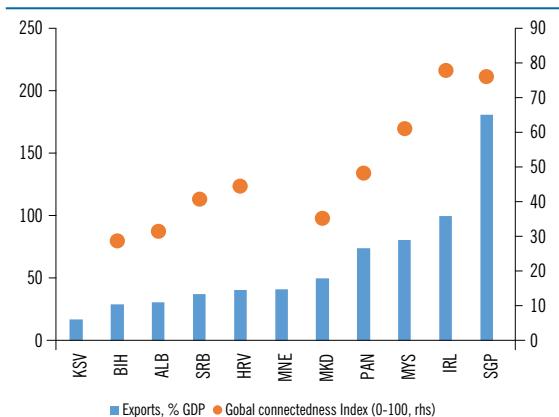
During the post-war economic recovery, BiH did not create new foundations for sustainable economic growth. Since the early 2000s, BiH has been an economy reliant on remittances—averaging around 20 percent of GDP—for fueling consumption growth. These financial inflows were important in the recovery after the war, but when these flows rapidly declined during the global financial crisis, the structural problems of the economy became more evident. Growth was driven by consumption from the non-tradable sectors over 2000-08. Between them, wholesale/retail, real estate and financial services made up over a third of economic growth during the period. Even today, consumption remains at over 100 percent of GDP. By contrast, exports are worth only 30 percent of GDP, one of the lowest in Europe and a sign of the country's weak competitiveness.

As BiH struggled to recover in the aftermath of the global crisis, the underlying challenges came to the forefront. BiH has a poor business environment, high labor taxes, and strict labor market policies, some of Europe's worst transport infrastructure, wasteful public expenditures, Europe's lowest energy efficiency, high urban pollution and vulnerability to catastrophic risks. These barriers made it difficult for firms to thrive and create employment, even in the best of times. During the crisis, firms were under undue pressure and were unable to adjust to the new economic environment. The non-tradable sectors such as retail, construction, services have done well since 2000, contributing two thirds of economic growth, while tradable sectors such as manufacturing and agriculture contributed only a third.

Significant structural bottlenecks make it difficult to compete internationally. The public sector remains large—spending close to 50 percent of GDP—more than most western European countries but without having the public services to match. In addition, investments—public and private—took a hit during the crisis, prejudicing future economic growth. Part of the challenge is the legacy of inefficient SOEs which have been only partially resolved. Many SOEs do not function at all, while others are on “life support”. Large SOE arrears, including to the social security system, make privatization difficult. In 2013, wages and other direct employment costs (e.g. social contributions) swallowed two thirds of the gross value-added of workers, leaving little room for profit, investment or other taxes. In addition, the gap between gross and net wages has widened in recent years, making it more and more difficult for firms to compete, especially as infrastructure deteriorates and land markets function poorly. BiH's traditionally strong energy sector has not been well maintained and the country's main port on the River Sava has become silted and difficult to access for larger vessels. BiH's business climate is the poorest within the region, and it performs particularly badly on ease of paying taxes, getting electricity and obtaining a construction permit (Figure ES.7).

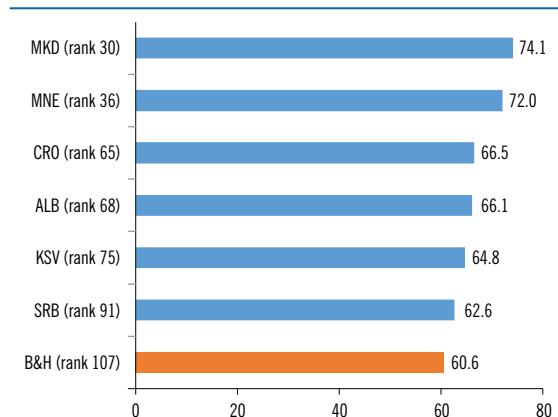
The new borders, especially with Croatia and Serbia make it more difficult to trade. Differences in currencies, laws and regulations, safety standards (e.g. in agriculture or transport) as well as increased border crossing times are some of the recent challenges facing BiH exporters. Combined with the loss of a captive market for goods and services that BiH had previously supplied to the whole of Yugoslavia (such as energy or military equipment) and the psychological “border effect” it becomes clear why, even though former Yugoslav republics remain important partners, trade with them is far below the levels reached during the Yugoslav period. While BiH was exporting an estimated 98 percent of GDP prior to the war if one also includes trade with the previous Yugoslav republics, total exports have dropped to 31 percent today, one of the lowest in Europe (Figure ES.6).

Figure ES.6: Weak export performance and poor connectedness ...



Source: WDI, Exports of goods and services, % GDP 2012 and DHL, Global Connectedness Score, 0 (=worst) to 100 (=best), 2013

Figure ES.7: ... and at the bottom in Doing Business in South East Europe



Source: Doing Business Report 2015

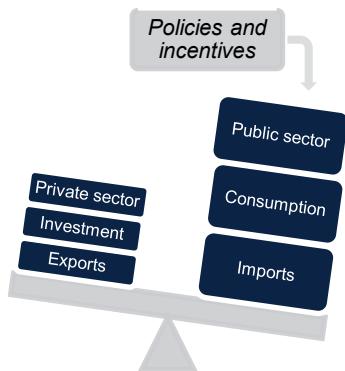
Note: 0=worst to 100=best practice frontier

The post-Yugoslav economic environment would have required a systematic and ambitious reform effort to establish a fully functioning market economy. The absence of key economic reforms has resulted in BiH being less integrated with its neighbors and the rest of the world than sustainably good economic performance would require especially as smaller countries generally need strong external trade relations. By 2012 it was rated as one of the least globally connected countries in the region. As neighboring countries are now part of the EU (Croatia) or progressing towards accession (Serbia, Montenegro), the cost of inaction will increase. Unless reforms accelerate, BiH risks becoming a *landlocked island* surrounded by EU members. The risk is rising that even larger economic walls will isolate BiH as EU requirements demand increased standards (e.g. in agriculture) and upgraded border and inspections systems for trading with the EU.

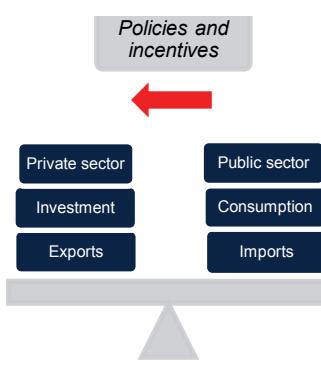
Convergence with average European living standards remains elusive. With today's per-capita income of around US\$ 4,700, BiH would need two decades of high growth to reach high-income status. If the country repeated the performance of the period from 2000 to 2008 when per capita growth averaged 5.1 percent, BiH would become a high-income country with a per-capita income of US\$ 12,500 in 2033.

The political economy of reform

BiH has chosen a development path that has created deep social, economic, and institutional imbalances. Policies and incentives are such that the public sector and import-oriented industries (typically those linked to consumption) benefit to the detriment of the private sector and export-oriented industries (Figure ES.8). The result has been economic stagnation, emigration, and massive unemployment and underemployment.

Figure ES.8: Current model: Economy out of balance

Source: BiH SCD team

Figure ES.9: Rebalancing towards production and integration

Source: BiH SCD team

Poor governance and an over-sized public sector, partially the result of institutional structures, reduce the effectiveness of public policy and hamper reforms. BiH performs poorly on a multitude of governance, corruption and institutional indicators. The Bertelsmann Transformation Index (BTI) suggests weakening performance in *democracy status* and *economic management performance* between 2006 and 2013, while the Global Integrity Scorecard (GIS) suggests declining scores in *executive accountability*, *legislative accountability*, *judicial accountability* and the *budget process* between 2007 and 2011. Despite this, the public sector controls well over half of the economy. The GIS suggests that the large public sector is good at passing laws, but it often fails to implement them effectively.

Citizens and businesses face a sclerotic legal system and significant corruption. Businesses face long delays in having cases processed with disposition times nearly twice as long as the Council of Europe average and nearly three times as long as EU and EU-CEE averages. These delays are also reflected in the Doing Business Report, where in 2015, BiH ranks 95th out of 189 economies on the ease of enforcing contracts. Transparency International ranks BiH as one of the most corrupt countries in Europe (at 73rd out of 175 countries globally). Around 10 percent of firms report having had to pay a bribe to public officials over the past year and between a third and two thirds of citizens believe connections are essential to obtain jobs, education or official documentation.

For BiH to reach high income the country would need to “turn the wheel” and fundamentally rebalance its social and economic model. A prosperous BiH would be achieved by creating a bigger, more vibrant and internationally competitive private sector, which would also create new incentives for the youth to stay in BiH or for the diaspora to return or invest in export-oriented sectors. As the domestic market is saturated, one of the keys to higher levels of growth and job creation is producing goods and services for export outside its territory (Figure ES.9).

BiH is faced with the dilemma of weak winners and strong losers. The winners of reform will be the poor and often voiceless masses who will reap benefits only after a few years. By contrast, the potential losers tend to be a small group of easily identifiable people with significant ability to influence reforms. A dominant state sector generates many opportunities to create and share

rents. The reform effort is made even more difficult because of the fragmented political system where the two Entities, which can sometimes behave antagonistically, are holding sway over key economic decisions. At lower levels of government, cantons control significant powers, notably in the health sector. The poor and vulnerable have been left out of the system, and around half of the population can be considered at risk of social exclusion by some measures. Roma, youth and children are particularly at risk and without obvious champions. Significant improvements in BiH's governance system and standards will be needed to get the country back on the path to reducing poverty and achieving shared prosperity.

Priorities for BiH: Realigning incentives for shared prosperity and sustainable development

The highest priority for BiH is to accelerate growth in an inclusive fashion. Experience from the collapse of Yugoslavia and elsewhere suggests that it is easier to divide a growing pie than to redistribute during stagnation, especially in a country with strong regional identities. In the past, economic growth was key for tackling poverty and boosting the living standards of the B40. Survey data show that during years of positive economic growth, the B40 saw faster consumption growth than the T60. In addition, the current development model, focused on consumption driven by remittances and the public sector, has reached its limits. Boosting production as a growth driver and reducing the relative size of the public sector while sustaining consumption levels will be almost impossible without economic growth.

People at risk of social exclusion tend to face similar challenges to the rest of the population. Household data show that some of the main issues faced by the poor and B40 relate to employment. Females, youth and Roma all face particularly low employment and high unemployment rates. Similarly, consultations undertaken for this SCD reveal that youth, pensioners, Roma and the LGBT community report, in addition to (un-)employment issues, challenges related to the business environment and corruption.

Even though the B40 benefit from growth and tend to face similar challenges to the rest of the population, the poor and vulnerable groups have a number of specific needs. Poorer groups, which are often excluded from the labor market, especially formal employment, due to high labor taxes and rigid labor market laws, would benefit more from tax and labor market reform than wealthier groups, especially if taxes/social security contributions for low-earners are reduced. Some specific targeted assistance is also warranted to ensure social inclusion, particularly due to the high level of poverty among children, with the aim of reducing inter-generational poverty transfer, and among Roma, who may suffer discrimination in some areas such as education and employment.

BiH's current development model is unsustainable in the long-term, especially as the country is exposed to a number of risks. During recent years, BiH has experienced severe weather shocks, violent protests and an economy that has been running out of fiscal buffers to respond to future crises. BiH has been particularly vulnerable to natural disasters, especially droughts and flooding. The losses and damages from the 2014 floods cost the country close to 15 percent of GDP, harming

virtually all aspects of its economy and firms in many sectors. Many households are vulnerable to weather shocks, particularly those involved in agriculture, which occupies around one in five working individuals, including those who produce for own-consumption.

This SCD has developed a prioritization methodology to identify BiH's most important priorities to contribute to achieving the twin goals of poverty reduction and shared prosperity in BiH. The methodology includes qualitative and quantitative dimensions and was tested during the consultation process. Several robustness checks were also undertaken. The prioritization process was completed in four steps (for a detailed overview of the prioritization process and methodology see the section 6 in the main document and Annex XV):

- *Step one:* The team identified a series of seven initial hypotheses designed to help understand better the key issues. The team then tested these hypotheses based on extensive consultations and deeper analysis.
- *Step two:* Based on the deeper analysis—presented in this report—and the extensive consultations, the team identified the emerging themes which paved the way for the formulation of the reform areas.
- *Step three:* The team used two complementary methodologies to identify the most important priority reform areas. This included one qualitative method and one quantitative method in which the reform areas were rated across the dimensions of economic growth, inclusion and sustainability to categorize them into top priorities, high priorities and medium priorities.
- *Step four:* The team compared the results of the different methodologies, discussed with internal experts on BiH (who did not have a direct interest in the results of the findings of the SCD) and identified the priority reform areas and secondary priorities.

This prioritization exercise resulted in ten priorities for BiH, of which the top four focus on the rebalancing of the economy to create and sustain more and better jobs. The implementation of these reforms would realign incentives and policies toward the private sector with a specific focus on successful international integration. A second set of three priorities would accelerate BiH's social and economic development once the “economic train” is put on the right track to make the reforms sustainable. A final set of three priorities concerns long-term investments in the social sectors and improvements for excluded groups, for which higher growth and more job opportunities would not be sufficient (Box ES.2).

A successful turn-around of BiH's economy will need a focused reform effort. Within the larger context of an over-sized public sector, rigid labor markets and poor competitive environment, the below list of priority reforms presents would help to reenergize BiH's economy and improve service delivery in a sustainable way, with particular benefits for the B40. These reforms are necessary for economic, environmental and social stability, by way of achieving greater inclusiveness, increasing competitiveness and offering a possibility to build fiscal reserves to cope with the shocks to which BiH is prone.

Box ES.2: Priorities for BiH: Rebalancing incentives for shared prosperity and sustainable development

Top priorities—Accelerating growth and creating jobs

Putting BiH to work: reforming the labor market, improving social protection delivery and reducing the cost of labor

Rationale: Labor market rules and the tax system are reinforcing BiH's consumption driven economy, protecting insiders often at the expense of the young or socially excluded, including females and Roma. The tax system discourages (formal) employment—especially of the lower-paid—and production for export, and encourages consumption and imports. In addition, the linked health insurance and unemployment discourages (formal) employment and increases budget costs. The labor market rules also makes it difficult for enterprises to adjust in changing economic conditions, which means that they do not hire in the first place.

Making it easier to do business: improving competitiveness, entrepreneurship and the investment climate

Rationale: BiH is one of the worst places to do business in Europe and Central Asia (ECA). Investors do not trust the institutions and mainly engage in investments with short-term pay-offs (e.g. construction, services). By contrast, investments in agri-processing, forestry, manufacturing or tourism need a stable investment climate with a long-term perspective. Basic business needs such as constructing new facilities, securing land ownership and/or secure access rights, getting electricity, importing and exporting, and paying taxes are still too difficult. This is why entrepreneurship is also weak including in the services and IT start-up industries where BiH could succeed.

Creating an efficient and effective government: reducing the size of the public sector while ensuring fiscal sustainability and improving public service delivery

Rationale: With expenditures at close to half of GDP and SOEs adding even more government control to the economy, BiH has one of the world's largest public sectors. Its size likely harms economic growth and employment, particularly affecting the prospects of the B40. Much of the public expenditure is inefficient, failing to reach the people or investment areas that most need it. The current situation also breeds opportunities for poor governance.

Investing in economic infrastructure for growth and inclusion: powering and connecting BiH to the world

Rationale: The current state of infrastructure services is poor and at risk of severe deterioration. Improving transport and ICT infrastructure would give exporters easier access to markets and generate employment. It would also help to improve rural connectivity and enhance the marketability of production, boosting shared prosperity by improving the quality of life in rural areas, where many of the poor and B40 live. BiH's reasonable headline energy performance disguises one of Europe's most energy inefficient and carbon intensive economies, harming firm competitiveness and contributing to high urban pollution, while at the same time losing major export opportunities.

High priorities—Securing a resilient and long-term future

Building resilience: helping BiH cope with adverse natural events.

Rationale: BiH is highly vulnerable to adverse natural events such as flooding, some of which may result from climate change or environmental degradation. Boosting its resilience would help to reduce the social and economic impacts of such shocks and especially support the B40, some of whom still live partially from agriculture.

Boosting brains: improving education services and labor market skills

Rationale: Education is closely linked to poverty. Some groups suffer in particular, including the B40 and Roma communities. BiH is lagging in early childhood education (ECE), posing risks for inter-generational poverty transfer, and quality standards are mixed in secondary and tertiary education. There are significant knowledge gaps which need to be filled, including identifying the needs of the private sector, which should begin quickly.

Living healthy lives: improving health services and access to water and sanitation **Rationale:** Despite reasonable life expectancy, many health outcomes are poor, particularly with regards to non-communicable diseases, partly resulting from high tobacco consumption. Health outcomes are worse among poorer groups and over half of Roma are considered malnourished. There is large wastage in pharmaceutical procurement providing scope for budgetary savings. Rural poor also have low access to water and sanitation, forcing many to rely on expensive private facilities.

Medium priorities—Ensuring stable and sustainable economic opportunities

Adding financial firepower: maintaining financial stability and expanding access to finance

Rationale: While financial sector stability has been broadly maintained new risks are emerging, including from non-performing loans (NPLs). Firms also face financial constraints to growth. Resolution of NPLs may help make additional financial resources available for credit. Access to finance could be improved for some groups at risk of exclusion. Although the banking system—dominated by foreign banks—appears broadly sound, significant pockets of vulnerability exist among banks. A number of smaller banks are struggling to meet capital requirements, with some facing high concentration risks and heavy reliance on public sector support. Moreover, significant deficiencies remain in the financial safety net, including with respect to resolution powers, institutional responsibility for resolution, and resolution funding.

Cleaning BiH: reducing pollution and protecting the environment

Rationale: BiH is wasting a lot of its resources and air pollution remains a major challenge, especially in cities, due to the use of traditional heating in the winters. This also contributes to BiH's high number of respiratory diseases and international evidence suggests that the poor are most likely to shoulder the burden. In addition, large amounts of solid and liquid waste pollute BiH's waterways and countryside. This poses health concerns directly and indirectly through contamination with drinking water and agriculture, particularly during floods.

Boosting agriculture: increasing agricultural productivity and opportunities

Rationale: Most of the poor live in rural areas, rural poverty rates are higher than urban ones and the poor are more likely to work in agriculture than wealthier groups. Improving agricultural productivity would improve their livelihoods. Agriculture would also receive a boost by reforming the land market and upgrading rural transportation networks.

BiH's pathway to prosperity will come from higher growth and better services, which will be driven both by better governance and an increased share of the private sector in the economy. The violent disintegration of Yugoslavia derailed the country's quest for prosperity. After some progress in the decade after the war, the country is at risk of permanent stagnation if it does not begin to address the root causes of the current social, economic and institutional stagnation. Shifting from an inward-looking economic model to outward integration combined with a jobs strategy that unleashes the strength of the private sector will be key. If the new government implements these reforms, BiH can also join the group of emerging European nations that have already made great gains in eliminating poverty and achieving shared prosperity for its citizens.

CHAPTER ONE

THE COUNTRY CONTEXT

BiH was the most ethnically diverse and one of the poorer republics in Yugoslavia. It stagnated in the 1980s and was, by many measures, the country hardest hit by the collapse of communism in Eastern Europe, the collapse of Yugoslavia, and the war that followed in BiH in the 1990s. The Dayton Accords brought peace that has lasted twenty years. It also brought a fragmented institutional structure, which allows for a significant degree of self-determination of BiH's constituent peoples. Many public services are delivered at highly localized levels, whether appropriate or not, particularly within FBiH. As a result, the public service is large, controlling nearly half of the economy (mostly excluding SOEs). Unfortunately, a wide range of indicators suggest that public sector performance in BiH is sub-par. Regulatory quality is low, the judicial process is considered poor, public financial management is weak, corruption is endemic and, while laws are considered adequate, implementation and enforcement of them tends to be weak.

Like much of Eastern Europe, BiH is experiencing population decline and aging, with both Entities exhibiting similar patterns. Reforms are taking place against the background of demographic decline which cannot be reversed in the short-term, but can be mitigated if the country provides more employment opportunities for its youth. The future of BiH lies in Europe and the country aspires to join the EU. However, even though a Stabilization and Association Agreement was ratified in 2011, it only entered into force in mid-2015 due to slow progress in implementing its conditions. The EU cites various factors that stop BiH from advancing, including lack of political will, an inability to agree on reforms, lack of capacity in using EU resources, and institutional complexities. BiH risks losing EU resources in a number of sectors due to lack of progress in aligning laws. In some cases, BiH exporters also risk losing access to EU markets.

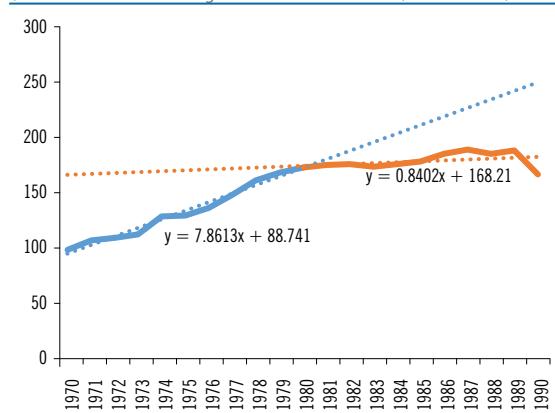
1.1 History: Yugoslavia and BiH in Yugoslavia

- 1.1 **BiH was dominated by a number of powers for most of the last 500 years.** It was ruled by the Ottomans in 1463-1878, and then by the Austro-Hungarian Empire for a shorter period in 1878-1918. It was incorporated into the Kingdom of Yugoslavia after 1918 and its successor state, the Socialist Federal Republic of Yugoslavia from 1945, as a republic.
- 1.2 **Yugoslavia developed a highly decentralized structure with significant powers granted to republics, which exacerbated differences in living standards between them.** In contrast to the Soviet bloc countries, “Yugoslavia was... the most decentralized of the socialist economies, both in terms of its economic and fiscal management and its political structures. The republics had significant autonomy from the very beginning... Tax reforms ...gave greater revenue raising powers to the republics and local authorities... with ‘areas of common interest’ remaining the responsibility of the state.”⁷ Decentralization meant that wealthier republics had higher incomes and revenues and could allocate more to social spending—further revealing regional imbalances.

⁷ “Fiscal Federalism in Bosnia-Herzegovina: The Dayton Challenge.” William Fox and Christine Wallich. World Bank Policy Research Working Paper 1714. January 1997.

- 1.3 **Industrial production was initially concentrated in northern Yugoslavia but there were some efforts to spread this in the 1960s.** During the post-WWII period, most manufacturing took place in the north of the country, which comprised the main traditional manufacturing regions, whereas the sources for raw materials tended to be concentrated in the south of the country. In the early 1960s, the industrial policy was changed so that new manufacturing facilities would be built closer to raw material sources in southern Yugoslavia rather than in the north. The new policy led to increasing resentment among the richer northern republic economies (especially Croatia and Slovenia).
- 1.4 **The Federal Fund for Accelerated Development of the Less-Developed Regions (including BiH, Macedonia, Montenegro and later Kosovo) was designed to reduce regional disparities within Yugoslavia.** All republics and provinces contributed to the Fund. "At its peak, this fund mobilized some 2 percent of Gross Social Product (GSP)—from the better off regions who [sic] contributed a fixed proportion of their GSP to fund it... Federal budgetary resources were also directed to raising the level of social outlays in the poorer republics."⁸
- 1.5 **Despite this, regional inequality in Yugoslavia was large and BiH was one of the poorer republics.** While GDP per capita reached around \$3,200 in the northern regions, it was only half in the southern regions; BiH's GNP per capita at the time was \$1,737 (Table 1.1). The combination of economic decline and rising regional inequality led to increased tensions between the republics including over pricing policy, customs duties, and protection.
- 1.6 **The 1980s was an era of economic stagnation in Yugoslavia.** Real GDP growth, which averaged 5.8 percent per year during the 1970s slowed to an annual average of just 1 percent (Figure 1.1) between 1980 and 1989. Inflation reached over 200 percent in the late 1980s.⁹

Figure 1.1: Yugoslavia grew until 1980 and stagnated until 1990
(Index of Real GDP in Yugoslavia and Trend Lines, 1970-1990)



Source: Kushnirs (http://kushnirs.org/macroeconomics/gdp/gdp_yugoslavia.html) and staff calculations Note: equations are the simple OLS of the lines from 1970-1980 (blue) and 1981-1990 (orange)

Table 1.1: BiH was part of Yugoslavia's "poor south"
(GNP per capita in 1980 by region or republic)

Croatia	\$3,314
Slovenia	\$5,193
Serbia (proper)	\$2,534
Vojvodina	\$3,189
More Developed Regions (North)	\$3,233
Bosnia and Herzegovina	\$1,737
Kosovo	\$812
Macedonia	\$1,721
Montenegro	\$2,086
Lesser Developed Regions (South)	\$1,580

Source: World Bank (1983)⁹

⁸ Ibid.

⁹ The stagnation shown in the 1980s holds for all republics and regions analyzed by Rodriguez-Pose and Stermsek (2014). See: <http://infogen.webs.uvigo.es/WP/WP1408.pdf>

- 1.7 **During the 1980s, the north-south gap became larger.** Finished goods from developed regions were subject to trade protection measures, whereas raw materials from the less-developed regions were subject to few if any protective measures. Below market prices for raw material shipments meant that less-developed areas subsidized wealthier ones to some extent. Disagreements over the level of contributions to the Federal Fund became stronger, with the wealthier republics contributing 75 percent to the Federal Fund in the 1980s, down from 78 percent in the 1970s.¹⁰ The fall of the Berlin wall and communism in 1989 exacerbated the fragmentation of Yugoslavia as it disintegrated into a series of conflicts in the 1990s. Overall, longstanding and growing economic inequalities helped to drive Yugoslavia apart politically.¹¹
- 1.8 **BiH was hard hit by the disintegration of Yugoslavia and the subsequent war.** By some estimations, it suffered more than any other Eastern European country economically. The war, which lasted nearly four years (April 1992 to December 1995), resulted in an estimated 110,000 killed and 2.5 million displaced persons and refugees—or over half of the pre-war population, according to the International Criminal Court. The World Bank estimated a total of \$15-20 billion in destroyed assets.¹² The war ended with the Dayton Peace Accord in December 1995.

1.2 Population challenges: aging and shrinking

- 1.9 **Apart from being one of the poorer Yugoslav republics, BiH was also the most ethnically diverse.** It comprised three sizable ethnic groups: Bosniaks (44 percent), Serbs (31 percent); and Croats (17 percent) (see Annex IV). Around 0.2 percent of the population was reportedly Roma, although this may have been under-estimated as this group was less likely than others to respond or self-identify.
- 1.10 **The population is shrinking and getting older.** BiH lost nearly a quarter of its population between 1989 and 1996 as a result of the war, much of it due to emigration. Its population declined from around 4.5 million in 1990 to fewer than 3.8 million in 2013, according to preliminary results from the census that year. While some people chose to return after the war, slightly increasing the population, the population is estimated to have fallen every year since 2002 due to emigration and because the natural rate of population increase turned negative in 2005 (i.e. deaths have outnumbered births since 2005, (Figure 1.2). In 2014 for the first time, the country has more old people (over 65 years of age) than young (under 15 years). As in other aging European countries this poses significant challenges for the labor market (fewer working age, savings for pensions), public spending composition (e.g. more health, less education), public service delivery (more lifelong learning and old-age health, less child health and primary education).

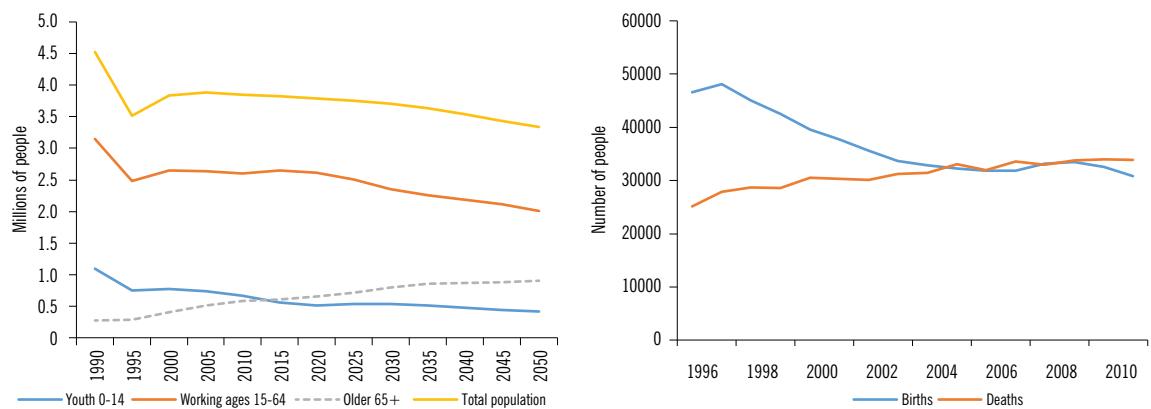
¹⁰ Federal Statistical Office of Yugoslavia.

¹¹ “There were many reasons for the breakup of Yugoslavia, [and]... quasi-fiscal and redistributive factors played...[a] role. Redistribution policies of this scope were bound to nourish political separatism, as prosperous republics became more and more reluctant to release and transfer resources to poorer republics. The lack of transparency in the system made it possible for each republic to argue that it bore the costs of the intergovernmental system, while the benefits accrued to others, so that each thought the others gained, at its expense.” “Fiscal Federalism in Bosnia-Herzegovina: The Dayton Challenge.” William Fox and Christine Wallich. World Bank Policy Research Working Paper 1714. January 1997.

¹² “Bosnia and Herzegovina: Toward Economic Recovery.” World Bank. 1996.

- 1.11 Both Entities are experiencing similar population challenges.** RS's demographic decline started a decade earlier than in FBiH with deaths exceeding births each year since 2002, whereas this likely only happened in FBiH in 2012 (data only to 2011). Nonetheless, the trend is clearly in the same direction in both Entities. Birth rates in BiH are significantly lower than in neighboring countries, with 8.3 births per 1,000 population in 2011 compared to 9.4 in Croatia, 9 in Serbia and 11.6 in Montenegro (see Annex IV).

Figure 1.2: BiH is aging and shrinking



Source: United Nations Population Division

Notes: Based on UNPOP medium fertility scenario: <http://esa.un.org/wpp/>
Excel-Data/population.htm

Source: FBiH and RS statistical agencies

1.3 Institutions and political economy

Institutional framework

- 1.12 The Dayton Accords of December 1995 brought peace to BiH and kept the territory as a single country split into two Entities and an autonomous town (Brcko District).** The Dayton Accords established a highly decentralized country with a relatively weak Council of Ministers at the central level (and often referred to as "the State" level). It delineated a governmental structure comprised of two Entities for three constituent peoples: the Federation of Bosnia and Herzegovina (FBiH, composed largely of Bosniaks and Croats), and the Republika Srpska (RS, composed primarily of Serbs). FBiH has 10 cantons and 79 municipalities, while RS has 63 municipalities. Finally, the constitutional architecture also includes the autonomous Brcko District. The Office of the High Representative (OHR) was created by the international community to oversee the implementation of the Dayton Accords. Its powers were increased in 1997 to allow it to adopt binding decisions when local parties were unable to act and to remove public officials in some circumstances. While the institution remains in place today, it rarely opts to use its powers.

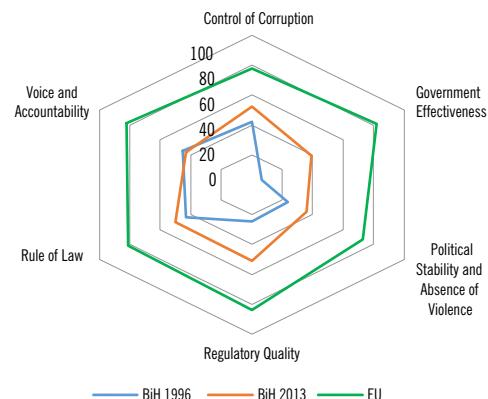
- 1.13 The institutional arrangements were designed to bring peace but may have reduced the quality of governance in BiH.** "Bosnia's goal ... [has been] a unified multiethnic state, but its political institutions support ethnic partition at every level of government. ... Almost every public office -- including low-level administration jobs -- is allotted according to an

ethnic quota, a spoils system that has led to extensive patronage networks, corruption, and inefficiencies.”¹³ The country has been plagued by governance and institutional dysfunction, political disagreements, paralysis and deadlock. Some of the consequences have been, among other things: lack of progress in reforming the economy; lack of a government in BiH for over a year; a temporary interruption in debt servicing to an IFI (the IMF); high unemployment (especially among youth and women) and poverty levels; an unattractive environment for doing business and investing; corruption; lack of internal socio-economic and political cohesion; and slower progress toward European accession than its neighbors. A large public sector that consumes about half of the country’s GDP combined with institutional fragmentation/duplication of functions contributes to a constant and unsustainable drain on the country’s finances.

Institutional performance and governance

- 1.14 **With a public sector that controls close to 50 percent of the economy in BiH, well-functioning public institutions matter.** While reducing the size of the public sector is advisable, it is also important to improve the efficiency and effectiveness of public institutions. The choices made by public institutions can influence economic growth (e.g. capital investments, business environment). They are important to ensure efficient use of public resources and to ensure the poor and B40 have sufficient assets (such as education) to benefit from and contribute toward economic growth.
- 1.15 **Evidence from comparative institutional indicators is mixed.¹⁴** The World Bank Group’s (WBG’s) World Governance Indicators (WGI)¹⁵ suggest that there was a gradual improvement in five out of six governance indicators between 1996 and 2013 although BiH remains far below EU standards in all areas. BiH had a minor reversal in *voice and accountability*, which measures the extent to which citizens participate in selecting their government, as well as freedom of expression, freedom of association, and a free media (Figure 1.3). Several other indicators also suggest some improvement over time, including the *Fragile States Index*¹⁶. However, improvements have leveled off since 2013 in nearly all WGI indicators.

Figure 1.3: BiH made progress in governance since 1996, but is still a long way from EU standards



Note: Percentile rank, with 0 corresponding to lowest rank and 100 to highest rank.
Source: Worldwide Governance Indicators, 1996–2013

¹³ “The Death of Dayton: How to Stop Bosnia From Falling Apart,” Patrice C. McMahon and Jon Western, *Foreign Affairs*, September/October 2009.

¹⁴ The mixed evidence suggests that the indicators presented in this section should be taken as broad indications of the institutional/governance/political economy environment in BiH rather than precise measures of it. Different indicators measure different institutional variables suggesting improvement in some areas and reversals in others. In addition, some indicators measure perceptions, others measure laws, and still others measure implementation of laws or practices. Differences between indicators may also partly arise due to difficulties in measurement.

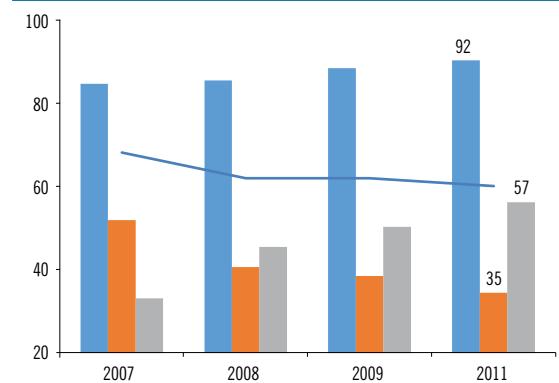
¹⁵ See: <http://info.worldbank.org/governance/wgi/index.aspx>

¹⁶ See: <http://ffp.statesindex.org/>

- 1.16 **Other indicators suggest little improvement or some reversal.** The Bertelsmann Transformation Index (BTI)¹⁷ suggests weakening performance in *democracy status* and *economic management performance* between 2006 and 2013 (Annex I), while the Global Integrity Scorecard (GIS)¹⁸ suggests declining scores in *executive accountability*, *legislative accountability*, *judicial accountability* and the *budget process* between 2007 and 2011.
- 1.17 **Most comparative indicators rate BiH's institutions or governance as worse than those of its neighbors.** Low comparative ratings matter both because of the low institutional and governance standards they capture and because they may deter badly-needed investment in the country. Of particular concern are the Economist Intelligence Unit's (EIU) country risk ratings, which rate *political efficacy risks* and *legal and regulatory risks* as among the worst in SEE and far behind the EU-CEE including in: *policy formulation*; *quality of bureaucracy*; *excessive red tape*; *fairness of the judicial process*; *enforceability of contracts*; *speediness of judicial process*; and *integrity of accounting practices* (Annex I).
- 1.18 **A gap may exist between the intention of laws as enacted and their implementation.** The GIS measures areas such as government oversight and controls, anti-corruption efforts, and public administration quality and professionalism across several dimensions. It measures both legal provisions ("in law") and implementation of the laws across the measured dimensions ("in practice"). The difference is termed the "implementation gap" (Figure 1.4). While the GIS in law score was rated as "very strong" for BiH in 2011¹⁹ (and the fourth highest of the 31 countries measured), the implementation of these laws was considered "very weak" (and the fourth lowest of the 31 countries measured). The gap between the quality and intention of the laws and the actual implementation of these laws in 2011 was larger in BiH than any other country surveyed. While a variety of reasons likely exist for this gap, administrative and technical capacity, unclear mandates of agencies, and overlapping competencies, appear to contribute.

Figure 1.4: Large gap between intention of laws and actual implementation

Global Integrity Scorecard, % score for laws and practices and the gap, 2007-11



Source: Global Integrity Index

Justice Institutions

- 1.19 **Business operations are negatively impacted by a complex and fragmented legal framework.** According to the Investment Climate Statement 2014, the multitude of state, Entity, cantonal, and municipal administrations—each with the power to regulate business and arbiter disputes—creates a heavily bureaucratic, non-transparent system. Businesses

¹⁷ See: <http://www.bti-project.de/bti-home/>

¹⁸ See: <https://www.globalintegrity.org/>

¹⁹ The latest available data are from 2011.

straddling the different legal regimes find it difficult to know all of the rules that might apply to their activities. Small businesses are particularly affected, as they are least able to afford the high costs of navigating the justice system, given the lack of any central source of information. The complexity limits the ability of businesses to enforce rights and resolve disputes.

- 1.20 **Inconsistent decision-making undermines predictability and the uniform application of the law.** For example, disputes arising in FBiH are heard in Cantonal Courts of general jurisdiction, whereas disputes arising in RS are heard in specialized Commercial Courts with different laws and procedures, with no supreme body to reconcile them. Practices within courts are also uneven, which relates in part to lack of coordination, but also to the capacity of the judiciary to deliver high-quality decisions. Despite this, court expenditure is approximately 0.8 percent of GDP, which is higher than the EU and Council of Europe averages. However, budgets are deeply fragmented, particularly in FBiH, and capacities for planning remain weak, which undermines service delivery.
- 1.21 **These challenges are compounded due to inefficiencies within courts.** Businesses face long delays in having cases processed. Disposition times for civil and commercial cases average 656 days, nearly twice as long as the Council of Europe average and nearly three times as long as EU and EU-CEE averages. In some courts, users wait years for their first hearing date. These delays are also reflected in the Doing Business 2015 Report, where BiH ranks 95th out of 189 economies on the ease of enforcing contracts. Courts also are clogged with a large backlog of cases, 80 percent (1.7 million cases) of which is comprised of unpaid utility bills. Backlogs in civil and commercial cases are falling however, with more cases being heard than new ones created. Alternative dispute resolution mechanisms exist in law but are difficult to use in practice.
- 1.22 **Judicial corruption and undue influence remain a challenge** (see Box 1.1). The Global Corruption Barometer reports that the judiciary is among the most corrupt institutions. According to the Business Environment and Enterprise Survey (BEEPS) 2014, 18.4 percent of firms report that unofficial payments in court are required sometimes, frequently or very frequently, which is higher than most regional neighbors. The government's attempt to reduce corruption by increasing the salaries of judges has yet to produce positive results. According to the 2013 Enterprise Survey, only 37.5 percent of firms believe that the court system is fair, impartial and uncorrupted, which is on par with the ECA average but significantly lower than EU and EU-CEE averages. The capacity of the police and judiciary to investigate and prosecute economic, financial and public procurement-related allegations is also weak. Appointment processes for key positions within the justice system are reportedly politicized, and according to the European Commission's 2014 Progress Report, political parties undermine the independence of the judicial system in individual cases.

1.23 **The B40 are particularly disadvantaged when it comes to access to justice.** Notwithstanding the availability of legal aid, many areas remain under-served, leaving poor and vulnerable groups without access to basic justice services. There is no legal aid law at State level, resulting in a patchwork of programs. Brcko District has a particularly successful and cost-effective legal aid program, which could potentially be replicated across BiH.

Public financial management

1.24 **The challenging institutional environment and weak implementation of laws can be seen across several sectors of BiH, including Public Financial Management (PFM), which both suffers from the weaknesses and may help to create them.** Sound PFM is essential to ensure that the limited resources are used efficiently and in ways that can most enhance economic growth and boost opportunities for the B40.

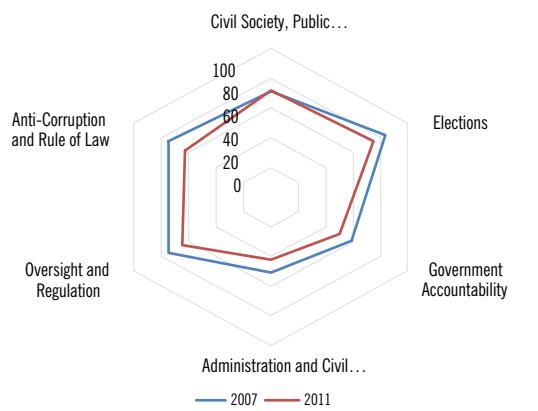
1.25 **A recent Public Expenditure and Financial Accountability (PEFA) assessment of all BiH governments pointed to several common issues across the country.²⁰** Some of these key findings include:

- “**The process of preparing the budget and public investment program is not well integrated with the medium-term macroeconomic outlook** and overall/sectoral strategic documents. Credible and comprehensive medium-term macro-fiscal strategies are lacking at all levels.”
- **Inadequate procurement practices along with regular follow up on external audit findings can lead to poorly informed policy decision-making.** “Despite some recent progress in budget execution, the lack of strong internal controls (especially in public procurement) makes the PFM systems in BiH vulnerable to inefficiency and waste.” The GIS indicator for procurement suggests that standards declined between 2007 and 2011 and of the 31 countries surveyed in 2011 only two (Jordan and Zimbabwe) had a poorer rating in *transparency, fairness, and conflicts of interest* safeguards in public procurement (Figure 1.5).
- **Different recording systems across the country make it difficult to consolidate public expenditure data.** “In budget reporting, the fact that the charts of account of the four main government levels are not harmonized hampers access to consolidated data. Within the Entities (primarily in FBiH), consolidation of data for all general government levels (...) is complex, and data are generally not used to inform policy decisions.”
- **There are insufficient audits of public expenditure accounts to ensure resources are used for their intended purposes.** “Despite recent improvements, better follow-up of external audit findings and recommendations is needed. Furthermore, the coverage/ quality of internal audits and of external performance audits is not comprehensive.” The GIS suggests that the quality of the auditing bodies declined significantly between 2007 and 2011, as did oversight in other areas (Figure 1.5).

²⁰ 2014 PEFA report. It took account of recent analytical work on PFM, including Public Expenditure and Institutional Reviews (2012, 2006), an OECD/SIGMA Public Expenditure Management and Control Assessment (2011) and Public Procurement Assessment (2011, 2008), and various other donor-financed studies on PFM in BiH.

1.26 The Global Competitiveness Report (GCR) finds that there have been improvements in the perception of use of public resources and some set-backs but other indicators suggest some set-backs. The GCR found that there was some improvement between its surveys in 2006/07 and 2013/14 of the perception of diversion of public funds, while government spending was perceived as becoming more wasteful during the period (Figure 1.6). Exactly what drove these changes is not clear as the Global Competitiveness Report is driven by perceptions.

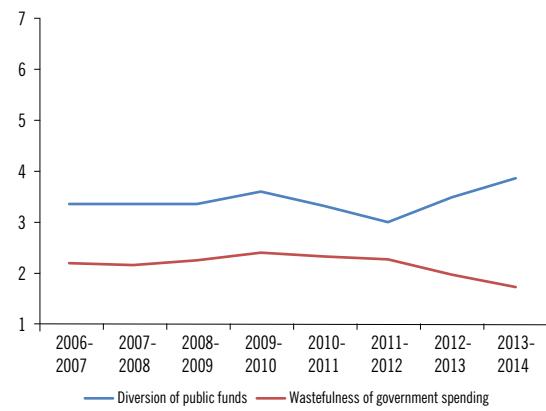
Figure 1.5: Integrity: Modest set-backs ...



Source: Global Integrity Index

Notes: from 0=worst performance to 100=best performance

Figure 1.6: ... and increased government wastefulness

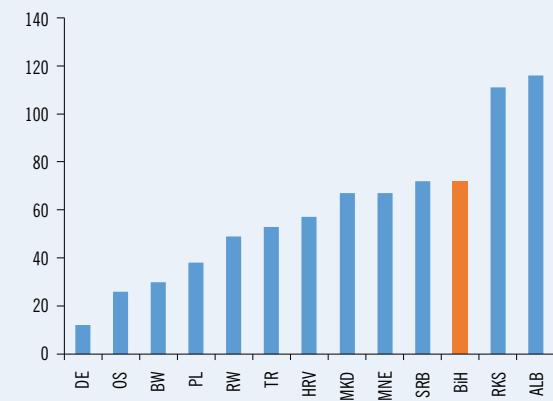


Global Competitiveness Report, Select Indicators from Institutions Pillar, 1-7 (best); Source: World Economic Forum

Box 1.1: The cost of corruption in BiH

The lack of trust in institutions in BiH stems partly from high levels of corruption. Despite some efforts to combat it²², corruption is endemic in BiH (as it is in much of the Balkans), affecting all layers of government, making it more difficult to conduct business in the country, and harming the delivery of public services. Public procurement is believed to face particular challenges with only an estimated quarter of contracts awarded competitively. Transparency International's Corruption Perception Index ranks BiH as one of the most corrupt countries in Europe with only Kosovo and Albania performing worse in SEE (Figure 1.7). The WBG's World Governance Indicators similarly find that BiH lags considerably its EU-CEE peers in terms of control of corruption and all SEE countries except Albania and Kosovo perform better than BiH.

Figure 1.7: BiH is ranked among most corrupt countries in Europe



Note: Rank from 1=best to 175=worst

Source: Transparency International, Corruption Perception Index 2013

Citizens experience widespread bribery. A UN Office of Drugs and Crime (UNODC) (2011) survey of around 5,000 respondents across BiH²² reported that 20 percent of citizens had been exposed to a “bribery experience” with a public official in the 12 months prior to a survey, and that bribery is as present in rural as in urban areas. The cost of the average bribe was €112. In around 27 percent of cases, bribes were initiated by the citizens themselves and just over half were requested by officials. The remainder were jointly initiated or it was unclear.

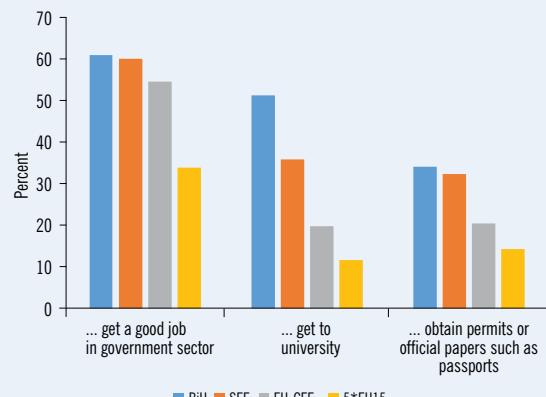
Bribery creates a two-tier public service and prevents a well-functioning justice system. Around a quarter of bribes were paid to speed up procedures (e.g. medical, passports) and around a quarter were to avoid fines. Over half (54 percent) of respondents had paid bribes to doctors and 31 percent to nurses. Over half of respondents who reported paying bribes said they paid them to police officers.

A widespread belief that personal connections are essential to access public jobs or public services. The 2011 Life in Transition Surveys (LiTS) suggests that 62 percent of BiH citizens felt that connections are either “very important” or “essential” to secure a good government job, slightly above the SEE average (Figure 1.8). This suggests that public jobs may not always go to the most qualified applicants. Around 52 percent believed connections matter to secure a place at university, compared with 36 percent on average in SEE.

Firms report levels of bribery comparable with other countries in the Western Balkans.

The UNODC surveyed over 12,000 firms in the Western Balkans on their experience of corruption in 2013. Around 10.4 percent of firms in BiH that had encounters with public officials (around three quarters had) reported giving money or a gift to at least one public official in the twelve months prior to the survey, slightly above the regional average of 10.2 percent (see Annex I). BEEPS data suggests that 8.3 percent of firms reported that gifts were required to secure public sector contracts. Of those who had paid bribes to public officials, the average number of times in the previous year was 6.2, below the regional average of 7.1. As in other countries, most bribes were reported by firms operating in the trade and construction sectors.

Figure 1.8 : Believing Connections “Very Important” or “Essential” to...



Source: LiTS, 2011 and staff calculations

²¹

For example, the RS has an Anti-Corruption Strategy and Action Plan and has established a Strategy Implementation Committee.

The road to EU accession

- 1.27 **BiH has been a potential candidate for EU membership since 2003.** The Stabilization and Association Agreement (SAA) with BiH was signed in June 2008 and has been ratified by all EU Member States. However, the SAA entered into force only in June 2015. The 2014 Progress Report on EU Enlargement notes that the country remains at a standstill in the European integration process. It reports very limited progress on political and economic issues and on moving towards European standards, citing a lack of collective political will on the part of the political leaders to address the reforms necessary for progress on the EU path.
- 1.28 **Cooperation with the EU has recently stepped up a gear and the SAA entered into force in June 2015.** Following widespread, citizen-led protests in early 2014, the EU launched three initiatives to address citizens' concerns: (i) it has expanded the EU-BiH dialogue on justice to additional rule of law matters, in particular the fight against corruption; (ii) it has established a joint EU-BiH Working Group to accelerate the implementation of EU funded projects; and (iii) it has developed a 'Compact for Growth and Jobs'²² together with key actors including international financial institutions. Public statements by EU officials and several key member states reinforce this change of focus toward economic and social issues that would help pave the way for closer relations. The European Council adopted a decision in April 2015 to conclude the SAA, which led to its coming into force in mid-2015, based on progress in jointly defining priorities for economic governance reforms.
- 1.29 **The EU has voiced concerns that the governance structure may make it more difficult to use EU resources effectively.** 2014 EU Progress Report for BiH and the Country Strategy Paper 2014-2017²³ note that governance is built on a highly decentralized and very costly structure, with competences divided between the State level, Entities, cantons and municipalities and a lack of functional coordination and policy-making mechanisms and processes. The fractured planning and budgeting processes, the lack of clear accountability and oversight lines and mechanisms, and the division of competences and responsibilities continues to undermine the efficiency and effectiveness of delivery of public services and state governance as a whole. This fragmentation appears to delay implementation of agreements with the EU, including those under the SAA, many of which have yet to be implemented. It has also made agreements on use of Instrument for Pre-accession Assistance (IPA) resources difficult, leading to the cancellation of some projects, including in rural development.
- 1.30 **Progress is required in several areas of the economy to reach compliance with EU standards including but not limited to the following:**
- **Agriculture, rural development and food safety, veterinary and phytosanitary standards:** A countrywide rural development strategy has not yet been adopted, however over the past year both Entities have developed their respective strategic programs that are substantially similar in terms of broad strategic objectives reflecting the

²² <http://europa.ba/Live.aspx?lang=EN>

²³ http://ec.europa.eu/enlargement/pdf/news/annexe_akte_autonome_nlw_part1v1.pdf

respective landscapes and agro-climatic situation. State-level capacity for coordination and harmonization needs strengthening to integrate the two Entity documents into a single coherent document representative of the perspective of both Entities vis-à-vis the EU. Improving productivity and competitiveness is being hampered by the lack of an efficient administration and effective rural credit schemes, and the very high collateral requirements that smaller farmers do often not have. This is particularly the case in absence of complete clarity of land records that would provide a basis for collateral, and a very conservative approach to credit in the sector from both, lenders and borrowers.²⁴ Although BiH has preferential access to EU markets for some of its agricultural products, and although the majority of rural forest products are now derived from certified forests that comply with EU and global standards, institutional constraints have prevented BiH from achieving the full benefits. For instance, the country lacks EU-compliant and harmonized food safety institutions and regulations across all governmental levels of the country.²⁵ However, the situation is improving with the strengthening of the state level agencies for Food Safety, Veterinary services and Plant Health and Phyto-sanitary services and the amendments currently being discussed in parliament for the State level agricultural, veterinary and food safety legislation.

- Education: BiH agreed to follow the Bologna Process, which harmonizes European higher education systems, under the SAA, although full implementation is some way off. BiH signed an agreement to participate in the EU's student exchange program, ERASMUS in 2014 though much more needs to be done to ensure alignment with European standards.
- Energy: Each Entity has an energy strategy but these have not been harmonized, reflecting the fragmented BiH, and indeed, Balkan-wide energy markets. Energy acquis have not yet been adopted according to the 2014 EU Progress Report, and tendering procedures in the sector are complicated and non-transparent. An electricity market liberalization planned for January 1, 2015, was not fully implemented, and there is no genuine platform to determine electricity prices by the market. There are delays in implementing EU energy efficiency requirements and obsolete existing thermal capacity that does not comply with EU emission standards.
- Health: BiH has completed National Health Accounts (NHAs) for some years but a Health Technology Assessment (HTA) and quality control mechanisms still need to be implemented in line with EU laws/regulations/standards.
- ICT: Draft laws transposing the EU regulatory framework of 2002 was prepared in September 2013, but is still being debated. The current regulatory regime fails to ensure the financial and institutional independence of the regulator, which makes it difficult to safeguard efficient competition and creates an uncertain legal and regulatory environment for market players.²⁶ Policies aimed to guide and promote the development of the ICT

²⁴ Commission Staff Working Document, Bosnia and Herzegovina, 2012 Progress Report. Communication from the Commission to the European Parliament and Council. Enlargement Strategy and Main Challenges 2012-2013.

²⁵ Bosnia and Herzegovina Country Program Snapshot. The World Bank. April 2014.

²⁶ Progress Report 2014, European Commission, at: http://ec.europa.eu/enlargement/pdf/key_documents/2014/20141008-bosnia-and-herzegovina-progress-report_en.pdf

sector as a whole and broadband access in particular expired in 2012, while a new policy has not yet been approved (draft policy for 2013-2017 was prepared in 2013).

- Justice: The EU broadened its dialogue on justice from reform of the judiciary and issues related to processing war crimes to include issues related to corruption, conflict of interest, and accountability and efficiency of the police force. This was partly as a result of the 2014 protests.
- Trade: The 2014 Progress Report notes that BiH risks having some trade benefits with the EU suspended—including those with Croatia, a significant export partner—if it fails to adopt quality standards (notably in agriculture) by end of 2015. Around 19 percent of standardization requirements needed to join the European Committee for Standardisation and the European Committee for Electrotechnical Standardisation remain to be adopted.
- Transport: A State-level transportation policy has yet to be adopted, and “...key strategy and policy documents for all transport sub-sectors have yet to be developed”.²⁷ Legislation needs to be properly aligned with the EU acquis with regard to all modes of transport, especially for rail, road and maritime means of transportation.²⁸ EU acquis for transport have barely been implemented, and the two Entities still maintain vertically integrated railway companies that over-employ numbers of people but lack competent staff. Better coordination and improvements/modernization in transportation linkages are needed within the country. For example, travelling by rail between the Entities still requires changing locomotives.
- Water: Improving wastewater management facilities to meet EU standards will be costly. The current lack of adequate wastewater management creates a significant health and environmental hazard. The recent floods resulted in solid and liquid waste being returned to land, for example. In addition, freshwater is contaminated by wastewater. It may become one of the most expensive EU requirements to comply with—compliance with the two main EU Directives, Drinking Water Directive and EU Urban Waste Water Directive is estimated to cost around €3.7 billion. This will likely result in significant tariff increases for water and wastewater services, potentially straining lower-income households.

²⁷ Commission Staff Working Document, Bosnia and Herzegovina, 2012 Progress Report. Communication from the Commission to the European Parliament and Council. Enlargement Strategy and Main Challenges 2012-2013.

²⁸ Commission Staff Working Document, Bosnia and Herzegovina, 2012 Progress Report. Communication from the Commission to the European Parliament and Council. Enlargement Strategy and Main Challenges 2012-2013.

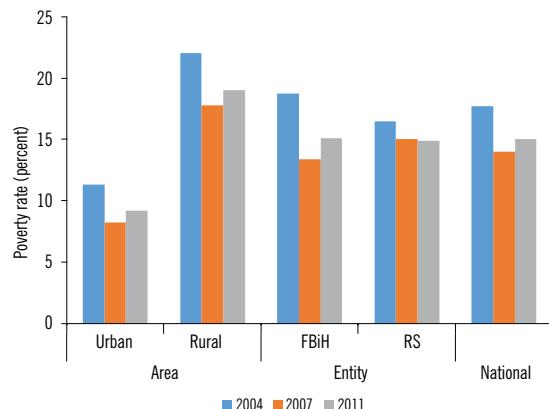
POVERTY AND SHARED PROSPERITY

BiH is one of Europe's poorest countries, even though inequality is relatively low and life expectancy above the average for SEE. When economic growth was strong poverty fell from around 18 percent (2004) to 14 percent (2007). During the crisis, poverty stagnated and is now estimated at 15 percent (latest data is from 2011). Economic growth was the major driver of poverty reduction, which benefitted rural and urban areas equally. The poor benefitted from rising wages and from rising transfers which were made possible due to higher state revenues. However, the social protection contributed more to income growth during the growth period than during the crisis and the wealthiest 60 percent of the population benefit significantly from public transfers, including social assistance. This suggests that public sector transfers were used to re-distribute resources toward specific groups (such as the poor) during periods of economic growth but not to cushion families from national or individual economic hardships, when they arise.

Poverty levels are similar across entities and gender but are more than double in rural than urban areas (19 percent vs. 9 percent). At the same time, few people choose to urbanize due to higher cost of living in cities, lack of job opportunities, and several advantages to living in the countryside. Poverty was particularly pronounced among large families (e.g. 35 percent among families with three and more children), posing risks for inter-generational poverty transfer. While children were significantly more likely than the average to live in poor households, Bosnians over 50 years are less affected by poverty and there has been a notable decline in poverty among those of 65+ (from 13 to 11 percent) between 2007 and 2011. B40 households are much less likely than others to have an employed female than those in the T60. Poverty is strongly associated with the level of education; and almost a quarter of Bosnians with no education are poor.

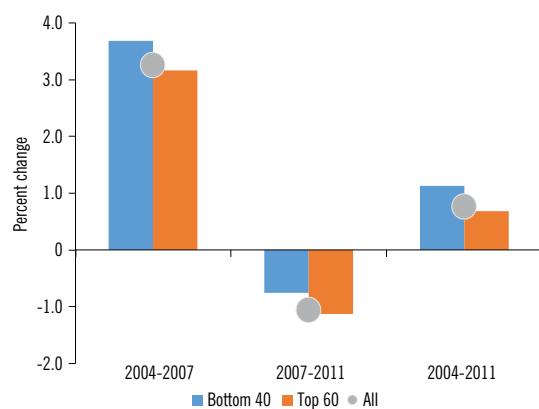
2.1 Poverty dynamics

- 2.1 **Between 2004 and 2007 poverty fell and incomes of the B40 grew rapidly, and at a higher pace than the incomes of T60.** Poverty (measured against a 205KM daily threshold) fell from 17.7 percent of the population to 14 percent between 2004 and 2007 (Figure 2.1). The reduction in the poverty headcount was most pronounced in FBiH, where the poverty fell from almost 19 percent in 2004 to just over 13 percent in 2007. More generally, the population in the bottom 40 percent (B40) saw average annual consumption growth of around 3.7 percent during the 2004-07 period. This compares to 3.2 percent of the wealthiest.

Figure 2.1: Growth has been good for the poor...

Notes: Poverty rate based on the KM 205 daily threshold and World Bank poverty methodology

Source: HBS 2004-2011 data

Figure 2.2: ...and for the B40 more generally

Notes: Growth rate of consumption for Bottom 40, Top 60 and all, 2004-2011

Sources: World Bank (2014)30; HBS 2004-2011 data

2.2 The poor and B40 in rural areas and towns outside of the capital city fared particularly well prior to the global crisis. Consumption of the B40 in rural areas grew at an annual average of 4 percent between 2004 and 2007 compared to 2 percent for the rural T60 during the same period. The rate of growth of expenditures of the rural B40 group was similar to that in urban areas outside of Sarajevo (3.8 percent) (rural livelihoods are discussed in more details in section 2.4). However, the B40 in Sarajevo did not perform as well as those elsewhere, with average annual consumption growth of just 0.4 percent. Sarajevo was, however, particularly dynamic for the T60, who had average annual consumption growth of 5 percent over the period.

Box 2.1: Data availability and challenges in BiH

This SCD assembled and analyzed the existing data for producing a comprehensive diagnostic of BiH's development challenges and opportunities. However, BiH also faces a number of data limitations and issues with data transparency which are important development issues for the country to unleash its full potential. This has constrained the analysis, leading to some gaps in knowledge. This box notes the main data constraints faced by the SCD team, while broader knowledge gaps are noted in section 6.3.

Household data: Nationally and Entity-representative household surveys were undertaken in 2004, 2007 and 2011. A new survey is in the field at the time of writing. This means that the latest available data for estimating poverty dates from 2011. Analysis such as the factors driving poverty and the characteristics of poor and B40 households was constrained by the vintage of the latest data.

Income data: While a nationally representative Labor Force Survey is undertaken each year (with results reported in the SCD), broader income data relies on the household survey data and is of low quality. The household survey focuses on consumption—a more reliable way to estimate living standards and poverty. Unfortunately, as in much of the world, income data is considerably less reliable. Indeed, reported household income amounts to only around a third of consumption. While we have made efforts to understand the changes in income sources (including wage income, social assistance and remittances), this analysis should be considered within the context of this caveat.

National accounts data: The BiH Agency for Statistics (BHAS) produces the national accounts (NA) for BiH. The compilation of data started in 2005 with the reorganization of the BHAS and NA data are compiled based on the System of National Accounts (SNA)'93 and European System of Accounts (ESA)'95. The GDP data are collected in accordance with the production and expenditure approach, although their time-series availability differs and there is a discrepancy between the numbers produced under each method. Production approach data are available since 2000, while the expenditure approach data since 2006. In 2008 the estimates of GDP by production approach were compiled for the period 2000-2003 and the data series was revised backward for the period 2000-2007 and published. It is worth noting that in the period prior to 1991, the concept of material production was applied in BiH, while for the period 1992-1995 there were no reliable estimates of the BiH GDP due to the war.²⁹ Aggregate countrywide estimates of GDP based on the production approach are prepared by the BHAS based on the data compiled separately for the two Entities' statistical institutes and one in Brcko District. As for the expenditure approach, annual GDP estimates were compiled on an experimental basis for years: 2004 and 2005, both at current and constant prices. These were disseminated for the first time in 2007. The estimates of GDP by expenditure approach are now a part of regular compilation program of NA estimates. Due to the fact that neither an Input-Output framework nor supply-and-use tables have been developed yet the discrepancy between the two approaches of GDP estimates persists. In addition the BHAS presented for the first time quarterly estimates of GDP by production approach on June 2013. Historical time series, compiled by the production approach is available from the first quarter 2006 to the last quarter of 2012 by NACE Rev 1.1 and for the first quarter of 2008 to the fourth quarter of 2014 by the NACE Rev. 2.

Fiscal data: The World Bank Group has access to public sector revenues and expenditure data at the Entity level (central and general government) via the Central Bank of Bosnia and Herzegovina (CBBH) online portal and ITA publications. This is publicly available and is reported in this SCD. However, several caveats are warranted. Fiscal data reported by the governments, the Central Bank and the IMF have significant discrepancies in some years. A large part of the differences results from a lack of knowledge (or recording) of donor financing. Significant knowledge gaps also exist in terms of canton and municipal debt and contingent liabilities. In addition, State-Owned Enterprises may generate both significant revenues and expenditures, not all of which are believed to be captured by the fiscal accounts.

State-Owned Enterprises: In addition to revenues and expenditures which should, in some cases, be captured by the fiscal accounts but are not, there is a lack of understanding even as to the number of SOEs (including those established at canton and municipal level), their liabilities (notably toward employees), the number of employees, as well as other factors. This reduces our ability to analyze the true extent of the public sector and its economic impact.

Other areas: Several other areas were also found to lack information. This includes education—where the latest internationally comparable data date from 2007 and where there is little information on the skills required by firms; the size of the informal sector (though we do estimate this using Labor Force Survey data); and the full impact of the war on output. In addition, at the time of analysis, 2013 census data was available only on a municipal level and not on a sub-municipal level.

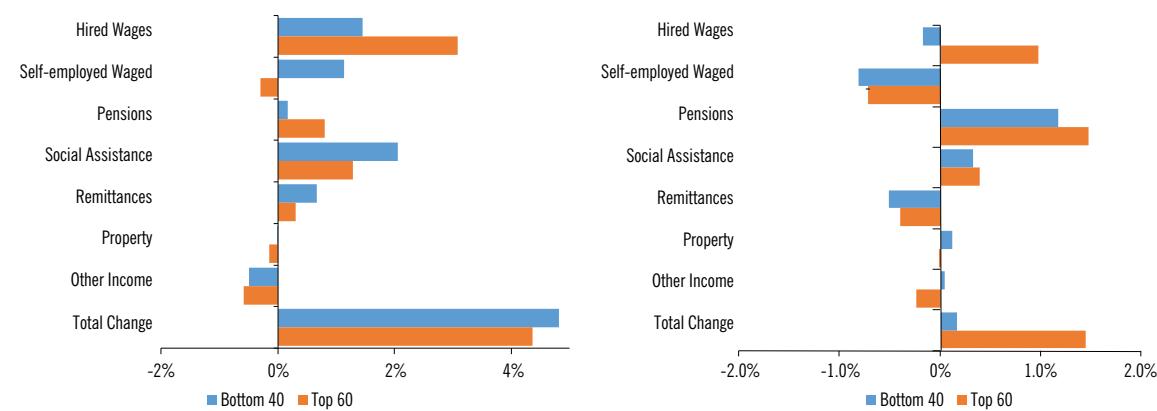
²⁹ See: <http://www.bhas.ba/metodoloskidokumenti/2010-md-BiHInventory-en.pdf>

2.2 Drivers of poverty reduction

- 2.3 **Growth was good for the poor in BiH as the B40 were able to expand their consumption during periods of economic growth.** Overall growth in consumption accounted for three quarters of total poverty reduction during 2004-07 at the national level. During periods of economic growth, people also had a greater chance to get a good job. Around a third of the overall growth in incomes of the B40 over 2004-07 came from labor earnings (Figure 2.3).³⁰ This reflects growth in sectors that can employ lower skilled people. Growth in services (wholesale/retail trade, real estate, construction, transportation, administration, accommodation/restaurants, public services and other services) contributed over two thirds of overall growth during the 2001-07 period. The remainder came primarily from growth in manufacturing, electricity, mining and agriculture. Growth patterns/sources of growth are discussed in more detail in section 3.1.

Figure 2.3: Wages and social assistance contributed most to income growth during growth periods but social assistance could have contributed more during the crisis

Income dynamics for B40 and T60 groups by income source, Average annual growth 2004-07 (left) and 2007-11 (right)



Source: Staff calculations based on HBS 2004, 2007 and EHBS 2011 data

- 2.4 **The B40 also benefited from an expansion of public and private transfers, even during the economic growth period.** Pensions and social assistance both made up a larger proportion of income among the B40 than among the T60. During the 2004-07 period, almost half of the overall income growth of the B40 was due to social assistance transfers—a more important contribution than that of labor earnings. Between 2004 and 2007 domestic pension coverage in FBiH expanded from 38 percent of the population to 45 percent of the population, and from 39 percent to 49 percent in RS. The average pension value also rose by 78 percent in FBiH and 89 percent in RS during 2004-07. Finally, the incidence of remittances (both foreign and domestic) and the coverage of non-contributory transfers increased in FBiH during 2004-07 and declined in RS, which contributed to the faster pace of poverty reduction in FBiH between 2004 and 2007 (World Bank, 2010).
- 2.5 **With the onset of the financial crisis, poverty stopped declining, although redistribution moderated very slightly the impact of slower economic growth.** At 15 percent of the population in 2011, poverty was slightly higher than the pre-crisis 2007 estimate, although

³⁰ Wages and productivity are discussed in more detail in section 3.7.

the difference is not statistically significant. The incidence of poverty remained stable during the period both in urban and rural areas of BiH. An increase in poverty was registered in FBiH,³¹ whereas poverty incidence remained stable in RS. The increase in poverty during the crisis was driven more by (a lack of) growth than redistribution. Between 2007 and 2011 consumption expenditures fell across the entire distribution and in almost all consumption categories (and in particular for alcoholic beverages, recreation and transport), while consumption patterns remained stable. At the national level, changes in mean consumption contributed 1.4 percentage points to the overall increase in the poverty headcount. However, some wealth redistribution helped to reduce poverty by 0.3 percentage points. These figures are similar across urban and rural areas and are consistent with the marginally pro-poor shape of the growth incidence curves.³²

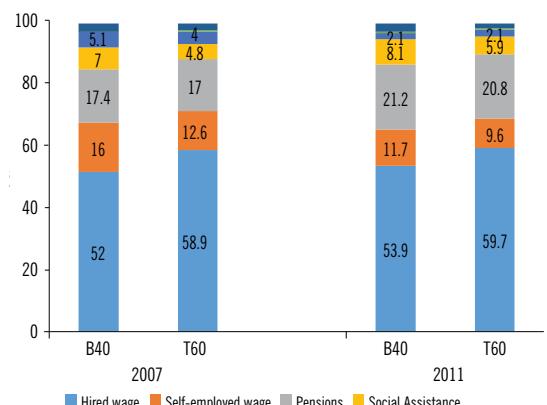
- 2.6 **During the crisis, consumption of the B40 fell less than those of the T60 group.** Between 2007 and 2011 consumption fell at an annualized rate of 1.1 percent nationally, but expenditures for the B40 group fell by an annual average of 0.8 percent. Income data tends to be less reliable than consumption data—in the BiH case, reported household incomes are just a third of consumption—but nonetheless provide some evidence of income patterns.
- 2.7 **Despite the decline in consumption over 2007-11, household data suggest that some sources of income—notably pensions and social assistance—provided a cushion.** Pensions and social assistance benefits were key contributors to the growth of incomes in the B40 group during the crisis-affected period of 2007-11. (Social assistance and pensions are discussed in more detail in section 3.2). The increase in the relative importance of pensions during the 2007-11 period was most prominent in rural areas and urban areas outside of the capital. Wage income declined during 2007-11 in Sarajevo but saw positive growth outside of the capital. In Sarajevo, all sources of income, with the exception of pensions, shrunk during the crisis. The relative share of self-employed wages also decreased in rural areas (Figure 2.4), consistent with the negative contribution of agriculture to growth during this period, since a large share of those who declared themselves to be self-employed were employed in agriculture. Remittances played a secondary role during the pre-crisis growth period, at least in relative terms, and they do not appear to be counter-cyclical in that the economic slowdown is also associated with a fall in remittances, consistent with EU-wide effects of the financial crisis.
- 2.8 **However, BiH's social assistance system tends to be pro-cyclical.** Social assistance grew fast during the growth period of 2004-07 for both the B40 and T60. Social assistance helped to boost B40 income by more than T60 income as a share of income, the T60 also gained significantly from social assistance during 2004-07 (2.1 versus 1.3 percentage points increase annually). While social assistance did provide some cushion during the financial crisis, they contributed significantly less to income growth over 2007-11. In addition, they

³¹ This is sensitive to the level of the poverty threshold.

³² In the case of the poverty gap and the squared poverty gap, both the growth and the distribution components had positive contributions to the overall change in the corresponding indicators; the relative contribution of the growth and redistribution components was also more balanced in the case of FGT (Foster–Greer–Thorbecke)(1) and FGT(2) indices.

Figure 2.4: Wages are the main income source but self-employment and public transfers matter more for the B40 than T60...

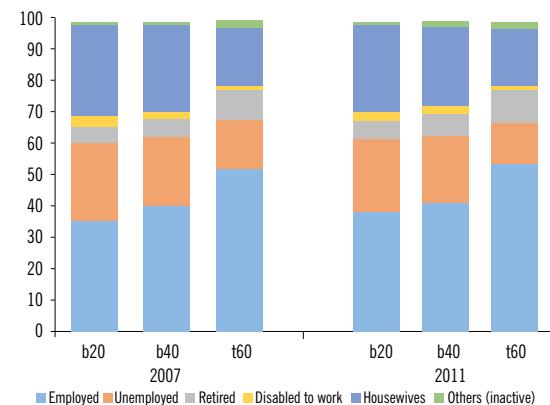
Share of total household income by income source (%)



Source: Staff calculations based on HBS 2007 and EHBS 2011 data

Figure 2.5: ... and wealthier people are much more likely to be employed showing the importance of jobs for shared prosperity

Labor force status (25-64 age group)



Source: Staff calculations based on HBS 2007 and EHBS 2011 data

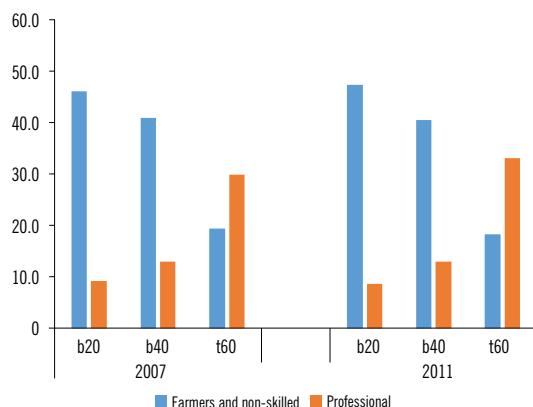
contributed slightly more to T60 income increase during the crisis than to B40 income (0.4 versus 0.3 percentage points per year). This suggests that (i) social assistance is poorly targeted (this is discussed in more detail in section 3.2) and (ii) social assistance is partially about redistributing resources to selected groups rather than supporting households in need during national or individual economic downturns.

2.3 Persistence of characteristics of the poor and B40

- 2.9 **The shared prosperity performance in BiH, both pre- and post-crisis, is tied to the characteristics of the B40 group, characteristics that largely persist through time despite pre-crisis income convergence.** BiH has one of the lowest shares of employed individuals in the working age population in the B40 in SEE (World Bank, 2014). Those in the B40 are less likely to be employed (and more likely to be unemployed) than those in the T60 (Figure 2.5). The discrepancy between the two groups in terms of the unemployed population

Figure 2.6: Poorer groups are less likely to have professional jobs...

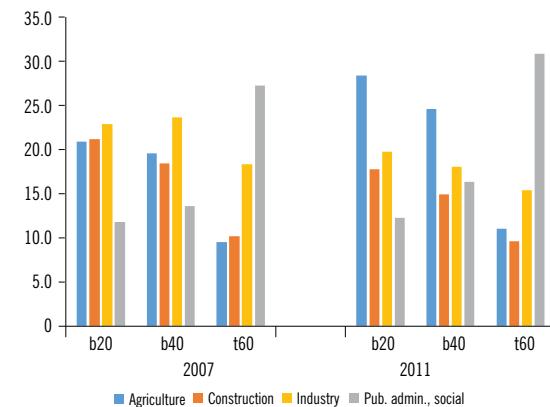
Occupational distribution (15-64 years)



Source: Staff calculations based on HBS 2007 and EHBS 2011 data

Figure 2.7: ... and more likely to be employed in agriculture or construction

Sectoral distribution of employment (15-64 years)



Source: Staff calculations based on HBS 2007 and EHBS 2011 data

increased between 2007 and 2011. Among those in the B40 who are employed, a much higher share are in low-skilled occupations and/or sectors (Figure 2.6 and Figure 2.7). These patterns explain, on the one hand, why the strong employment performance pre-crisis was beneficial to the B40 group, and, on the other hand, the contribution of transfers to income dynamics in the B40 group, which relies on transfers more heavily.

- 2.10 Education matters in getting jobs, especially for the B40.** The level of human capital in the B40 is quite low, both in absolute terms and in comparison to other SEE countries. More than half of individuals in the B40 had completed at most the primary education level in BiH, whereas only 2 percent had completed tertiary education (Figure 2.8). By contrast, someone in the T60 is four times more likely to have completed tertiary education and much less likely (20 percentage points less likely) to have only primary (or lower) education. The low stock of human capital leads both to lower chances of employment and lower quality jobs. In the 25+ age group, among those with tertiary education over 60 percent reported being employed in 2011, compared to only 22 percent of those with primary education, and only 7 percent of those with no education (Figure 2.9). Among the employed in the same age group, 58 percent of those with tertiary education have professional occupations (and only 2 percent have elementary occupations). However, very few of those without tertiary education (including those with secondary education) have professional jobs, while the prevalence of non-skilled occupations is quite high (one third of those with primary education are in non-skilled occupations).
- 2.11 The risks of falling into poverty are strongly associated with the type of job someone pursues.** The poverty incidence varies considerably across occupational categories and sector of employment (Figure 2.10). Poverty is very low among professionals (legislators, scientific and other professional occupations), and it was also reasonably low in occupations such as technicians and clerks (comprising one third of the 25+ age cohort), while farmers and non-skilled professions recorded poverty rates in excess of 20 percent in 2011 (the situation was similar in 2007). Across sectors, those employed in the financial/real estate

Figure 2.8: Low educational attainment means greater difficulty in getting jobs...

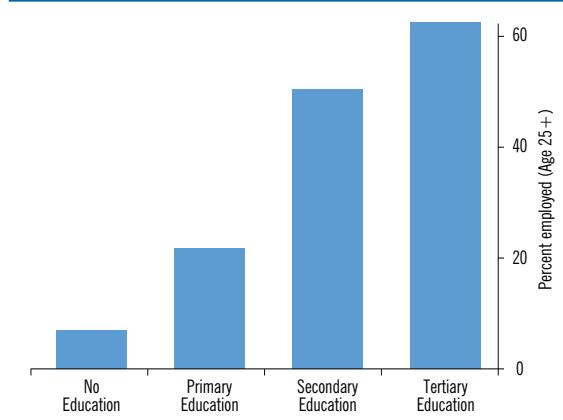
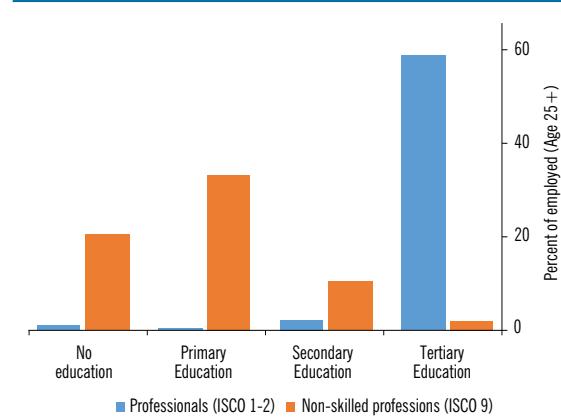
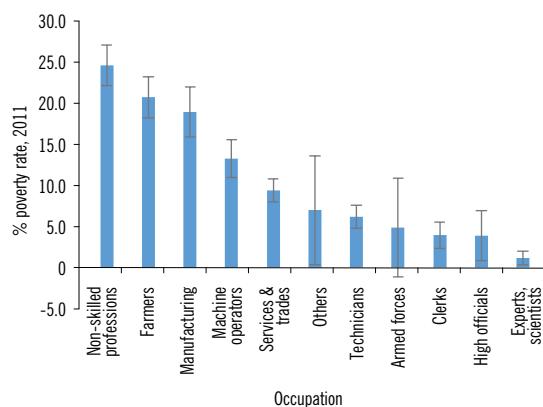


Figure 2.9: ...and lower quality jobs



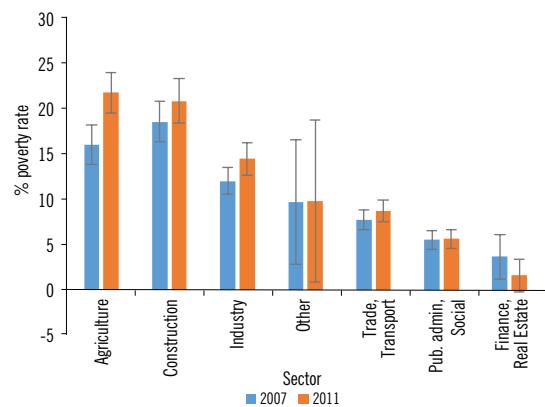
sector, public administration, as well as trades/services sectors are relatively unlikely to be poor, while those working in agriculture, industry and construction were much more likely to be poor. Poverty among those working in agriculture and construction increased between 2007 and 2011, consistent with the macroeconomic indicators of sectoral growth during this period, which show declining output in both sectors (Figure 2.11). Economic growth and sectoral employment are discussed in more detail in sections 3.1 and 3.7. There has been a shift from agricultural occupations to trade and services occupations among younger age cohorts (20 percent of those aged 45+ were in the trade and services sector, compared to 31 percent aged 25-44).

Figure 2.10: Poverty incidence is especially high in low skilled occupations...



Source: Staff calculations based on HBS 2007 and EHBS 2011 data

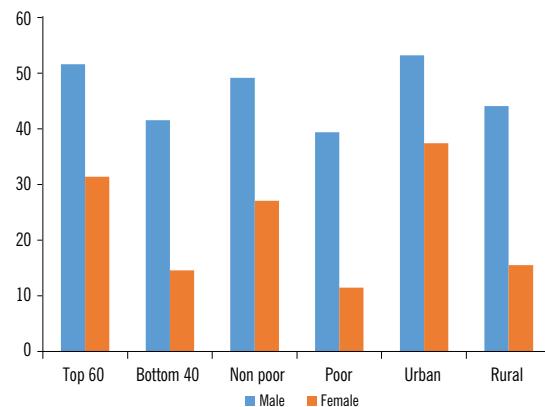
Figure 2.11: ... and in sectors like agriculture and construction



Source: Staff calculations based on HBS 2007 and EHBS 2011 data

2.12 Labor market participation by females in the B40 and in rural areas is low and persistently so. While males in the T60 are more likely to participate in the labor market than males in the T40, the gap is fairly small compared to that of women in the B40 (Figure 2.12). Around 52 percent of males in the T60 are in the labor market, while 42 percent of males in the B40 are. However, females in the B40 are less than half as likely to participate in the labor market as their T60 counterparts (15 versus 32 percent). Among the poor (or the B40) there is also a large difference in the labor force participation of men and of women—only 15 percent of women in the B40 group were active, compared to 42 percent of men. The gap between male and female labor force participation is especially large in rural areas, where 16 percent of females are in the labor force, compared to 45 percent of males. A recent qualitative survey revealed that key among obstacles to female participation in the labor markets are factors such as: (i) more household responsibilities for women; (ii) fewer

Figure 2.12: Female labor force participation especially low in B40 group, and in rural areas

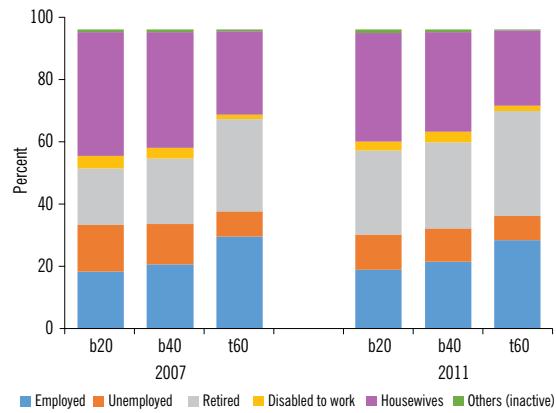


Source: BiH Household Budget Survey, 2011

work opportunities; (iii) little motivation for women to continue their education; (iv) greater difficulty in accessing and owning assets; and, (v) in particular in rural areas, the limited number of child care services (World Bank, 2015). A recent World Bank gender assessment for BiH also pointed to “discriminatory attitudes and social norms towards women” reducing economic opportunities for females. Gender and social inclusion are discussed in more detail in section 2.5.

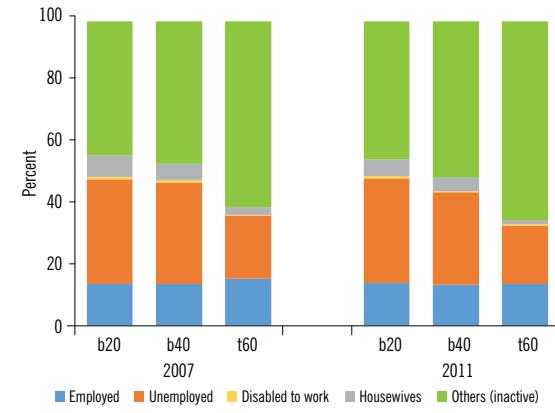
- 2.13 Unemployment in the B40 group is particularly high among the youth and also among the Roma.** Overall in 2011, the difference between the share of unemployed adults of working age in the B40 group and the T60 group was about 8 percentage points. Differences are quite small among those nearing retirement (aged 55-64) where the difference was only 3 percentage points (Figure 2.13). On the other hand, youth (aged 15-24) in the B40 are much more likely to be unemployed than youth in the T60, with unemployment 11 percentage points higher in the former (Figure 2.14). Unemployment is even higher for Roma minority (many of them below the poverty threshold or in the bottom 40 percent), with 44 percent who are unemployed (compared to 27 percent non-Roma neighbors living in the same community).³³

Figure 2.13: While differences in among those aged 55-64 are small...
Labor force status (55-64 years)



Source: Staff calculations based on HBS 2007 and EHBS 2011 data

Figure 2.14: ... much higher unemployment rates among youth in the B40 compared to wealthier peers
Labor force status (15-24 years)



Source: Staff calculations based on HBS 2007 and EHBS 2011 data

- 2.14 BiH's tax system is contributing to high unemployment among the youth and low-skilled workers.** The country's *tax wedge*—the indirect costs of bringing a worker into the formal labor market—is one of the highest in the region. Social security contributions (33 percent of gross wages in RS and 41.5 percent in FBiH) are the highest in SEE. The high contribution rates are likely to be particularly biting for low earners. Koettl and Weber (2012) show that BiH has a very high tax wedge for low wage earners (measured for a single worker at 33 percent of average wage), and a very low progressivity of the tax. This may encourage many to prefer the informal sector (employment is discussed in more detail in section 3.7 and taxes in 3.2).

³³ UNDP/WB/ EC Regional Roma Survey, 2011.

- 2.15 Without jobs, it is difficult for the B40 to contribute to and benefit from economic growth.** An analysis of the income generating capacity of the B40, based on the assets framework proposed by Bussolo and Lopez-Calva (2013)³⁴ shows that the population in the bottom two welfare quintiles is characterized by a lower stock of assets (human and otherwise) to draw upon. The B40 have lower levels of education, lower employment rates, particularly among women, and higher unemployment rates among youth and Roma than the rest of the population.³⁵

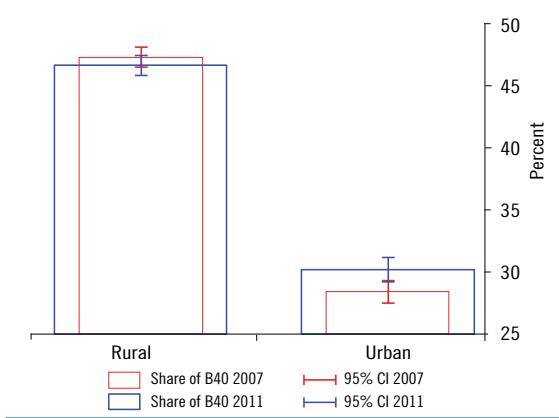
2.4 Rural livelihoods

- 2.16 The B40 (and the poor) are overrepresented in rural areas, although this is in part the result of differences in underlying characteristics of urban and rural populations.** A higher poverty and B40 rate among rural residents is a common feature across many countries, although this difference has been minimized in a number of northern European countries. In BiH, the discrepancy is pronounced—only about 30 percent of urban residents were in the (national) B40 group according to latest data, compared to more than 45 percent of rural residents (Figure 2.15).
- 2.17 People living in rural areas are more likely to be poor and less educated compared to urban people.** Poverty is significantly higher in rural areas, at 19 percent, compared to 9 percent in urban areas, with similar results in both Entities. Education differences of HH head account for around half of urban-rural income differential (Figure 2.17). Controlling for demographics (age, sex, household size, number of children) and labor market status reduces the differential to 3 percentage points. The additional contribution of labor force status is minimal when conditional on education level, suggesting education drives this. These factors make it harder for women to participate in the labor market, particularly with low rates of access to early childhood education (in BiH in general and rural areas in particular). A lack of early childhood education is also a concern for inter-generational poverty transfer risk, given the increased poverty in large families.
- 2.18 Despite this, the rural population has remained stable as a share of the total population since 1990.** The rural population declined from around 80 percent of the total in 1960 to around 60 percent in 1990 (Figure 2.16). However, it has remained stable at this level since then. This contrasts markedly with other SEE countries, where the urbanization trend resumed after the break-up of Yugoslavia, albeit at a slower pace.
- 2.19 Geographical population patterns are partly determined by BiH's topography and a process of sub-urbanization has occurred since the war.** The population is concentrated mainly in valleys, as illustrated by night time light emission (Annex II). The strongest light growth since the war however, can be seen in sub-urban or peri-urban areas, suggesting some degree of movement to these areas.

³⁴ Bussolo, Maurizio, and Luis F. Lopez-Calva. 2013 "Shared Prosperity: Paving the Way in Europe and Central Asia." Washington, DC: The World Bank Group.

³⁵ UNDP/WB/ EC Regional Roma Survey 2011.

Figure 2.15: The share of B40 population is much larger in rural areas of BiH

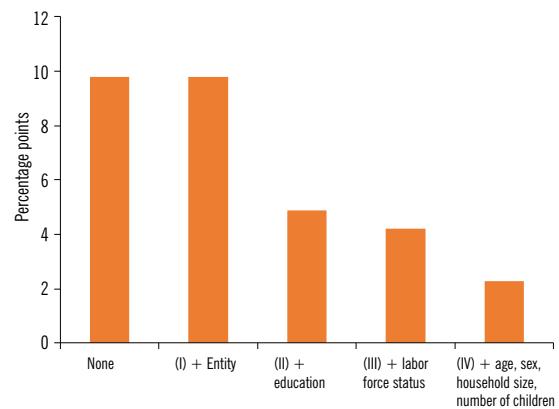


Notes: Staff estimates based on EHBS 2011 data

2.20 “Large villages” are becoming more important, partly because towns are shrinking.

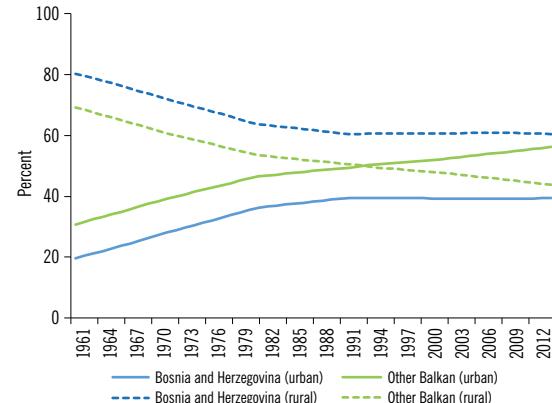
Administrative data also suggests a degree of sub- or peri-urbanization. Although imperfect³⁶, the data indicate that municipalities with high density and very low density (defined as below 50 persons/km²) saw declines in their populations between 1991 and 2013, reflecting the general population decline. However municipalities with densities of 50 to 100 persons/km² saw increases in their population over the period in both absolute terms and as a share of the population.

Figure 2.17: Half of rural-urban poverty gap is explained by educational differences



Sources: 2011 EHBS and staff estimations. See Annex II for full regression results.
Notes: Coefficient on Rural Dummy with different sets of characteristics. “None” shows the raw difference between rural and urban poverty headcount in percentage points. Subsequent columns show remaining difference after accounting for household characteristics.

Figure 2.16: BiH: Not urbanizing anymore
Rural and Urban Population as % total



Source: World Bank WDI

Table 2.1: Rural people sometimes need to travel far to reach infrastructure services

	<100m	100m-3km	>3km
Shop	26%	56%	18%
Primary school	9%	52%	39%
Clinic	6%	54%	40%
Hospital	1%	10%	90%
Post office	6%	32%	62%
Bank	2%	18%	80%

Source: UNDP Bosnia and Herzegovina Rural Household Survey, 2012

2.21 Rural and urban areas differ in access to services or quality of life in some ways. For example, some 80 percent of rural households need to travel over 3 kilometers to access a bank and 40 percent need to do so to access a clinic (Table 2.1). While no comparable statistics exist for urban areas, this suggests that rural road transport is important for access to services in rural areas. Access to some types of education are better in urban areas with more urban children in Early Childhood Education (22.8 percent vs 7.9 percent).

³⁶ Sub-municipality data not available and local community data not yet available for 2013.

- 2.22 **However, in most ways, BiH does a decent job of ensuring its rural citizens have access to basic services.** Age differences between rural and urban areas are minimal and therefore do not appear to account for either education differences (which are driving income differentials) (Annex II). There is little difference in many health indicators (e.g. child immunization, sickness, and malnutrition), little difference in school enrollment or literacy, and little difference in access to clean drinking water.
- 2.23 **The 2012 UNDP Rural Household Survey (RHS) revealed that around two thirds of rural income comes from employment.** This matches similar findings in the 2011 Extended Household Budget Survey (EHBS), which found that around 55 percent of rural income came from wage labor (Table 2.2). The RHS suggests that just 6.6 percent of rural income comes from selling agricultural produce. Between a fifth and a quarter of household income comes from social security.

TABLE 2.2: Rural income sources

	Average monthly income		
	Amount (KM)	%	% HH receiving
Agriculture	50	6.5	9.4
Employment	517	67.4	53.4
Self-employment	13	1.7	1.8
Services and seasonal	12	1.5	4.8
Assets (e.g. savings, rental income)	9	1.1	2.5
Support	167	21.7	51.2
Remittances	1	0.2	1.2
Family	3	0.3	1.7
Social payments	163	21.2	49.6
Total	767	100.0	

Source: UNDP 2012 Rural Household Survey

- 2.24 **With a third of rural households having no land and 16 percent having only “gardens”, low income and low wage employment from agriculture in rural areas is unsurprising.** The RHS estimated that 35 percent of rural households have no land; 16 percent have “gardens”; and 37 percent can be considered smallholders. Just 13 percent of rural households have farms.
- 2.25 **Although around a fifth of workers nationally are estimated to be employed in agriculture, most are self-employed.** Although the 2013 Labor Force Survey found that 19.6 percent of all those employed worked in agriculture, the RHS found that agriculture generates little formal wage employment. Agricultural employment is therefore largely for self-consumption. In rural areas, “non-agricultural households” have higher average income than “agricultural household” except the largest farms (although this fails to monetize own-consumption). Agriculture contributes little to income for households with less than 3ha of land.

2.26 The fragmentation of land ownership presents a major challenge for agricultural producers.

Farms in BiH are on average 2 hectares subdivided into 6 to 8 plots. Fragmentation is also common among larger farms, which typically comprise 6 to 8 lots of 2 to 3 hectares. BH's farm structure is more fragmented than that of Southern Europe in the 1970, as well as most neighboring countries today.³⁷ Such land fragmentation adversely impacts farm productivity, and, since 2013, BH is piloting land consolidation over approximately 3,000 ha in the municipality of Ravno and Orašje.³⁸

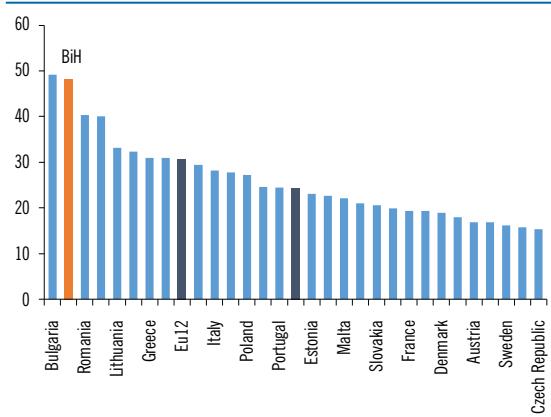
2.5 Social and political exclusion

Social inclusion

2.27 Nearly half of the BiH population was found to be at risk of poverty or social exclusion (AROPE).

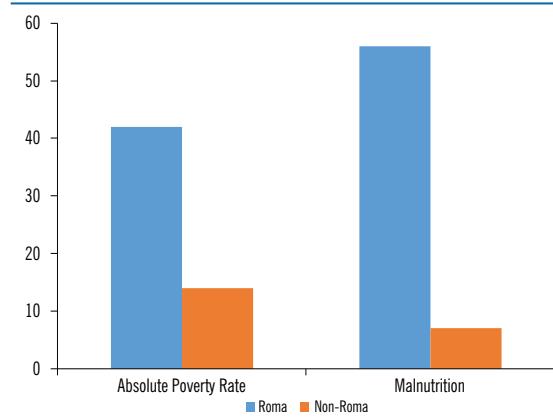
The 2007 UNDP National Human Development Report (UNHDR) for BiH, found that half of the BiH population could be categorized as socially excluded. They note that a tighter definition defined 22 percent as socially excluded based on a combination of living standards, health, education, participation in society and access to services. A standard EU indicator defines a household as at risk of poverty or social exclusion based on income poverty, very low work intensity, material deprivation or an inability to meet a significant unexpected expense.³⁹ Based on this standard definition, the 2011 Extended Household Budget Survey (EHBS) reveals that around 48 percent of the population fell into this category. This compares to 32 percent in Croatia and 31 percent for eastern EU countries on average. Only Bulgaria has a higher proportion of its population AROPE (Figure 2.18). Based on AROPE and other indicators⁴⁰, the main categories of people identified as being particularly at risk of social exclusion in BiH are: (i) elderly; (ii) children; (iii) youth; (iv) persons with disabilities; (v) refugees and internally displaced persons; (vi) Roma; and (vii) lesbian, gay and bisexual (LGBT) people.

Figure 2.18: People in BiH are at great risk of being socially excluded



Source: % individuals at-risk-of-poverty-or-social-exclusion, 2011 World Bank staff estimates based on BiH 2011 HBS dataset for BiH and Eurostat

Figure 2.19: Roma are most affected in BiH



Source: UNDP/WB/EC Regional Roma Survey 2011

³⁷ World Bank, 2010, Agricultural sector policy note for BiH, Trade and Integration Policy Note

³⁸ Željko Obradovic, 2015, Land Tenure and Land Consolidation Issues in post-War and post-Socialist Countries, Paper prepared for presentation at the "Annual World Bank Conference on Land and Poverty" The World Bank - Washington DC, March 23-27, 2015

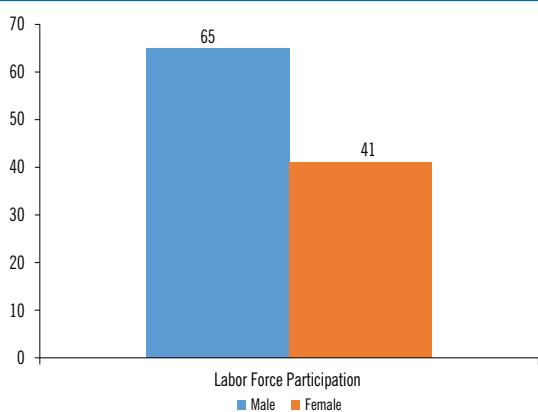
³⁹ The UNDP National Human Development Report (NHDR) for BiH, similarly finds, based on a different measure that half of the BiH population could be categorized as socially excluded. A stronger definition defined 22 percent as socially excluded based on a combination of living standards, health, education, participation in society and access to services. More details are available from: http://ec.europa.eu/eurostat/statistics-explained/index.php/People_at_risk_of_poverty_or_social_exclusion

⁴⁰ See the full list of Laeken indicators used: <http://www.poverty.org.uk/summary/eu.htm>

2.28 Roma groups are considered to be particularly at risk of exclusion based on both material and discrimination indicators. The absolute poverty rate is estimated to be around three times higher among the Roma than the general population, while malnutrition rates are eight times higher (Figure 2.19). Roma also have significantly lower literacy rates than their non-Roma counterparts (82 percent versus 97 percent) and are less likely to have medical insurance coverage than other people (70 percent versus 96 percent). Roma women are particularly disadvantaged, suffering from literacy rates as low as 70 percent (compared to 90 percent for males) and employment rates of 5 percent (compared to 32 percent for males) (see figures in Annex III.)

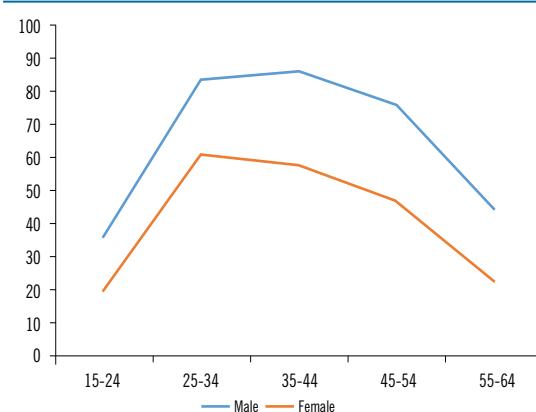
2.29 While women are not considered an AROPE group per se, gender issues remain relevant in some areas in BiH. For example, women are around a third less likely to participate in the labor force than men (Figure 2.20) and this is the case for all ages (Figure 2.21). Men tend to earn around 9 percent more than women (KM 3.9 per hour on average for men compared to KM 3.5 for women).⁴¹ A gender gap exists at most levels of education, age groups, occupations and industries. Controlling for observable characteristic differences between males and females reduces the wage gap by only around a quarter. Over 6 percentage points of the wage gap remains unexplained. In addition, women are much less likely to have a bank account at a formal financial institution (48 percent compared to 67 percent for men) and may find it difficult to access loans due to low property ownership rates, which reduces potential collateral (74 percent of dwelling properties are owned only by men, see Annex IX), potentially stifling female entrepreneurship. A recent survey finds that one in two women in BiH has experienced at least one form of violence starting at age 15.⁴² Analysis undertaken by the Copenhagen Consensus suggests that domestic violence may have significant economic costs due to increased health expenditure and lost days of work or study (Fearon and Hoeffler, 2014).⁴³

Figure 2.20: A large gender gap in employment ...



*Labor force participation, Males and Females;
Source: BiH Labor Force Survey 2013*

Figure 2.21: ... that exists for all age groups



*Labor force participation, Males and Females;
Source: BiH Labor Force Survey 2013*

⁴¹ See World Bank Gender Diagnostic for BiH (2015).

⁴² Estimate taken from forthcoming publication: World Bank, Agency for Statistics of BiH, FBiH Institute for Statistics and RS Institute for Statistics. 2015. "Bosnia and Herzegovina: Gender Disparities in Endowments, Access to Economic Opportunities and Agency." mimeo: Technical report, Poverty Global Practice, World Bank.

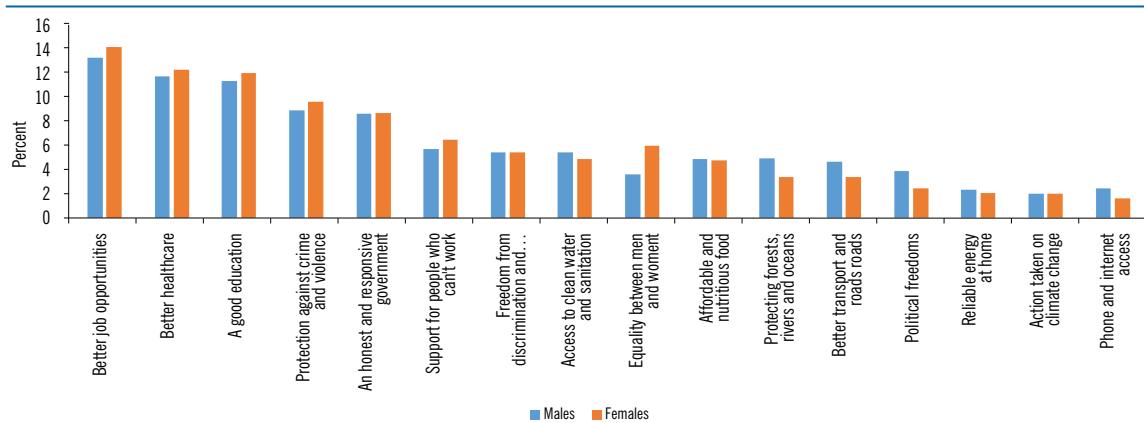
⁴³ See: http://www.copenhagenconsensus.com/sites/default/files/conflict_assessment_-_hoeffler_and_fearon_0.pdf

- 2.30 One of the main obstacles to gender development in BiH may be the persistence of traditional social norms about women's roles. A recent Gender Diagnostic found that Women's lives are sometimes governed by a patriarchal value system, the remnants of communism, and a state of post war transition, all of which limit their capacities and prospects.⁴⁴ Further, data on the impact of the Law on Gender Equality and the result of the introduction of various mechanisms on the status of women is limited⁴⁵ making it difficult to measure their impact and to make a case for areas requiring urgent attention.

Administrative inclusion, citizen engagement and trust in institutions

- 2.31 BiH citizens value increased employment opportunities highly. Surveys undertaken by international institutions provide insight into BiH citizens' priorities. The United Nations "Citizen Aspirations" survey and the Life in Transition Survey (LiTS) undertaken by the EBRD and WBG reveal that citizens value increased access to employment, and improved health and education (Figure 2.22 and Annex I). However, the LiTS indicated that respondents would need to pay more taxes or give up part of their income to finance the improvements. With the high tax burden (but low income tax base), it is unsurprising that fewer people in BiH indicated being prepared to do this than any other country in SEE apart from Albania. Both males and females indicated that *improved job opportunities* were their most important aspiration, with *better healthcare* and *a good education* also important. For both males and females *an honest and responsive government* was their fifth most important aspiration.

Figure 2.22: BiH citizens report better job opportunities as their top aspiration
% of respondents indicating aspirations in each area



Source: United Nations My World "Citizen Aspirations" survey, <http://data.myworld2015.org/> Accessed March 4, 2015

- 2.32 Citizens have good access to parliamentary procedures and BiH parliaments allow for extensive citizen engagement. BiH constitutions allow for citizens' access to parliament in person and parliamentary proceedings are broadcast/webcast. In addition, many laws demand significant public consultations. There is a consultative group established for Roma issues (although anecdotal evidence suggests that there is some concern regarding the

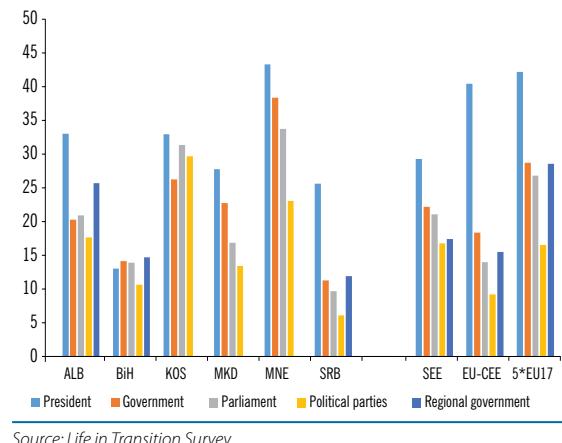
⁴⁴ CEDAW, 2010

⁴⁵ European Commission, 2013.

representativeness of this group). Women represented 20 percent of all parliamentarians. The extensive public consultations may allow for capture by special interest groups. For example, any efforts to make reforms that refocus social protection on the poor may suffer from coordinated interventions by current (non-poor) beneficiaries.

- 2.33 **Some elected posts are reserved for people of specific ethnicities.** One of the remaining key political issues is that BiH citizens are obliged to register as one of three “constituent peoples” to hold certain public positions. For example, the three-person Presidency is held by a Croat, a Serb and a Bosniak, according to the constitution. While any BiH citizen is able to declare themselves any one of these, a ruling by the European Court of Human Rights (known as ‘Sejdic-Finci’ after its plaintiffs) brought by Roma and Jewish citizens found that BiH should open all elected positions to citizens who do not belong to the three groups of constituent peoples.
- 2.34 **BiH citizens trust their institutions less than people in other countries.** BiH suffers from perceived widespread corruption (see Box 1.1) and firms identify “political instability” as their largest constraint to doing business (see Section 3.4). As a result, BiH citizens reported in 2011 having low trust in their presidents, governments, political parties, parliaments and regional governments (Figure 2.23). A recent survey suggests that fewer than a quarter of Bosnians have trust in their political parties or governments, making them the least trusted institutions in the country, and well below the trust won by the police or media.⁴⁶

Figure 2.23: BiH citizens have little trust in their institutions
% reporting “some” or “complete” trust in the following institutions



Source: Life in Transition Survey

2.6 The roadmap for ending poverty and creating shared prosperity

- 2.35 **BiH can end poverty and achieve shared prosperity in this generation.** For this to happen, the country needs to rebalance economically, socially and institutionally. High economic growth is critical for BiH to win its fight against poverty and become a high-income economy, especially as growth has been closely associated with poverty reduction in the past. However, BiH needs a number of complementary interventions so that everyone can successfully participate in society and in the economy. This includes protecting the environment and managing shocks, including from natural disasters.

⁴⁶ <http://pasos.org/12122/pasos-poll-citizens-of-six-balkan-countries-identify-political-parties-as-the-most-untrustworthy-institution-in-their-respective-countries/>

- 2.36 **The next three chapters will outline BiH’s main challenges and opportunities through which it can eliminate poverty and achieve shared prosperity.** Chapter 3 deepens the diagnostics on the drivers and constraints to inclusive growth and job creation. This includes the sources of growth and employment, and the infrastructure required to achieve shared prosperity. It sheds light on the bottlenecks that need to be removed to achieve economic and employment growth. While employment is a key path to ensuring inclusive growth, social policies also play an important role. Chapter 4 therefore analyzes some of the underlying requirements for inclusive shared prosperity and improving the quality of life for all, including education and health improvements. This chapter also analyzes the significance of exclusion and vulnerability, especially of rural dwellers, females and Roma. Chapter 5 notes that BiH faces risks from a number of shocks, which could set back the quest for shared prosperity on both a national level and an individual level. In particular, recent floods and other extreme weather conditions have revealed BiH’s vulnerability to climactic shocks, which harmed economic growth and hit some families and businesses (notably in agriculture) particularly hard. Chapter 6 reports priority reform areas for poverty reduction and shared prosperity, noting that both poor and vulnerable households would tend to benefit from similar reforms to the non-poor, and firms face similar challenges in all sectors.
- 2.37 **Restoring growth and creating jobs is the most direct and effective pathway out of poverty in BiH.** This will require actions on a number of fronts. A key area is the *relationship between the public and private sector* and their relative shares in the economy. A public sector that absorbs a smaller share of GDP would help to reduce the current high tax burden that stifles firms and individuals, and the structure of tax disfavors production (taxes are discussed in more detail in section 3.2). Another challenge are efficient *labor markets* that encourage both labor supply and hiring, including: (i) addressing the issue of high labor taxes—particularly for low-earners—which have pushed many B40 into the informal labor market, reduced their take-home pay, or prevented the creation of jobs they would otherwise have had access to; (ii) improving job matching and skills training, the latter based on evidence of employers’ skills requirements; (iii) reducing the share of output absorbed by wages by allowing more flexible contracts and increasing productivity. Labor market issues are discussed in more detail in section 3.7. *Social welfare*, while beneficial to the B40 pre- and especially post-crisis, remains poorly targeted with wealthiest quintile also receiving significant amounts of social assistance. The poor and B40 could therefore, have performed better with a more streamlined social welfare program. Social protection issues are discussed in more detail in sections 3.2 and 3.7. Another key area is a *better investment climate*, which would help to boost employment, entrepreneurship, output and productivity. Currently BiH suffers from the worst business environment in Europe, with some key areas for entrepreneurship and SMEs in general—such as paying taxes, construction permits and property registration—in particularly poor shape. Alignment with EU standards to allow firms to grow and export would also help to generate employment. Business environment issues are discussed in more detail in section 3.4. Also important for improving private sector prospects is the provision of sufficient *infrastructure* over the medium to long term. This includes ensuring energy supply remains sustained and roads are improved. Infrastructure is discussed in more detail in section 3.6.

- 2.38 **Promoting social inclusion is key to shared prosperity.** By some measures, up to half of the BiH population are at risk of social exclusion. Some potentially at-risk groups include rural dwellers, females, youth, Roma, and younger war veterans. By-and-large, these groups face similar challenges to those of the rest of the population. This includes employment (section 3.7), business environment (section 3.4), corruption (Box 1.1), and poor public services. This suggests that tackling the challenges noted above will benefit socially excluded groups. For example, rural dwellers would benefit from job creation, including in towns and cities. All groups would also likely benefit from economic growth. Some groups also face some specific issues. This includes higher poverty among children (i.e. in households with more children) and very low rates of early childhood education, especially in rural areas. Improved access to *early childhood education and childhood care*—particularly in rural areas (section 2.4)—would help both to break a cycle of inter-generational poverty (especially important since families with more children and lower educational levels are more likely to be poor) and provide increased childcare that could allow more females to seek employment. Education is discussed in more detail in section 4.2. Together, this presents a very real risk of inter-generational poverty transfer.
- 2.39 **Managing risks for sustainable growth is critical.** BiH faces significant risks to sustainable and inclusive growth from several factors, many outside of the control of governments. In particular natural disasters, including climactic shocks, have hit BiH hard over the last decade with harsh winters and floods hitting growth in most sectors of the economy (environmental risks are discussed in section 5.1). Pollution in urban areas also harms health and quality of life (health is discussed in section 4.1). BiH is also vulnerable to external economic and financial shocks, as demonstrated by its growth slow-down (from which it has yet to recover) during the global financial crisis. The BiH economy is already intertwined with that of the EU through trade, remittances and other financial flows. Finally, BiH is vulnerable to social shocks, as shown by demonstrations in 2014 (social risks are discussed in section 5.2). Reforms that promote more inclusive growth may face resistance by insiders who benefit from a status quo that doesn't always benefit the wider population. At the same time, a lack of reforms could also result in social unrest as 'outsiders' claim greater rights. Navigating needed reforms will therefore not be easy and will require good communication and designing 'reform packages' from which the population as a whole benefits.

CHAPTER THREE

RESTORING GROWTH AND CREATING JOBS

Over the last 20 years, BiH has had three distinct economic periods. After the end of the war, the economy rebounded strongly, driven by exceptionally high foreign aid and remittances (1996-1999). In a second period from 2000-2007, the economy grew moderately at an average of 5 percent per year until 2007 when the global financial crisis unfolded. Since the end of the war, remittances and aid played a critical role in the recovery, fueling a consumption-driven economy, with consumption at over 100 percent of GDP and non-tradables contributing two thirds to economic growth. Since 2008 the economy has stalled with average growth rates of below 1 percent.

BiH has maintained macroeconomic stability with relatively low inflation; public debt stayed at a reasonably low level until the crisis—reaching just 19 percent of GDP in 2007, but has more than doubled since then. BiH governments have a strong track record in raising revenue, especially VAT, which helps to maintain low fiscal deficits. At the same time, BiH is over-taxing its citizens and pushing them and the firms they work for into the gray economy. Labor taxes hit the B40 especially hard both directly and through increased unemployment. Public expenditures are also high, at close to 50 percent of GDP, and are focused on current items. BiH has the largest public sector wage bill in the region but citizens don't enjoy corresponding high quality public services.

Today, BiH is an economy out of balance that needs to look at new sources of growth. Economically, there are three main imbalances. First, the public sector dominates the economic landscape, controlling half of the economy (not including SOEs) to the detriment of the private sector. Second, consumption is at record levels (above 100 percent of GDP), while investment rates are low. Third, exports are hindered by BiH's exceptionally poor business environment, and are among the lowest in Europe (at 32 percent), while high levels of imports are creating a significant current account deficit, which is being financed by external flows, especially remittances.

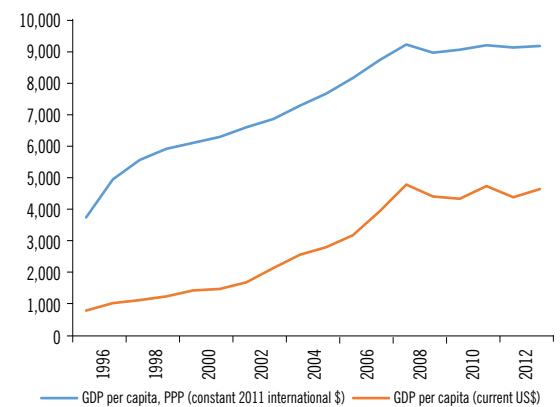
Poverty and labor market outcomes are closely linked but jobs are scarce, with only 27 out of every 100 people employed, and half of those work either in the public or informal sectors. Over half of the working age population has dropped out of the labor market altogether. Female employment is low, particularly in the B40, and accounts for some of the differences between B40 and T60 households. Output per worker is low but comparable to some other countries in the region; however, the few employed people need to support a large number of others. Two thirds of the output per worker is absorbed by labor costs, and the minimum wage as a share of output per worker is very high, leaving little room for investment or risk-taking. Rigid labor market rules make it difficult for employers to hire people, and they think twice before doing so, as making redundancies is so difficult. Social benefits are costly, reach the rich as much as the poor, crowd out expenditure on Active Labor Market Policies (ALMPs), including training, and discourage work. Employment services are overwhelmed by people who are more concerned with obtaining health insurance than employment.

3.1 Economic performance

Historical Growth Performance

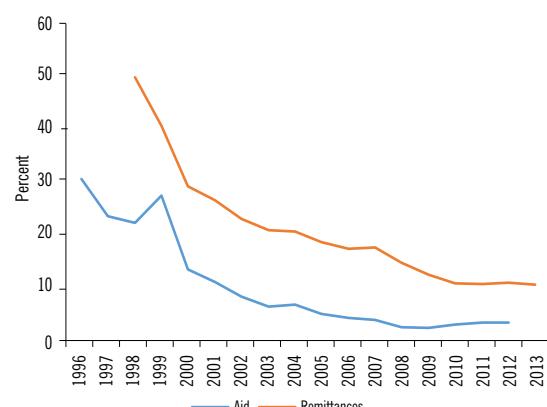
- 3.1 BiH was one of the poorer republics in the former Yugoslavia and, by some measures, was the hardest hit country following the break-up of Yugoslavia. Estimates place BiH GDP at \$1,713 per capita in 1990 compared to an average of \$3,549 in Yugoslavia as a whole. The notable exception is Sarajevo, which had a GDP per capita a third above the Yugoslav average. By the end of the war an estimated 1 million people had left the country and 60 percent of those who remained were internally displaced. Output declined by an estimated 79 percent between 1989 and 1995 as a result of the cumulative effects of war and the break-up of Yugoslavia, significantly higher than in other former Yugoslav republics.
- 3.2 The “peace dividend” allowed BiH to enjoy an economic rebound during the three years after the Dayton Accords were signed. Between 1996 and 1999, GDP per capita grew by close to 60 percent or an average of 16.5 percent per year (see Annex XII). Overseas Development Aid (ODA), averaged 26 percent of GDP per year between 1996 and 1999 but dropping considerably in the following years, and remittances were instrumental in supporting the economy, with the latter estimated at over 10 percent of GDP, even in 2014.
- 3.3 Growth slowed considerably after 2000 and was on par with the SEE region. Economic growth per capita slowed to an annual average of 5.1 percent between 2000 and 2008, around the SEE average of 5.0 percent (Figure 3.1). With faster growth over the period, BiH narrowed the gap with EU-CEE and EU17 countries. Per capita GDP increased from 42 to 44 percent in EU-CEE (and from 19 to 25 percent in EU17), though this could be considered slow convergence given BiH’s low starting point (Figure 3.2).

Figure 3.1: BiH's strong recovery after the war ...



Source: WDI, 2014

Figure 3.2: ... fueled by remittances and aid which have declined since the late 1990s



2014 Overseas Development Aid and Remittances, % GDP

Source: WDI, 2014

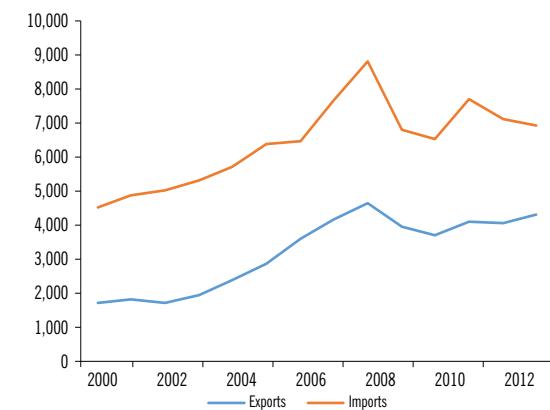
3.4 Until 2008, BiH broadly achieved macroeconomic and fiscal stability. Positive and broadly stable economic growth was achieved in the years between the post-war recovery and the global financial crisis (2000-08). A currency board, first with the Deutsche Mark and then Euro helped to ensure monetary stability. Inflation averaged 2.4 percent between 2001 and 2008 and has remained low (even negative) since then. Headline fiscal numbers were decent over the period, with modest deficits or surpluses. The establishment of the Indirect Tax Authority (ITA) in 2004 helped BiH generate some of the world's highest public revenues as a share of GDP. Public debt remained at moderate levels, reaching a low of 19 percent of GDP in 2007 before increasing during the crisis. The financial system provided private sector credit that grew at more than 25 percent per year, helping to boost the private sector. Exports increased from 26 percent of GDP in 2000 to a high of 36 percent in 2006 before falling back somewhat. Partly as a result of the stable macroeconomic performance, unemployment fell between 2006 and 2008 from 31 to 23 percent. The close link between employment, poverty and the performance of the B40 was reflected in notable improvements in the consumption of the B40, which saw greater growth than the average population between 2004 and 2007.

The Impact of the Financial Crisis

3.5 The global financial crisis, which began in late 2008, affected all parts of the BiH economy. Exports and imports both fell (Figure 3.3). BiH's metals (especially steel and aluminum) and commodities industries were particularly hit as global commodity prices and exports fell. The two biggest metal exporters, Zenica's Arcelor Mittal Steelworks and Mostar's Aluminij plant, announced large cuts in production because of falling prices and demand. With base metals accounting for some 27 percent of exports, BiH's economy experienced a major blow.

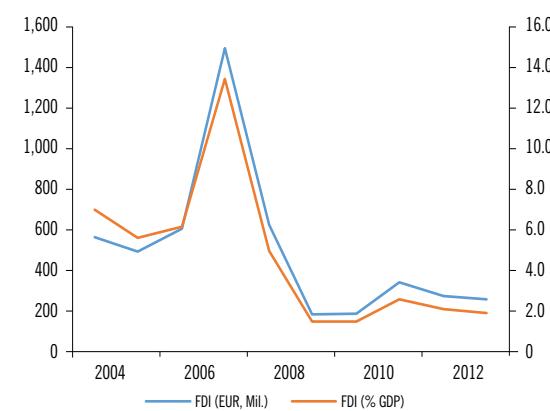
3.6 The inflow of FDI, fell to less than 2 percent of GDP during the crisis and has failed to recover since. In 2007 BiH received the highest FDI inflow over the preceding 20 years, mainly due to privatization of some large state-owned enterprises (Figure 3.4). In 2009 FDI dropped to its lowest level—less than 2 percent of GDP—due to the global financial crisis. Since BiH operates a currency board with the Euro as its anchor,

Figure 3.3: Both imports and exports fell (€, Mil.) ...



Source: WEO, IMF

Figure 3.4: ...FDI dropped to its lowest level...



Source: WEO, IMF

little monetary adjustment was possible, and money supply and credit growth both slowed considerably (Figure 3.5).

3.7 Unemployment increased and remittances fell, affecting especially the poor and B40.

After falling from 31 percent in 2006 to 23 percent in 2008, unemployment expanded again to 27 percent in 2010 and crept up further in following years (see Appendix XII). While remittances can have a counter-cyclical element, they can also be driven by (pro-cyclical) investment motivations and earnings in countries that host migrants.

With EU countries suffering, remittances

declined from 15 percent of GDP in 2008 to around 11 percent in 2013. The poor were particularly affected, given their greater reliance on remittances.

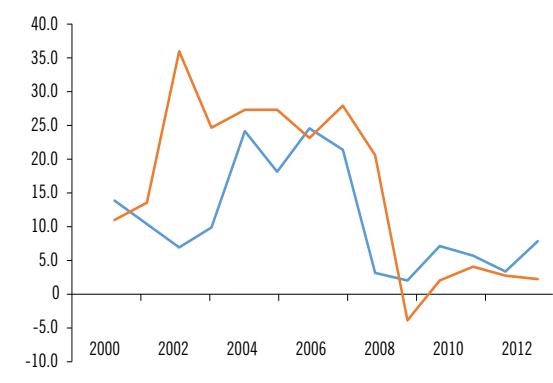
3.8 The crisis saw BiH reverse some of its previous gains and revealed BiH's underlying structural weaknesses of the pre-crisis model.

Growth averaged just 0.3 percent per year in BiH between 2008 and 2013. Along with much of the region, the country suffered from a “double dip” recession with negative growth in 2009 and 2012 of -2.7 and -1.2 percent, respectively. With average per capita growth rates of 0.7 percent in SEE and 0.8 percent in EU-CEE, GDP growth in BiH fell behind other countries in the region. Structural weaknesses were revealed, which favor consumption over investment, hinder firm growth and employment creation, make it difficult to export, and discourage job-seeking. Rigid labor market laws, high taxes—particularly on labor, a poor business climate, and poor transport infrastructure all made it difficult for firms to adapt during the crisis, and likely held back growth and employment prior to it.

3.9 Headline fiscal performance was reasonable in the pre-crisis growth period but that performance disguised unsustainable elements of the system and deep inefficiencies.

The average fiscal deficit was 0.6 percent of GDP between 2002 and 2008, the lowest in SEE except for Kosovo. In addition, the fiscal balance tended to be positive in the years of fast economic growth, making the fiscal policy somewhat counter-cyclical. With revenues averaging 46.5 percent of GDP between 2000 and 2013, not many countries in the world, can display a better performance in generating public sector resources. VAT productivity is the highest in SEE. Public debt was maintained at moderate levels between 2000 and 2008 and even reached as low as 19 percent of GDP in 2007. However, evidence suggests that the excessive tax burden may have pushed firms and citizens into the informal economy. In 2013, two thirds of gross value-added per worker was absorbed by wages and labor taxes (including SSC), leaving little room for investment or risk-taking. Public expenditure is also inefficient, with its over-focus on wages and transfers. Transfers are poorly targeted, with the wealthiest quintile benefitting almost as much as the poorest. Fragmented public

Figure 3.5: ...and money and credit growth slowed significantly

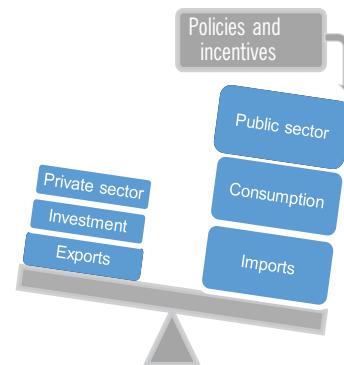


Source: WEO, IMF

institutions, including the ministries of health also result in inefficiencies. Despite high revenues, BiH needed to raise significant resources to finance fiscal deficits during the crisis, so that public debt increased to 44 percent of GDP by 2012.

- 3.10 Weaknesses were revealed in the financial sector, which performed reasonably well pre-2008.** While credit growth to the private sector helped to finance economic activity between 2000 and 2008, the crisis revealed similar weaknesses to the rest of Europe. Non-performing loans reached over 15 percent in 2014, up from less than 6 percent in 2009. A small non-banking financial sector also displayed weaknesses in expanding insurance markets to protect firms and homeowners against natural disasters that have hit BiH over the last five years. BiH is subject to Moneyval's Compliance Enhancing Procedures due to weaknesses in their anti-money-laundering and countering terrorist financing system, which is not fully in compliance with the international standards. Failure to enhance due diligence measures would put international financial connectivity at risk, and significant progress would be particularly important in a country where remittances plus foreign wages account for close to 15 percent of GDP. Although the banking system—dominated by foreign banks—appears broadly sound, significant pockets of vulnerability exist among banks. A number of smaller banks are struggling to meet capital requirements, with some facing high concentration risks and heavy reliance on public sector support. Moreover, significant deficiencies remain in the financial safety net, including with respect to resolution powers, institutional responsibility for resolution, and resolution funding.
- 3.11 Given the country's significant structural weaknesses, BiH's macro-fiscal stability will depend on a more sustainable economic model.** Weaknesses in the business climate, labor markets, fiscal revenue structures and levels, fiscal expenditure efficiency, financial regulation and breadth, as well as an economic growth model focused on domestic consumption rather than investment or tradable production mean BiH's economic stability could be placed in jeopardy. While BiH's economy is not broken, it could be seen as "out of balance", with some areas overly prominent compared to their sustainable levels, and others less prominent (Figure 3.6). Addressing the major structural weaknesses will be key to ensuring continued macro-fiscal-financial stability.

Figure 3.6: Current model: Economy out of balance



Source: BiH SCD team

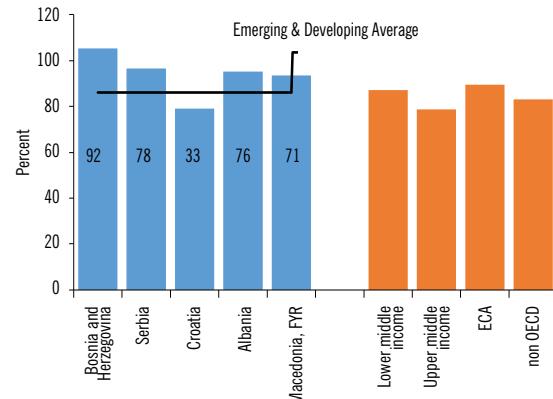
Drivers of economic growth

3.12 BiH has a strongly consumption-driven economy. With consumption averaging 105.4 percent of GDP between 2010 and 2013 and even higher before the crisis⁴⁷, BiH is one of the most consumption-driven economies in the world (Figure 3.7). Only eight other economies had higher consumption as a share of GDP over the same period.⁴⁸ Even in a region characterized by high consumption, BiH citizens consume more as a share of GDP than Albania, Croatia or Serbia and significantly above the ECA average of 89 percent. Remittances combined with a large public sector, which favors spending on wages and transfers over investments, support the consumption-driven economic model.

3.13 Even during the crisis, consumption stayed persistently high although the crisis altered GDP composition in other ways. Government consumption remained at 20-22 percent of GDP and household consumption at 81-83 percent of GDP. Exports increased from 25 to 30 percent of GDP between 2008 and 2013. Imports showed more variability, reaching a high of 57 percent of GDP in 2008 - at the height of the boom - and a low of 46 percent of GDP as the economy collapsed in 2009 (Figure 3.8).

3.14 The crisis hit investment hard and it has not yet recovered. A concerning long-term trend is the declining importance of Gross Fixed Capital Formation (GFCF), which fell from 26 percent of GDP in 2008 to 19 percent in 2009, as investment was cut due to the crisis. It never recovered from the fall and indeed, fell further, reaching 17 percent of GDP in 2013. While all forms of GFCF were hit (Figure 3.9), investment in machinery and equipment fell fastest and has not recovered since. This bodes poorly for future industrial output in BiH. Investment was lower than in other SEE or EU-CEE countries in 2013.

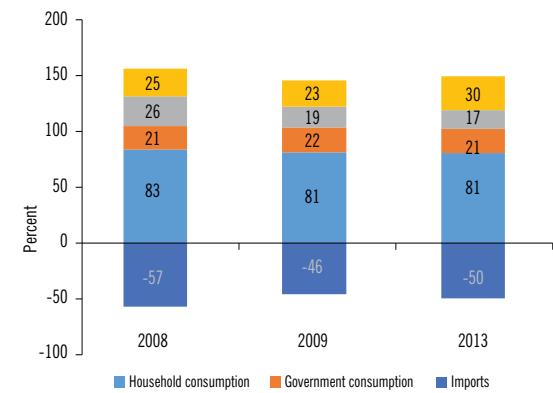
Figure 3.7: BiH: A Consumption-based economy
Consumption, % of GDP, 2011-13 average



Source: IMF World Economic Outlook

Note: percentages shown inside country columns are the percentile ranking of each country within Emerging & Developing countries

Figure 3.8: Consumption stayed high despite crisis...



Sources: BiH Agency for Statistics and staff estimations

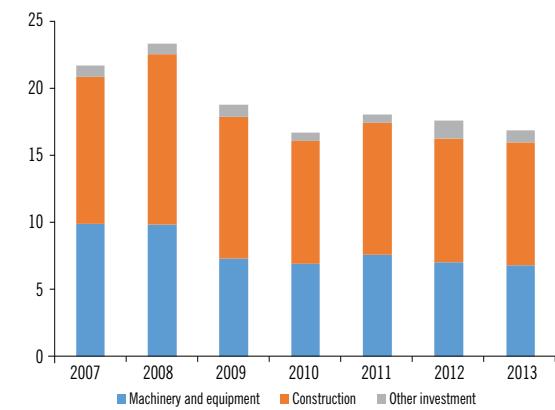
⁴⁷ Consumption averaged 114.7 percent of GDP between 2000 and 2007.

⁴⁸ They are Afghanistan, Burundi, Comoros, Haiti, Guyana, Kyrgyz Republic, Lesotho, and Tajikistan.

3.15 Although annual economic growth was much lower in the crisis period, the patterns of growth remained largely unchanged and were likely to have benefited the B40 in particular. Manufacturing and wholesale/retail continued to be the main drivers of growth between 2009 and 2013, with the former buoyed by exports in 2013 in particular. Despite this, the global financial crisis does not appear to have changed the overall “growth model” in BiH. These drivers of growth are likely to have benefited the B40 in particular. For example, agriculture, in which the poor and B40 are more likely to work, contributed significantly to growth.

3.15 Construction drove growth before the crisis but contributed negatively after the crisis, while the most significant structural change after the crisis is the increased importance of the public sector. Between 2001 and 2008, construction activities contributed 7.6 percent to total economic growth but displayed a significant negative contribution of—15.4 percent of GDP after the crisis. The public sector, however has significantly gained importance, contributing 27 percent to the total growth over the period compared to 14 percent over 2001–08.

Figure 3.9: ...but investment declined without recovering since

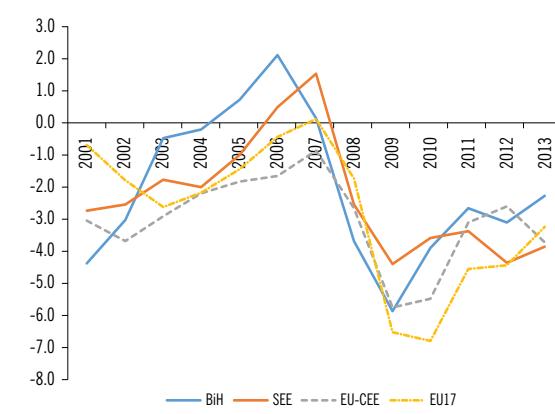


Notes: GFCF, % GDP

Sources: BiH Agency for Statistics and staff estimations

Figure 3.10: Approximately counter-cyclical fiscal policies in BiH

Fiscal balance, % GDP



Source: WEO IMF

3.2 Fiscal position

- 3.16 Fiscal performance has been mixed.** On the positive side are: sustainable fiscal balances (Figure 3.10), sustainable (though fast growing) public debt, broadly counter-cyclical fiscal policy, and effective revenue collection. On the negative side are: fast increasing debt and debt service, high taxation, and expenditure patterns that could do significantly more to promote growth, shared prosperity and promote public services.
- 3.17 Fiscal deficits during the 2000s were contained, allowing BiH to run deficits during the crisis.** BiH succeeded in maintaining either fiscal surpluses or deficits below 0.5 percent of GDP in every year between 2003 and 2007. While many other European countries ran pro-cyclical fiscal policies. With deficits despite positive economic growth, BiH achieved increasing surpluses as growth speeded up. The surpluses turned to deficit during the crisis,

bottoming out at 5.8 percent of GDP in 2009, the height of the crisis when the BiH economy shrunk by 2.7 percent. This represents a good example of a counter-cyclical fiscal policy. It could be that BiH's institutional arrangements—which help to contain debt and ensure broad agreement on the fiscal stance across different levels of government—helped the country to generate fiscal surpluses and broadly contained deficits during the crisis.

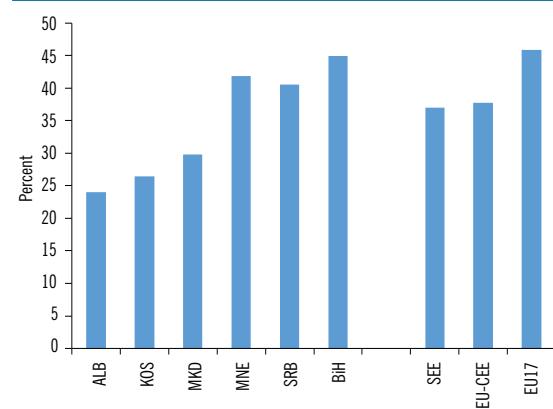
- 3.18 The fiscal stance has promoted redistribution but not always to poorer groups, and not always generating incentives to work or invest.** High taxation—particularly on the private sector and on labor—results in redistribution from formal private sector employees to (often inefficient) public sector employees. There is also re-distribution from able-bodied workers to the dependent population via pensions and categorical safety nets. Finally, there is redistribution from the less well-off to the better-off through high labor taxation among less well paid workers and poorly targeted safety nets. These issues are discussed in more depth below.

Taxes and revenue

- 3.19 BiH's revenue performance is almost too good.** BiH collected revenue worth 45 percent of GDP in 2013 (Figure 3.11), well above the SEE average of 37 percent or the EU-CEE average of 38 percent. Indeed, as a share of GDP, BiH's revenue collection out-performed the EU17 average every year between 2001 and 2012, averaging 46 percent of GDP compared with the EU17's average of 44 percent. Recent analysis of tax potential, tax gaps and tax space (Khwaja and Iyer, 2013⁴⁹) suggests that BiH has among the lowest difference between its legal and economic tax potential. That is, BiH's tax rates are close to the rate its economy can support without prejudicing economic growth.⁵⁰ While this is a nice problem to have, it does have consequences.

- 3.20 Value Added Tax (VAT) collection is very efficient.** Indirect taxes—in BiH's case, VAT—made up 41 percent of total revenue in 2013. VAT productivity (tax revenues as a percent of the tax base divided by the standard tax rate) was the highest in SEE at 89 percent in 2012 compared to a regional average of 73 percent. Other taxes, notably personal income tax, perform more poorly. With consumption at an unsustainable level of over 100 percent of GDP, VAT may be an efficient way of raising public resources.

Figure 3.11: BiH: One of the world's best collectors of revenue
Revenue, % GDP 2013



Source: IMF WEO, April 2014

⁴⁹ See: <https://openknowledge.worldbank.org/handle/10986/18806>

⁵⁰ 'Tax effort' is defined as the ratio between the actual revenue collected and the revenue potential of an economy. The difference between the revenue potential (legal) and the actual revenue collected is commonly understood as the "tax gap". The difference between the revenue potential (economic) and the actual revenue collected can be termed the "tax space", i.e., the amount of revenue that a country can afford to collect, given its inherent economic strength, not based on what the parliament has mandated. The difference between the tax gap and the tax space—called "difference".

3.21 BiH may be over-taxing its firms and citizens. For the period 2000-10, Khwaja and Iyer (2013) found that BiH's revenue collections are estimated to have been around 6.3 percent higher than the economic potential of the country, highlighting the possibility that high taxes have prejudiced economic growth. In the world only a small group of countries have higher revenue as a share of GDP than BiH. These are a handful of wealthy western European countries; oil-dependent countries or small island states largely reliant on donor financing.⁵¹

3.22 Social security rates are particularly high, likely harming (formal) employment, and the B40. While rates of VAT, Corporate Income Tax (CIT) and Personal Income Tax (PIT) are in line with other countries in the region (Table 3.1), social security contributions are the highest in SEE (Table 3.2). Social security rates amount to 33 percent of gross wages in RS and 41.5 percent in FBiH.⁵² The high contribution rates are likely to be particularly biting for low earners, and may encourage many to prefer the informal sector (with consequences for tax collection). If the high rates harm employment creation, the B40 will take a double hit: first from reduced access to labor markets and second from high taxes.

3.23 The PIT threshold makes a minimal contribution to supporting low income earners and creating a minimally progressive tax system. Workers earning €100 per month have a tax wedge—the difference between the cost to the employer and their take-home pay - of 33 percent in RS and 38 percent in FBiH (Figure 3.12).⁵³ The tax wedge increases after workers earn above the thresholds of €102 (in RS) and €153 (in FBiH). For example, workers earning €1,000 per month face a tax wedge of 38 percent in RS and 41 percent in FBiH, and

Table 3.1: While VAT, CIT and PIT tax rates are consistent with the region...

	VAT rate	CIT rate	PIT	PIT Threshold, € per month
ALB*	20%	15%	13-23%	214
BiH				
FBiH	17%	10%	10%	153
RS	17%	10%	10%	102
KOS	16%	10%	4-10%	80
MKD	18%	10%	10%	118
MNE	19%	9%	9%	0
SRB**	20%	15%	10-15%	226

Source: Deloitte; KPMG; Ernst & Young; PWC; Eurofast

Notes: *23% PIT rate applies to income over €927 per month; **15% PIT rate applies to income over 9 times the average salary. The threshold is 40% of average salary. In FBiH the employer also pays 0.5% of contribution for protection from natural and other disasters as well as 0.5% of the water protection charge, calculated on net salary. In the RS, employers and employees each temporarily contribute an additional 1.5% for recovery following the 2014 floods. A proposed law in the RS reduces SSC by 1.4pp. In MNE, the employer pays an additional 0.2% to the Work Fund, 0.27% to the Chamber of Commerce (CoC) and 0.2% to labor unions. Serbian firms also pay at rates to local CoC or municipalities ranging between 0.19% and 0.35%.

Table 3.2: ...social security contributions are the highest in SEE (2013)

	VAT rate	CIT rate	PIT
ALB	11.2%	16.7%	2.1%
BiH			15.5%
FBiH	10.5%	31.0%	
RS	33.0%	0.0%	
KOS	5.0%	5.0%	0.6%
MKD	27.0%	0.0%	8.0%
MNE	24.0%	9.8%	10.9%
SRB	17.9%	17.9%	11.5%

Source: Deloitte; KPMG; Ernst & Young; PWC; Eurofast

⁵¹ An exception is Lesotho, which could be considered a small island state dependent on Southern African Customs Union (SACU) resources, most of which are not the result of imports consumed in Lesotho.

⁵² The FBiH law is available from: <http://www.pufbih.ba/sr/propisi/zakoni/zakon-o-porezu-na-dohodak/item/27-zakon-o-porezu-na-dohodak> and summary statistics on both Entities available from: <http://www.investsrpska.net/index.aspx?PageID=363&menuID=302>.

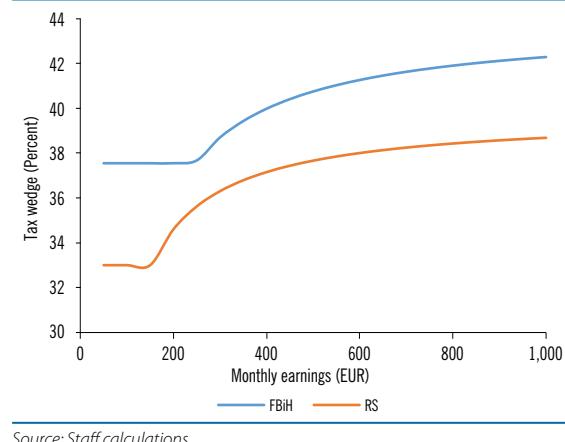
⁵³ Assuming they have no dependents.

higher if disaster insurance (in FBiH) and temporary post-flood solidarity payments are included (in RS). Palermo and Arias (2014) estimated that tax wedges in BiH were among the highest in the ECA region in 2011, with only five countries having higher tax wedges.⁵⁴

- 3.24 Despite the minimally progressive tax system the high SSC mean that even low-income earners are paying high taxes, with negative impacts for the B40.** A tax wedge of even 33 percent is high for low income earners. As noted above, this may discourage formal employment and make it difficult for poorer individuals to access the formal labor market. With unemployment being a key determinant of poverty and being in the B40 (see section 2), finding ways to encourage low-earners into (formal) employment will be important. Reducing the tax wedge is likely to be one part of the solution.

Figure 3.12: Higher earners face only slightly higher tax wedges

Tax wedge, % cost to employer, €



Source: Staff calculations

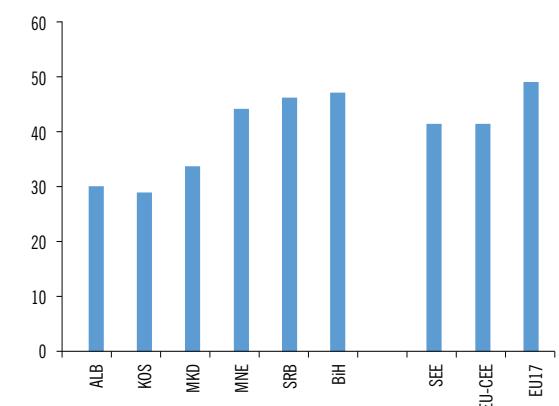
Public expenditures

- 3.25 Public expenditure makes up a higher share of GDP than in most other European countries, or even the world.**

Between 2001 and 2013 BiH averaged public expenditures of 48 percent, higher than any country in SEE or EU-CEE, except Hungary, and even higher than the EU17 average⁵⁵ over the period. Indeed, BiH's public expenditure as a share of GDP has averaged higher than ten EU17 countries⁵⁶ and been consistently high since 2001. With such high public spending, the public sector becomes instrumental in supporting economic growth and shared prosperity (Figure 3.13).

Figure 3.13: BiH: Expenditure higher than SEE and EU-CEE averages

Expenditure, % GDP 2013



Source: IMF WEO, April 2014

⁵⁴ These are: Romania, Slovenia, Hungary, Czech Republic, and Latvia. See: <http://www.worldbank.org/content/dam/Worldbank/document/Back-to-Work-Full.pdf>

⁵⁵ Hungary's average public expenditure as a share of GDP between 2001 and 2013 was 50 percent while the EU17 average was 47.4 percent.

⁵⁶ The seven EU17 countries with higher public expenditure than BiH as a share of GDP between 2001 and 2013 are: Austria; Belgium; Denmark; Finland; France; Italy; and Sweden.

3.26 Public expenditures have been concentrated on current spending including public wages, pensions and social transfers. BiH spent around 12.9 percent of GDP on compensating public sector employees in 2012, over 3 percentage points higher than the SEE average of 9.7 percent (Table 3.3). This results partly from wage increases prior to the economic crisis and may also be influenced by the number of layers of government (see Box 3.1 for details of sub-national expenditure patterns). With an estimated 180,000 public employees, around one in twenty Bosnians is employed by the public sector. While this is high, it is similar in Croatia and lower than in Serbia (where an estimated one in fourteen is employed by the public sector). Low private sector employment however means that in BiH, around a third of employees are employed by the public sector. In addition, evidence suggests that BiH does not enjoy a high level of public services despite its high wage expenditures. With few of the B40 in public sector employment, they are unlikely to benefit significantly from this public expenditure. As with wages, spending on goods and services is also the highest in SEE as a share of GDP. This stems partly from inefficient spending as a result of the fragmentation of government, for example, unnecessarily duplicated spending on some healthcare in different cantons or lack of reference pricing in pharmaceuticals or joint procurement. High social security revenues are matched with high social security spending and, in SEE, only Serbia spends more on social benefits, which are often poorly targeted (see below).

Table 3.3: BiH: Current spending including public wages, pensions and social transfers dominate share of expenditure
2012, % GDP

	ALB	BiH	KOS	MKD	MNE	SRB
Compensation of Employees	5.1	12.9	8.4	7.5	12.6	11.4
Goods and Services	2.3	10.4	3.9	4.5	6.9	8.7
Interest	3.0	0.9	0.2	0.9	1.8	2.1
Subsidies	0.1	1.6	1.9	2.2	0.8	4.4
Grants	0.0	0.0	0.0	0.0	3.1	0.0
Social Security	6.6	10.6	0.6	8.9	13.3	14.4
Other Social Benefits	2.2	3.8	3.3	5.6	0.0	5.3
Other Expenses	4.4	2.2	0.0	0.5	0.8	0.3
Capital Expenditure	3.7	6.3	11.3	5.3	3.6	3.6

Source: Ministries of Finance and staff calculations

3.27 Pensions account for most social security spending but there are sustainability problems.

Spending on pensions was estimated at around 9.4 percent of GDP in FBiH and 10.2 percent of GDP in RS in 2009 (World Bank, 2012)⁵⁷, higher even than many “older” and wealthier countries like Sweden and Japan. Each contributor supported 0.73 pensioners in FBiH and 0.76 in RS, with only Italy and France having higher dependency ratios in Europe. The low formal labor market participation rates (ironically exacerbated by the high social contributions) are partly responsible. The high spending on pensions is partly the result of large number of people receiving disability pensions pre-retirement age. Working age

⁵⁷ 2012 PER.

pensioners (younger than 65) are 33 percent of the total in FBiH and 42 percent of the total in RS. But, while many working-aged people are receiving pensions, as many as 39 percent of the elderly may not be collecting any state pension, despite the fact that the elderly have lower poverty rates than many other groups. See section 3.7 for more details of social welfare expenditures, including targeting.

Box 3.1: Sub-National Public Expenditures

Fiscal responsibilities are highly fragmented in BiH. Almost all responsibilities are at the level of the Entity. This includes areas such as transport, health, education, social benefits including contributory ones. The FBiH further devolves responsibility for health and education to its cantons. As a result most spending is decentralized. In 2013, total public expenditures was worth 47.1 percent of GDP. Of this, the State was responsible for 7.3 percent (3.4 percent of national GDP), FBiH, with around two thirds of the population, 59.1 percent (27.8 percent of national GDP), RS, with around one third of the population, spent 31.6 percent (14.9 percent of national GDP), and Brcko District, with 2.5 percent of the population, spent 2.1 percent (0.9 percent of GDP) (Table 3.4). Within FBiH public spending is also highly decentralized. In FBiH, the central government was responsible for just 21.5 percent of total public spending in 2013. The remaining 78.5 percent was spent by the ten cantons (themselves subdivided into 79 municipalities), and 35 extra budgetary funds (one pension, 11 employment, 11 health, 11 road and one motorway).

Public spending in RS, is somewhat less fragmented. The central government was responsible for 44.7 percent of expenditures in 2013. Six extra-budgetary funds (pension, employment, health, child, road, motorway) and 63 municipalities were responsible for the remainder. An additional—off-budgetary—fund was created following the floods in May 2014 to pay for reconstruction. It is financed by a 3 percent tax on gross pay.

Table 3.4: Public Expenditures,
% GDP, 2013

	Total	Institutions of BiH	FBiH			RS			Other	Brcko
			Total	Central	Other	Total	Central			
Expense	40.7	3.2	23.7	5.1	18.6	12.9	5.8	7.1	0.9	
Compensation of Employees	12.2	2.4	6.1	0.9	5.2	3.4	2.6	0.8	0.3	
Goods and Services	10.4	0.7	5.8	0.3	5.5	3.6	0.6	3.0	0.3	
Social Benefits	14.3	0.0	9.4	1.7	7.7	4.7	0.9	3.8	0.1	
Interest	0.7	0.0	0.4	0.3	0.1	0.4	0.2	0.1	0.0	
Subsidies	1.4	0.0	0.9	0.5	0.4	0.5	0.4	0.0	0.1	
Transfers to other Gov't Units	0.1	0.0	0.0	1.2	-1.2	0.0	0.9	-0.9	0.0	
Other Expenses	1.7	0.1	1.1	0.2	0.9	0.3	0.1	0.2	0.1	
Net Acquisition of Non-Financial Assets	6.4	0.2	4.1	2.5	1.6	1.9	1.0	1.0	0.1	
Acquisition of Non-Financial Assets	6.5	0.2	4.2	2.5	1.6	2.0	1.0	1.0	0.1	
Foreign Finance Capital Spending	4.2	0.0	2.9	2.5	0.4	1.3	0.8	0.5	0.0	
Domestically Financed Capital Spending	2.3	0.2	1.3	0.0	1.2	0.8	0.2	0.6	0.1	
Disposal of Non-Financial Assets	0.1	0.0	0.0	0.0	0.0	0.1	0.0	0.1	0.0	
Total	47.1	3.4	27.8	7.6	20.2	14.9	6.7	8.1	1.0	

The high degree of fragmentation reduces the efficiency of public expenditures. For example, the 11 health and education funds in FBiH may find savings through more centralized procurement. At the same time, greater sharing of services may lead to cost savings and improved quality of public services (see e.g. health section of this report).

Despite their differing degree of decentralization, the two Entities have very similar budget compositions in terms of the economic classification. For example, in 2013, FBiH spent 22 percent of its total expenditures to finance compensation of employees, compared with 23 percent in RS, while capital expenditures (NANFA) were worth 15 percent of the total in FBiH and 13 percent in RS (Table 3.5). The difference was driven by slightly higher foreign financed capital spending in FBiH.

Table 3.5: Public Expenditures Composition,
% Total Expenditure

	Total	Institutions of BiH	FBiH			RS			Other	Brcko
			Total	Central	Other	Total	Central			
Expense	86	94	85	67	92	87	86	88	91	
Compensation of Employees	26	69	22	11	26	23	38	10	30	
Goods and Services	22	19	21	4	27	24	9	37	30	
Social Benefits	30	1	34	23	38	32	13	47	14	
Interest	2	0	1	4	0	2	4	2	0	
Subsidies	3	0	3	6	2	3	6	0	8	
Transfers to other Gov't Units	0	1	0	16	-6	0	14	-11	1	
Other Expenses	4	3	4	3	5	2	2	2	8	
Net Acquisition of Non-Financial Assets	14	6	15	33	8	13	14	12	9	
Acquisition of Non-Financial Assets	14	6	15	33	8	14	15	13	9	
Foreign Finance Capital Spending	9	0	10	33	2	8	12	6	0	
Domestically Financed Capital Spending	5	6	5	1	6	5	3	7	9	
Disposal of Non-Financial Assets	0	0	0	0	0	1	0	1	0	
Total	100	100	100	100	100	100	100	100	100	

Source: BiH SCD team

Differences between two Entities appear to stem largely from their different degrees of decentralization. In RS, where more public services are provided by the central government, 38 percent of central government spending goes on salaries, while just 10 percent of other budgetary units' spending does. In FBiH, where cantons take an important role in providing public services, this is reversed with 11 percent of central government spending going on wages, while 26 percent of other budgetary units' spending does.

The State plays a different role to that of the Entities resulting in a different budget composition to that of the Entities. Over two thirds (69 percent) of the State budget in 2013 was spent paying the salaries for the functions assigned to the central government (e.g. civil servants, military). An additional fifth went on goods and services. Just 6 percent of State resources were invested.

3.28 Donor financing used for capital investment. Although, in total, capital expenditures averaged 6.3 percent of GDP between 2011 and 2013, between one half and two thirds were financed by donors. Large investment projects such as the Vc motorway⁵⁸, connecting the north and south of the country, for example, are donor financed.

Public debt

3.29 Public debt is low and consists largely of concessional debt to International Financial Institutions (IFIs) due to limited access to international financial markets.⁵⁹ Public debt fell from 32 percent of GDP in 2002 to 19 percent in 2007, thanks to low fiscal deficits. However, BiH public debt has almost tripled since, reaching 47 percent in 2013. This reflects a counter-cyclical fiscal policy, which was able to boost public expenditure during the crisis, and remains at limits considered to be sustainable, according to the IMF Debt Sustainability Analysis (DSA) conducted in 2014.⁶⁰ The majority of public debt is either external debt contracted at the State level and on-lent to the two Entities (66 percent of total public debt) or domestic debt (31 percent of total public debt) issued directly by the Entities. The remaining debt represents small amounts of external borrowing undertaken directly by the Entities, external State debt on-lent to the Brcko District, and external State debt allocated to the State level. The largest share of the public external debt (23 percent at the end of Q2 2014) is to the International Development Association (IDA) acquired during the post-conflict reconstruction phase (1996–2002). The remainder of the external debt is to other IFIs as BiH has not had access to international capital markets until recently. The degree of risk in the external debt portfolio is relatively low because of its currency composition (largely linked to the EUR, with which BiH has a currency board) and the main lenders (IFIs).

3.30 Debt growth is contained by law. Debt laws⁶¹ set statutory ceilings on government debt which is considered a key measure to maintain fiscal discipline. The laws stipulate that new loans can be contracted only insofar as debt service on long-term loans does not exceed 18 percent of fiscal revenues at the respective level of government in the previous fiscal year and that guarantees may not exceed 30 percent of revenues. Repayments on short-term debt cannot exceed 5 percent of revenues in the Entities. The Entity laws set such limits to municipal borrowing as well. A new RS Debt Law sets the public debt limit at 55 percent of GDP and short term debt cannot exceed 8 percent of regular revenues in previous fiscal year.

⁵⁸ See EBRD evaluation: <http://www.ebrd.com/downloads/about/evaluation/1203Corr.pdf>

⁵⁹ Due to the limited development of local financial markets, governments in BiH did not issue domestic securities until 2011, when the first Treasury bills were issued. The primary debt markets improved between 2011 and 2014 helping additional domestic debt issuances. For example in the first half of September 2014, there were three auctions on BiH stock exchange (bond and T-bill auctions on Sarajevo Stock Exchange-SASE and a T-bill auction on Banja Luka Stock Exchange-BLSE). At the end of September 2014, SASE held the 22nd auction for FBiH domestic debt, while in BLSE the sixth auction of RS bonds were held. The secondary market for government securities is virtually non-existent, with exception of war claim bonds.

⁶⁰ See: <http://www.imf.org/external/pubs/ft/scr/2014/cr14189.pdf>

⁶¹ Debt laws have been enacted by the three governments (the State in 2005, RS in 2007 and amended in 2012 and 2014, and FBiH in 2007).

3.31 While the levels of total public debt in BiH are considered sustainable, there are a number of causes for concern. Notably:

- The external debt portfolio has been growing at a unsustainably rapid rate, which is an indicator and potential driver of distress despite the existence of debt laws;
- The ratio of debt/GDP in the RS is significantly higher than for either the State or the FBiH. The rate of growth in the stock of debt in the RS will need to slow down if the debt position is to remain sustainable;
- The fast increase in debt service costs in recent years means BiH could get caught in a vicious debt cycle if care is not taken to contain debt stocks and extend maturities;
- The lack of comprehensive statistics on private external debt is a concern; and
- The lack of knowledge of local government and SOE debt or liabilities is a concern.

The lack of common ground on borrowing strategies between the Entities may result in worse terms.⁶² Taken together these issues could lead to an increasing debt service burden putting additional pressure on public finances. If these are not addressed borrowing costs could rise, putting the sustainability of public debt in jeopardy, and squeezing out expenditure on other important areas for boosting growth and shared prosperity.

3.32 Although BiH has mostly contained deficits, fiscal risks remain significant, including from economic shocks, natural disasters, and SOE-related liabilities. It has been difficult to quantify the potential liabilities that may result from SOEs but they appear to be significant. Many SOEs do not operate, or operate only on life support with fiscal transfers. Many SOEs continue to employ people, building up arrears, including to the social welfare system. Privatizing companies with arrears is difficult. Risks also arise from natural disasters such as floods, droughts, which have been shown to have a significant impact on economic growth, and therefore hit revenues. Economic shocks hit revenues and increase demand for social welfare. Building fiscal buffers to cushion against these shocks would help to reduce fiscal risks.

⁶² There is fragmentation of almost all technical aspects of domestic securities borrowing between RS and FBiH that inhibits the pooling of resources for developing market infrastructure. Bosnia and Herzegovinian law allows internal and external debt to be created by the State, either Entity or Brcko District. The State is responsible for making payments on external debt, financed by 'skimming off' the required repayments from the (nationally implemented) VAT collection before distributing the revenue to governments. The State has been allowed to borrow domestically since 2005 but has yet to do so, with all domestic borrowing being conducted by the Entities. The market is also fragmented between the FBiH and RS not only in terms of volumes but also in relation to different infrastructure, issuing mechanisms, settlements and trading. Each Entity has a separate stock exchange, securities register, Securities Exchange Commissions and Regulatory bodies.

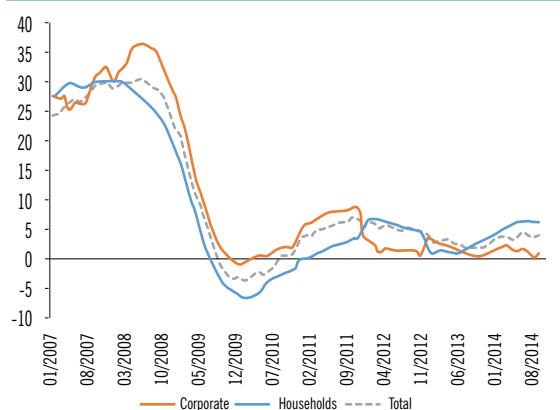
3.3 Financial sector development and inclusion

- 3.33 **The financial sector is heavily bank-dominated and moderately concentrated.** There are 27 banks operating in total in BiH, of which 17 are in FBiH and 10 in RS accounting for 87.1 percent of financial system assets (Annex IX), which were equivalent to 84 percent of GDP as of end-2013. The banking system comprises mostly foreign subsidiaries—91 percent of the banking sector assets, while domestically-owned and state-owned banks account for 7 and 2 percent, respectively. There are 17 banks in FBiH and 10 in RS, with a share of 70 and 30 percent of the banking system respectively. The five largest banks represented about half of banking sector assets in 2013. As a result of the slowdown in foreign funding, banks have become more reliant on domestic resources through private and public deposits. From the pre-crisis peak (Q1, 2009) to the first quarter of this year, the decline in cross-border funding has been equivalent to \$2.7 billion or 16 percent of BiH's GDP. In contrast, domestic deposit mobilization has increased by 8 percent in the same period, reaching 50 percent of GDP.
- 3.34 **The banking sector in BiH overall remains reasonably liquid and well-capitalized, though growing NPLs and the resulting provisioning may erode some banks' capital buffers in the future.** Capital adequacy of the system reached 17.3 percent as of March 2014, which overall should be sufficient to absorb risks in the system. However, there are pockets of vulnerability with certain banks close to minimum standards. In addition, growing NPLs and the resulting provisioning pose risks for banks' assets quality in the future. Slow credit growth, at an average of 4 percent per year since 2010, reflects in part sluggish domestic demand (Figure 3.14). The earlier impacts of excessive lending practices, fueled by an inflow of foreign capital and poor credit underwriting before the crisis, have become apparent in the sharply rising volume of bad loans burdening banks' balance sheets, undermining profits and capital and suppressing banks' interest in new lending. The total NPL ratio posted a record level of 15.1 percent as of year-end 2013 (compared to 5.9 percent in 2009) with corporate loans being more problematic than consumer loans (Figure 3.15). Importantly, while banks' provisions for possible loan losses are relatively high at about 80 percent of NPLs, the level of "watch" loans, which exhibit clear weaknesses (but have not yet reached NPL status) are about an additional 10 percent of total loans, posing significant further risks to the financial system. Further negative impacts arose from the flooding in 2014, which has inflicted severe damage across portions of BiH - with a major impact on business, housing and infrastructure in affected areas.
- 3.35 **Financial sector development and access to finance for firms is constrained by weak domestic demand, high collateral requirements and inadequate credit enforcement mechanisms.** Credit to the non-financial private sector expanded by only 0.9 percent year-on-year in the first nine months of 2014, and by 1.1 percent in 2013. A significant portion of the loans were used to finance working capital rather than investments, mostly due to unfavorable growth prospects. Collateral requirements are high, with collateral-to-loan values at 216 percent for small firms⁶³ in BiH and execution of collateral warranties is lengthy, taking three to seven years, hampered by inefficient judicial processes. Overall, firms in BiH identify access to finance as the second major constraint after political instability in the Enterprise Survey 2013.

⁶³ Enterprise Survey 2013.

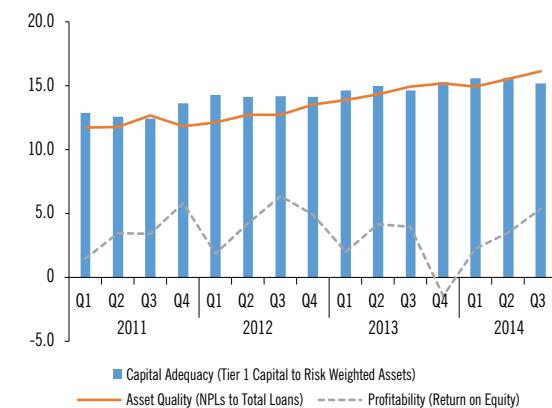
- 3.36 **The non-banking financial system is small, boding poorly for insuring weather shocks, including the impacts on agriculture.** The non-banking financial system is distributed among 25 insurance companies (5 percent of financial system assets), 8 leasing companies (2 percent), 34 investment funds, and 19 micro-credit organizations (MCOs) (3 percent each) and 1 factoring company as of end of 2013. The agricultural sector, in particular, suffered during the 2012 droughts and 2014 floods and may be under-insured. This bodes poorly for reducing the risks faced by many of the B40, who often work in agriculture.
- 3.37 **Bankruptcy laws are reasonable, but implementation is weak.** While bankruptcy legislation appears to be sufficient, with a decent Doing Business rank, there are questions as to its enforcement, notably vis-à-vis SOEs. Recent Central Bank data⁶⁴ reveal that there are some 45,000 companies with at least one bank account blocked, which makes them candidates for bankruptcy. However, there is only a handful of reorganizations/bankruptcy procedures initiated. Many of these companies are state owned or were candidates for privatization. A recent Insolvency and Credit Rights ROSC (that the WB conducted in parallel with the FSAP) revealed that the legal framework governing creditor/debtor relationships is comprehensive, however neither debt resolution, businesses reorganization or bankruptcy liquidation work effectively. There is a need to streamline execution procedures, introduce tools and incentives to facilitate corporate debt restructurings and resolution, and adopt out-of-court restructuring guidelines. The institutional framework could be further improved through hiring more commercial court judges with appropriate experience and improving the regulation of the insolvency profession.

Figure 3.14: Credit growth has been slow since crisis
Credit Growth, 2007-2014



Source: Financial Sector Assessment 2015

Figure 3.15: Banks display low profitability due to NPLs, 2011-2014



Source: Financial Sector Assessment 2015

- 3.38 **Among households, the overall access to financial services is relatively strong in BiH compared to peers, but more constrained among some population groups, including the poor, the B40, and women.** A total of 56.2 percent of adults in BiH have an account at a formal financial institution (Annex IX) and 31.9 percent of these account holders use it

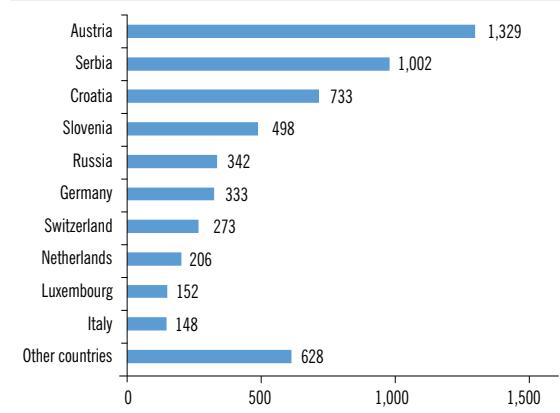
⁶⁴ Issued on February 2, 2015.

with high frequency⁶⁵ compared to the regional average of 44.9 percent and 22.5 percent, respectively. Lending services have a high outreach compared to regional peers, while the usage of saving services are low with only 13.5 percent of adults reporting saving any money in the past year compared to the regional average of 20.4 percent. In particular, for the B40 percent, the ratio of adults reporting saving any money in the past year is even lower at 9.8 percent.⁶⁶ Moreover, BiH is facing one of the largest gender gaps in the region, with the difference between male and female account holders at a formal financial institution amounting to 19.5 percentage points.⁶⁷ The World Bank 2011 Financial Literacy Survey suggests a low financial literacy in the BiH private sector.

3.4 Private sector development

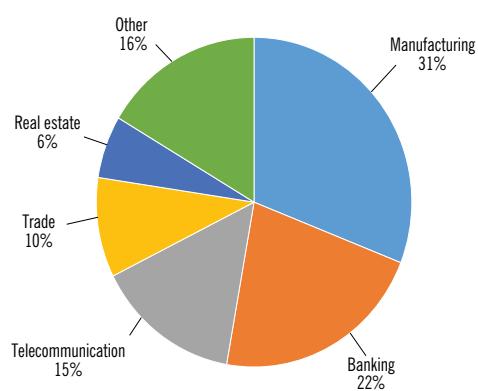
- 3.39 **The private sector contributes significant investment resources, including through FDI.** Between 2006 and 2013, the private sector has contributed around 80 percent of total investment (see Annex VII) out of a total of around €5.6 billion. Austria was the largest foreign investor in BiH between 1994 and 2013, accounting for almost a quarter of all FDI received. Austria is followed by Serbia (18 percent) and Croatia (13 percent) (Figure 3.16). The overwhelming majority of foreign investors in BiH are European. The biggest share of FDI went to the manufacturing industry (31 percent) in such sectors as fuel, food and beverage, mineral and chemical products; followed by banking and telecommunication 22 percent and 15 percent, respectively (Figure 3.17).

Figure 3.16: Top ten investor countries in BiH, 1994-2013 (EUR million)



Source: Central Bank of Bosnia and Herzegovina

Figure 3.17: Manufacturing leading share of FDI FDI in BiH by industry, 1994-2013



Source: Central Bank of Bosnia and Herzegovina

⁶⁵ Measured by withdrawals of three or more times in a typical month.

⁶⁶ Findex, latest available data is 2011.

⁶⁷ Usage statistics show that this gap arises mostly from the fact that women are using their accounts much less than men for receiving wages and government payments. This is an expected result, as according to the International Labor Organization (ILO) statistics, the female labor force participation is very low at 34.1 percent in BiH in 2012.

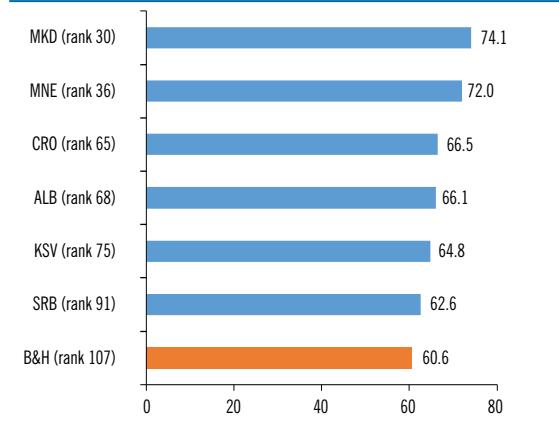
- 3.40 **The private sector's overall performance is likely stifled by the public sector.** Although public sector expenditures is close to 50 percent of GDP, the percentage is likely even higher, when SOEs are taken into account. It is difficult to obtain accurate information on SOEs but some official information suggests that among the companies that were public during the Yugoslav period, some 70 percent of large ones and 40 percent of small ones are still public.⁶⁸ Some are loss-making, requiring subsidies, while some reportedly no longer function but maintain workers. This diverts resources away from the productive private sector, including labor (some are employed without needing to work, preventing them from seeking other employment), land (under- and even un-used land remains in the hands of non-functioning SOEs), and capital (buildings, for example, could be re-purposed or sold).
- 3.41 **Firms do not always achieve the employment and sales growth expected** (Annex VII). BEEPS data suggest that in most ECA countries smaller firms (in terms of employment) tend to grow faster than larger ones. However, in BiH this does not seem to be the case, which reflects low private sector dynamism and prevent small firms in a variety of sector from growing. In addition, even though younger firms in BiH increase employment faster than older ones, it is not clear whether they are able to increase sales faster than their older competitors, unlike in the rest of ECA. Interestingly, being in a large city in BiH seems to be a constraint to sales growth among BiH firms, unlike in the rest of ECA.

Poor business environment and regulation

- 3.42 **The Foreign Investors Council notes that BiH could be a very competitive country** thanks to “its geographical position, natural resources, traditions and untapped potential in the fields of construction, energy, agriculture, timber industry and industry in general”. Unfortunately, its poor business climate may mean that the country performs well below its potential.
- 3.43 **BiH's business environment is the worst in SEE and needs major work if BiH is to boost private investment and improve competitiveness.** The poor business climate forces entrepreneurs to face burdensome institutional and regulatory barriers. BiH was ranked 107th out of 189 countries globally in the 2015 Doing Business (DB) survey (Figure 3.18). BiH performs worse than any other country in SEE and among former Yugoslav republics. BiH's distance to frontier score of 60.6 was the worst in the SEE7 region in 2015, compared to 74.1 for the region's best performer, FYR Macedonia, even though there has been some recent progress (Figure 3.19).
- 3.44 **Entrepreneurs and SMEs in general face tough constraints.** These include high social contributions, fiscal and para-fiscal fees, a lack of access to export markets, and a non-harmonized regulatory environment. A number of public sector and donor-led support programs have provided support to SMEs to strengthen their business, marketing and financial management skills but so far, with limited impact on employment.

⁶⁸ “Large” and “small” are not defined and how the estimation is done is unclear. Nonetheless, this is indicative of a lack of progress in privatization. See: <http://www.bhembassy.co.uk/en/investiranje.html>

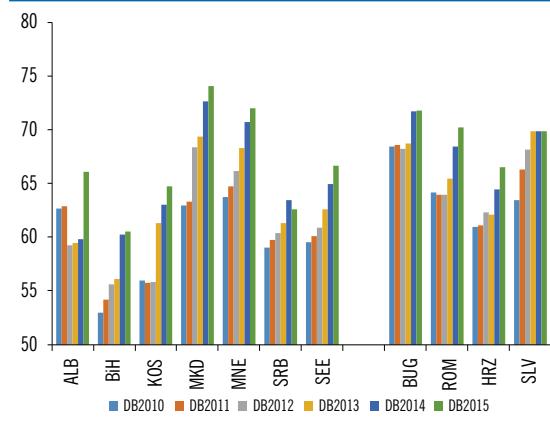
Figure 3.18: BiH's business environment is the worst in SEE...
Distance to the best practice frontier (lower bar = further away)



Note: (from 0=worst to 100=best practice frontier)

Source: Doing Business Report 2015

Figure 3.19: ...but has made some progress in recent years
Distance to the best practice frontier (lower bar=further away)

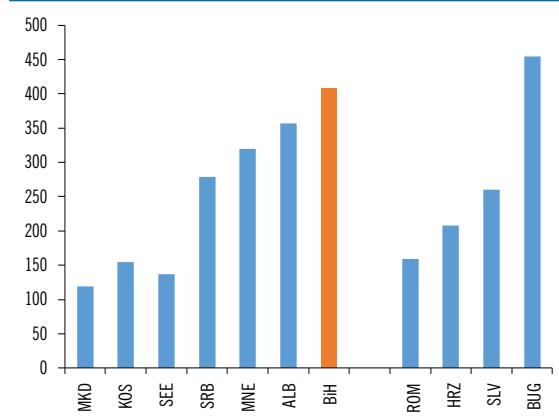


Source: Doing Business Report 2015

3.45 BiH performs particularly poorly in indicators related to starting a new business and paying taxes. The 2015 Doing Business report ranked BiH among the worst countries in the world for: 1) Dealing with construction permits (182nd); 2) Getting electricity (163rd); 3) Starting a business (147th); and 4) Paying taxes (151st) (Figure 3.21). These are particularly unfortunate areas to perform badly in as the first three indicate that starting a new business poses significant challenges. Making it difficult for firms to pay taxes forces firms to spend significant amounts of time paying them rather than finding ways to improve their business and can encourage tax evasion. At 407 hours per year, firms in BiH devote more time to paying taxes than in any other SEE country (Figure 3.20)—a heavy burden on SMEs in particular.

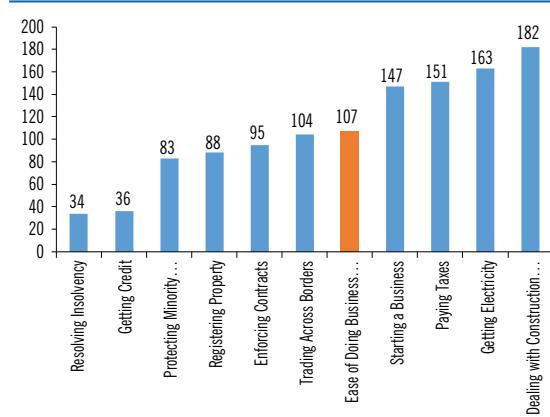
Figure 3.20: BiH: One of the worst in the world at paying taxes...

Annual hours to pay taxes



Source: Doing Business Report 2015

Figure 3.21: ...and at dealing with construction
Doing Business Rank



Note: DB 2015 rank of categories (from 1=best to 189=worst)

Source: Doing Business Report 2015

- 3.46 **Challenges also remain with respect to real property rights.** BiH ranks 88th in the world in the 2015 Doing Business report. The costs of property registration amount to 5.2 percent of the property value on average, compared to 2.5 percent for ECA as a whole. According to the 2011 Doing Business regional report, it takes more than 100 days to register a real property in Banja Luka and Mortar, while the same operation takes on average 23 days in the 22 cities ranked. There have been significant improvements in the land administration sector but the accuracy of the cadaster and land records need to be improved. Many subdivisions have not been recorded and numerous real properties are registered under the name of their previous owners, including the state and deceased individuals. BiH has embarked in an ambitious harmonization program whereby cadaster and land registry records are being updated and integrated. However, it will take several years to cover the country while BiH needs to sustain its efforts to further streamline and automate land administration services.
- 3.47 **There have been a number of improvements in the business climate, but private sector operations remain difficult across the country.** Several examples include: the introduction of a One-Stop-Shop for opening businesses, which reduced the time and cost of opening a limited liability company (from 23 days and €750 to 3 days and €100) in RS; simplification of obtaining construction permits in RS; a new Inspections Law, which removed some obstacles to exports to the EU in FBiH; and a new business registration law that simplified the business registration process in FBiH. While there are differences between the two Entities and the Doing Business indicators only capture imperfectly the business environment, other evidence also points toward a problematic business environment. For example, there are 355 business related licenses, permits, approvals and consents required for businesses in FBiH, and 319 in RS, as well as an additional 102 at the level of the Institutions of BiH. Cantons (in FBiH) and municipalities add a further 161 and 94 respectively.⁶⁹ A firm wishing to operate across the whole of BiH faces over a thousand potential licenses, approvals and consents, many of them duplicated.
- 3.48 **Institutional and governance barriers represent a critical obstacle to business development.** Although corporate income taxes are harmonized, each Entity has its own business registration requirements and each governmental level has the power to establish business laws and regulations. Within FBiH, each of the ten cantons has different business regulations and administrative procedures. Simplifying and harmonizing these regulations and procedures will be key to improving the overall investment climate and help fight corruption.⁷⁰
- 3.49 **All BiH governments have implemented accounting practices in line with international norms but implementation is weak.** The government has also failed to translate the international standards into local language so that firms can properly implement the standards. In addition, “legislative officials have been criticized for attempts to change these standards in an effort to protect local accounting firms. Foreign investors should

⁶⁹ IFC staff calculations based on official government records and databases. This represents the total universe of licenses.

⁷⁰ 2014 Investment Climate Statement, U.S. Department of State.

therefore carefully scrutinize BiH corporate financial statements.⁷¹ The corporate financial reporting framework needs to be better harmonized. Specifically, the two Entities should create a coordination mechanism for the parallel alignment of their laws and regulations with the relevant provisions of the EU *acquis*. Both Entities also need to better coordinate with respect to accounting and auditing reforms.⁷²

3.50 Agriculture, small and large scale, suffers from various aspects of the poor business environment. For all farms, but especially for small farms the cost and pressures involved in moving into the formal sector and complying with the legal framework are high. With the creation of a farm register that requires extensive reporting of production and assets to access government support, the application of phyto-sanitary rules for any plant based production, more regulated livestock production due to the animal identification and registration system, as well as food safety requirements makes the cost of compliance increasingly high. This pushes the least productive farms slowly out of business. Partly as a result, according to FAOSTAT, in 2011 imports of foodstuffs were about four times the amount exported. While this represents an improvement since 2001 (when the ratio was 15:1) this is largely despite of rather than because of regulations.

3.51 Stronger codes of corporate governance could help to attract investment. In addition to governance issues in SOEs, which are prevalent in BiH as in many other countries, private firms are also sometimes characterized by low levels of transparency. Many of them are not prepared to transition from family business stage to a corporate stage which limits their growth prospects and make them less attractive for FDIs. Managers of enterprises are often not accountable for their performance, key information for many companies is not available, the duties of the boards are not always clear.

3.52 Multivariate analysis helps identify constraints faced by firms, based on self-reporting (Annex VII). Key findings are:

- Larger firms are more likely to report that skills are more of a constraint than smaller ones, after controlling for other firm characteristics.
- Being in a large city is linked to reporting that political instability and corruption are greater constraints than otherwise.
- The practices of the informal sector are also more challenging in cities.
- Corruption appears to be closely linked to the construction sector.
- Construction and wholesale/retail companies are less likely to report access to finance as a constraint than other sectors.
- Labor regulations are particularly likely to be cited by wholesale/retail firms as a constraint.

3.53 Interestingly, only a few constraints appear to impact on firm performance. For example, after controlling for other firm characteristics, corruption and political instability do not appear to negatively impact sales or employment growth, despite the fact that when firms were questioned about the single most important constraints, political instability was ranked first and

⁷¹ 2014 Investment Climate Statement, U.S. Department of State.

⁷² Report on the Observance of Standards and Codes, Bosnia and Herzegovina, December 2010.

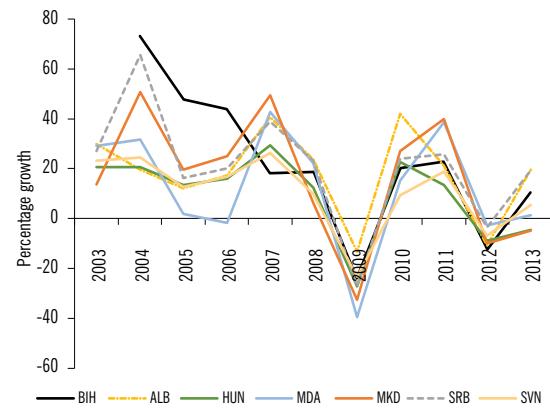
corruption the fourth. The reason for these results are unclear but there are several potential explanations. It is possible that constraints affect most firms in a similar way, holding back growth en masse rather than only for those firms that most feel them. Alternatively, since firm surveys target only successful firms, it could be that the constraints prevent new firms from starting up and growing and actually protect some existing firms from competitors. Corruption is pervasive throughout all areas of society (see Box 1.1).

- 3.54 Two constraints stand out as significant.** Access to finance is negatively associated with employment growth in BiH and ECA in general. Transport, despite being ranked as one of the least important constraints, does appear to have a negative impact on employment growth.

The need for dynamic exports

- 3.55 BiH could have higher and more sustainable growth by focusing more on producing goods and services for export.⁷³** Exporting firms in BiH tend to employ more people (both skilled and unskilled), pay higher wages, and have a higher “skill intensity”. In addition, BiH exports embody more value-added and physical capital content than other emerging economies in Eastern Europe.
- 3.56 Reasonable export growth during the 2000s but the crisis hit exporting firms.** Exports of goods and services grew from around 29 percent of GDP in 2000 to 36 percent by 2006. In USD terms⁷⁴, export growth was among the fastest in the region between 2004 and 2008 (Figure 3.22). However, export growth turned negative during the crisis as the EU economy (BiH’s largest market) faltered, declining to just 25 percent of GDP in 2009. Exports have since rebounded somewhat, but at 32 percent of GDP in 2013 remain low by both regional standards and compared to other small countries (Figure 3.23). This is of particular concern because among EU-CEE countries, no small country⁷⁵ succeeded in moving from lower income to medium income status or from medium to upper income status since 1996 without substantially boosting exports during the period.⁷⁶

**Figure 3.22: BiH: Export growth was hit by crisis...
Export growth, Current USD**



Source: Staff calculations based on UN Comtrade

⁷³ The “sophistication” and destination markets for BiH matter for its future development path. Empirical studies show that what a country exports and where it exports affect the level and composition of labor demand in the exporting country and its economic growth performance. The structure of a country’s exports – that is, what types of products it exports, in which sectors and with what levels of value-added – affects the types of labor needed to produce these exports. In addition, the export structure tends to vary by destination market. Exporting to high-income countries, where consumers have a relatively high preference for quality, stimulates the production of high quality goods, and increases the demand for skilled labor (Brambilla et al. 2012). Hausmann, Hwang and Rodrik (2007) provide evidence that the types of products countries export matters for economic growth. Verhoogen (2008) shows that more productive plants produce and export higher-quality goods than less productive plants, and they pay higher wages to maintain a higher-quality workforce.

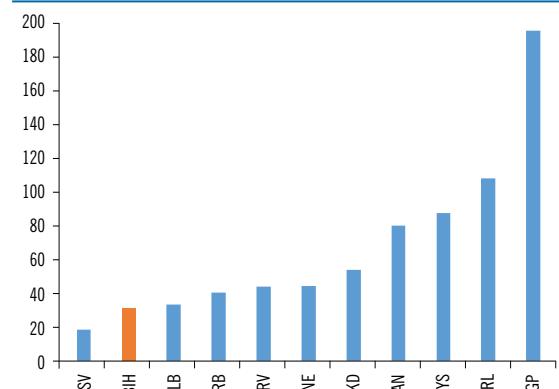
⁷⁴ USD are in “current terms”—i.e. the exchange rate for each year is used for that year.

⁷⁵ Defined as having a population of 10 million or fewer.

⁷⁶ Countries classified as “small” are: Bulgaria; Croatia; Czech Republic; Estonia; Hungary; Latvia; Lithuania; Slovak Republic; and Slovenia. Croatia, the

3.57 BiH's goods exports have become somewhat more diversified in recent years. Goods exports—which represent around 60 percent of total exports—became more diversified between 2003 and 2013 and some BiH companies have successfully integrated into EU supply chains. The top ten products exported represented 47 percent of total exports in 2003, compared to 30 percent in 2013 (Table 3.6). In addition, several increases in the exports of some top-ten products reflect successful integration into some EU supply chains. This is notably the case for the cars and footwear industries, as well as for furniture products reflecting an abundance of wood, much of which is Forest Stewardship Council (FSC)⁷⁷ certified. This reflects the country's status as having Europe's largest forested area, and the potential of the forestry sector to contribute strongly to export through wood in its raw or processed form, or through tourism activities such as people visiting parks. Forestry can generate employment, benefiting both rural dwellers—many of whom may be self-employed in agriculture—and the B40. However, management of SOEs in the forestry sector is constrained by a policy of maintaining short-term employment using labor-intensive processes; production is expanding moderately but at sub-optimal levels due to capital constraints and inadequate common infrastructure (primarily roads and bridges).

Figure 3.23: ...but remained below regional standards
Exports of goods and services, % GDP 2012



Source: WDI

Table 3.6: Top export products in 2003 and in 2013

Description	Top 10 in 2013		Description	Top 10 in 2003	
	Value (USD)	Share (%)		Value (USD)	Share (%)
Parts of seats	299,876	5.8	Aluminum alloyed	96,879	10.4
Electrical energy	298,192	5.7	Aluminum not alloyed	63,570	6.9
Aluminum alloyed	269,008	5.2	Other engines	61,693	6.6
Petroleum Oils	160,285	3.1	Electrical energy	46,767	5.0
Footwear with rubber	99,837	1.9	Parts of seats	45,211	4.9
Other footwear	97,893	1.9	Beech Coniferous	44,124	4.8
Other clad	84,121	1.6	Coniferous wood sawn	22,784	2.5
Coniferous wood sawn	80,506	1.5	Footwear with rubber	20,511	2.2
Other wooden furniture	79,981	1.5	Bovine Hides and Skins	17,032	1.8
Other engines	76,086	1.5	Ferro-silicon	14,221	1.5

Source: Ministries of Finance and staff calculations

only country in the sample with exports below 50 percent of GDP, achieved high income status but is currently mired in its seventh consecutive year of recession. Hungary, despite almost doubling exports from 49 to 94 percent of GDP, has so far failed to reach middle income status.

⁷⁷ Forests in RS are 100 percent FSC certified but many cantons in FBiH need to either obtain or renew their certification.

3.58 Despite the slowdown in economic activity in the EU during the crisis, BiH increased goods exports to this market between 2003 and 2013. The share of BiH's exports to the EU increased steadily by 12.7 percentage points from 46.3 percent in 2002/03 to 59 percent in 2012/13 (Figure 3.24).

3.59 Goods exporters managed to increase their market share with their main trading partners, even if these have shown sluggish demand. BiH's exporters have gained market share in its main trading partners with the exception of Switzerland. However, since 2004, the number of different products exported has increased only slightly from 1044 to 1081 (see Annex V).

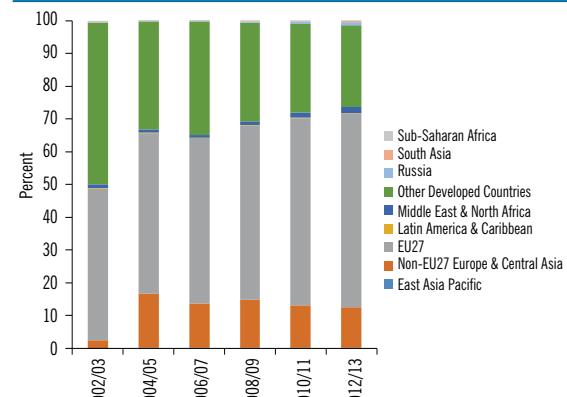
3.60 Exports are dominated by furniture, fabricated metal and wood products and garment manufacture. For example, 87 percent of furniture producers in BiH export, and on average these exports account for 40 percent of their total sales. Production of exporting textile and garment producers almost entirely targets export markets. Two-thirds of those textile producers that do not export directly supply local producers, including garment exporters.

3.61 The export orientation of sectors reveals elements of the country's revealed comparative advantage, many of which may support employment among the poor and B40, particularly in rural areas (see Annex V). BiH's most significant comparative advantage in 2013 can be found in footwear exports (a third of which are directed to Italy). BiH's comparative advantage in footwear increased between 2002/03 at an annual average rate of around 20 percent. Metals, wood and wood products also showed high and dynamic revealed comparative advantage. BiH also has a small revealed comparative advantage in foodstuffs, including agricultural products (see Box 3.2). Taking advantage of comparative advantage in agriculture could help to support the B40, many of whom work in agriculture, and rural areas, where rates of poverty are higher.

3.62 Exporting firms are significant employment generators. As in much of the world, in BiH exporting firms are larger than non-exporters in the manufacturing sector, and employ both more skilled workers and more unskilled workers (based on number full-time employees) (Table 3.7).

3.63 Both exporting and non-exporting firms in BiH increased their relative skill intensity since 2002 however, exporting firms did so by more. Non-exporting firms in BiH employed a slightly higher proportion of skilled workers compared to non-exporting firms in 2012. However, the gap between exporters and non-exporters narrowed over the period.

Figure 3.24: Share of BiH exports to the EU increased
Goods export structure by destination



Source: Staff calculations based on UN Comtrade

Table 3.7: Size of exporting vs. non-exporting manufacturing firms (average number of full-time employees)

Year	Exporting status	BiH		ECA	
		Skilled employees	Unskilled employees	Skilled employees	Unskilled employees
2002	Non-exporters	59	39	50	35
	Exporters	68	109	179	129
2012	Non-exporters	35	15	22	15
	Exporters	39	36	66	46

Source: World Bank Staff calculations based on data from World Bank enterprise surveys. Sample of ECA countries includes Albania, Armenia, Belarus, Croatia, Georgia, Latvia, Lithuania, FYR Macedonia, Montenegro, Romania, Serbia, Slovenia, Tajikistan, and Ukraine.

- 3.64 The higher skill intensity of exporters is reflected in wages with exporters paying higher wages.** Median manufacturing wages are significantly higher than ECA averages, although these summary statistics mask important inter-industry differences. For example, textile sector workers in BiH earn less than half the median ECA wage for textile workers. However, in BiH, textile production is less skill-intensive than in most ECA countries⁷⁸, despite the fact that some textiles products are among the top 10 exports for BiH.
- 3.65 High wages among exporting firms offer both an opportunity and a risk.** Boosting export-orientated industries may eventually help to generate better-paid employment. However, high wages may also make it more difficult for exporting firms to compete, harming employment and growth. It is interesting to note that there are some sectors in which non-exporters pay higher wages than exporters (furniture, publishing and other manufacturing), perhaps because they can remain competitive at home even with high wages.
- 3.66 But even though exporting firms are larger on average than non-exporters they do not appear to grow faster after taking into consideration firm characteristics.** In ECA (and the world in general), exporting firms grow faster in terms of employment and sales than their non-exporting counterparts, even after controlling for sector and other firm characteristics (see Annex VII). However, in BiH after controlling for other firm characteristics, exporting firms do not appear to perform better than other firms.
- 3.67 Services exports grew in line with comparator countries during the 2000s but have shown significant weakness since the crisis.** Prior to the crisis, services export growth was strong and at levels comparable with peer countries (See Annex V). Between 2000 and 2007, BiH achieved an annual services export growth rate of nearly 20 percent, above that of Georgia, Hungary or FYR Macedonia. Services export levels in 2007 were more than three times those in 2000, driven largely by travel, construction, and transport services. While all peer countries' performance dropped between 2008 and 2013 with the exception of Georgia, BiH has become the weakest performer of its peer countries, averaging a 6 percent annual decline. In fact, all other peers have recovered to or surpassed their pre-crisis levels.

⁷⁸ Skilled workers in BiH textile firms account for 39 percent of total textile employment, compared to 70 percent in ECA as a whole.

Box 3.2: Agricultural potential for jobs, growth and exports

BiH remains a fairly rural country with 60 percent of its population living in rural areas. While topographic limitations restrict farmers to certain crops/livestock options, the agricultural sector⁷⁹ still plays a key role in poverty reduction and shared prosperity⁸⁰, employing 19.2 percent of the total labor force in BiH (including both formal and informal, including own-consumption). For 61 percent of these 19.2 percent it is the primary occupation. However, agriculture's contribution to GDP has declined from around 15 percent in 2001 to 7 percent in 2013. Over the past few years, the country has been confronted with a series of extreme floods, long periods of extreme heat, combined with highly variable winter weather which have negatively affected the sector. In BiH agriculture can be classified as (i) farming that complements other household income; (ii) commercial family farms or (iii) larger commercial operations (of which there are only a few). There are an estimated 600,000 holdings in BiH, but due to minimum thresholds to qualify as a farm, only about 15–20 percent of the holdings are formally registered and apply for support with their respective Ministries of Agriculture, however commodity price support reaches all producers. Smaller farmers in mountainous regions often receive a subsidy through milk price support. The overall agricultural expenditures—including subsidies - of 2-3 percent of GDP amounts to only about half of what the other countries in the region spend on the sector.

Agricultural productivity and trade

In spite of challenges, the agricultural sector is not without some dynamism and potential. While the overall contribution to GDP has consistently dropped over the past decade and a half, local production has gradually gained domestic market share. In 2001, the value of foodstuff imports were 15 times the level of exports, in 2012 they were down to about four times that ratio.⁸¹ During the same period, agricultural value added per worker more than doubled.⁸² In 2012, a detailed competitiveness assessment of the agribusiness sector revealed medium-term competitive advantage (compared to EU-27) of fruits, vegetables and dairy. BiH had revealed comparative advantage (RCA)⁸³ for food products of 1.19 (share in exports 3.8 percent), and products of animal origin 1.02 (share of exports 1.65 percent). BiH is a significant global producer of blueberries (10th position globally), plums and strawberries (35th).

While agriculture does show some vulnerability to extreme weather events and climate change, it is relatively insulated from downturns faced by the rest of the economy. For instance during 2012-13, the agribusiness sector recorded average annual growth in production of about 9.5 percent, while overall industrial production grew only 6.7 percent. In 2013, agriculture trade amounted to 2.4 percent of total exports and 4.4 percent of total imports. Yet BiH imports nearly two thirds of the food it consumes, mainly processed foods, while it exports lower value food commodities. This leaves significant room for increased production and growth in domestic market share for fresh and processed food products. To increase exports of agricultural products, BiH would need to fully adopt EU food security and phytosanitary measures.

⁷⁹ National accounts tables classify agribusiness as manufacturing.

⁸⁰ Agricultural production in BiH comprises a variety of grain crops, horticulture, orchard and field fruit, and niche products (spices, herbs, and mushrooms, berries) and some industrial crops. Livestock products dominate the overall picture with milk being the most traded commodity. The diversity in production is largely due to topography and land use with over 40 percent of the country covered in forest, 25 percent as pasture land, and only 20 percent of the overall area as arable land of which only about 5 percent is in flat plains. The variety is also due to the farm structure with little specialized production and most family farms producing a bit of everything with only the most entrepreneurial farmers trying to focus their operations. While the arable land area is relatively small, good soils and favorable climate conditions with long growing seasons provide a good basis for production increases.

⁸¹ Eastern Europe and Central Asia Agro Industry Development Country brief, Bosnia and Herzegovina.

⁸² FAOSTAT.

⁸³ Based on HS 6-digit data.

Potential for growth and employment creation

The sector is important in providing social stability to a large segment of BiH's population, and in particular the poor and B40, and will continue to play a significant role in economic growth and job creation. Already, some of its most productive value chains are relatively labor intensive and provide significant seasonal employment. With more investments, the competitiveness of already productive families could be enhanced, especially in dairy sector and horticulture, while smaller holdings would need investments that require limited land such as greenhouse production, specialty production, or intensive livestock, all of which are relatively capital intensive, but necessary to make a livelihood from farming.

Source: BiH SCD team

3.68 Services exports represent an important part of the country's international trade and BiH's service exports are above that expected given its level of development supporting employment and the B40. According to balance of payments data, services exports from BiH in 2012 represented nearly 40 percent of total exports (goods represented 60 percent). Services exports thus represent an important source of export diversification for the country. BiH per capita services exports are slightly above other countries of similar income level. Tourism offers one service export that may have potential to expand, and to employ significant numbers of people, including in the B40. It may be complementary with some goods exports including agricultural and viticulture (and notably wine). BiH's per capita exports of services are high for the country's stage of development (See Annex V).

3.5 Forests: An under-utilized asset⁸⁴

3.69 Forests in BiH are underexploited. Forest management throughout the world has been a challenge to governments as they weigh the needs of economic development that involve generating revenue from forest assets, against the complementary needs of conservation that recognize the important ecosystem services that forests provide. Standing forests contribute to erosion and flood control, harbor globally important biodiversity, store carbon, and perform a host of other ecosystem services on which people depend. This "development vs conservation" issue does not, however, exist in BiH. The forests are among the most pristine in Europe: historical labor-intensive logging practices have hardly made a dent in the 3.2 million hectares (ha) of forest and forest land. The 2.2 million ha of forest designated as "economically exploitable" (of which 0.7 million ha are privately owned) remain largely intact. Conservation and recreation interests are largely fulfilled in 0.6 million ha of designated protected area. As a consequence, the asset is underperforming from an economic perspective. The FAO (2015)⁸⁵ notes: "Forests in BiH are under-used" in comparison to the annual allowable cut in both private and public forests. This means there is potential for wood mobilization in some areas, especially in those areas that are currently not productive or are inaccessible." Management techniques are also ripe for modernization in a manner that supports economic and conservation interests. The FAO (2015) observes

⁸⁴ Broader environmental issues and risks are discussed in chapter 5.

⁸⁵ FAO. 22 January 2015. The Forest Sector in Bosnia and Herzegovina, Rome.

"...the high amount of coppice forests requires dedicated objectives. Coppice forests are a potential treasure trove of biodiversity, but also have potential as a biomass source. Specific programs to reach private forest owners (the main holders of coppice forests) are needed." Private owners are most likely to exploit these forests for economic benefit.

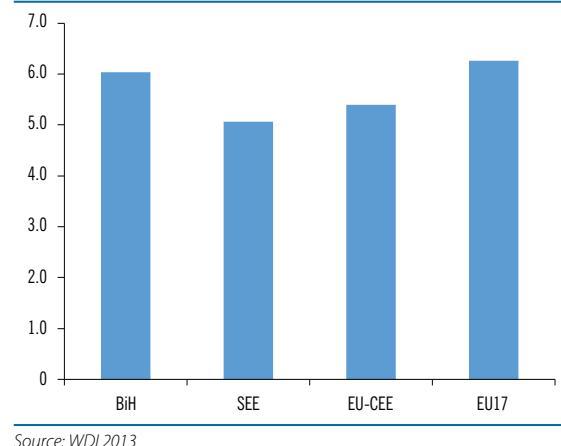
- 3.70 **Forests perform an important social function by providing employment relevant to the B40.** Socially relevant forestry and employment of disadvantaged groups (war survivors, disabled, widows) has been an explicit policy objective of the SOEs responsible for forestry on public lands. Expansion of production could potentially enhance this role, without necessarily threatening the overall rents derived from the forest estate.⁸⁶ Current employment in the sector is approximately 20,000, with recent rates of increase of the order of 6 percent per annum. Forestry sector gross value added (GVA) increased by around 50 percent in a decade.
- 3.71 **Forestry Stewardship Council (FSC) Certification has in-built mechanisms to ensure responsible management, transparency and financial sustainability.** In early 2015, 1.65 million ha of the BiH 2.2 million ha of forests were certified for export under the FSC scheme. This has permitted increased exports, most notably within Europe, while also ensuring that environmental constraints are respected through best silvicultural practice and replanting. Notably, the FSC standards also mandate financial sustainability and sound use of financial resources under a responsible management regime with clear accountability criteria.
- 3.72 **Forest access is consistently cited as a key constraint to expansion.** Although transport to market for all products (including forestry) is constrained by the general state of road and infrastructure in BiH, forest product transport is further hindered by the very low density of forest roads *within* the forest estate. The BiH road density within the forest estate is extremely low (around 7km/1000 ha) in comparison to forests in Western European countries (around 30km/1000 ha). These roads are important for ongoing thinning and production purposes, for reinvestment (planting and restoration), and for routine monitoring and management (notably fire management).
- 3.73 **Absence of a Forest Law has hindered full realization of the sector's potential.** The general business environment and infrastructure constraints pervasive in BiH are described elsewhere in this SCD. In addition, other policy-level constraints have been identified that prevent the sector from moving forward. Chief among these is the lack of a Forest Law. Such a law is necessary for equitable revenue sharing, decentralized management, and improved accountability. The lack of a Forest Law also makes tenure less clear and prevents access to financial markets for debt financing of operations.

⁸⁶ Based on inspection of RS Sume financial records (2013) audited for purposes of FSC certification, operational costs excluding labor represent 43% of revenues.

3.6 Infrastructure services

- 3.74 **Physical infrastructure is essential for economic growth—providing businesses with the services they need to increase output and employment—and may have beneficial impacts on inequality.** Global evidence suggests that investment in infrastructure, including transport and communications, can help to increase worker productivity and boost economic growth (Calderón and Servén, 2014, WP7034). There is some evidence that, if done properly, infrastructure investment may also benefit the poor, in particular through, for example, increased access to economic opportunities. Infrastructure investment may also have larger multiplier effects, making such investment projects a particularly good tool during economic downturns (IMF, 2014).⁸⁷
- 3.75 **Donor resources are important for infrastructure.** Each year between 2011 and 2013, between a half and two-thirds of all capital investment is estimated to have been financed by donors. Despite that, BiH has some of the worst infrastructure in SEE.
- 3.76 **BiH's investment rate remains the lowest one in the SEE region and has fallen behind average rates of EU17 and EU-CEE** (Figure 3.25). BiH's low investment rate is partly the inverse of high consumption and insufficient savings. Since increases in the capital stock are a major factor in explaining growth in industrialized countries, BiH's current consumption-based growth model actually risks lower levels of future output as its capital stock continues to decline. At the same time, there is precedent that BiH could catch up to wealthier economies by increasing investment in productive, tradable sectors of the economy. For example, East Asian economies that started at similarly low levels of capital stock and then increased investment rates to an average of 32 percent of GDP, have enjoyed a long period of high economic growth that have transformed the standard of living for their people.

Figure 3.25: BiH: Low capital stock due to low investments
Gross fixed capital formation, 2013, % GDP



Source: WDI 2013

- 3.77 **There is little private sector involvement in public infrastructure.** Currently, there is a lack of prioritized investment plans in many ministries infrastructure projects, making it unclear where the private sector could invest and charge user-fees. The use of PPPs is limited. Despite a reasonable regulatory framework⁸⁸ there remain a number of issues including

⁸⁷ World Economic Outlook, February 2014. See: <https://www.imf.org/external/pubs/ft/weo/2014/02/pdf/c3.pdf>

⁸⁸ The EBRD rates the quality of PPP and concession laws of BiH "in medium compliance with the international best practices (66.2 percent compliance), while their implementation is ranked as "medium effective". The existing regulatory framework is a good starting point to demonstrate government's intent to create a reliable legal basis for concessions and PPPs which would attract FDI. It allows for a wide range of schemes and provides adequate provisions for dispute resolution. However, complex and inconsistent legal framework, as well as weak implementation capacity of the civil service underline weaknesses of the current framework regulating PPPs and concessions (Commercial laws of Bosnia and Herzegovina, An assessment by the EBRD, August 2014).

alignment with EU acquis (also the case for concessions)⁸⁹, a lack of capacity within the public sector to implement PPPs, and inconsistencies between the laws of the different levels of government.⁹⁰

Connecting to the world: Upgrading transport and ICT services

- 3.78 **If BiH is to take advantage of its geographical situation next to the world's largest market by increasing exports and export-related employment, it will need to improve its transport and trade infrastructure.** Improvements in transport, whether this be related to new investment, better (and cheaper) maintenance or enhanced coordination within BiH and between BiH and other countries, would reduce trade and logistics costs, helping firms to compete in international markets. This could have benefits for employment and wages.
- 3.79 **Upgrading rural and regional transport infrastructure has been shown globally to have potential for alleviating poverty, boosting economic activity and reducing income inequality.** Transport infrastructure implies greater access to goods and services for the population, greater mobility, and better access to employment and commercial opportunities.⁹¹ The poverty reduction impacts stem primarily from enhancements of the income of the poor both from farm and non-farm employment (Webb, 2013; Jacob and Minten, 2009 and Dercon et al., 2008) as well as access to social services and markets (Mu and Van de Walle, 2007; Khandker et al., 2006). Improving the quality of a road reduces the time and costs associated with transportation. As a result, demand for transportation increases resulting in more trips along the improved road, as well as lower prices for transported goods. At the household level, real consumption increases as a result of both lower prices for consumer goods as well as increased earnings from employment and business opportunities due to the intervention. At the firm level, lower transportation costs mean increased real returns on investment, which in turn transforms into higher levels of investment. These help to increase economic growth and reduce poverty (NORC, 2013).
- 3.80 **Despite the importance of transport for market access for people and goods, BiH's transport infrastructure is rated as the poorest among SEE, EU-CEE and EU17 countries by the World Economic Forum (WEF).** In 2012-13, BiH scored 2.1 out of seven on the WEF's Global Competitiveness Indicator (GCI) for quality of transport infrastructure index, lower than the SEE average of 2.8, the EU-CEE's average of 3.6 or the EU17's average of 5.2 (Figure 3.26). The Logistics Performance Index similarly rates BiH as having below SEE-average infrastructure (2.55 out of 5 compared with a regional average of 2.65) and standards significantly below those of the EU-CEE or EU17 (Figure 3.27). Indeed, BiH has the worst score among comparator groups among the four modes of transport rated (roads,

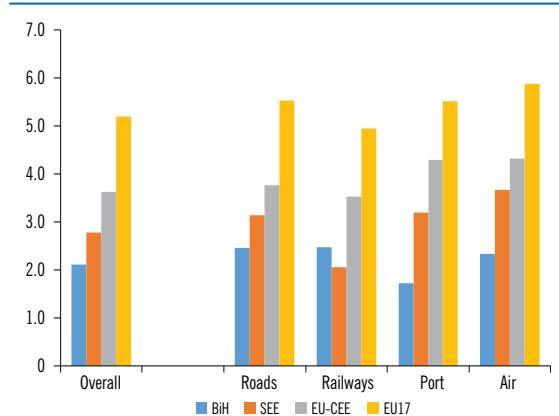
⁸⁹ For example, the current Law on Concessions does not contain provisions regulating final negotiations, which undermines transparency, equal treatment and competition of the tendering process. The current framework also does not endow the contracting Entity with the authority to terminate negotiations with the selected bidder and start negotiations with the second best bidder.

⁹⁰ For example, FBiH and local PPP/Concession laws are not harmonized with the relevant national, FBiH and local sectoral laws are inconsistent and overlapping. This is particularly relevant for the Concession Law, Roadways 5C Law and Public Procurement Law. While there are PPP laws in the Brcko District and RS, this law does not exist in FBiH and its current draft does not include provisions which would facilitate private sector participation. Moreover, FBiH's concession law does not recognize availability payment structures, e.g. payment for performance made irrespective of demand.

⁹¹ A small sample of studies show the following: proximity to a railway station in China resulted in higher GDP per capita for the residents in the area of influence; improvements in the access to all-weather local roads in Vietnam, Peru, Bangladesh, and Morocco have resulted in positive schooling and health outcomes for rural population groups; highway investments in India, Spain and the U.S. have helped to close the economic gap between the lagging regions and the more developed ones.

railways, ports, air), except railways, which, although above the average for SEE countries, is significantly worse than for EU-CEE and EU17 countries. Transport infrastructure barely improved since 2006, when the index was first launched.

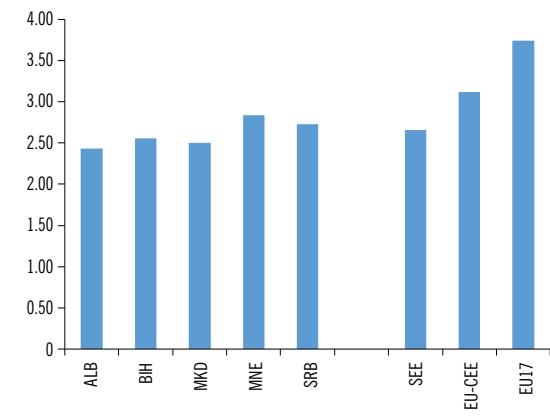
Figure 3.26: BiH: Quality of transport infrastructure lagging behind SEE and EU 27...



Note: Quality of transport infrastructure (0-7), 2012-13

Source: World Economic Forum, Global Competitiveness Indicators

Figure 3.27: ...as well as quality of trade and transport-related infrastructure



Notes: Logistics performance index (0-5): Quality of trade and transport-related infrastructure. All 2014 except Albania, which is 2012

Source: WDI

3.81 BiH performs poorly on many road transport indicators. The road density is the lowest in SEE, at 45 kilometers per 100 square kilometers of land area, compared with a regional average of 52 kilometers (Annex XIII). It is far behind the EU-CEE average of 116km. When considered on a per-person basis, BiH has fewer kilometers of road than any country in SEE except Kosovo (Annex XIII). BiH also uses its transport network less than many countries in the region, with each individual traveling an average of 543 km per year compared with a SEE average of 964 km and an EU-CEE average of over 4,500 km (Annex XIII). For each dollar of GDP, its goods are transported 0.14 ton-kilometers, below the SEE average of 0.18 and much lower than the EU-CEE average of 0.31. Goods in the EU17 meanwhile travel just 0.08 ton-kilometers per dollar of GDP on average (Annex XIII).

3.82 The highway network is limited, increasing costs and transport time for firms, and making it more difficult for firms to export. BiH has fewer than 140 kilometers of highways and a number of road bottlenecks have been identified (Figure 3.28). Although highway network development, especially the north-south Corridor Vc, is considered a national priority, considerable resources are still required for their realization, although efforts are underway on some sections. The road construction has been one of the main drivers of investment spending

Figure 3.28: Road bottlenecks identified in BiH

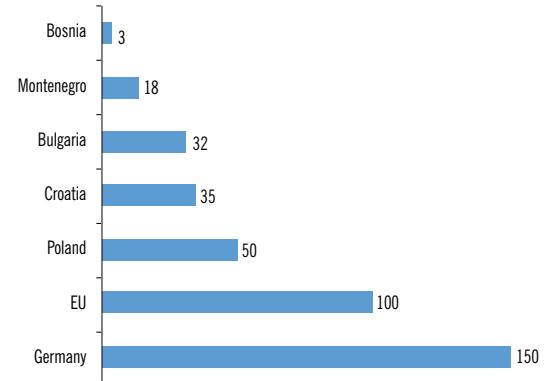


Source: South East Europe Transport Observatory: <http://www.seetoint.org/wp-content/uploads/downloads/2013/12/SEETO-Comprehensive-Network-Development-Plan-2014.pdf>

and employment, generating around 5,000 jobs and spending KM 472 million in 2013 and an estimated KM 567 million in 2014 in FBiH alone. Much of the road-building is financed through donor grants credits and loans.

- 3.83 Railways are poorly maintained and not fully modernized.** Traveling or transporting goods by rail is severely hampered by out of date rolling stock and railways, as well as by the fact that locomotives need to be changed as trains pass between the two Entities. As a result, rail transport is significantly below potential. On average BiH residents travel 14 km per year by train (see Annex XIII). This is just 13 percent the level in Serbia (111 km) despite having a similar population density (75 versus 82 people per square kilometer) and being only around 40 percent smaller (Figure 3.29). Indeed, the number of passengers kilometers travelled per kilometer of track was just 3 percent of the EU average in 2011. Transport of goods, however is of a similar intensity to in Serbia and above the SEE average.

Figure 3.29: BiH: Rail passenger traffic density is low
Passenger-kilometers divided by network length, 2011



Source: UIC

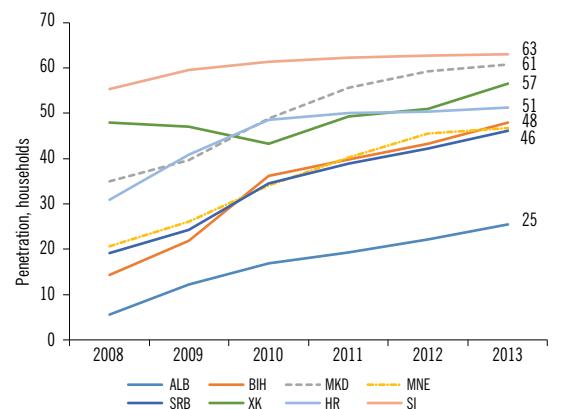
- 3.84 BiH is dependent on ports located in Croatia, creating constraints in terms of accessing markets. The only international inland waterway, the Sava River, has suffered from lack of maintenance since the 1990s.** Despite its potential in providing clean and efficient freight transport, the Sava River experiences very low levels of traffic reflecting poor navigability conditions. Safe and guaranteed navigation for commercial traffic requires de-mining and a major rehabilitation of the river.
- 3.85 There is a lack of coordination among the different transport authorities.** Despite two attempts, a national transport strategy does not yet exist. Such a strategy would help to identify the priorities across all modes of transport, determined by clear technical, economic and financial considerations. It would also enable the coordinated sequencing of interventions within the available funding constraints, and define necessary changes in legislation, regulation, organizations, and financing to implement the plans for the development of the sector, in a manner consistent with the development needs of BiH as a whole. This would help BiH to develop the strong transport system it needs to reduce the economic distance⁹² to markets by expanding opportunities for trade, by improving the competitiveness of national locations for production and distribution, and by facilitating mobility.

⁹² This measure reflects all the necessary and unnecessary transportation and clearance expenditures. Thus, a reduction in economic distance can be realized not only from improved physical infrastructure, where justified by economic criteria—a necessary condition for economic development—but also from improvements in the institutional framework (harmonized and simplified policies and regulations which offer significant unrealized gains in some of the countries at present), better cost recovery and improved maintenance, simplified transit procedures, improved provision of information, and the reduction of unofficial payments or corruption, across the whole region. World Bank (2004).

3.86 Penetration of fixed broadband internet access has grown in line with regional comparators over recent years. Fixed broadband penetration on a household level stood at 47.9 percent in 2013, compared with a regional average of 47.2 percent with only FYR Macedonia and Kosovo achieving higher rates (Figure 3.30). The growth of new subscribers slowed from around 65.5 percent in 2010 to 10.6 percent in 2013, indicating that most of the urban areas are covered while expansion to less profitable areas is constrained, though some solutions may exist such as “bidding out” least-cost subsidized services for rural areas. BiH has good potential to achieve better results using existing fixed telephony lines. This existing infrastructure (if well maintained) could be used for provision of the fixed broadband Internet access services via DSL⁹³ technology. BiH has the lowest level of alignment with the relevant EU acquis in SEE for electronic communications and as a consequence is among the latest in the region to put in place relevant competition safeguards. The growth trajectory of the mobile broadband penetration has also been strong but rural areas are under-served. In 2012, the number of dedicated data cards / wireless modems per 100 subscribers in BiH was low (Figure 3.31). In 2013, the country’s wireless penetration stood at 89.7 percent, low when compared to the regional average of 145 percent. During the same time period the country’s mobile broadband population penetration (3G) stood at 35.8 percent, lower than in Serbia (41 percent), Slovenia (69.9 percent) or Croatia (73.9 percent). Well-developed wireless infrastructure is important to serve the rural and isolated areas of the country (65 percent of the population is rural) as an alternative to the fixed broadband networks.

Figure 3.30: Internet access is rising but remains below most neighbors ...

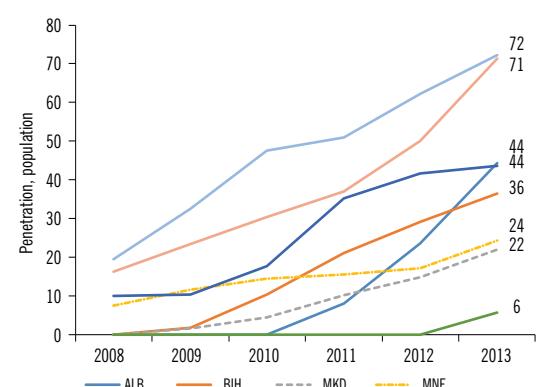
Growth rates of the fixed broadband Internet access penetration, 2008-2013



Source: Telegeography Global Comms database, data retrieved October, 2014

Figure 3.31: ... while broadband access is rising strongly

Growth rates of the mobile broadband Internet access penetration, 2008-2013



Source: Telegeography GlobalComms database, data retrieved October, 2014

3.87 Competition is lacking in internet service provision, negatively impacting service delivery.

Although BiH had 73 internet service providers (ISPs) in 2013, competitive conditions and market entry are highly constrained by the licensing regime and the dominant position of two government owned incumbents, which jointly control around 60 percent of the fixed broadband Internet access market in terms of subscribers and revenues. BiH is the only country in the region still applying individual licensing for electronic communication services, which is not in line with the relevant EU acquis.

⁹³ Digital Subscriber Line technology

- 3.88 **The low competitive environment in the market is being mirrored in low quality of the broadband internet access services.** BiH's international Internet connectivity channels are the second narrowest in the region, which is limiting the potential to deliver high quality (high speed) broadband connections. The majority of the broadband Internet access connections are considered slow by international standards.⁹⁴ This may pose an obstacle to the investment and trade activity.⁹⁵ The broadband Internet connections at a speed higher than 4Mbps experienced a significant take-up only since 2013, whereas in other countries higher-speed broadband connections have already become prevalent.
- 3.89 **BiH has among the cheapest broadband retail offerings in the world making it affordable for households at most income levels.** Fixed broadband Internet tariffs⁹⁶ in BiH were the 15th cheapest (in PPP terms) in the world in 2013, up from 32nd cheapest in 2012. As of June 2014, the price of the cheapest average fixed broadband package with the connection speed of 1Mbps accounts for 3.3 percent of the average disposable monthly income and the price of the similar mobile broadband package stood at 3.6 percent of the average disposable monthly income. This makes broadband affordable for most households. However, at internationally agreed affordability threshold of 5 percent of monthly disposable income, broadband remains just out of the reach of the poorest segments of the population. A representative of the poorest average household in BiH (defined as the B40 of the total population) needs to allocate 7.5 percent of the monthly disposable income to afford the cheapest fixed broadband package and 8 percent of the monthly disposable income for the cheapest mobile broadband package. While BiH is a regional leader in terms of the most affordable fixed broadband Internet, Croatia and Slovenia demonstrate higher affordability when it comes to the purchase of mobile broadband Internet packages. In these countries the B40 spends less than 5 percent of their disposable monthly income on mobile broadband packages.⁹⁷

Energy provision

- 3.90 **BiH has about 4,000 MW of installed power generation capacity and has experienced a 55 percent growth in electricity generation since 2000 to 16,300 GWh in 2013.** Coal-fired power plants account for about 60 percent of total generation, with hydropower plants providing the balance. In 2013, more than 95 percent of generation capacity is owned by the three major utility companies. All thermal power plant (TPP) blocks are dimensioned to operate with domestic coal (lignite and brown coal), supplied mostly from open-cast mines, also mainly owned and operated by the three main utilities. The transmission system consists of about 6,300 km of 400 kV, 220 kV and 110 kV lines, 36 interconnections, over 140 substations and over 250 transformers. The system is owned by the transmission company "Elektroprenos Bosne i Hercegovine a.d." (Elektroprenos BiH) based in Banja Luka and operated by an Independent System Operator (ISO BiH). The 10(20) kV distribution

⁹⁴ Connections with speed below 4 Mbps constitute over 70 percent of all the connections in 2012, while portion of connections above 8 Mbps is negligible.

⁹⁵ According to the State of the Internet Report, Akamai

⁹⁶ Understood here as any dedicated connection to the Internet at downstream speeds equal to, or greater than, 256 kbps, using DSL.

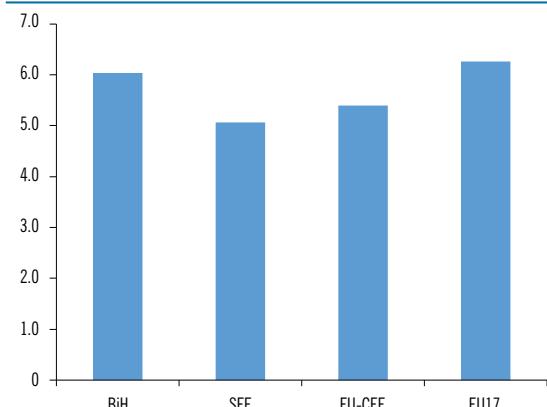
⁹⁷ <http://knoema.com/ixray/networked-readiness-index-nri-2014>

network has a total length of almost 22,000 km, the low voltage network is over 62,000 km long, and transformation from medium to low voltage is conducted in close to 20,000 transformer stations.⁹⁸

- 3.91 **Three power utilities are the most relevant players in the power sector.** These are “JP Elektroprivreda Bosne i Hercegovine - d.d.” (EPBiH) in Sarajevo, “MH Elektroprivreda Republike Srpske a.d.” (ERS) in Trebinje, and “JP Elektroprivreda Hrvatske Zajednice Herceg Bosne d.d.” (EP HZHB) in Mostar. All three perform generation, distribution, trade and supply in their respective license areas. In RS, five companies operate within the structure of ERS as distribution system operators and suppliers to tariff customers. In FBiH, EPBiH and EP HZHB perform electricity distribution and supply to tariff customers. There are about 1.3 million registered electricity users in BiH; EPBiH serves 48 percent, EPHZHB 13 percent, ERS 37 percent with the remaining 2 percent served by the distribution company of the Brcko District. Energy sector policy and regulatory development is largely driven by the EU accession process and the obligations under the Energy Community Treaty.
- 3.92 **The current energy system requires minimal public sector financing.** Generation, distribution and transmission do not need direct government financing. However mines are currently partially supported by the EP BiH, mostly due to modernization needs. All three Elektroprivredas are self-sustainable, an example of which is that their flood recovery needs were covered by their internal capacities, without substantial governmental support
- 3.93 **At first glance, the BiH power sector is one of the healthiest in the region and has been performing well since 2001.** Over the period, power generation increased by 50 percent between 2001 and 2013 (see Annex XIV), distribution losses halved between 2007 and 2010 (Figure 3.34), exports more than quadrupled between 2001 and 2011 and net exports also showed an upward trend. Power generation per capita reached that of other Eastern European countries since 2010 (see Annex XIV). Hydropower generated around 59 percent of total power between 2001 and 2013 (with thermal (coal) power plants responsible for the remainder).
- 3.94 **The WEF rates the quality of electricity supply as approaching EU17 standards, and access is high for all wealth quintiles.** In 2012-13, electricity scored 6.1/7 on the index, close to the EU17's 6.3 and significantly above the SEE average of 5.1 or the EU-CEE's 5.4 (Figure 3.32). Access to electricity is correspondingly high—approaching 100 percent for all wealth quintiles (Figure 3.33).

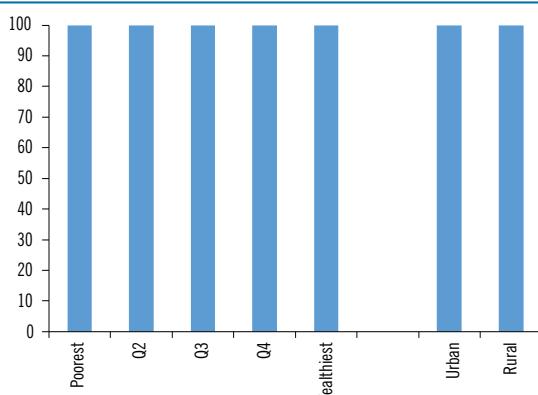
⁹⁸ World Bank Energy Sector Study, Bosnia and Herzegovina, 2008

Figure 3.32: BiH: Quality of supply of electricity is high... (0-7), 2012-13



Source: World Economic Forum, Global Competitiveness Indicators

Figure 3.33: ... and inclusive Electricity Infrastructure Access by Wealth Quintile

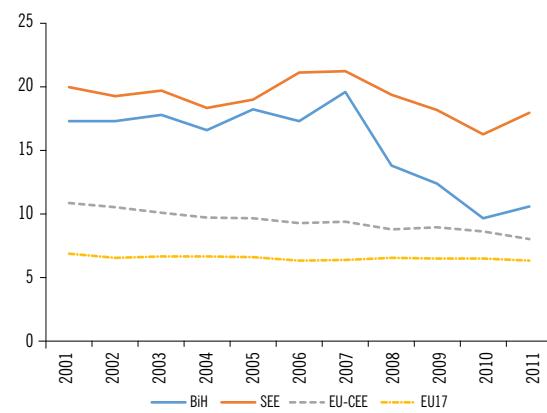


Source: MICS, 2011

- 3.95 BiH benefits significantly from net power exports.** Between 2001 and 2011 net power exports averaged 14 percent of total generation. A linear trendline reveals net export growth, with a positive coefficient of 0.16 (Figure 3.35). Energy exports have made a significant contribution toward exports of goods and services. With very limited trade between companies, partly as a result of low power prices mandated for local sales making it more profitable to sell abroad, and using imports to balance supply and demand.

Figure 3.34: BiH: distribution losses are falling

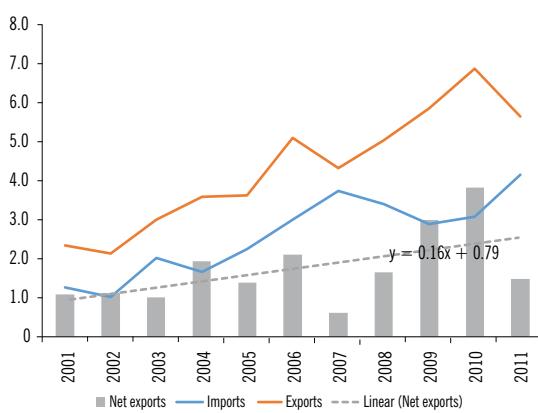
Distribution losses as % net generation



Source: U.S. Energy Information Administration and Staff Calculations

Figure 3.35: ... and net exports are positive

Power trade, GWh



Source: U.S. Energy Information Administration

- 3.96 Investments in new renewable energy (RE), including small hydro plants, sources experienced steady growth in recent years.** Due to abundant natural potential, focus is mostly on small hydropower plants, with few wind parks in preparation. Further utilization of new RE sources is limited by budgetary constraints (for financing of subsidization schemes) which is partly necessary due to below-cost tariffs, and transmission grid bottlenecks due to the need for them to be safely accommodated.⁹⁹

⁹⁹ Currently, the transmission grid enables 350 MW of wind power capacity to be safely accommodated—more than that is not possible due to grid constraints. ISO identified wind projects with total size of 2,700 MW on the waiting list (including those 350 MW).

- 3.97 Yet behind this positive story lies a sector with deteriorating assets, underutilized resources, and high inefficiency.** Aging thermal power plants slated for closure need to be replaced. Hydropower potential is continually unrealized as large projects are postponed or cancelled. At the same time, consumption is estimated to increase significantly. In addition, BiH is one of Europe's least energy efficient economies, consuming public and private resources and harming firms' export competitiveness due to higher energy inputs compared to other countries. It also presents a future risk for firms if energy prices increase. A combination of the aging power plants, energy inefficiency, and tariffs that are below cost recovery (financed partly by subsidies to mines, which are owned by the generators) help to create polluted cities. In addition, the country's large electricity exports are, in part, a reflection of less than perfectly functioning domestic markets as electricity firms would have to sell to each other internally at below-market prices. Finally, a State-level energy sector strategy, a core document to address these and a range of other energy sector issues, has never been developed in BiH.
- 3.98 A significant amount of installed thermal capacity is slated for closure and if no significant power generation facilities are brought on-line in the next 10 years, BiH could become an electricity importing country.** A little over half of thermal capacity dates from the 1960s and 1970s and over half of the TPP capacity is slated for closure in the next ten years, although it seems likely planners may adjust the closure dates to help meet demand.¹⁰⁰ A new plant under construction¹⁰¹ will replace only a third of this capacity, while two other plants designed to replace the remainder¹⁰² will unlikely be ready in time although planned closure dates could be adjusted. The list of thermal power plants (TPPs) slated for closure includes 52 percent (920 MW out of 1775 MW) of the country's thermal capacity, exclusively serving baseload power needs. Although it is difficult to estimate the total cost of future investment needs, the privately owned TPP, Stanari (currently in construction stage), has a total investment value of €550 million for 300 MW of generation capacity, and four times this may be required over the next 15 years to keep pace with demand and to replace existing obsolete capacity. Other TPPs in the pipeline have uncertain completion dates.¹⁰³ Long development periods for TPP plants are not uncommon, and in BiH's case has tended to take six to seven years. For example, an Engineering, Procurement and Construction (EPC) contract for TPP Stanari was signed in May 2010, and the plant is planned to be on the grid in 2016.
- 3.99 New hydropower plants appear unlikely to be able to fill the gap without significant effort.** Hydropower projects with capacity totaling over 16 percent of the currently installed capacity have recently been cancelled or postponed, often following pressure from civil society organizations (CSOs).¹⁰⁴ The reasons for cancelling or postponing hydropower projects vary. However, only in a few cases the reasons were based on environmental or

¹⁰⁰ The following TPPs are slated for closure by 2025: Kakanj 5 (110 MW capacity TPP due for closure in 2022); Tuzla 3 (110 MW and 2019); Tuzla 4 (200 MW and 2024); Tuzla 5 (200 MW and 2024); Ugljevik (300 MW and 2025). See: Energy Community (2013), "Study on the Need for Modernization of Large Combustion Plants in the Energy Community" and Independent System Operator (2014), "Generation development indicative plan 2015 - 2024"

¹⁰¹ Stanari (300 MW capacity).

¹⁰² Tuzla 7 (450 MW capacity), for which an MoU for financing recently signed but no construction has yet begun. Kakanj 8 (300 MW capacity), which is still in the design phase. Commissioning of Tuzla 7 is planned for 2019, and Kakanj 8 for 2022. No construction has started yet. Since construction of the TPP takes 5-7 years, it does not seem realistic these two plants will be commissioned on time.

¹⁰³ Ugljevik 3 (600 MW), no construction started; Banovici (300 MW), design documents under preparation; Zenica (388 MW gas-fired); Kongora (550 MW).

¹⁰⁴ Cancelled project is: Konjic. Postponed are: Buk Bijela, Glavaticevo, Foca, Paunci, and Ustikolina.

social issues (although one recent case on River Drina involved reducing the dam height on Buk Bijela, but the project is still to be developed with reduced capacity). Other failures often involve administrative issues. On the BiH level, no competencies exist related to project development. However, the BiH Council of Ministers has to approve all projects being developed on rivers with neighboring countries. RS tried to utilize the middle Drina river stretch (bordering Serbia), but the plan was not approved by the Council of Ministers. In RS a number of concessions (or similar water rights) were granted, in some cases to renowned international companies, but the majority of these projects were ultimately not implemented. The reasons for failure to develop those into investments were a combination of political instability, lack of adequate consultations on or readiness for concessions from the other Entity, lengthy procedures, unrealistic demands by the local community (local communities take shares in fees collected by the project and often demand unrealistic concession fees). Some companies faced their own internal problems or pulled their investments in the region as a whole. The fact that the only two medium-size hydropower plants are currently being developed in RS indicates that only a limited number of companies are able to successfully develop their projects in such an environment. In FBiH there have been two success stories: Mostarsko Blato (60 MW) and Pec Mlini (30 MW) are already in operation. Construction of the HPP Vranduk (20 MW) will start very soon. A number of additional projects are currently being developed by Elektroprivredas. The FBiH government has never granted a concession for an HPP with a size of more than 10 MW to a private company, due to the intention of developing such projects through SOEs.

3.100 Currently no comprehensive and reliable assessments of wind or solar potential and estimates for hydro potential date to the Yugoslav period. These hydropower assessments may not be reliable and do not take into account developments on environmental and social requirements, new riparian issues or institutional issues related to the creation of the political Entities after the war. Nonetheless, the estimates are the following:

- Theoretical hydropower potential amounts to 99.256 GWh/a
- Technical hydropower potential amounts to 23.396 GWh/a
- Utilized hydropower potential amounts to 9.000 GWh/a (approx. 40 percent of the technical potential)

3.101 Energy tariffs are too low to encourage the private sector to finance the construction of many new power plants. With pre-tax residential tariffs at around 7.6 €cent per kilowatt hour at end 2013 (though slightly increased since then) (Figure 3.36), tariffs are unlikely to encourage private sector investment in significant new generation. Higher energy tariffs would be required to stimulate significant private sector investment in new power generation capacity. This would place additional urgency on the importance of well-targeted social protection mechanisms so that the poor are cushioned against unaffordable price increases.¹⁰⁵

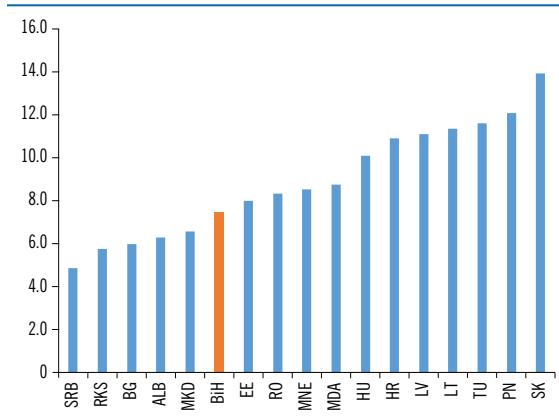
¹⁰⁵ The social protection mechanism should support the poor in general rather than subsidies energy, which is just one product they consume. See: World Bank (2012), "Balancing Act: Cutting subsidies, protecting affordability, and investing in the energy sector in ECA". Available from: <https://openknowledge.worldbank.org/bitstream/handle/10986/12296/9780821397893.pdf?sequence=7>

3.102 Electricity tariffs are determined in a complex process led by the energy regulators, in which the SOEs must justify the reasons for their request related to tariff increase. When conducting feasibility studies for investment projects, SOEs sometimes rely on hypothetical market prices for electricity rather than on the actual tariff structure in the country. Despite this, SOEs are allowed to pursue their investment plans under market prices. If projects are developed by the IPPs, the transmission and distribution network is obliged to purchase generation only from power plants under 10 MW installed capacity. Investment relying on higher than regulated tariffs and no clear domestic market may present future contingent liability issues. Increasing tariffs to at least cost would, however, have social impacts on poorer groups that would need to be mitigated through a functioning social protection mechanism that targets the poor effectively.

3.103 At the same time as power stations are closing and new ones difficult to build, power demand is likely to increase. Power consumption per capita increased by 53 percent between 2001 and 2011 but still remained just 86 percent of the SEE average (see Annex XIV). Boosting shared prosperity will likely require this to increase. Some estimates place energy demand increases at 50 percent between 2010 and 2030, even under a scenario of little manufacturing growth¹⁰⁶ (Figure 3.37). Faster economic growth including in the manufacturing sector results in a more-than-doubling of power demand over the period. Meeting this demand will be challenging in an environment of decreasing generation capacity. Data from the Independent Systems Operation of BiH suggests that if all power plants are closed on the currently planned dates, BiH would become an energy importer by 2020, though a more likely scenario is that the aging power plants will continue to operate with ever decreasing efficiency (causing even more pollution in coming years), until new facilities come online.

Figure 3.36: BiH: Low tariffs unlikely to attract investment in much new generation

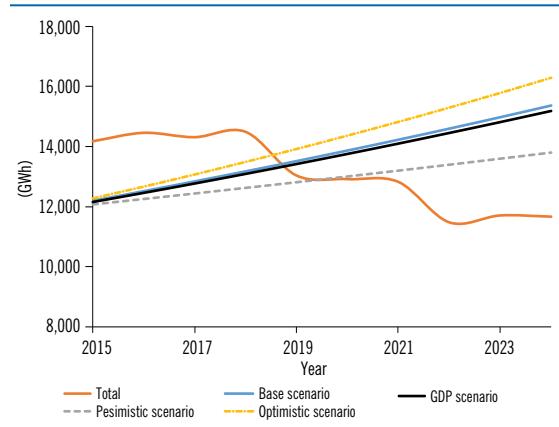
Residential energy prices, 2013 or 2012, €cent/kWh



Source: Energy Regulators Regional Association

Note: Data are from Q4-2013 except ALB, BG, HR, EE, PN, RO, SR, TU, and RKS, which are from Q4-2012.

Figure 3.37: BiH risks an energy crisis by 2020



Source: Staff estimations based on Independent Systems Operator of BiH:

<http://www.nosbih.ba/>

¹⁰⁶ See Avdacic et al. (2015).

3.104 Hydropower—which generates between a half and two thirds of the country’s power—is highly susceptible to weather conditions. Low rainfall reduced hydropower generation by over 20 percent in 2011, compared with the average of the previous ten years. The following year was even worse.

3.105 The growing exports of energy are matched by growing imports and both partly reflect a poorly functioning domestic energy market. Between 2001 and 2011 imports increased nearly as fast as exports. Domestic price regulation means that companies, after meeting domestic demand in their own supply area, prefer to sell (for higher prices) abroad. At the same time, power purchasers need to import energy, sometimes at higher tariffs than they charge. Domestic energy prices were liberalized only on paper as of January 1, 2015, meaning (i) it is difficult to purchase power at short notice if required since there is not a spot market and prices cannot adjust to demand and (ii) prices are not high enough to attract private investment in the sector. With the public sector unable to afford to invest without significant cuts elsewhere, the outlook for the BiH energy sector is bleak.

3.106 BiH is one of the most energy inefficient countries in Europe. Between 2001 and 2004, BiH generated around \$5.90 of GDP per kilogram of oil equivalent (koe) used, in line with the SEE average. From 2005, other SEE countries have begun to improve their energy efficiency, while BiH has stagnated. Its GDP per koe fell from \$6.40 in 2007 to \$5.00 in 2011. This compares with an improvement in SEE (from \$6.80 to \$6.90), EU-CEE (from \$7.90 to \$8.40) and EU17 (from \$8.80 to \$9.00). At the same time EU-CEE (which, in 2001, were as efficient as BiH) and EU17 countries also made steady improvements.

3.107 BiH releases substantially more carbon per koe than any other country in the SEE, EU-CEE or EU17.¹⁰⁷ In 2010, BiH released 4.8 kg of carbon per koe, 28 percent higher than the second worst performer, FYR Macedonia. The best performers in SEE, Albania and Montenegro, are in line with EU17 averages of 2.1 kg per koe, largely thanks to their use of hydropower, which generates almost all electricity in Albania. BiH’s poor performance stems from the fact that many of the coal generation facilities are inefficient lignite-burning plants.

3.108 Several factors contribute to the poor energy efficiency in BiH. High levels of losses in energy transformation, dated infrastructure and technologies, poorly insulated buildings and the use of inefficient equipment are major factors contributing to the inefficient use of energy on both the supply and demand side. Moreover, distorted energy pricing, combined with a fragmented legislative and institutional framework create an insufficient environment to incentivize energy efficiency improvements.

3.7 Making labor markets and social welfare work

3.109 BiH’s labor market challenge is twofold: to create suitable jobs for the de-skilled transition generation while ensuring that the younger generation moves into increasingly high-productivity jobs. The generation that entered labor markets before or during the transition and the war finds itself, to a significant extent, confronted with low demand for its skills. Their education is partially outdated, and so are some of the skills they acquired during their working careers. Many of them have either not found new proper employment after having

¹⁰⁷ Kosovo is not included in the database used.

lost their jobs in SOEs; or they are still working in SOEs, many of which are not sustainable in the future. Unfortunately, the prospects for this transition generation to find jobs in the modern, exporting sectors are dim. But, the service sector might offer opportunities for them in the form low-paying jobs, maybe even part time jobs. Germany, for instance, was able to create two million jobs in that category after its labor market reforms in the early 2000s. This would require opening up an entirely new segment of low-paying, flexible part-time jobs, with significant reforms of the labor code and labor taxation. At the same time, investments in the human capital of the next generation would have to be significantly increased to prevent youth from entering this low-pay sector, and ensure that they get the right skills and education for the jobs of the future.

3.110 Just 27 out of every hundred people were employed in formal or informal jobs in 2013.

A further seven were able to work but were not doing so and not looking for employment (Figure 3.38). This included discouraged workers and those for whom working may put them at risk of losing social welfare entitlements as well as others. Ten out of every hundred people were unemployed—that is actively seeking work and willing to work at the relevant wage rate. A total of 56 out of every hundred people were not in the labor force at all.¹⁰⁸ Even of those employed, more than half either work informally or in the public sector, leaving only very few that have formal private sector jobs—too few to sustain a country aspiring to become an EU member. Around 20 percent of employed people are estimated to be informally employed and around half of all formally employed people are employed in the public sector.

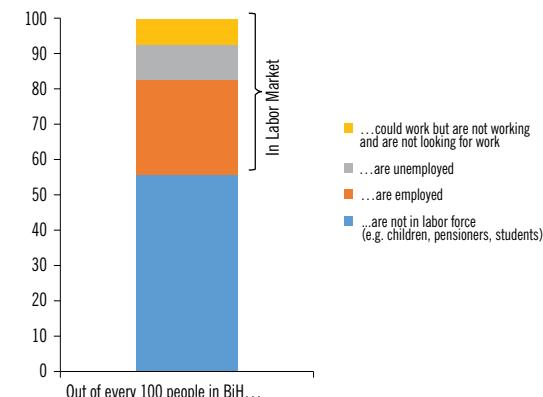
3.111 Long-term unemployment and short-term employment are particular issues. Of the unemployed, only 14 percent of men and 28 percent of women are unemployed for less than a year; the rest has been looking for a job more than a year, many for 10 years or more. Some employed people report having repeated three month contracts, which employers use to avoid the burdensome labor regulations. This adds to employment precariousness.

3.112 The low employment rate means that the few people with jobs need to support many others. The 27 out of every hundred people who are employed need to support not only themselves but also the remaining 73. This has resulted in high social security contributions rates (to fund pensions and benefits for the unemployed, for example), discouraging employment further.

3.113 Despite an output per worker that compared reasonably well with other Balkan countries in 2013 (including two EU members), output per resident was low. At over €13,200 output per worker in 2013, BiH's productivity compared well with other countries in the region. However, due to low employment rates, output per resident was just €2,884 in 2013 (Figure 3.39).

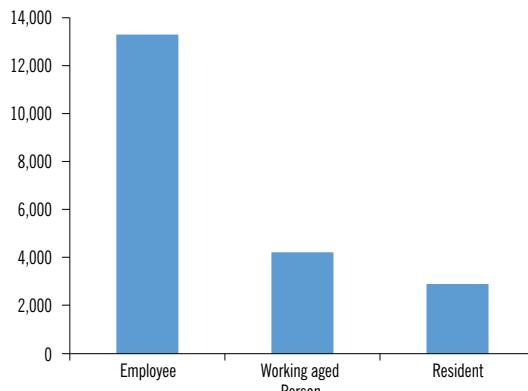
¹⁰⁸ Including, but not limited to: children, students, pensioners and the disabled.

Figure 3.38: BiH: Weak labor market engagement...



Source: BiH Agency for Statistics (LFS and preliminary census results) and staff calculations

Figure 3.39: ... and low output per resident



Source: BiH Agency for Statistics and staff calculations

Employment generators

3.114 Employment declined during the financial crisis and bottomed out in 2012. Official data record employment declining from around 890,000 people in 2008 to 813,000 in 2012 (Figure 3.40). Over half of the net job losses of 42,000, were in the industrial sector. Employment declined by around 16,000 and 19,000 in the agriculture and services sectors, respectively.

3.115 Males and females were differently affected by the financial crisis. In the industrial and service sectors, males and females lost jobs at around the same rate (Table 3.8). Male employment in the industrial sector was 14 percent lower in 2012 than in 2008 while female employment was 15 percent lower, for example. However, in the agricultural sector, which employed around a fifth of all workers in 2008, 12 percent of males lost their jobs compared to 4 percent of females. This may be because male agricultural workers tend to be more formal and females self-employed.

Table 3.8: Since 2008, most jobs were lost in industrial sector

% net job losses 2008-12

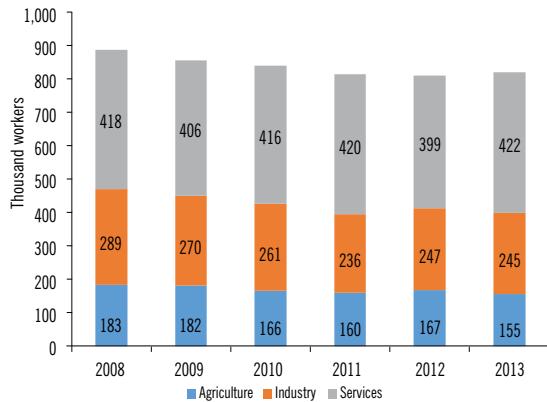
	Males	Females
Agriculture	12%	4%
Industry	14%	15%
Services	5%	3%
Total	10%	6%

Source: BiH Agency for Statistics and staff calculations

3.116 The crisis altered the sectoral composition of employment, particularly for males. With significant job losses in the industrial sector but comparatively few in services, the sectoral composition of employment shifted toward the latter. The manufacturing sector employed 40 percent of males in 2008 but this had fallen to just 30 percent by 2012 (Figure 3.41). At the same time the share of males employed in the service sector rose from 40 to 49 percent. There was a similar but much smaller adjustment toward the service sector and away from manufacturing for females.

Figure 3.40: Crisis caused decline in employment, especially in the industrial sector

Employment by sector, 2008-13



Source: BiH Agency for Statistics and staff calculations

Figure 3.41: Services sector driving employment away from manufacturing

Structure of employment



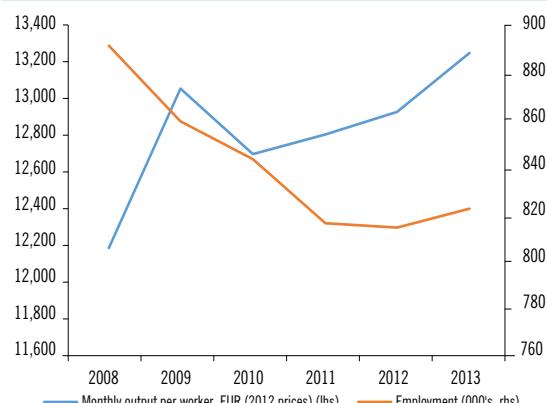
Source: BiH Agency for Statistics and staff calculations

Productivity and wages

3.117 Productivity—imperfectly measured as output per worker—increased during the crisis each year except 2010, but is far behind the best performers. Output per worker increased from €12,184 per year in 2008 to €13,243 in 2013, an increase of close to 9 percent or 1.7 percent per year. With the small increase in total output this was driven largely by reductions in employment, which declined by almost 8 percent over the period (Figure 3.42). At €1,109 per month (€1,243 per year), gross value added per worker in BiH is above estimates for FYR Macedonia (€823) and Serbia (€964) but below that for Montenegro (€1,281).¹⁰⁹ BiH also compares favorably with its two Balkan neighbors, Bulgaria and Romania, both of which are EU members. However, BiH is far behind the best performing eastern EU countries—average monthly gross value added per worker in Slovenia was €2,807 in 2013 and EU17 countries perform considerably better (Figure 3.43).

Figure 3.42: Productivity increased...

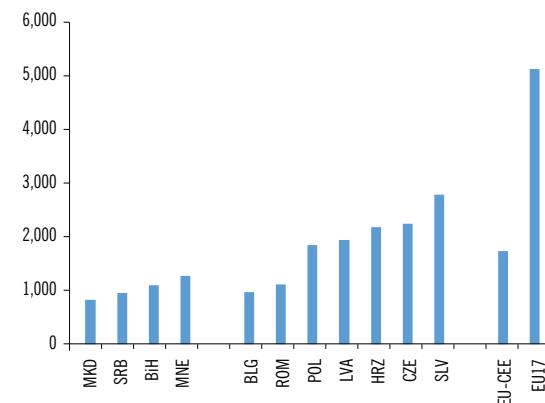
Output per worker per year and employment, 2008-13



Source: BiH Agency for Statistics and staff calculations

Figure 3.43: ... yet remains low compared to best performers

Gross value added per worker per month, 2013 (EUR)



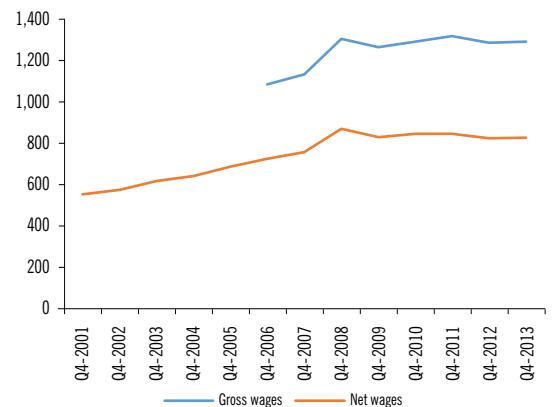
Source: Eurostat, BiH, SRB and MNE agency for statistics and staff calculations

¹⁰⁹ Montenegro may be overestimated since employment (the denominator) was based on official statistics, rather than Labor Force Statistics, as it was for all other countries in the sample.

3.118 Real wages increased fast during the boom years. Net wages increased by an annual average of 6.7 percent between 2001 and 2008. Gross and net wages both increased by around 9.5 percent between 2006 and 2008, pulled by an exceptional increase in 2008 as the European economy overheated (Table 3.9). The average worker's net wages rose from KM 599 per month (at 2012 prices) in 2001 to KM 879 in 2008 (Figure 3.44).

3.119 However, wage growth was constrained during the global financial crisis. Between 2009 and 2013, real gross wages rose an average of 0.5 percent per year. Real net wages have seen no real growth. Real wage growth has been held down since 2009 by a "double dip" recession which saw two years of negative GDP and wage growth. Average net wages declined by 4.6 percent in 2009 (Figure 3.45). In the same year, employment declined by 3.9 percent and GDP growth turned negative at -2.7 percent. Similarly, in 2012, real net wages fell by 2.6 percent as GDP contracted by 1.2 percent. The first seeds of healthy recovery were only seen in 2013. In 2013, productivity, employment and real wages all increased simultaneously for the first time since the start of the crisis.

Figure 3.44: Real average monthly wages
(KM, 2012 prices)



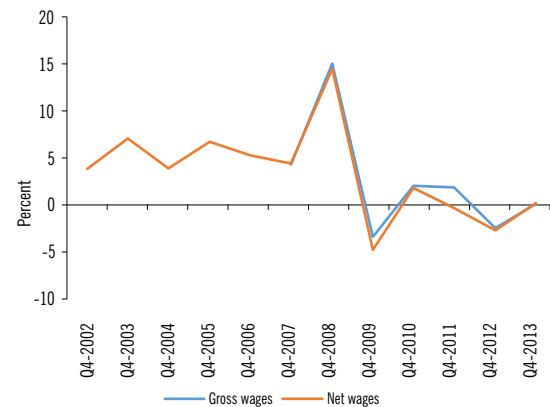
Source: BiH Agency for Statistics and staff calculations

TABLE 3.9: Increasing wages halted by crisis
Average annual change in real wages

	Gross	Net
2001-08		6.7%
2006-08	9.7%	9.5%
2009-13	0.5%	-0.1%
2008 increase	15.3%	14.7%

Source: BiH Agency for Statistics, IMF and staff calculations

Figure 3.45: Change in real monthly wages
(KM, 2012 prices)



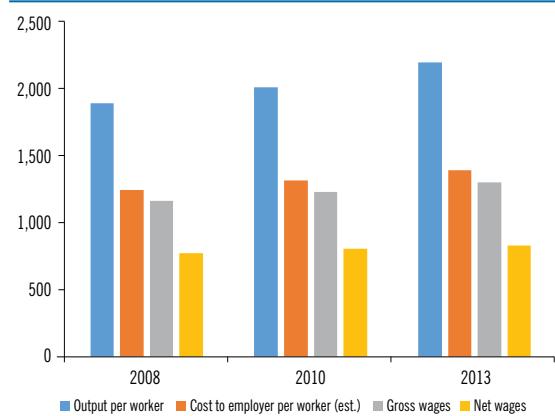
Source: BiH Agency for Statistics and staff calculations

3.120 Wages absorbed an estimated two thirds of total output before the crisis and remained high during it. Gross value added per worker was KM 1,893 per month in 2008 (Figure 3.46). With gross wages of KM 1,163 and estimated total labor costs slightly higher (KM 1,244), labor costs were around 66 percent of total worker productivity. Wage restraint combined with some increase in productivity between 2008 and 2013 helped this to fall to 64 percent in 2013.

3.121 Despite this, the gap between gross and net wages has widened in recent years. Between 2006 and 2013, the gap between average gross and net wages has widened from KM 297 per month in 2006 to KM 469 in 2013, although the increase has slowed since 2011 (Figure 3.47). In percentage terms, in 2006, workers took home 67 percent of their gross salary but by 2013, they took home only 64 percent. High social security contributions are responsible for a large proportion of this gap.

Figure 3.46: Whilst wages have remained high...

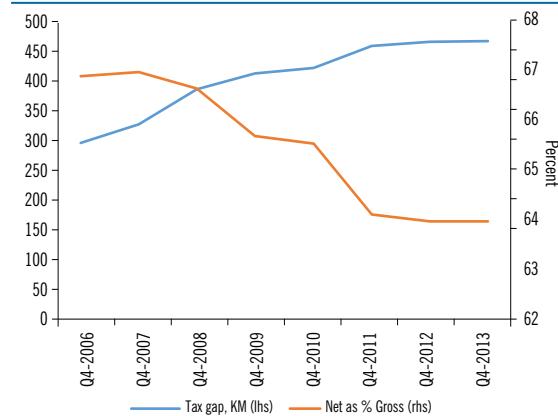
Nominal monthly output per worker and labor costs, KM



Source: BiH Agency for Statistics and staff calculations

Figure 3.47: ...the gap with net wages has widened

Gap between gross and net wages, monthly



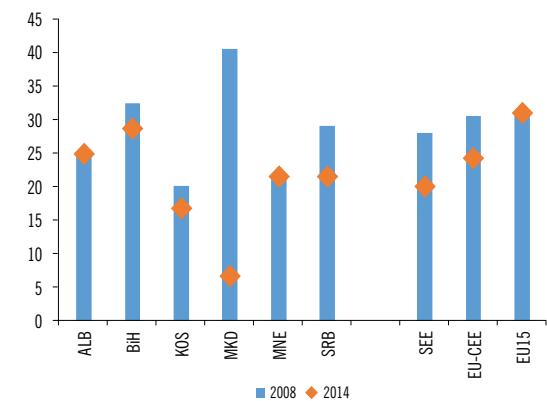
Source: BiH Agency for Statistics and staff calculations

Labor market regulations

3.122 BiH has some of the most rigid labor market regulations in SEE. The WBG rigidity of employment indicators offer an (imperfect) insight into how easy or difficult it is to employ workers. It includes factors such as the minimum compared to the average wage and redundancy costs.¹¹⁰ Overall, BiH is estimated to have the most rigid labor market rules in SEE, in line with those in EU15 countries (Figure 3.48). Hiring and firing are both difficult (Figure 3.49 and Figure 3.50) and the minimum wage as a share of output per worker is higher even than in EU15 countries (Figure 3.51). Collective bargaining combined with the Labor Codes currently enforced drive these rigidities. An estimated 50 percent of employees in BiH were covered by collective bargaining agreements in 2008, similar to Croatia—and these are largely in the public sector.

Figure 3.48: BiH: most rigid labor market rules in the region...

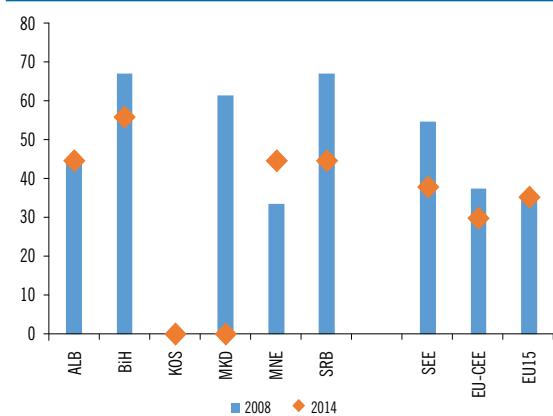
Rigidity of employment, index



Source: World Bank calculations based on Doing Business indicators (2008 and 2014).

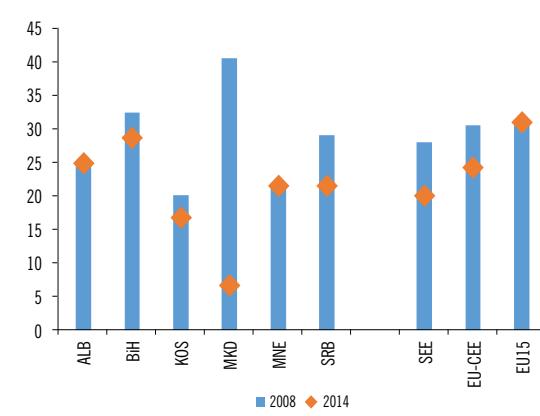
¹¹⁰ See: <http://www.doingbusiness.org/data/exploretopics/labor-market-regulation>

Figure 3.49: ...most difficult in hiring...
Difficulty of hiring, index



Source: World Bank calculations based on Doing Business indicators (2008 and 2014)

Figure 3.50: ... most difficult in firing...
Difficulty of redundancy, index



Source: World Bank calculations based on Doing Business indicators (2008 and 2014)

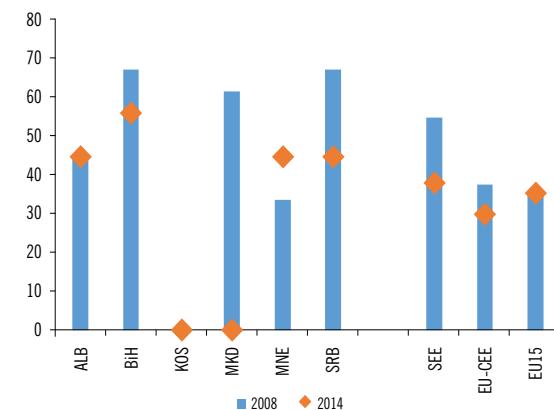
Social benefits that help the poor and encourage work

- 3.123 **Spending on social protection schemes in BiH is high by international standards.** However this spending is biased toward high public spending on pensions (at 10.2 percent of the GDP) and categorical benefits out of non-insurance social assistance. On the other hand, spending on active labor market programs is low resulting in limited opportunities for employment support for disadvantaged groups in the labor market.
- 3.124 **BiH spends close to 3.5 percent of its GDP (2011) on non-insurance-based cash transfers, which makes the country one of the highest spenders in the ECA region.** About 80 percent of this spending is allocated to categorical benefits for persons with non-war-related disabilities, civilian victims of war, and war veterans, which are disproportionately benefiting individuals in the richest quintile of the population in terms of targeting.
- 3.125 **The current mix of social protection programming and spending is unsustainable and does not fully respond to the needs of the population.** It puts disproportionate weight on categorical benefits (about 7.4 percent of fiscal expenditure), crowds out potential investments on labor market programs and does not provide much room for benefit design reforms and expansion of coverage; e.g. introduction of in-work benefits or expansion of employment support programs.
- 3.126 **The main performance indicators of the social assistance system in BiH are poor by the standards of middle-income countries in Europe.** Targeting accuracy is low, while the leakage of resources to the richest 20 percent of the population is significant. According to the estimates published in a study (IBHI and Maastricht 2013),¹¹¹ in 2011, the members of the poorest quintile received only 18 percent of non-contributory cash benefits, whereas the richest quintile received about 20 percent.

¹¹¹ Non-contributory Cash Benefits for Social Protection in BiH (2013). IBHI and Maastricht.

3.127 Institutional capacity and linkages across social assistance and labor programs are serious challenges to serving the populations at risk. Centers for social work lack technical and administrative capacity to substantially improve targeting of social benefits and be able to offer serious social work and counseling to reach out to populations at risk of poverty. In addition, lack of coordination/data sharing between social assistance and employment services i.e. public employment services (PES) and centers for social work. Finally, the PES's ability to serve that function is severely limited by various obstacles: it is overwhelmed with registering unemployed who are not looking for work, but want free health insurance.

Figure 3.51: ... and highest minimum wage as % value added per worker

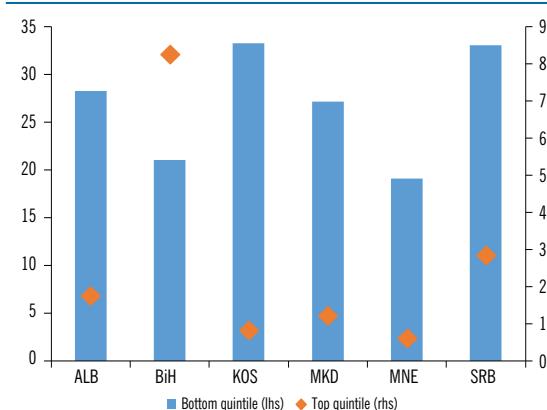


Source: World Bank calculations based on Doing Business indicators (2008 and 2014).

3.128 The social benefit system not only fails to help the unemployed find work but actually provides disincentives. Social assistance is currently withdrawn at a rate of 100 percent of any formal income—meaning that for every KM earned, beneficiaries lose one KM in benefits. This, combined with a tax system that penalizes low-income workers, helps to keep unemployment high.

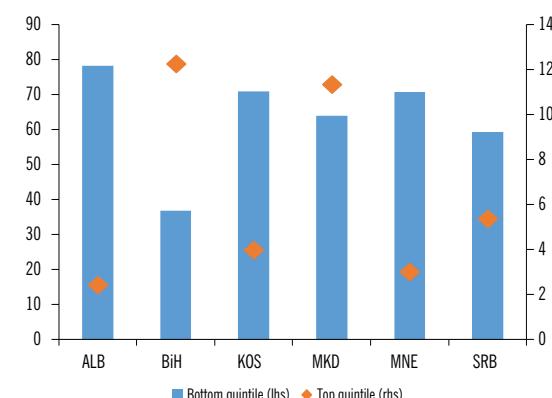
3.129 The current social safety net system does not provide adequate coverage to the poor. Despite the large share of GDP used for social security and other social benefits, these benefits fail to reach the poor adequately. Only around 21 percent of the poorest quintile receive some form of social benefits, lower than any other country in SEE except Montenegro (Figure 3.52). Over 8 percent of the wealthiest quintile receives benefits. The targeting of social benefit spending is also inefficient, with just 37 percent being received by the poorest 20 percent and 56 percent by the B40, significantly worse than any other country in SEE (Figure 3.53). At the same time, over 12 percent of public spending on social benefits reaches the wealthiest 20 percent of the population. Further, the poor only absorb around three quarters of total non-contributory spending in RS and around two thirds in FBiH. A 2010 World Bank Poverty Report found that if these transfers were to be eliminated, the poverty headcount would increase by only 1.2 percent. In contrast, without pension transfers poverty would increase to 25.8 percent of the population.

Figure 3.52: Social safety net generous, but coverage needs improvement...
% of top and bottom quintiles receiving social protection



Source: World Bank Europe and Central Asia Social Protection Database based on household surveys from the following years: ALB: 2008; BiH: 2007; KOS: 2009; MKD: 2010; MNE: 2011; SRB: 2010.

Figure 3.53: ...as well as targeting
% of social protection spending going to the top and bottom quintiles



Source: World Bank Europe and Central Asia Social Protection Database based on household surveys from the following years: ALB: 2008; BiH: 2007; KOS: 2009; MKD: 2010; MNE: 2011; SRB: 2010.

3.8 Emerging issues and reform areas: Restoring growth and creating jobs

3.130 The BiH economy needs to rebalance away from a dominant state, imports and consumption, toward the private sector, investments and exports. This reorientation would also provide the biggest push in creating jobs, from which the B40 would benefit as many of them are shut out from the formal labor market. There are five main policy areas which BiH needs to address to achieve higher growth and more prosperity for its citizens: Putting BiH to work through labor market reforms, making it easier to do business, creating a leaner and more effective government, maintaining and deepening financial and macroeconomic stability, and building economic infrastructure for growth.

3.131 Putting BiH to work: reforming the labor market, improving social protection delivery and reducing the cost of labor. BiH needs to open up the job market so that many more, especially in the B40, would benefit from better paid and more regular employment. The EU's recent Compact for Growth and Jobs¹¹² notes the importance of labor market reforms including changes to the labor code (capping severance pay, time-limiting collective agreements, etc.) and the reform of social assistance benefits (adoption of in-work benefits, reform of unemployment benefits). Policies that could help to achieve this are wide ranging; the priority measures are the following:

- Reducing the tax wedge, particularly on lower paid workers could help to boost formal employment.
- Introducing the phased withdrawal of social assistance would encourage employment among poorer groups and help to boost the prospects of the B40. De-linking unemployment benefit and health insurance would also discourage abusive use of the public employment services and allow the PES to concentrate on employment services, including training.

¹¹² Available at: http://europa.eu/?page_id=547

- Increasing private sector provision of employment services would improve the coverage, and breadth and quality of services provided by public employment services and thereby improve employment outcomes.

3.132 Making it easier to do business: improving competitiveness, entrepreneurship and the investment climate. With one of Europe's poorest business environments, BiH risks suppressing its private sector, preventing it from competing in export markets and even in the domestic market. Establishing a company that operates across the entire country is difficult due to a plethora of different licenses or permits required in each canton. Improving the business climate would help to improve competitiveness and enhance agricultural and manufacturing exports, areas in which the poor and B40 are more likely to work. A recent report by the European Stability Initiative (ESI) highlighted fourteen steps that BiH (and its Entities or cantons) could take to make significant improvements in its Doing Business rankings.¹¹³ While, like any indicators, the Doing Business rankings provide only a broad indication as to the overall business environment, any steps would be positive. Difficulties improving even only the indicators included in Doing Business does not bode well for the broader business environment. After first important steps to streamline the business climate, BiH could go much further to make it attractive to do business, including through the following reforms:

- Improving the ability to export—through improved ports and soft infrastructure at land borders—would be a boon for exporters in all sectors, including agriculture and manufacturing, and help firms from BiH insert themselves into European supply chains. It could also encourage export-orientated FDI.
- Making it easier to trade across borders by streamlining customs procedures, including the introduction of risk-based inspections, and upgrading its quality assurance infrastructure, especially regarding phyto-sanitary standards.
- Reducing red tape through further enhancements in business licensing, paying taxes, registering real properties, and construction permitting.

3.13 Creating efficient, effective and sustainable government: reducing the size of the public sector while ensuring fiscal sustainability and improved public service delivery. Public revenues and expenditures are among the highest in the world and both their amount and structures hinder growth and harm employment. A number of specific measures would make the government more efficient, effective and sustainable:

- With consumption at over 100 percent of GDP the structure of revenues could be changed so that it favors production rather than consumption, and the complexity and time burden of tax compliance could be reduced. Shifting toward a new production-and export-growth model is necessary to boost productivity and competitiveness of the economy, generate long-term employment gains and expand inclusiveness. Reducing taxes on labor and production would be one step forward, while exports would also gain from an improved investment climate and better transport connectivity.
- Public investment is low despite record high public expenditures. Additional efforts could be made to leverage EU resources for public investment.

¹¹³ See: http://www.esiweb.org/index.php?lang=en&id=156&document_ID=163

- The significant SOE sector, offers an opportunity to raise resources, reduce subsidies and contingent liabilities and help to boost the private sector. Gradually reducing the public sector role in the economy, including through reduced SOE presence, would help to re-allocate resources toward the more productive private sector. This would help to boost growth and employment, benefiting in particular those who do not have access to the labor market, who tend to be in the B40. Unfortunately, this SCD has not been able to obtain detailed information to understand the SOE sector in depth. Further information would be required to understand the best reform path.

3.134 Adding financial firepower: maintaining financial stability and expanding access to finance.

Even though BiH maintained macroeconomic stability, even during the global financial crisis, new vulnerabilities are emerging. Large non-performing loans and public sector arrears must now be addressed in order to reignite growth and maintain long-term macroeconomic stability. The following reforms will be crucial:

- Expanding access to finance would help to boost private sector output and employment growth and investment;
- Finding ways for banks to resolve NPLs to spur higher lending, which could particularly benefit agricultural enterprises and thus many B40 farmers who are currently unable to expand;
- Safeguarding financial sector stability by strengthening supervisors' corrective and enforcement powers, strengthening of governance and risk management practices in selected banks, and improvements in the financial safety net framework. The benefits would be threefold: maintaining the stability of the financial system, protection of insured depositors and limiting fiscal implications; and
- Improving banks' risk analysis would also help reduce future NPLs.

3.135 Building economic infrastructure for growth: powering and connecting BiH to the world.

Despite high access levels of close to 100 percent, falling distribution losses and positive net exports, the energy sector in BiH is facing many challenges. BiH is one of Europe's most energy inefficient and carbon intensive countries, harming competitiveness and increasing pollution, especially in its cities. In addition, BiH has the poorest physical transport infrastructure in the region and poor "soft infrastructure" making border crossing time consuming for firms and citizens. ICT infrastructure is affordable but international connections are poorer than in neighboring countries. The following priority reforms are critical:

- Ensuring sufficient power supply—including through a renewed effort to boost renewable generation capacity—would help to maintain future economic growth and prevent power cuts, which could occur if supply does not keep pace with demand, harming the private sector and economic growth;
- Ensure sufficient investment in the sector and to reduce over-consumption of power which is driven by subsidized tariffs;
- Tackling energy inefficiency would help to improve the competitiveness of exporters (partly compensating for increased tariffs), and reduce urban pollution; and
- Improving transport would help to connect rural populations to services, including health, education and banking as well as employment in larger settlements.

PROMOTING SOCIAL INCLUSION

BiH is undergoing a major demographic transition which also influences its development outlook. Since 2014, old people (age 65+) exceed the number of children (0-14 years). The country faces two additional challenges which are rare among emerging economies: First, it is shrinking. The overall population has been declining significantly from 4.5 million before the war to 3.8 million today. Second, BiH stopped urbanizing. Due to a combination of lack of demographic momentum and lack of job opportunities in cities (and elsewhere), as well as other reasons, many Bosnians live in rural areas, where poverty is higher.

With low employment, many citizens rely on social welfare, as well as remittances and pensions from abroad. Social indicators are around average for a European middle income economy and financing for health and education is significant. However, results do not match the large amount of spending. Fragmentation and duplication of services results in substantial wastage, for example in the procurement of pharmaceuticals. In addition, BiH faces significant health challenges with a dual challenge of stunting and obesity among children, as well as a rising burden of other non-communicable disease among adults, which are responsible for almost all premature deaths and, with one of the world's highest smoking rates, tobacco use presents a large challenge.

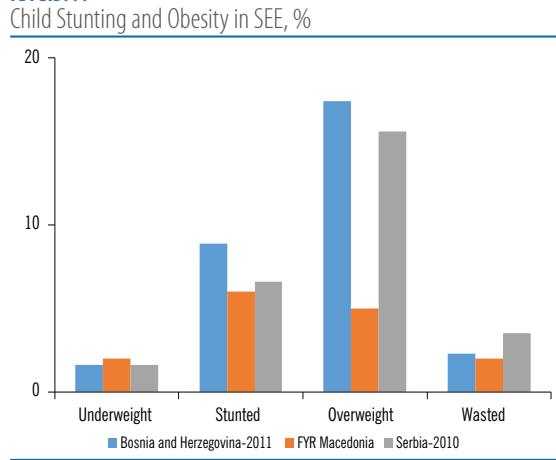
Enrolment rates are broadly in line with regional comparators with the exception being early childhood education and pre-primary education, which have among the lowest enrolment rates in the region. Education resources fail to follow pupils, resulting in large disparities in expenditure per pupil across the country. Information and statistics on human capital remain scattered and scarce thus preventing effective policy-making. Lack of useful information makes it difficult to collect the evidence required to hold teachers, schools, cantons and Entities accountable for their work and to allow for monitoring and reporting on education statistics and learning outcomes. There is no nation-wide student assessment or examination system in place, and BiH has not participated in international benchmarking exercises, such as PISA. This severely hampers the ability of the government to assess efficiency and effectiveness of sector spending, and the impact of education policies on learning.

Access to piped water is high in total but only around three quarters of the poorest quintile have access to it, with lower rates for the B40 especially in rural areas. Water tariffs are below-cost but there are significant maintenance needs in some areas (partly to reduce water loss). Access to sewage systems is low, driven primarily by very low rural access which forces (generally poorer) rural households to use more expensive sanitation facilities.

4.1 Health service delivery and efficiency

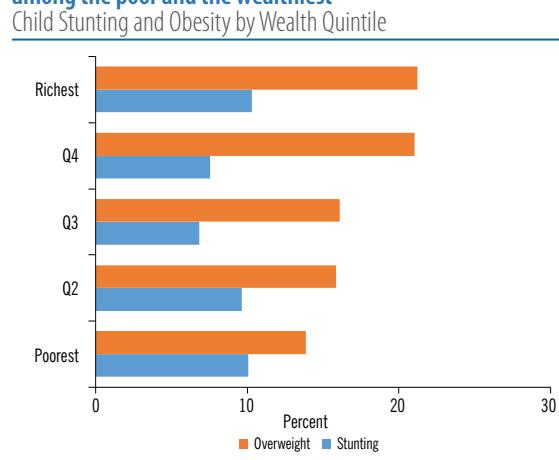
- 4.1 **Although BiH performs better than the SEE or EU-CEE average in life expectancy, it faces significant health challenges, with relatively poor health outcome indicators.** While infant mortality rate (5.8 per 1000 in 2011) was below Serbia's 6.3 per 1000, it was 20 percent higher than Croatia (4.6 per 1000). Latest data places the infant mortality rate in the RS at 3.2 in 2014. The life expectancy gap between BiH and the EU has increased since 1990 (from 73/75 years in 1990 to 76.6/80.2 years in 2011 for males and females, respectively). In addition, access to health service and medical insurance is limited for vulnerable groups, in particular for Roma (72 percent of Roma having service access and 66 percent of them having access to medical insurance, compared to non-Roma living in the same community with 93 percent service access and 97 percent medical insurance access).¹¹⁴
- 4.2 **BiH has one of the highest prevalence of childhood malnutrition in the region, characterized by a double burden of overweight and stunting in children.** One in ten children is stunted (signaling chronic under-nutrition), whereas one in five is overweight or obese (Figure 4.1). Moreover, half of children who are both stunted and overweight (SO) are 0-12 months, which has acute long-term health consequences. Malnutrition is prevalent across all wealth quintiles (Figure 4.2), but the poor, especially in rural areas, have higher levels of both stunting and overweight than those in middle-income groups (although the wealthiest also have high rates of overweight). For instance, overweight in rural children ranges between 15 percent in the B20 to 10 percent in the T20. Children's overweight prevalence declined between 2000 and 2011 in RS from 19.4 to 17.4, percent but increased in FBiH from 15 and 17.4 percent. Similarly, chronic malnutrition declined over time in RS, but remained at about 10 percent in FBiH.

Figure 4.1: BiH: Child stunting and obesity at worrisome levels...



Source: MICS and staff calculations

Figure 4.2: ... with higher rates of both stunting and obesity among the poor and the wealthiest

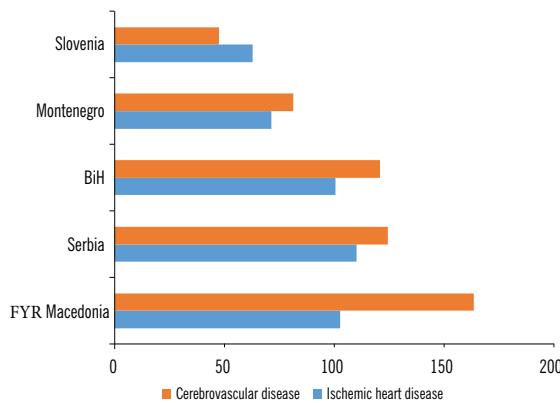


Source: MICS and staff calculations

¹¹⁴ UNDP/WB/ EC Regional Roma Survey 2011.

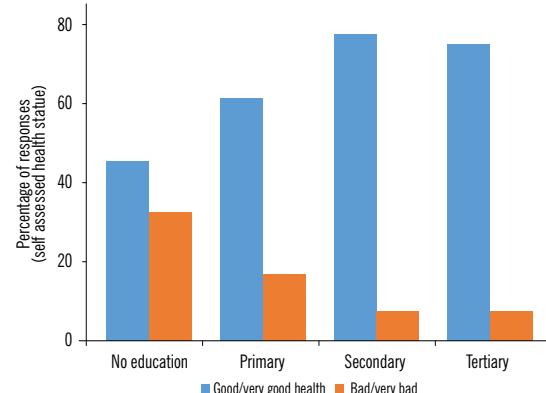
4.3 **The WHO estimates¹¹⁵ that 95 percent of premature deaths in BiH are attributable to four major non-communicable disease (NCD) groups.** These NCDs - cardiovascular diseases, cancers, diabetes and chronic respiratory diseases - are also the leading cause of ill health and disability in the country. This epidemiological pattern is the result of the demographic transition but also due to the fact that BiH has one of the highest rates of smoking prevalence in the world.¹¹⁶ Dietary risks, high blood pressure and alcohol use are also important risk factors, the latter particularly among adults aged 15-49 (HMNE, 2010¹¹⁷), particularly cardiovascular diseases (CVD). CVD accounted for over half of all premature deaths in 2008 (Figure 4.3), rising to nearly two-thirds of total death in BiH in 2013 (WHO, 2014). Within the former Yugoslav Republics, BiH and Serbia have CVD age-standardized mortality rates (both sexes) much higher than Slovenia or Montenegro, but not as high as FYR Macedonia. In terms of mental health, while depression disorders were a leading cause of reductions to Disability Adjusted Life Years (DALYs) in 1990, BiH has made remarkable progress in reducing by half associated burden of disease from these conditions (IHME, 2012). Nevertheless, 45 percent of people in FBiH reported having experience stress in the month prior to the survey (Health Survey FBiH, 2014), and there is some evidence that this may have negative labor market impacts.¹¹⁸

Figure 4.3: BiH: CVD rates are around average for SEE
CVD age-standardized mortality rates



Source: WHO, 2008

Figure 4.4: Education level, not wealth, drives perceived health
Self-assessed health status by education status



Source: HBS 2011 and ECAPOV

4.4 **Self-assessed health status is correlated with level of education but not socio-economic status.** Around 80 percent of those with secondary or tertiary education reported being in good or very good health compared to just 60 percent of those with no education and 70 percent of those with only primary education (Figure 4.4). Interestingly, self-assessed health status differs very little between the socio-economic quintile.

¹¹⁵ World Health Organization-NCD Country Profiles, 2011

¹¹⁶ Euromonitor International, Tobacco in Bosnia and Herzegovina, April 2012

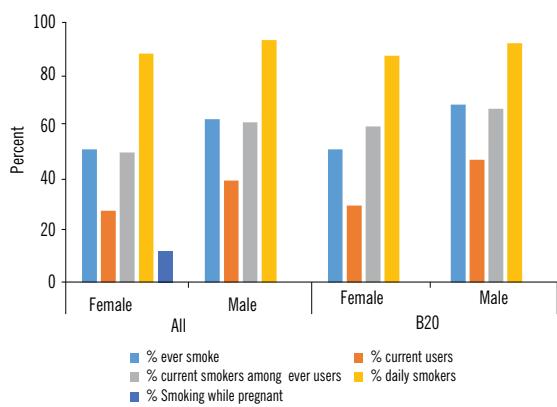
¹¹⁷ HMNE (2010) GBD Country Profile: Bosnia and Herzegovina as part of the The Global Burden of Disease Study 2010 (GBD 2010), Seattle, USA. http://www.healthdata.org/sites/default/files/files/country_profiles/GBD/ihme_gbd_country_report_bosnia_and_herzegovina.pdf

¹¹⁸ Do and Iyer, 2009. See: <http://documents.worldbank.org/curated/en/2009/11/11364029/mental-health-aftermath-conflict>

4.5 BiH has one of the highest smoking rates in the world, with higher rates among poor and the B40, but tobacco taxes are relatively low and enforcement of anti-smoking regulations remain weak, while urban pollution also likely contributes to high rates of some NCDs.

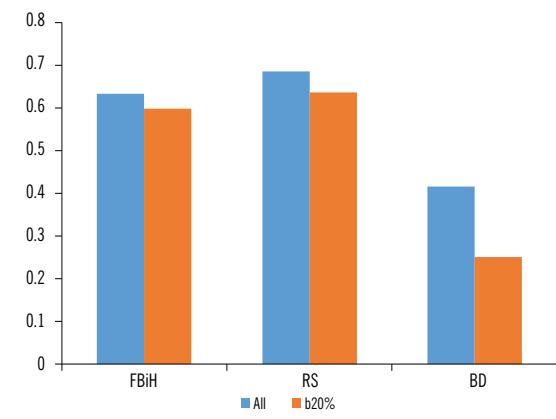
Smoking behavior differs by demographic characteristics such as gender and wealth (Figure 4.5). Males are more likely to smoke than females (40 vs 28 percent) or to have ever smoked (64 percent vs 52 percent). Poor males are particularly likely to smoke (48 percent) or to have tried smoking (70 percent) though there is not a large difference in the number of cigarettes per day between the poor and non-poor (for either males or females). Around 12 percent of females report smoking while pregnant. Binomial (probit) and smoking intensity selection models¹¹⁹ reveal that higher levels of education are significantly associated with lower probabilities of smoking for both women and men (especially secondary for women and higher education for men). Smoking rates in rural areas are significantly lower than in urban areas, but there is no difference in the number of cigarettes consumed between rural and urban men. Tobacco excise taxes are currently only 58 percent of retail prices, which is lower than the EU averages and the WHO recommendation of 75 percent. An amended excise tax law on tobacco was passed in July 2014¹²⁰, which proposes incremental increases to tobacco excise taxes to raise additional revenue and attempt to reduce smoking rates. While some legislation is in place to discourage smoking, BiH remains far from WHO recommendations in terms of restrictions on tobacco advertising, cigarette warnings, and restrictions on public smoking. Moreover, enforcement of existing regulations on smoking in public buildings and restaurants is limited. In addition to smoking, BiH has some of Europe's highest urban pollution rates. A large pool of evidence suggests that this is detrimental to health and that poorer groups suffer most. See chapter 5 for more details.

Figure 4.5: BiH: Smoking rates higher among the poor
Smoking Indicators, 2011



Source: MICS and staff calculation

Figure 4.6: B20 children less likely to be vaccinated
Immunization Rates, Population versus Poorest 20 percent, 2011



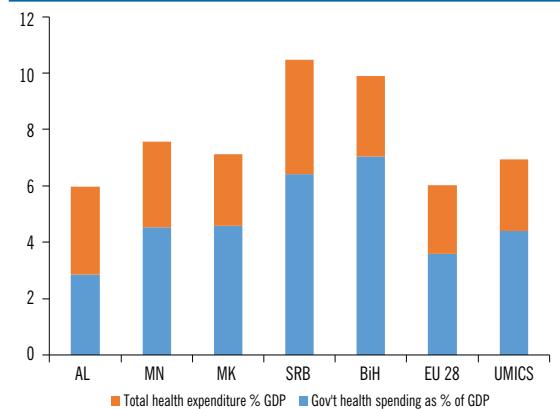
Source: MICS and staff calculation

¹¹⁹ See full statistical model in Annex XI. Having secondary or higher education reduces also the number of cigarettes smoked among men, whereas only having higher education reduces smoking intensity among women. Smoking probability rates among poor women (B20) are higher than women in other wealth quintiles. Whereas being in the T20 is associated with lower smoking prevalence among men.

¹²⁰ Under the amended law, the general excise duty is increased from 126 Bosnia-Herzegovina Convertible Mark (BAM) (about US\$88) (stipulated under art. 21(6) of the Law on Excise Duties) to BAM176 (about \$123) per 1,000 cigarettes. (*Id.*) In addition, a duty on fine-cut tobacco is introduced in the initial amount of BAM78 per kilogram, but in future it is expected to increase to at least 80% of the minimum duty on cigarettes, i.e., to about US\$70 per kilogram. (*Id.*; Zakon o Akcizama u Bosni I Hercegovini [Law on Excise Duties in Bosnia and Herzegovina] (June 18, 2009), Official Gazette of BiH, No. 49/09.)

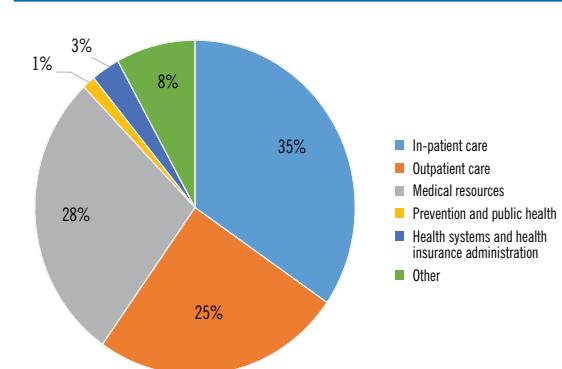
- 4.6 **Routine vaccinations are low compared to European standards, with children from poorer households having slighter lower vaccination rates.** Routine vaccinations for children are 80 percent or higher except for measles (68 percent), Hib1 and polio4 (54 percent).¹²¹ This compares to European average of 94 percent for measles and 90 percent for HiB1. Differences exist across regions. In particular, BD has lower immunization rates than the rest of BiH in hib (first dose), dpt3, hepb3 and measles (but not for BCG (TB)). While differences with respect to wealth were small within FBiH and RS, children in the bottom 20 percent had a lower probability of having the four main vaccines (dpt3, bcg, polio3, and measles) (Figure 4.6). The vaccination rate for Roma is lower than for non-Roma in the same community (83 compared to 95 percent).¹²²
- 4.7 **The family medicine (FM) model—implemented in recent years—has been the single largest reform implemented by the governments in the health sector.** Under the family medicine model, Primary Health Care (PHC) facilities were rehabilitated and medical doctors and nurses are being regularly trained for FM specialization. Coverage of the population through family medicine teams has reached 95 percent in RS and more than 69 percent in the FBiH in 2014.
- 4.8 **Total health expenditures in BiH have grown since 2000, and government spends 7 percent of GDP on health—the highest in the region.** Both public and private health expenditures have grown substantially in recent years. Total health expenditures are now estimated to have increased from 7.1 percent of GDP in 2000 to an estimated 9.9 percent of GDP in 2012, a level similar to the average for EU countries and higher than many of BiH's neighbors (Figure 4.7). Government spending as a percentage of GDP is the highest in SEE, and significantly higher than the average for the EU or upper middle income countries as a group (about 4 percent of GDP). In the period 2009–2011, while the share spent on inpatient care (35 percent) decreased, it was higher than the expenditure on outpatient care (25 percent)

Figure 4.7: Health expenditure is high for the region...
Total health expenditure and government health expenditure as a % of GDP



Source: WDI

Figure 4.8: ... and spending is focused on in-patient care rather than prevention or primary care
Health expenditure by function as % of total health expenditure



Source: BiH NHA 2009–2011 Report

¹²¹ BCG, three doses of DPT (DPT1, DPT2 and DPT3), Polio 1-4, Hepatitis B (1-3) and measles vaccines) and the booster dose of DPT administered at 18 months were calculated.

¹²² UNDP/WB/ EC Regional Roma Survey 2011.

contrary to most EU countries (Figure 4.8). Relatively high in-patient spending indicates opportunities to improve health spending efficiency by shifting to outpatient services. In addition, 47 percent of households' health spending is allocated to pay for pharmaceuticals whereas 21 percent of private spending is still allocated to finance in-patient care (through informal payments) (BiH NG+HA Report).

- 4.9 **Public health insurance is funded by a mixture of contributions collected from employers, from the salaries of employees and general revenues.** Over 50 percent of those who receive health insurance coverage are exempt from paying personal contributions (mostly pensioners, the unemployed, the disabled, and war veterans), and their health insurance is financed by transfers from other extra budgetary funds and from general revenues.
- 4.10 **The financial sustainability of the system is threatened by inefficiencies resulting from the fragmentation of service delivery and insurance systems, an inefficient hospital sector, and high spending on pharmaceuticals.** At 10.9 per 1000 population, the number of hospital discharges in BiH is comparable to that of Southern European countries such as Spain or Portugal, and below regional averages. The number of acute hospital beds (3.45 per 100,000) remains within the same range as the OECD and EU averages. The hospital system is excessively fragmented and many hospitals have a very low throughput and are inefficient. Occupancy rates are low, particularly in the FBiH where they averaged at 51 percent in 2013; the ratio of staff per bed varies from 1.5 to 4 across hospitals. There is thus considerable room to reorganize service delivery across and within hospitals to improve efficiency while maintaining access.
- 4.11 **Pharmaceuticals represent about 30 percent of total health spending, about double the average for OECD countries.** Medication prices are frequently double international reference prices in both RS and FBiH. In FBiH, drug procurement is undertaken separately by each canton, with little or no use of reference pricing. In addition, cantons are unable to purchase in large enough quantities to keep costs down. Other cost drivers in both RS and FBiH include inadequate monitoring systems for prescription and dispensing practices; pricing policies that do not provide incentives for dispensing lower-cost drugs; and limited mechanisms to evaluate the cost-effectiveness of new, expensive drugs before including on the health insurance reimbursement list.
- 4.12 **The financing system may also threaten the financial sustainability of the system and increase the registered unemployment rate.** Health insurance is provided through the public purse for those registered as unemployed. With an official unemployment rate of over 40 percent compared to an unemployment rate of around 27 percent according to the ILO definition (which counts unregistered workers as employed) it seems likely some people register as unemployed while working in the gray economy. Evidence suggests that one of the main reasons for this is the provision of free health insurance to the unemployed. This serves both to increase the public costs of health insurance and reduces social insurance contributions and other taxes.

Table 4.1: No major impact on poverty resulting from OPP...
Impact of out of pocket expenditures on poverty rates

	Poverty headcount, gross of health payment	Poverty headcount, net of healthy payment	Relative increase in poverty due to OOP (\$)
2007	14.04	15.64	11.4
2011	14.95	16.06	10.1

Source: HBS 2011 and ECAPOV

Table 4.2: ... which represent only small share of total income
Out of pocket expenditures, % total expenditures

	5%	10%	15%	25%	40%
2007	23.8	10.4	5.2	1.9	0.5
2011	22.8	10.2	5.3	1.8	0.4

Source: HBS 2011 and ECAPOV

4.13 Overall, individuals' health costs are reasonably well covered with fairly low levels of catastrophic expenditures and low poverty increases as a result of out-of-pocket expenses.

The poverty headcount is estimated to increase by around 1 percentage point in 2011 as a result of out of pocket (OOP) health expenditures (Table 4.1), from 15 to 16 percent. OOP were above 25 percent of total expenditures for around 2 percent of households (Table 4.2). Out-of-pocket spending represented 28 percent of total health costs in 2012 (WHO).

4.14 One underlying cause of the high cost, disparities and poor performance is the highly fragmented nature of the health systems in BiH.

In FBiH, the responsibility for health services has been further delegated to the cantons, so the FBiH health sector includes the FBiH Ministry of Health (MoH), the 10 cantonal MoHs, the Federal Solidarity Health Insurance Fund (HIF), the 10 cantonal HIFs, and 11 Institutes of Public Health (IPH). The RS health system is centralized at the Entity level, so responsibility is shared only between the Ministry of Health and Social Welfare of the Republic of Srpska (RS MoH), a single health insurance fund (the Health Insurance Fund of the Republic of Srpska - HIFRS), and a single Public Health Institute (RS PHI). The District of Brcko also has a Department of Health and a separate HIF. As a result, BiH has 13 MoHs, HIFs, and IPHs, which has led to substantial duplication and inefficiency. While it will be politically challenging to reduce this fragmentation and diffusion of authority within the health systems within BiH, it would increase efficiency and improve both service delivery and health outcomes.

4.2 Education service delivery and efficiency

4.15 Improving the quality and relevance of the education and training system while ensuring that learning outcomes are translated into relevant skills that meet the needs of the labor market.

Consistently, countries in the region have found human capital, particularly skills, to be a constraint for economic growth and shared prosperity. To tackle this challenge, it is important to distinguish between the current stock of workers—youth and adults already outside the formal education system—and the flow of future workers—those of school age and youth still in school.¹²³ With a youth unemployment rate at 63 percent, and 31 percent not in education, employment or training (NEET), especially for those with secondary education, a focus on offering active labor market programs (ALMPs) to unemployed workers, as well as updating the skills of those who are already employed through training and retraining programs is needed. These programs respond to the immediate jobs crisis and play a critical

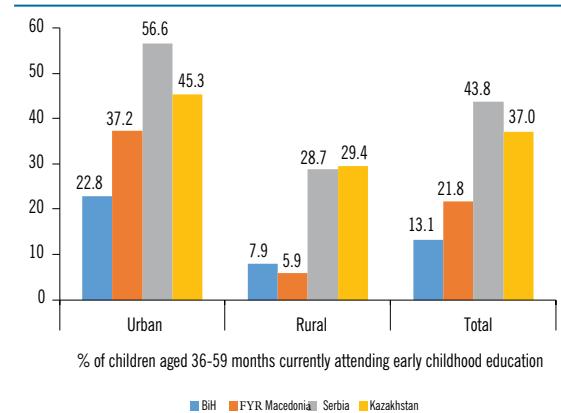
¹²³ Arias, Omar S, Carolina Sanchez-Paramo. 2014. *Back to Work: Growing with Jobs in Europe and Central Asia*. Washington, DC: World Bank.

role in getting people back to work, although in the longer-term, higher employment generation is needed. Enhancing the skills relevance of future workers is equally important. Getting children off on the right start and ensuring that all students learn and build job-relevant skills requires significant improvements in the access, quality and relevance of the formal education system.

- 4.16 BiH performs well in primary and secondary enrollment rates but poorly in early childhood and pre-primary education.** Early childhood education (ECE) enrollment rates (for children aged 3-5) stood at 13.1 percent in 2011, significantly below rates in Serbia or FYR Macedonia (Figure 4.9). Rates were especially low in rural areas where fewer than 8 percent of children attend ECE. There are also differences between the Entities with enrollment rates of 14.4 percent in FBiH and 10.3 percent in RS. BiH also lags significantly behind in access to pre-primary education. In 2011, only 16 percent of children attending the first grade of primary school had attended preschool the previous year (18 percent in the FBiH and 13 percent in RS)¹²⁴, with higher enrollment in urban areas (25 percent) compared to children in rural areas (13 percent).¹²⁵ These low rates are of particular concern in light of strong global evidence of the importance of ECE in escaping inter-generational poverty. Only six out of ten Roma children are enrolled in compulsory education (in comparison nine out of ten non-Roma neighbors in the same communities).¹²⁶ Upper-secondary gross enrolment rate for Roma are much lower than for non-Roma in other children (14 compared to 74 percent).

- 4.17 Nearly all primary-age children attend school.** The 2012 MICS estimates that 98 percent of primary age children attend school (99 percent in RS and 97 percent in FBiH). The net enrolment rate (NER) was 83.2 percent, however there was a large difference between the Entities with a 92.9 percent NER in RS and 9.7 percent NER in FBiH.¹²⁷ This suggests that there are more children who repeat years in FBiH than in RS.

Figure 4.9: Early childhood education based on MICS 4 in BiH, Serbia, FYROM and Kazakhstan



Source: UNICEF¹²⁶

¹²⁴ Compared to 75 percent in Kosovo and 98 percent in Serbia.

¹²⁵ UNICEF: Multiple Indicator Cluster Survey (MICS), Final Report, 2011-2012.

¹²⁶ UNDP/WB/ EC Regional Roma Survey 2011 (<http://www.eurasia.undp.org/content/rbec/en/home/ourwork/povertyreduction/roma-in-central-and-southeast-europe/roma-data.html>).

¹²⁷ The definition of the gross and net enrolment rates are available from: http://www.unicef.org/infobycountry/stats_popup5.html. Gross primary or secondary school enrolment ratio - The number of children enrolled in a level (primary or secondary), regardless of age, divided by the population of the age group that officially corresponds to the same level. Net primary school enrolment ratio - The number of children enrolled in primary school who belong to the age group that officially corresponds to primary schooling, divided by the total population of the same age group.

- 4.18 **While education and human development statistics remain scattered, data suggest that school enrollment drops at upper secondary level and above.** Upper secondary enrollment was just 77 percent, and tertiary enrollment was 37 percent (data from 2010). Upper secondary gross enrollment rate is far below some of the regional comparators (such as Kosovo and Albania, where gross enrollment is at 92 percent for each), and well below the average rate of countries in Europe (93 percent). In recent years, the number of private tertiary education institutions has increased, suggesting the access to tertiary education may have increased. According to the Centre for Information and Recognition of Qualifications in Higher Education list, which is compiled on the basis of information provided by the ministries of education, there are currently 10 public and 37 private higher education institutions in BiH (see Annex XI).¹²⁸
- 4.19 **Inequalities in enrollment and educational attainments in BiH.** Children from the lowest income groups have lower enrollment rates and lower educational attainment, limiting the access of these groups to economic opportunities. For example, 31 percent of children from the richest quintile had access to ECE compared to only 2 percent in the poorest quintile (MICS 2011-2012). Studies have demonstrated the importance of early childhood development for overall cognitive development and for lifetime earnings potential, particularly among poor and marginalized populations. These figures imply that most children in BiH do not have the opportunity to gain a set of emotional, behavioral and cognitive skills that lead to better school (and later, work) preparedness. Further, in upper secondary education, 92 percent of children from the richest quintile had access to secondary education compared to 84 percent of the poorest quintile. Children from the Roma community are particularly disadvantaged with only 2 percent attending ECE and only 57 percent of the poorest income group were attending primary (compared to 95 percent of the total population in the same income quintile), perpetuating the cycle of poverty.
- 4.20 **The education system does not systematically measure or monitor quality, but limited data available suggests that quality of education is inadequate to equip students with the basic skills the labor market requires.**¹²⁹ BiH has not participated in any international student assessment, such as Programme for International Student Assessment (PISA), and it does not have a national student assessment system to measure students' learning. The only available data to provide some international comparison are the results of the 2007 Trends in International Mathematics and Science Study (TIMSS) in which BiH participated. TIMSS compares mathematics and science achievement across countries. BiH eight-graders ranked below average in both math and science¹³⁰ and below the other countries in its region that participated in the test (Serbia and Slovenia) (Figure 4.10).

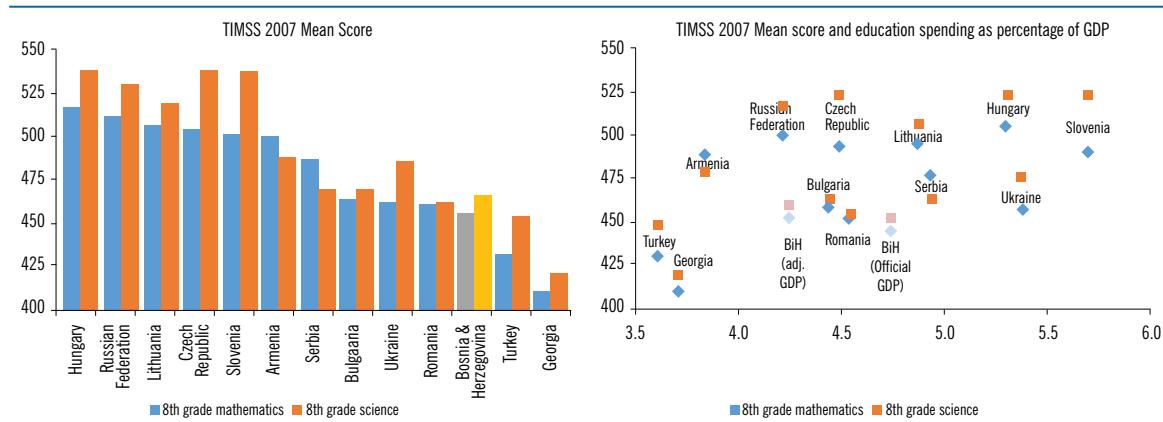
¹²⁸ <http://www.cip.gov.ba/index.php/bs/2014-01-21-22-32-01> (accessed on December 4, 2014).

¹²⁹ In strategic documents the desire for quality is not questionable. They all call for quality and there is explicit commitment for achieving good quality education. In practice, however, this is not always the case and the traditional approach to perception of quality, which places emphasis on structural dimensions rather than process and outcome dimension, is still in place. This indicates that the concept of quality as understood by some actors within the education system, might not fully align with international definitions of quality.

¹³⁰ With scores of 456 in math and 466 in science compared to the international average of 500.

Figure 4.10: BiH: Despite high spending on education, student performance is low compared to region

Comparison of BiH student results with comparator countries, TIMSS, 2007



Source:

- 4.21 **Some evidence suggests that BiH does not achieve value-for-money with its education expenditures.** Although difficult to estimate, BiH spends approximately 4.5 percent of its GDP on education, a little above the regional average of 4.2 percent. BiH's students performed about the same as those in Ukraine which spends 5.3 percent of GDP on education and Bulgaria and Romania, which spend about 4.2-4.3 of GDP, but much more poorly than those in the Russian Federation and Armenia whose spending was lower than BiH's.
- 4.22 **Available data point to weak higher education performance.** Limited progress has been made in terms of meeting the requirements for accreditation and quality assurance, prompted by the BiH Framework Law on Higher Education and Bologna Declaration (EU Progress Report, 2014). Internal efficiency is very low with nearly 24 percent of students repeating an academic year and nearly 13 percent dropping out completely (2008), and with only roughly 50 percent of students who enroll in universities actually graduating. As a result of the high repetitions, it takes an average student almost 7 years to complete a 4-year degree in BiH. In 2011, an estimated 6.2 percent aged 25 and older had a tertiary degree,¹³¹ far lower than neighboring countries (Croatia 11 percent and Slovenia 18 percent) and further below the EU average (24 percent).
- 4.23 **Firms in BiH cite inadequate skills as a constraint to business development.**¹³² According to the latest Enterprise Survey (2013), 7.3 percent of firms report the inadequately educated workforce is a major constraint, compared to 19 percent of firms in 2009. This decline is likely to be due to the poorer economic environment rather than improved quality of education. Moreover, a larger share of exporting firms in BiH (15 percent) report inadequate educated workforce as major constraint—less than FYR Macedonia (34 percent) but similar to Kosovo (15 percent), suggesting that the education system may not be providing the higher level skills that exporting firms would require.

¹³¹ UNESCO, Institute of Statistics, 2011.¹³² There is a lack of comprehensive data on demand for skills in BiH. The country has not participated in the OECD Programme for the International Assessment of Adult Competencies (PIAAC), which measures the key cognitive and workplace skills needed for individuals to participate in society.

4.24 Education matters for employment. Those with primary education or less represent 41 percent of the population but just 17 percent of the employed and even just 20 percent of the unemployed (Table 4.3). However, 60 percent of the inactive population has this level of education. Those with college, university education or above are more likely to be employed than others (19 percent of those employed, and out of just 10 percent of the population), and are also more likely to be unemployed (12 percent of the unemployed have this level of education). This may be due to a lack of skilled jobs available or due to a mismatch between the skills available and those required by employers. While high youth unemployment in BiH is partly due to low economic growth and low rates of job creation, available courses and school curriculum are not linked to labor market needs, resulting in low relevance of skills, including: “...lack of necessary skills: communication, computer literacy, fluency in foreign languages, managerial and leadership skills”.¹³³ These perceptions, combined with the insights that those with very low level of education tend to drop out of the labor market altogether, suggest that improved skill levels—in line with the requirements of the private sector—could help to lower inactivity and unemployment rates in BiH.

Table 4.3. Education and employment strongly associated but unemployment is high, even among university graduates
Educational level of working age population

Level of education	Employed persons	Unemployed persons	Inactive persons	Total
Primary school and less	17.3%	19.7%	59.3%	41.2%
Secondary school	63.7%	68.3%	36.0%	48.7%
College, university, masters, doctoral degrees	19.0%	12.0%	4.7%	10.1%

Source: BHAS LFS (September 2014):

4.25 Wages are high in education and are crowding out other spending. BiH spent 4.5 percent of GDP on education in 2009, a little above the regional average of 4.2 percent. Wages for primary and secondary education sector employees took up over 80 percent of education spending in 2009 and thus constrained non-wage spending and capital investments. In 2009, teachers were already slightly (FBIH on average) or significantly (RS) overpaid in terms of the ratio of their wages to GDP per capita.

4.26 Education policy is fragmented: a total of 14 ministries deal with education in BiH, of which 11 are in the FBiH. There is no Ministry of Education (MoE) at the state level. There is a small education unit within the Ministry of Civil Affairs (MoCA), but its involvement in education policy at the subnational level is minimal. The governance structures for the education sector are different in the two Entities. In RS, policy is formulated by a single MoE at the Entity level, while in FBiH, it is at the cantonal level. In the latter, each of the 10 cantons is responsible for all educational matters, and FBiH MoE cannot intervene in cantons. The education department of Brčko District is an independent agency that sets education policy in BiH. In total, 14 ministries deal with education in BH - MoCA at the state level, one MoE in RS, one at FBiH level and 10 cantonal MoEs in FBiH, and the education department of Brčko District. Under this extremely fragmented education system state-level or federation-level

¹³³ Strategic platform for adult education development from the perspective of lifelong learning. Final draft. March 2013.

reforms cannot be decided and implemented without consent of each Entity and canton. The Conference of Education Ministers established with the aim of developing consensus on education policies among cantons, is only an advisory body with no binding authority. Though intended to meet on bi-monthly basis, in 2013 it met only twice, thus resulting in ineffective coordination.

- 4.27 **The education budget is also highly decentralized.** The majority of the education budget is determined at the Entity level in RS and at the cantonal level in FBiH. Neither the Entity governments nor the cantonal governments receive any earmarked allocations for education from the higher levels, so the education budget is decided based on their respective financial capacities and policy priorities. This financing model also holds for higher education. In RS, the budget is determined at the Entity level but in FBiH, cantons finance higher education. The cantons where universities are located provide the bulk of finance even though the students may come from other cantons. The funding in both FBiH and RS is driven by inputs such as staff salaries rather than outputs. As a result, there is no financial incentive to encourage a more efficient management of students and the teaching process.
- 4.28 **The result is that there are large financing disparities in funding per pupil.** A UNICEF supported case study analyzed preschool financing which shows disparities in economic cost per child.¹³⁴ The study reports that in RS the economic cost varies from 400 KM in Banja Luka to 120 KM in Bileca, in FBiH it is from 400 KM in Zenica-Doboj Canton to 150 KM in Canton Posavina, Central Bosnia and Canton 10. Municipality contributions as well as parents' participation represent shares in the overall economic cost per child and partly explain these disparities.
- 4.29 **A declining school age population in the past decade (the total number of pupils enrolled in basic education has declined by 0.5 percent from 2003 to 2007) has resulted in small class sizes and low student teacher ratios with resources concentrated in basic education, and limited investments in pre-school, upper secondary and tertiary education.** While secondary class sizes are comparable across the two Entities - an average of 24.3 students in FBH and 25.0 in RS - class sizes in primary education vary substantially within the Entities, ranging from 19.4 in RS to 21.6 in FBiH's primary schools. As a result, small schools and classes in primary education lead to higher unit costs in RS. On average though, RS spends a lower amount per student than FBiH does. Variations across the cantons within FBiH are even greater.¹³⁵ Only about half of the variation in unit costs among cantons can be explained by the differences in average class sizes. While the educational norms of most cantons stipulate that the optimum class size in primary education should be at least 24 students, only half of the cantons maintain average classes below 21 students in primary education, thus incurring unit costs at least 12 to 15 percent higher than the cantons with primary classes near the optimum size.

¹³⁴ UNICEF (2013) Preschool Education in Bosnia and Herzegovina: Financial Analysis with Policy Recommendations on Standardization and Expansion of Required Programs, Financial Feasibility and Organization.

¹³⁵ In 2009, spending on primary education in FBH ranged from KM 1,450 per student in Central Bosnia Canton to KM 2,039 per student in Canton 10, compared to KM 1,753 per student in RS for primary education. Spending on secondary education varied even more across cantons—from KM 1,651 per student in Bosnian Podrinje Canton to KM 2,568 in Canton 10.

4.3 Access to water and sanitation

- 4.30 **Access to water services is high.** The Multiple Indicator Cluster Survey (MICS) shows a high percentage of citizens in BiH, both in urban and rural areas, have access to water services. According to the survey, 90 percent of households in urban and 83 percent in rural areas had piped private water accesses inside dwelling or yard in 2011 (Figure 4.11). Public water companies serve only around half of the population, while much of the rest of the population uses water from uncontrolled local systems.¹³⁶ These small systems were constructed many years ago and abandoned to local communities (i.e. individuals or villages) that have neither the capacity nor the knowledge to manage them appropriately. Much of the access from local systems is not subject to quality control.¹³⁷
- 4.31 **Access to sewer and sanitation facilities is much lower.** Around 48 percent of the BiH population is connected to the sewage system although there are large geographical differences (Figure 4.13). Around 58 percent of the FBiH population is connected to the sewage system compared to 29 percent of the RS population (Figure 4.14). This is as a result of very low rural access across the country (30 percent compared to 84 percent of those in urban areas), and is particularly low in RS. Furthermore, less than 3 percent of collected waste water is treated in waste water treatment plants.
- 4.32 **Poorer groups of the population are under-served by sanitation facilities and, to a lesser extent, piped water.** Data from the 2012 MICS survey shows that around 76 percent of the poorest quintile have access to piped water in the dwelling or yard compared with 85 to 93 percent for all other wealth quintiles (Figure 4.12). Sanitation access is even lower for the poorest segments of the population. Just 21 percent of households in the poorest quintile and around 37 percent of the B40 is connected to a piped sewer system. This compares to close to 80 percent for the wealthiest quintile.
- 4.33 **The result is that the poorest groups resort to septic tanks, at private expense.** Over half of households in the B40 use septic tanks compared with 22 percent of the wealthiest quintile. Using septic tanks in such percentage endangers water sources used for supply and generates an additional financial burden on households.
- 4.34 **Water and wastewater services fall short of EU standards and requirements.** According to the program *Water Policy in Bosnia and Herzegovina*¹³⁸, only 35 percent of the population in BiH is covered by public water with continuously satisfactory water quality, as required by the EU Drinking Water Directive, while the goal for the country is to reach 90 percent by 2035. At the same time, this document states that only 46 percent of population in agglomerations bigger than 2000 PE¹³⁹ is connected to sewerage systems while only 13 percent of those are

¹³⁶ Latest estimates are that only 56 percent of the FBiH population and 48 percent of the RS populations was served with water from public companies in 2003 with FBiH rising to around 60 percent in 2010 (2012 BiH State of the Environment Report and National Environmental Action Plan, data from 2003 and FBiH Water Management Strategy draft of 2010 reports that 60% of the FBiH population is supplied with water by public companies).

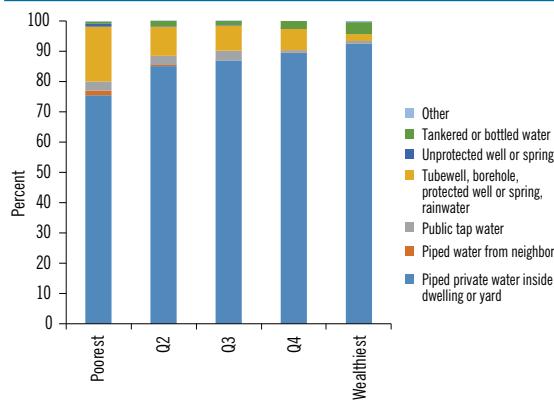
¹³⁷ Access to piped water in the dwelling or yard does not differ if water is coming from protected or unprotected source. There are many uncontrolled water networks on local level (mainly in rural areas) which deliver water through pipes, but used water sources are not protected and water quality is not in line with standards prescribed.

¹³⁸ Water Policy in Bosnia and Herzegovina Programme that has been prepared in October 2011 and financed by EU Delegation in BiH

¹³⁹ PE- Population equivalent, indicator according the EU "Urban Wastewater Directive" (91/271/EC)

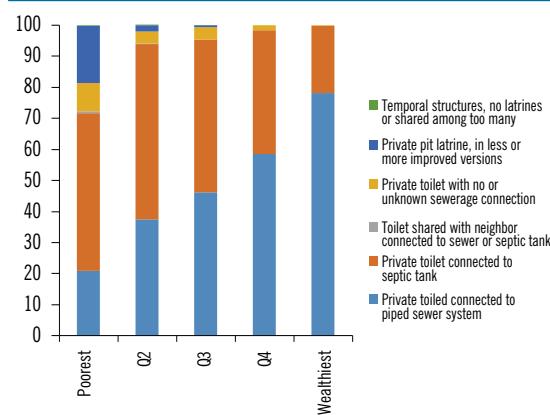
connected to wastewater treatment plants. The EU Urban Wastewater Treatment Directive requires full coverage for both. For the implementation of these two main EU Water Directives, it will be necessary to secure about €3.7 billion. A failure to sufficiently treat wastewater has negative environmental consequences as rivers become polluted. Agriculture can also suffer if polluted water seeps into agricultural areas. In addition, agriculture can contribute to poor water quality. For example, poor fertilization storage or practices can affect ground waters with increased levels of nitrates and pesticide/herbicide residues as a result of inadequate use of fertilizers and pesticides and poor soil management. In addition, over-use of fertilizer can pose environmental problems. While this has been the case in Croatia, there is not yet evidence of this becoming a problem in BiH.

Figure 4.11: Access to water services is high
Water Access by Wealth Quintile



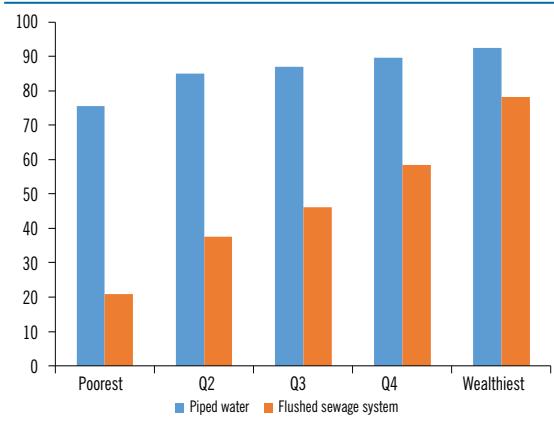
Source: MICS, 2011

Figure 4.12: Poor under-served by sanitation facilities
Sanitation Access by Wealth Quintile



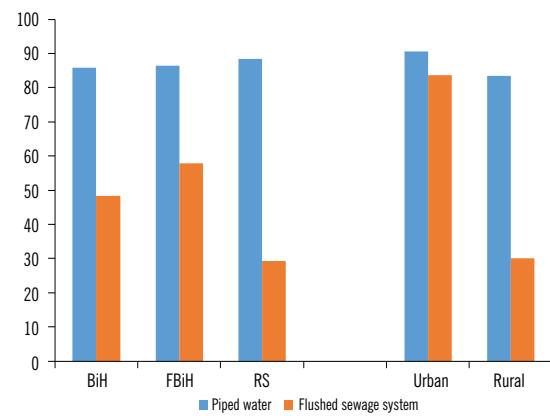
Source: MICS, 2011

Figure 4.13: ...piped water and sewage systems
Water Infrastructure Access by Wealth Quintile



Source: MICS, 2011

Figure 4.14: Only half of BiH's population connected to the sewage system
Water and Sanitation Access by Region



Source: MICS, 2011

- 4.35 **Some portions of the water supply system are in poor condition resulting in large water wastage and water prices are not cost-reflective.** Water networks in urban areas are in particularly poor condition—either damaged or badly maintained—resulting in water losses estimated at 40 to 70 percent, well above regional good practices of 20 percent and international best practices of 8-12 percent. In addition, around 60 percent of water provision in public services is not charged for. The municipal governments determine the nominal price of service; however, the set price typically does not reflect the real economic cost. The price of water and sanitation services is in general low, from €0.30/m³ in some small municipalities to €0.77/m³ in Bijeljina. A combination of low charges and no water rates reduces incentives to users to conserve water and to report problems with leakages.
- 4.36 **The provision of water services is undertaken by several levels of government or public companies, not always with clearly defined responsibilities.** The main pieces of legislation relevant to water utilities are the Laws on Public Enterprises / Utility Services. These laws do not distinguish between utilities, and do not consider the specific case of water supply services, nor adequately define the role, position, structure and degree of autonomy of water utilities in relation to municipalities. The delegation of responsibility to cantons in the case of FBiH creates further difficulties in implementing reforms. This has led to a complex relationship between water utility companies and municipalities, constraining the efficient operation of water utilities which are often in the situation of managing and operating water supply and sanitation systems without the full support of the municipality.

4.4 Emerging issues and reform areas: Promoting social inclusion

- 4.37 **Even though BiH is a relatively equal society, there are many possibilities to make it more inclusive, especially in allowing the poor and neglected parts of the population to participate more successfully in society.** BiH has a Gini-coefficient of around 33. This is not dissimilar from estimates made for Yugoslavia during the 1980s suggesting there has been little increase in inequality since then. It is slightly higher than some other countries in the region, like Albania (29 in 2012) but much lower than the Gini-coefficients reported in Latin America, where they tend to vary between 45 and 55. There are four main policy areas where the poor would benefit from more effective public policy and expenditures covering the challenges of rural livelihoods, health care, education and water.
- 4.38 **Boosting agriculture: increasing agricultural productivity and opportunities.** With the B40 predominately living in rural areas and the poor more likely to work in agriculture than wealthier people, the following would help to achieve inclusive growth benefiting the rural poor in particular:
- Reforming rural land markets to reduce the fragmentation of agricultural plots;
 - Finding ways to boost agricultural output on small farm in a sustainable manner;
 - Ensuring sufficient services are in place to help agri-business grow output and employment; and
 - Ensuring EU standards are adhered to and accreditation for the standards in place.

4.39 **Living healthy lives: improving health services and access to water and sanitation.** Although BiH life expectancy is above the average for middle-income economies, many are living unhealthy lives. In addition, incentives in the health sector are misaligned and are causing major inefficiencies and poorer services. This makes the sector very expensive and puts a high burden on labor cost, a major contributor to high unemployment in BiH (see section 3.2). Further, clean water and sanitation facilities are rare among the rural poor and add to the health problem. Focusing water supply efforts toward the B40 would help to improve the living standards of this group as they are disproportionately impacted by lower access to piped water compared to the rest of the population. BiH could improve its health services in a number of ways:

- Discouraging smoking to improve quality of life and reduce the health-related bills, including by increasing tobacco taxes and enforcing better anti-smoking regulations;
- Decoupling unemployment benefit from health insurance, while finding other ways to finance health insurance for the needy, would discourage people from falsely registering as unemployed, potentially saving money and increasing social security contributions and taxes;
- Ensuring water tariffs reflect costs and are uniformly levied, and that the resources used to improve the water infrastructure where required. This would also reduce water wastage and ensure prioritized investments; and
- Improving access to sanitation for the population in general is required, given subpar access to waste water treatment, which is important for limiting contamination resulting from soiled water (health impact, food safety impact) as well as reaching the standards under the EU acquis.

4.40 **Boosting brains: improving education services and labor market skills.** Raising the human capital of the population and aligning education and training systems with labor markets contributes to shared prosperity. While literacy is high, the education system does not produce the results one would expect given the high level of spending. The following priorities stand out:

- Reorienting financing toward early childhood education to reduce intergenerational transfer of poverty, especially as ECE is particularly beneficial for children from poorer families, as they are less likely to receive sufficient support from home;
- Improving the quality and efficiency of higher education by strengthening quality assurance mechanisms, and improving planning and financing would help to ensuring that employers can be sure of minimal standards; and
- Increasing transparency and equity in spending can be improved by the introduction of per capita financing (PCF) so that funding can follow the student.

MANAGING RISKS FOR SUSTAINABLE GROWTH

BiH faces three types of interrelated risks which have been interrupting the country's quest for higher economic growth and shared prosperity over the last years. First, BiH is vulnerable to environmental shocks, including drought, floods and earthquakes. Since 2010, BiH has experienced several environmental shocks, including a heat wave that triggered forest fires (in Europe's largest forested area), droughts that reduced energy generation by a quarter and destroyed 70 percent of corn and vegetable crops, and extraordinary floods causing damages and losses estimated at up to 15 percent of GDP. Second, BiH is vulnerable to external economic and financial shocks. The global financial and subsequent Euro crisis triggered economic stagnation and contraction. There are several transmission channels which make BiH vulnerable to external shocks, including the financial sector (strong role of Austrian and Italian banks), trade (EU remains the main trading partner) and remittances (Bosnian emigrants financial transfers still represent more than 10 percent of GDP). Third, BiH's social stability is fragile. Early 2014, the country faced severe riots around Tuzla. Protesters expressed their discontent against the lack of job opportunities and perceived corruption.

This section will also take a deeper look into the risks of climate change and broader environmental management issues, especially as urban pollution causes significant health risks and threatens shared prosperity and social stability. This is also linked to energy pricing which does not reflect usage. Combined with the lowest energy efficiency in Europe this contributes to unsustainable use of energy and increased levels of pollution.

5.1 Environmental and climate risks

- 5.1 **BiH has started to experience adverse effects of climate change.** BiH's GHG emissions per capita are about half of the EU average: 5.2 tons carbon dioxide (CO₂) equivalent per annum compared to the EU average of 9.9 tons (2008) and, as a small economy, they represent just a fraction of total world emissions.¹⁴⁰ The GHG intensity of BiH's economy, however, is almost four times higher than in the EU: emissions per Euro of GDP amounted to 1.6 kg CO₂ equivalent while the EU average was 0.4 kg in 2008.¹⁴¹ The high GHG intensity of BiH's economy is symptomatic of energy and industrial inefficiencies and, in urban areas, can have negative health implications. Regardless of its low contribution to the causes of climate change, BiH is faced with the negative consequences of this global challenge.
- 5.2 **Observed temperature and precipitation changes confirm that climate change is affecting BiH.** During 1961-2010, temperatures increased in all areas of the country. Increases in annual air temperature ranged from 0.4 to 0.8 °C, while increases during the growing season

¹⁴⁰ UNDP, Climate Change Adaptation and Low-Emission Development Strategy for Bosnia and Herzegovina, 2013.

¹⁴¹ Ibid.

(April to September) reached 1 °C.¹⁴² The rate at which temperature increase has risen over the last decade may indicate that BiH is experiencing the impact of climate change at an accelerating rate. Although the level of annual precipitation did not significantly change during the same period, the number of rainfall days per year decreased while the number of intense rainfall days increased.¹⁴³ This is a significant change to the rainfall pattern, particularly when combined with temperature increases. This change is likely to result in less moisture in the soil (potentially increasing the frequency and magnitude of droughts) and an increased likelihood of floods.

- 5.3 Increased climate variability is apparent in all seasons and across the entire territory of BiH.** In 2012, BiH experienced a heat wave that triggered forest fires, as well as heat-related health conditions and emergencies. These forest fires also spread through areas with land mines that remain from the war and some of the mines exploded. Controlling such fires is made more difficult by the continued existence of mines and unexploded ordnance. Heat waves have been accompanied by droughts, reducing river levels, affecting hydropower generation, destroying agricultural crops—and driving up food prices, especially for meat and milk. The drought and high temperatures in the summer of 2012 cost approximately \$1 billion in lost agricultural production and destroyed almost 70 percent of vegetables and corn.¹⁴⁴
- 5.4 BiH has also been exposed to other extreme weather events, including severe winters and flooding.** In February 2012, a heavy snowfall hit BiH and the region, prompting a state of emergency. BiH experienced water, food, fuel and medicine shortages, power and telecommunications outages, avalanches, and transportation system shutdowns. Many villages were completely cut off and isolated during the storm. In early 2014, BiH and the region were hit hard by floods and related landslides. The rain was the heaviest in 120 years. “Estimates indicate an overall impact of around \$1.6 billion of physical damage (8 percent of GDP) and \$1.2 billion of economic loss (6 percent of GDP) from the floods.”¹⁴⁵ The floods had an adverse impact on a large share of the population and land mass. “As of end-May 2014, 25 people had died, about 90,000 people had been evacuated, and about 1 million or one-fourth of the total population had been directly affected in around 60 of BiH’s 142 municipalities. The affected area covers more than one-third of the country’s territory, and the massive floods have caused over 3,000 landslides.”¹⁴⁶ The housing, energy, transport, water and sanitation, agriculture and services sectors were among the worst affected.
- 5.5 Floods in May 2014 exposed BiH’s vulnerability to extreme weather, with the poor suffering in particular.** The floods are estimated to have cost the equivalent of nearly 15 percent of GDP (9.3 percent in damages and 5.6 percent in losses) in 2014 in BiH. The removal of trees (minor deforestation¹⁴⁷) in some key areas around rivers as well as construction (often

¹⁴² Second National Communication of Bosnia and Herzegovina to UNFCCC, 2013.

¹⁴³ Ibid.

¹⁴⁴ Initiative on “Capacity Development to support National Drought Management Policy” (WMO, UNCCD, FAO and UNW-DPC). “Bosnia and Herzegovina - concise country report.”

¹⁴⁵ Bosnia and Herzegovina- Flood Emergency Recovery Project. World Bank. 2014.

¹⁴⁶ Bosnia and Herzegovina- Flood Emergency Recovery Project. World Bank. 2014.

¹⁴⁷ Note that in general there is not a problem with deforestation (but rather, an under-use of forestry resources) but in some key places, tree cover has

residential) in flood plains exacerbated the situation. The flooding also undermined growth prospects in some key sectors; the repair of roads and bridges in the forest estate required SOEs to redirect scarce capital to infrastructure repair rather than planned plantation investments.¹⁴⁸ A lack of investment in flood control is also likely partly responsible, with needed new infrastructure investments estimated to cost over €500 million.¹⁴⁹ An EU-led Recovery and Needs Assessment estimated that the cumulative impact could put BiH back into recession, increase poverty, and exert pressure on public finances.¹⁵⁰ The B40 are more than twice as likely to work in agriculture as the T60, and therefore suffer most from weather shocks that disrupt agricultural productivity, and the loss of crops drives up the prices of food for all. A fully fledged strategy and set of policies that provided a coordinated prevention and response to extreme weather could have helped the authorities to take action that would have reduced the negative impact of the floods.

- 5.6 Climate models predict that temperatures will rise by up to 1.0°C, with rainfall becoming less regular.** Temperature increases (Figure 5.1) in BiH are likely to have largely detrimental effects, particularly as predicted higher temperatures are associated with reduced rainfall (Figure 5.2) and higher evaporation rates for inland areas of the country. An average temperature increase greater than 2° C will result in costly adaptation and impacts that will exceed the adaptive capacity of many ecological systems. Climate change scenarios show significant decrease of precipitation in the region, especially during the summer season, which could lead to an increase of drought occurrence/frequency, intensity, and impacts. The increasing frequency and magnitude of droughts in recent decades, with its impact on agricultural production and water management sector emphasize the need for addressing the issue of droughts via tailored climate change related policies. Since 2000, there have been several drought years in BiH: 2000, 2003, 2007, 2011 and 2012.¹⁵¹

- 5.7 BiH's vulnerability to flood risks could also endanger the country's fiscal sustainability.** The government's liability associated with a once-in-a-50-year flood¹⁵² could amount to more than \$680 million, equivalent to about 4 percent of the country's GDP (Figure 5.3). By a different measure, a once-in-a-25-year flood is estimated to cause at least 1 percent loss in government revenues. More frequent events could entail significant fiscal risks. For instance, a once-in-a-10-year flood, with a 10 percent chance of occurring in any given year, could generate public damages and losses exceeding \$500 million, equivalent to 3.5 percent of BiH's GDP.

been removed making flooding impacts worse.

¹⁴⁸ Flood damage to forest roads in the RS was approximately 5 million BAM; about 20% of this is being addressed through RS Forest Enterprise resources but the balance remains unfunded. (World Bank. March, 2015. GEF Sustainable Forest and Landscape Management Project).

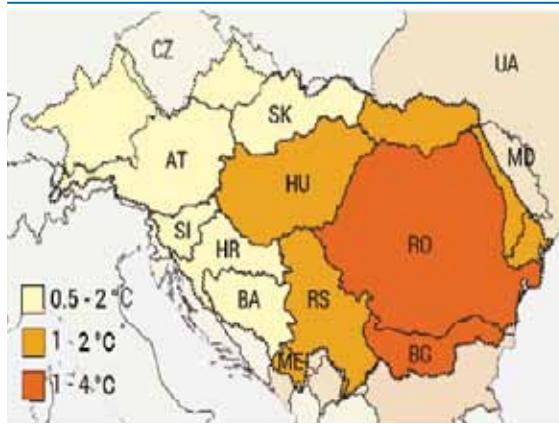
¹⁴⁹ Including the costs of reconstructing existing flood defense systems and implementing the EU Floods Directive. See: http://ec.europa.eu/enlargement/pdf/bosnia_and_herzegovina/ipa/2011/8_ipa_2011_environment_final.pdf

¹⁵⁰ Most sectors of the economy were hit with agriculture, transport and productive activities suffering the most. The floods had a devastating effect on agriculture destroying crops, livestock, stored goods and fixed assets amounting to some \$130 million. This is roughly equivalent to two years' worth of the combined agricultural budget of the two Entities. While a significant area of crops was re-sown as soon as water receded for harvest this fall, more permanent crops such as high value permanent crops, and fixed assets remain destroyed. Smaller farms, which represent a significant proportion of employment, are not likely to have any type of insurance, harming livelihoods. See: <http://europa.ba/Download.aspx?id=1521&lang=EN> and http://ec.europa.eu/enlargement/pdf/press_corner/floods/rna-executive-summary.pdf

¹⁵¹ Initiative on "Capacity Development to support National Drought Management Policy" (WMO, UNCCD, FAO and UNW- DPC). "Bosnia and Herzegovina - concise country report."

¹⁵² 50-year flood has a two percent chance of occurring in any given year.

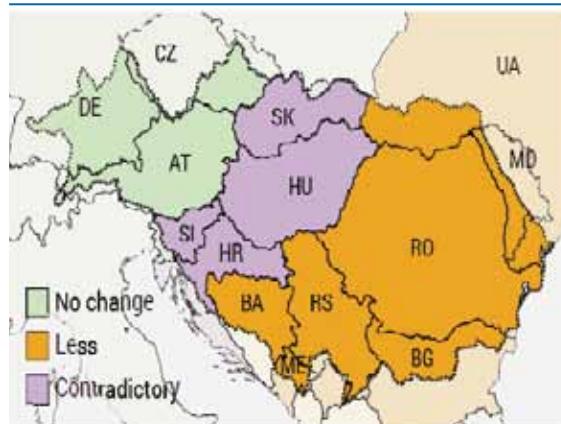
Figure 5.1: BiH will experience warmer temperatures...
Annual Mean Temperature Change, 2021–2050



Source: International Commission for the Protection of the Danube River Climate Change Adaptation study 2012

Note: "Contradictory" implies that different climate models give different results.

Figure 5.2: ...and reduced rainfall in the summer
Summer Mean Precipitation Change, 2021–2050

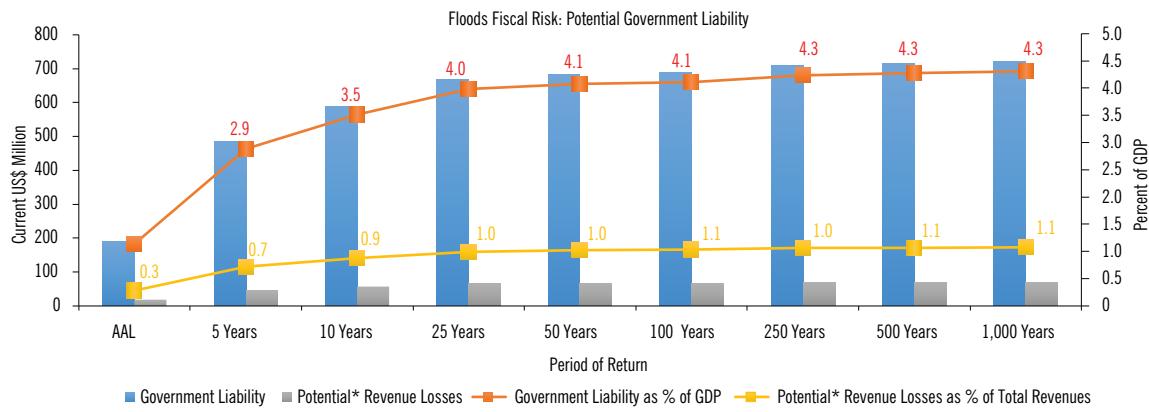


Source: International Commission for the Protection of the Danube River Climate Change Adaptation study 2012

Note: "Contradictory" implies that different climate models give different results.

5.8 Due to their exposure and sensitivity to natural changes, agriculture, water and hydropower sectors are most vulnerable to climate change. Of the total area of BiH, 46 percent is agricultural land. Climate is the primary determinant of agricultural productivity in the country. The impact of future climate change on the agricultural sector is forecast to be largely negative. Despite the abundance of water resources in the country, irrigation infrastructure is very limited: only 0.65 percent of arable land is irrigated. More hot days, reduced rainfall and higher aridity in the summer will increase the probability of droughts and lower river flows, which will in turn worsen water quality and supply. Conversely, fall and winter seasons will likely see increased frequency of floods. Increasingly erratic river discharges will also negatively affect the hydropower sector. While low river flows could halt production of hydroelectric power thus jeopardizing energy security and electricity exports, increased peak river flows in the event of floods could damage the hydropower infrastructure.

Figure 5.3: Fiscal risks associated with flooding are high



Note: *Scenario-based

Source: World Bank estimates, IMF, and World Bank Database.

- 5.9 **BiH is also exposed to earthquake risks.** The last devastating earthquake affected Banja Luka in 1969 destroying almost 60 percent of dwellings as well as partially damaging or completely destroying 266 schools and 592 cultural, health, social and business facilities. Currently, the potential losses¹⁵³ of a severe earthquake could be 15 to 24 percent of the GDP and affect almost 20 percent of the country's population. The most vulnerable segment of the population exposed to seismic risk is the B40 because of the quality of the infrastructure they live in. Old construction and poor construction control position them in a riskier situation than the rest of the population.
- 5.10 **Long-standing high pollution levels reduce living standards, harm health, and reduces works days, with poorer groups more likely to suffer from air pollution than other groups.** This stems from the choice of place to reside (wealthier people tend not to live in the worst polluted areas¹⁵⁴) and because poorer households are more likely to use solid heating and cooking fuels (such as wood or coal)¹⁵⁵, which pollute more. The WHO estimated that 58 percent of the population in BiH used solid fuels for heating purposes in 2012¹⁵⁶ compared with 38 percent in Albania and 32 percent in Serbia.¹⁵⁷ This has large health implications. A 2013 meta-analysis estimated that every increase or 10 mg/m³ of PM10 is associated with a 22 percent increase in cases of lung cancer¹⁵⁸, resulting in higher health costs.
- 5.11 **Available data suggest that air quality in Sarajevo has improved since Yugoslav periods but can become critical at some time of the year.** Due to its valley topography and lack of breeze, Sarajevo is particularly susceptible to air pollution. A World Bank report from 1972 recorded sulfur dioxide (SO₂) levels of 1,500 micrograms per cubic meter of air (mg/m³) on average over a 24 hour period.¹⁵⁹ This compared with US standards at the time of 365 mg/m³ and 2013 WHO guidelines of 20 mg/m³. At the same time soot had reached 1,000 mg/m³ compared with 2013 WHO guidelines of 50 mg/m³. The main sources of the pollution were the burning of wood and lignite for heating combined with fast industrialization of the city. Pollution levels have declined significantly since the Yugoslav period, partly as a result of a loss of heavy industry and partly thanks to reduced burning of wood and coal for heating. Nonetheless, reports of high pollution are frequent in winter. In 2012, for example, according to Sarajevo Canton, SO₂ concentrations reached 130 mg/m³, over five times the WHO recommended limit, while concentration of Particulate Matter (PM), including soot, reached 500 mg/m³, ten times WHO recommended limits.¹⁶⁰ Demonstrations against pollution in the industrial city of Zenica were held in December 2014 and February 2015, suggesting that in some urban areas, pollution could act as a catalyst for social instability.

¹⁵³ ECA Country Risk Profiles.

¹⁵⁴ For an example of this in the UK, see: http://www.sasi.group.shef.ac.uk/publications/2003/mitchell_and_dorling_air_quality.pdf

¹⁵⁵ In BiH, 95 percent of the poorest 20 percent of households heat their homes with wood, coal or other solid fuel compared to 54 percent of the wealthiest quintile, according to the 2011 EHBS. For a developing country example, see: <http://heapol.oxfordjournals.org/content/21/6/444.short>

¹⁵⁶ <http://apps.who.int/gho/data/node.main.135?lang=en>

¹⁵⁷ Estimates for Sarajevo alone not available.

¹⁵⁸ <http://www.thelancet.com/journals/lanonc/article/PIIS1470-2045%2813%2970279-1/abstract>

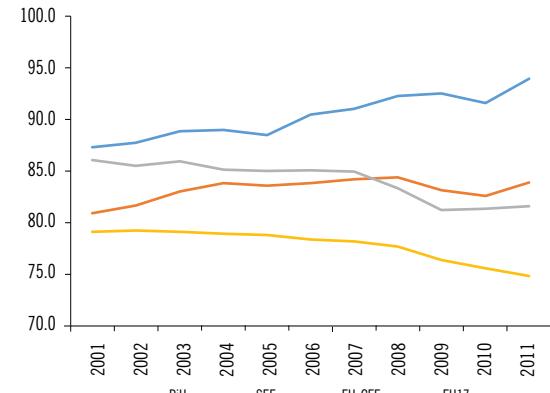
¹⁵⁹ http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2000/12/29/000178830_98101911183790/Rendered/PDF/multi_page.pdf

¹⁶⁰ <http://www.kanton-sarajevo.eu/en/wp-content/uploads/2014/04/Brochure.pdf>. See also: <http://www.neurope.eu/article/alert-dangerous-air-pollution-sarajevo>.

- 5.12 Heavy reliance on fossil fuels and poor energy efficiency likely contributes toward the pollution.** Outside of power generation BiH relies heavily on fossil fuels. In 2011, 94 percent of total energy consumption came from fossil fuels, 10 percentage points above the SEE average and higher than any other country in SEE (Figure 5.4). Reliance on fossil fuels grew between 2001 and 2011 increasing from 86 percent to 94 percent over the period.

Figure 5.4: BiH is a leading consumer of fossil fuel, and it is rising further

Fossil fuel energy consumption (% of total energy consumption)



Source: WDI

5.2 Social risk

- 5.13 Social instability in BiH could be provoked through two channels: (i) implementing reforms and (ii) not implementing reforms.** Walking the path between the two will require resolve, good communication, and good timing of reforms.
- 5.14 A general belief exists that the status quo in BiH favors social peace.** Examples abound of inefficiencies in public spending, public service provision or institutional structures designed to “keep the peace”. For example:
- The high spending on war veterans, even those who are well off, working-age and able-bodied may help to reduce the likelihood that they create social unrest.
 - The institutional structure of BiH, aims partly to ensure that people attached strongly to ethnic identities feel empowered.
 - The large number of people working in the public sector and high spending on public sector wages helps to reduce the chances that “insiders” will challenge the system or that unemployment will increase in the short-term.
- 5.15 Potentially negative consequences of these efforts remain, which themselves could lead to social instability.** The high taxes required to finance public sector wages and veterans’ benefits including so-called “privileged pensions” (going to groups such as retired judges or high-level public servants) impose a burden on workers and firms^a and may prejudice growth, potentially harming social stability in the longer-term. In the health sector, public resources are wasted due to the duplication of occasionally-used medical services, which also provides increased opportunities for corruption.
- 5.16 While efforts must be made to ensure social peace, a risk remains that society as a whole is held hostage by a few special interest groups.** The status quo results in transfers from “outsiders” to special interest groups of “insiders”. For example, from youth—who have high poverty rates and suffer from poorer education or lack of employment—to older people, with low poverty rates. Or from the unemployed—who are unable to find work—to the employed, who cost an average of two thirds of their output and often cannot be fired. Or from the private sector—which must pay high taxes—to public servants, whose salaries are paid with high taxes borne by society.

- 5.17 **The public vented some of these frustrations in demonstrations that erupted in February 2014.** The demonstrations were sparked by unemployed people who formerly worked at large SOEs in Tuzla, and spread quickly across other parts of the country. They protested initially about pensions and unpaid social security contributions but the broader demonstrations revealed a frustration with corruption (see Box 1.1) and poor public services. Making the reforms that address the frustrations, which will be required to maintain social stability in the medium to long term, while considering the need to maintain it in the short term, will be challenging.
- 5.18 **Social risks and risks for a sustainable public sector able to effectively implement reforms may be posed by the institutional structure, or at least the way in which it functions.** For example, reducing public expenditure to GDP from its very high level and addressing the large financing disparities between the various levels of government will be more challenging with the current institutional structure. BiH's fragmented governance structure creates an environment which results in different qualities of basic public services in different parts of the countries, likely provides increased opportunities for corruption and over-regulates businesses, often in inconsistent ways. This SCD focuses on economic and social reforms within the existing BiH governance structures, but existing institutional arrangements may pose an implementation risk which could make it more difficult to achieve a number of the reforms recommended by this SCD.

5.3 Emerging issues and reform areas: Sustainability

- 5.19 **BiH has been affected by shocks and a high likelihood remains that the country will be exposed to future shocks.** While it will not be possible to eliminate these risks, BiH can reduce them and build buffers to protect against the impact of the shocks. Increasing BiH's resilience to shocks will require action on several fronts. This will require building and maintaining sound macro-economic and fiscal management which will be the bedrock of reducing vulnerability to external economic and environmental shocks. Building sufficient fiscal reserves will be an essential part of this. BiH has also the weakest financial stability framework in SEE, with Entity-level governments that are responsible for supporting the financial system in the event of a systemic crisis unlikely to have the financial firepower or borrowing capacity to do so. Reducing the risks associated with environmental shocks will require building a coherent strategy for reducing existing risk, avoiding the creation of new risk and responding more efficiently to such shocks, as well as building further the institutional ability to deal with such shocks. This would ideally entail a broad approach that considers inter-related factors together including forestry, agriculture, municipal planning and climate change risk mitigation. Issues such as erosion control and flood management in and around towns and cities would particularly benefit from such a cross-sectoral approach.

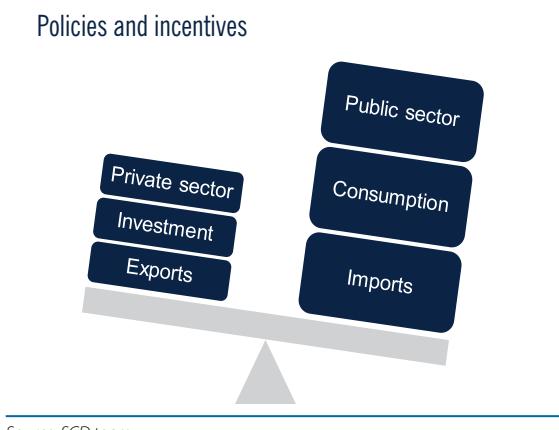
5.20 For BiH, to become more resilient to shocks, the country needs to focus on a number of reform areas:

- Reducing the risks of environmental degradation and natural disasters would entail sufficient flood water defenses, improved agricultural irrigation, an effective social safety net, robust transport infrastructure, an expanded insurance mechanism and, crucially, building sufficient fiscal space to be able to respond to disasters.
- Reducing risks associated with external economic shocks will require an effective social safety net and building sufficient fiscal space to cushion economic shocks. Strengthening financial system oversight and abilities to deal with a systemic crisis would help to reduce this risk.
- Reducing the risk of social instability will require walking the thin line between labor market and business environment and SOE reforms that create a more inclusive society, while mitigating negative impacts on vulnerable groups and communicating well with those who benefit from the status quo.

IDENTIFYING PRIORITIES FOR ACCELERATED, INCLUSIVE AND SUSTAINABLE GROWTH

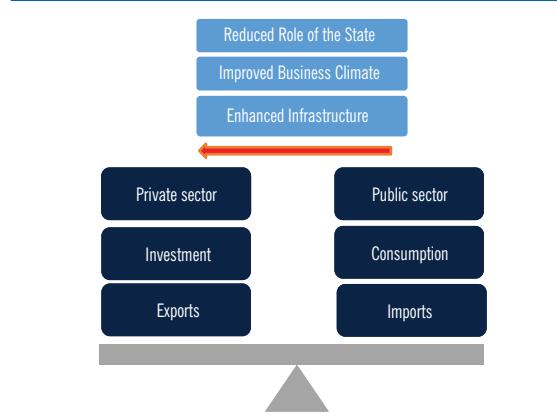
- 6.1 **This SCD makes the case that BiH can build on its strengths to achieve higher, more inclusive and sustainable growth.** BiH can leverage its proximity to Europe, and a reputation for stable macroeconomic policies, including during the global crisis. The country also has a few industrial clusters which date back to Yugoslav times, as well as an emergent urban service sector that has the potential to attract investment and create jobs, similar to its peers in Central and Eastern Europe.
- 6.2 **However, in order to succeed, BiH needs to fundamentally adjust its economic development model, which is out of balance.** High consumption, imports and a large public sector are dwarfing investment, exports and the private sector (Figure 6.1); BiH requires incentives and policies to generate a more productive, investment-driven and outward-oriented economic model (Figure 6.2). The current inward-oriented and consumption-led economic approach has helped to reduce poverty in the aftermath of the war but is not sustainable for the following reasons:

Figure 6.1: Current model: Economy out of balance



Source: SCD team

Figure 6.2: Rebalancing towards production and integration



Source: SCD team

- The growth model was based on high public and private consumption, with BiH having one of the world's highest rates of consumption at over 100 percent of GDP. This is not a sustainable path to prosperity.
- This consumption-led economic model is also behind BiH's trade imbalances with high imports and weak exports. BiH's production base was constrained by, among others, a poor business environment and rigid labor laws, holding back growth and employment generating exports.
- The economy stopped growing because investments were too low as the dominant public sector spent most of its resources on consumption and transfers, and the investment climate and regulatory regime made it difficult to create jobs.

- 6.3 **These challenges are compounded by BiH's historical and institutional legacy.** BiH's history is that of comparatively low income in Yugoslavia, as well as social fragmentation, war, large-scale emigration and dependency on donors immediately after the war. Today BiH is at peace, but living standards by some measures are yet to catch up with their pre-war levels. Unlike many other emerging economies, the country faces the additional challenge of an aging and shrinking population living largely in rural areas, slow pace of urbanization, and fragmented institutions.
- 6.4 **Growth has been good for the poor in BiH but it has been almost a decade since the country grew at or above five percent.** The analysis and consultations conducted for this SCD confirmed that economic growth is key for tackling poverty and boosting the living standards of the B40. When the economy grew strongly, especially between 1996 and 2008, the poor benefitted even more than the average. For BiH, the main challenge is to reach higher growth again and to mitigate the negative impact of shocks. BiH was badly hit by the global financial crisis with almost no growth between 2009 and 2013. The economy is also highly vulnerable to natural disasters, including flooding, which in 2014 caused damage and losses estimated at close to 15 percent of GDP.
- 6.5 **BiH also faces a challenge of inclusion, although the main issues they face are often similar to those faced by the population in general.** Almost half of the population of BiH is at risk of poverty or exclusion (AROPE) by some measures. Excluded groups often face the same problems as the rest of the population. Roma groups, for example, cited the poor business environment as a challenge they face, while Lesbian, Gay, Bisexual and Transgender (LGBT) groups noted that finding employment was challenging. Higher growth and more flexible labor markets will help these groups. For example, poorer groups—that are often excluded from the labor market due to high labor taxes and rigid labor market laws—would benefit from tax reform and labor market reform more than wealthier groups. However, additional more targeted measures are warranted. As the 2014 EU progress report notes, there is violence against specific minorities, including LGBT, while Roma face various forms of discrimination.
- 6.6 **With a broad range of challenges in mind, the SCD considered which reform areas could have the most impact on the twin goals, focusing in particular on reforms that could boost broad-based economic growth.** The key reform areas identified are generally those whose benefits have the potential to improve the lives of large segments of society as well as numerous productive areas of the economy. For example, while certain productive sectors (such as agriculture, tourism or forestry) are seen by some as having the capacity to boost growth and support the B40 (given their geographic location and sectoral composition of employment), these sectors face constraints similar to firms operating in other sectors, including the region's worst business climate and transport system. Similarly, supporting both growth of the productive sector, and employment for the B40 will require tackling the constraints of high labor taxes and rigid labor market laws.

6.1 Priority-setting exercise

6.7 **Based on the analysis in this SCD and consultations with stakeholders, ten key reform areas were identified to help BiH move toward shared prosperity (see Annex XV for methodological details).** This SCD goes further in its prioritization to identify the top four priorities to accelerate growth and achieve the Twin Goals. The prioritization exercise grouped the key reform areas into three categories based on their estimated contribution to achieving growth, shared prosperity and poverty reduction (Table 6.1).

Table 6.1: Key reform areas for achieving the Twin Goals

Key constraints	Key reform areas
Accelerating inclusive growth and creating jobs	
The high cost of employment combined with rigid labor laws and insufficient ALMPs reduce employment and increase unemployment, with the B40 and some groups such as youth and females suffering in particular.	Putting BiH to work: reforming the labor market, improving social protection delivery and reducing the cost of labor
Laws and regulations fail to provide an enabling environment for doing business, harming wealth generation, innovation and employment.	Making it easier to do business: improving competitiveness, entrepreneurship and the investment climate
The over-sized public sector is Scandinavian sized but fails to deliver quality public services. High taxes stifle the private sector and employment, while expenditure is largely focused on public sector wages and transfers rather than investment, reducing work incentives.	Creating an efficient and effective government: reducing the size of the public sector while ensuring fiscal sustainability and improving public service delivery
Businesses face some of Europe's poorest road infrastructure, limited port access, and complex trade import/export procedures. Rural dwellers are not always well connected to urban jobs. Energy infrastructure requires significant investment to prevent this sector turning from an asset into a liability.	Invest in economic infrastructure for growth and inclusion: powering and connecting BiH to the world
Securing a resilient and long-term future	
BiH has been shown to be highly vulnerable to adverse natural events such as flooding, some of which may result from climate change or environmental degradation. Boosting its resilience would help reduce the set-backs such shocks lead to.	Building resilience: helping BiH cope with adverse natural events
A lack of information makes it difficult to assess the key reform areas in education. However, available evidence suggests that skills do not match employer needs and there is a lack of quality control at most levels of education. Early childhood education is lacking despite its significance for reduced inter-generational poverty transfer.	Boosting brains: improving education services and labor market skills
Health care is expensive by international standards but many health outcomes are poor, and some minorities such as Roma. Rural poor have low access to adequate quality of water and sanitation.	Living healthy lives: improving health services and access to water and sanitation
Ensuring stable and sustainable economic opportunities	
Resolution of NPLs may help make additional financial resources available for credit. Access to finance could be improved for some groups at risk of exclusion.	Adding financial firepower: maintaining financial stability and expanding access to finance
Air pollution is a major challenge and contributes to BiH's high burden of respiratory diseases. Forest degradation in flood plains and in areas prone to landslides contributes to environmental disasters.	Greening BiH: reducing pollution and protecting the environment
Most of the poor live in rural areas. Increasing opportunities in agriculture, agribusiness and addressing land market issues would benefit the poor.	Boosting agriculture: increasing agricultural productivity and opportunities

- 6.8 **This section will present specific reforms and policies underpinning the identified priority reform areas.** The SCD identified four top priority areas which are centered on accelerating growth and creating jobs which is of highest importance for BiH in the coming years. These top reforms are complemented by four high priority and two medium priority areas. The high priority areas are important for the medium-term sustainability of BiH's development path, both environmentally and economically. The remaining two priority areas focus on reducing pollution and increasing agricultural productivity, including through addressing land market reforms and improving transportation networks.

Top reform priorities

- 6.9 **Reforming the labor market, improving social protection delivery, and reducing the cost of labor will help put BiH citizens, including especially under-employed groups such as females and youth, back to work.** Employment in BiH is hindered by a double burden of high taxation and highly sclerotic markets. High labor taxes combined with low thresholds mean that lower income groups are particularly hit by high taxation. Some of this tax burden could be shifted away from labor and toward other areas, such as tobacco and transport fuel (raising prices back to pre-oil price crash levels), which alone could raise over 5 percent of GDP in revenue, the equivalent of a third of that currently raised from social security contributions. Reducing the tax burden on jobs would help to improve the competitiveness of most productive sectors in the economy (including agriculture, manufacturing and tourism). Shifting the tax burden away from the B40 should help to boost shared prosperity. In addition, social protection is currently poorly targeted, with significantly more absorbed by wealthier groups than in neighboring countries. At the same time, many needy people do not receive benefits. With many of the poor having larger families, the risk of inter-generational poverty transfer is high. Improving the targeting of social benefits could help to reduce poverty and, critically, inter-generational poverty transfer. Making the labor market more flexible could help increase supply and demand for employment. Ultimately, the unemployed, many of whom are in the B40, would likely benefit greatly.
- 6.10 **An improved business environment will increase BiH's competitiveness and make it more attractive to investors.** With one of Europe's poorest quality business environments, BiH risks preventing its private sector from competing in export markets and even in the domestic market. Business licensing, inspections, trading across borders, paying taxes, registering real properties, and phytosanitary standards are all significant issues. Improving the business climate would help to improve competitiveness and boost exports from a large number of sectors, but particularly agriculture, which suffers from a lack of accreditation to meet EU standards. Investments including FDI could be boosted and BiH could take a further step toward aligning with EU best practices. Reforms that help to spur private sector growth will also boost sustainable employment, benefitting the B40. With potential increased agricultural and manufacturing exports—areas in which the poor and B40 are more likely to work—improvements in the business environment will help to boost shared prosperity. Specific groups that suffer from poverty, such as the rural poor with large households, could also benefit from improved employment prospects and the increased ability to sell agricultural output.

- 6.11 **Creating an efficient, effective and sustainable government will require reducing the size of the public sector and ensuring fiscal sustainability.** Gradually reducing the public sector role in the economy, including through reduced SOE presence (particularly those that no longer function), would help to re-allocate resources (including the land and buildings as well as workers, employed in the public sector) toward the more productive private sector. Increased efficiency in expenditures would help to improve public services, including in health, to which the B40 do not always have equal access. Ensuring infrastructure is prioritized and that EU resources are efficiently absorbed would help increase employment, improve public service delivery and support economic growth. Expenditure reductions could be implemented in conjunction with efforts to strengthen the effectiveness of the social protection system to provide an effective social safety net to low income households.
- 6.12 **BiH needs modern and efficient economic infrastructure in order to grow and ensure inclusion.** Improving transport and ICT infrastructure would help to connect rural populations to services, including health, education and banking as well as employment in larger settlements. In addition it would help rural businesses—such as agriculture—to reduce costs and reach consumers. Improving the ability to export—through improved ports or soft infrastructure at land borders—would be a boon for exporters in all sectors, including agriculture and manufacturing, and help firms from BiH insert themselves into European supply chains. It could also encourage export-oriented FDI and provide a boost to tourism potential. Improving ICT could help to facilitate communication for all, and in rural areas could provide access to services without the need for travel. It would also help private sector firms to access customers at home and abroad, and assist the nascent IT sector, which often serves customers in Western Europe or North America. Ensuring sufficient power supply—including through a renewed effort to boost renewable generation capacity—would help to reduce the likelihood of power shortages and maintain future economic growth. It would also help BiH to boost net exports, providing a valuable contribution to financing imports and helping to protect macro-stability. At the same time, cost-reflective tariffs would be important to ensure sufficient investment in the sector and to reduce over-consumption of power. Tackling energy inefficiency would help to improve the competitiveness of exporters (partly compensating for increased tariffs), and reduce urban pollution (which harms the poor in particular and has resulted in protests in 2014 and 2015).

High reform priorities

- 6.13 **BiH needs to strengthen its resilience to adverse natural events.** Along with other countries in the region, BiH has suffered over recent years from a sequence of environmental shocks. These include a harsh winter that hit consumption and construction, a drought that harmed agriculture, and severe floods that cost up to 15 percent of GDP. In 2012, these shocks contributed to pushing BiH into a double dip recession. Construction in flood plains of residential areas and businesses, as well as under-developed flood protections exacerbated the problems. BiH is also vulnerable to other adverse natural events, such as earthquakes. Natural disasters create significant set-backs for economic growth. They may be especially harmful for poorer groups and small firms that do not have the ability to bounce back easily.

Weather shocks are also particularly harmful for those in rural areas, many of whom are in the B40 and rely on agriculture. Ensuring resilience to such shocks is essential both for sustainable economic growth and for the livelihoods of the B40.

- 6.14 **Improving education services and labor market skills is key to escaping poverty.** Education is closely linked to employment and being in the B40. Quality education, especially pre-school, is essential for escaping from poverty. Despite the importance of education there is a lack of focus on the quality of education, with no national level exams guaranteeing learning standards and a proliferation of under-regulated universities. Some firms complain of skills constraints, with there being some evidence that larger firms are much more likely to suffer from skills shortages than smaller ones. Improving education and skills training would benefit the whole population but would have particular advantages for the poor, the B40 and rural dwellers, who have a poverty incidence twice as high as their urban counterparts, around half of which is explained by education differences. Providing access to opportunities for adult training would help these rural poor. Improved quality of education for their children—particularly early childhood education—would also be a significant step toward ensuring that inter-generational poverty transfer is reduced.
- 6.15 **Improving health services and access to water and sanitation may reduce burden on the budget, while improving coverage including for at-risk groups, such as Roma.** While BiH performs reasonably on some health indicators, such as life expectancy, it faces strong challenges and high costs in other areas, such as treating obesity, stunting and other non-communicable diseases. Combined with fragmentation in service delivery (especially in FBiH) and poor pharmaceutical procurement practices this means BiH has the highest public health spending in the region. Reforms in this sector would improve health care while reducing the burden on the budget. Changing the financing structure could further reduce budget costs, and increase social security contributions, while maintaining coverage. Increasing taxes on tobacco could reduce usage in one of the world's highest consuming countries and help to pay for reduced taxes on labor. Some of the resources freed could be used to improve health care services, including the basic services that some of the poor lack. Access to sewage facilities is low, particularly in rural areas and among the B40. This forces rural dwellers—who tend to be poorer—to use more expensive facilities, such as septic tanks. The lack of sewage treatment also poses health hazards and environmental issues, threatening potential growth sectors such as tourism and agriculture, in which many of the poor and B40 work. Finally, sanitation improvements may prove to be the most expensive EU acquis criteria to meet, posing issues of ensuring sufficient (EU) resources are available and the effective management of these resources. Higher—and uniformly levied—tariffs would help to provide resources for investment in reducing leakages and improving water treatment, yielding environmental and health benefits. It would also ensure future provision of water for the private sector, including agriculture (which has suffered repeatedly from droughts in recent years).

Medium reform priorities

- 6.16 **Maintaining financial stability while expanding access to finance** is a pre-requisite for sustainable shared prosperity. Financial stability has been broadly maintained but new risks are emerging, including rising NPLs. A lack of depth in domestic financial markets limits access to capital for firms and may increase the costs of public sector borrowing. A lack of access to finance appears to constrain firm output and employment growth in firms, harming growth and shared prosperity as well as reducing fiscal receipts.
- 6.17 **Reducing pollution and protecting the environment would help to promote sustainable growth.** Preventing wooded areas or forests from being destroyed in flood-prone areas would help to reduce the impact of flooding. Cleaning trash from water systems would prevent it from being returned to agricultural or urban areas during floods, reducing health risks.
- 6.18 **Boosting agricultural productivity and opportunities would support many of the 60 percent of the population who live in rural areas.** Upgrading agricultural productivity and enhancing agribusiness activity will benefit all, but will provide a direct benefit for the poor who primarily live in rural areas, partly directly, and partly through increased employment opportunities. Land market reform will improve access to land.

6.2 Trade-offs and complementarities between reforms

- 6.19 **As often in the policy environment, some reform areas are complementary to each other even if they are not all considered top priorities.** For example, the team identified some specific areas of the High or Medium Priorities that could be considered as particularly important because, for example, they help to reduce public sector costs or because they can help to ensure improved project implementation in the future or because they begin the reform process in other areas by targeting knowledge gaps. These areas include: (i) beginning to identify skills needs of firms, and training officials at education ministries on international quality standards; and (ii) identifying data needs in all sectors and setting in motion efforts to collect this information. In addition, while health reforms are considered a secondary priority, increasing pharmaceutical procurement efficiency and decoupling health insurance from unemployment benefits were considered to be particularly important as they can help to boost employment and generate needed fiscal savings. In all cases, BiH's track record of producing laws of reasonable quality but without satisfactory implementation needs to be considered when crafting a reform agenda and translating reforms into policy and enforcement mechanisms.
- 6.20 **Reforms will not be easy and, while necessary, some would likely have short-term impacts that would need to be partially mitigated.** There are several obvious examples. Reducing the size of the public sector would require a growing private sector to create jobs for those who would otherwise be in public employment. Similarly reforming SOEs may result in short-term increases in unemployment (either because people lose jobs which involve going to work on a daily basis or because people lose jobs officially that, de facto, have not existed for some time). Steps would need to be taken to mitigate the negative impacts including

through (re-)training and a functioning social welfare mechanism. An additional example can be found for energy tariffs. While below-cost energy tariffs are unsustainable, increases would have social impacts that would need to be mitigated. Cost-saving reforms (such as pharmaceutical procurement reform) could free resources for alternative investments.

- 6.21 **Some recommended reforms make others more urgent.** Public sector and SOE reforms make improvements in the targeting of social benefits and business environment reforms more essential as a means to cushion the any negative impacts. In addition, improvements in training and employment services would also be helpful. Increases in energy tariffs make social welfare reforms more important.

6.3 Areas with significant knowledge gaps

- 6.22 **Some potential reform areas, which appeared to be important, lacked sufficient information to make judgments, and there were also gaps within some of the reform areas that were impossible to evaluate.** These gaps include:

- Better knowledge of SOEs, including those at canton or municipal level, including the number of employees, whether or not they are working, and whether or not the SOE itself is operational.
- Better education data, including on quality of outcomes, and the skills required by the private sector.
- Better understanding of likely available resources from the EU if the accession process advances quickly.
- Better, more regular, and more broadly available household data to understand the performance over time of the poor, B40 and population in general, including information on income.
- Better and more regularly available data on firm performance, including employment.
- Better and more regular data on household incomes, rather than just consumption.

- 6.23 **Finally, the team also identified several issues that were not analyzed (in depth) in this SCD but could be considered in the future.** These include: civil service reforms; widespread health re-organization or liberalization; completion of the SOE privatization; development of gas storage (possibly regionally); shifting energy generation away from coal; systematically cleaning the countryside; immigration liberalization; regional transport connections including holding companies; land reform.

- 6.24 **With so many serious challenges in BiH, it is a notable caveat that this list is neither easy to prioritize within nor should it be seen it as exhaustive.** This is particularly the case since some reforms may be complementary, and sequencing may be important for others. Some areas may need a mix of ‘quick wins’ and long-term construction projects. Selecting which to begin with is not clear-cut. Furthermore, the selected reform areas have the capability of contributing to several areas of the economy and improving the lives of many groups of people. However, in a country where challenges abound, views observed in consultations range from the need to “change the mentality” to “change the constitution” or from “focus on tourism” to “provide more rural services”.

Table 6.2: Summary of reform priorities and their benefits

Priority areas	TOP PRIORITIES	Key reforms	Benefits (especially for B40)
Putting BiH to work: reforming the labor market, improving social protection delivery and reducing the cost of labor	<ul style="list-style-type: none"> · Reduce the tax wedge, particularly on lower paid workers · De-link unemployment benefit and health insurance · Increase private sector provision of employment services · Re-focus social benefits on the most needy 	<ul style="list-style-type: none"> · Encourage employment among poorer groups, especially the B40 and excluded groups (e.g. Roma) · Discourage abusive use of the public employment services, encourage SSC contributions, reduce cost · Ensure the neediest receive social benefits, including children to reduce inter-generational poverty transfer · Improve coverage, breadth, and quality of public employment services 	
Making it easier to do business: improving competitiveness, entrepreneurship and the investment climate	<ul style="list-style-type: none"> · Improve the business environment. Focus in particular on paying taxes, property registration, construction permits, and getting electricity · Simplify business practices including better regulation of insolvency and introduction of out-of-court legal procedures · Facilitate trading across borders, incl. reducing bottlenecks at borders and even between Entities through streamlined regulations · Introduce e-services for business licensing, procedures and inspections 		<ul style="list-style-type: none"> · Increasing domestic and foreign investment which in turn would both growth and employment · Expansion of export volume, markets and products · Speed up processes and reduce opportunities for corruption
Creating an efficient and effective government: reducing the size of the public sector while ensuring fiscal sustainability and improving public service delivery	<ul style="list-style-type: none"> · Grow public spending at a lower rate than economic growth · Reform the tax system to reduce taxes on tradables (especially labor) and shift them toward consumption taxes, particularly on fuel or tobacco · Consider restructuring/privatization/liquidation of SOE assets as appropriate and gather relevant information to make most appropriate decision · Improve debt management and extend maturities 		<ul style="list-style-type: none"> · Tackle unemployment, contribute to reducing the unsustainable consumption and tackle the issues posed by being Europe's most energy-inefficient economy, and among the world's heaviest smokers · Economize public expenditures without hurting public service delivery · Contain debt levels and reduce the risk of crowding out essential expenditures

Priority areas	Key reforms	Benefits (especially for B40)
Building economic infrastructure for growth and inclusion: powering and connecting BiH to the world	<ul style="list-style-type: none"> Tackle the “soft challenges” including recuperating expenses through the use of tolls to ensure well-maintained highways; reducing bottlenecks at borders and even between Entities through streamlined regulations. Upgrade the port at Brčko and the Sava River to allow access by larger vessels Use existing telephone infrastructure to expand rural broadband provision and ensure private sector leads these efforts Increase competition in the ICT market to further reduce cost and improve quality and penetration Ensure sufficient investment in power generation, including renewables, to meet growing demand Stimulate private sector participation in appropriate infrastructure development projects Upgrade the transmission network including for import and export Scale up energy efficiency through sustainable financing and implementation mechanisms Introduce more cost-reflective tariffs and speed up market liberalization 	<ul style="list-style-type: none"> Support the promotion of exports and facilitate trade and integration into EU trade corridors Improved access-to-services in rural areas (which have higher rates of poverty), easier access to markets for small agricultural producers (where many people in the B40 work), and reduced pollution in towns Enhancing strengths of (ICT) start-up companies (see also priority 2) Increasing energy investment to ensure continued supply for households and firms Improving energy efficiency, thereby improving urban pollution and increasing companies’ competitiveness over the long term Increased export opportunities
HIGH PRIORITIES		
Building resilience: helping BiH cope with adverse natural events	<ul style="list-style-type: none"> Address BiH's vulnerability to the risks of environmental shocks, external economic shocks and social instability to achieve sustainable growth and shared prosperity. Ensure sufficient flood water defenses, improved agricultural irrigation, an effective social safety net, robust transport infrastructure and an expanded insurance mechanism Build a coherent strategy for reducing existing risk, avoiding the creation of new risk and responding more efficiently to shocks, as well as building further the institutional ability to deal with such shocks Build sufficient fiscal space to cushion adverse natural shocks 	<ul style="list-style-type: none"> Reduce the risks associated with environmental shocks - Improve the quality of life of people who depend on agriculture for their livelihoods, many of whom are in the B40 will require ECCE generates high impact for B40 in terms of social, communication and cognitive development High-risk groups such as Roma (who have much higher illiteracy rates than the rest of the population) could benefit in particular Higher employment and worker productivity and contribute to a positive fiscal dynamic Reduce unemployment and make it easier for the private sector to grow and compete internationally Improved quality and efficiency of higher education - Guided education policy and decision making

Living healthy lives: improving health services and access to water and sanitation	<ul style="list-style-type: none"> Discourage smoking by increasing tobacco taxes and better enforcement of anti-smoking regulations Pool resources and adjusting procurement practices Decouple unemployment benefit from health insurance, while finding other ways to finance health insurance for the needy Focus water supply efforts toward the B40 Focus sanitation efforts more broadly with many in the population (not only the B40) with subpar access to waste water treatment Ensure water tariffs reflect costs · Prioritize financially sustainable investments 	<ul style="list-style-type: none"> Increase life expectancy, improve quality of life and reduce the health-related bills High-risk groups such as Roma (who have high malnutrition) could benefit in particular Discourage people from falsely registering as unemployed, saving money and increasing social security contributions and taxes Limit contamination with soiled water (health impact, food safety impact) as well as from the perspective of moving toward the EU acquis Reduced water losses Ensure timely and adequate investment in water infrastructure
	MEDIUM PRIORITIES	Benefits (especially for B40)
Adding financial firepower: maintaining financial stability and expanding access to finance	<ul style="list-style-type: none"> Deepen domestic debt markets to help finance growth and increase public debt options. Reduce NPLs while boosting credit for investment and maintaining a stable banking and financial sector. Safeguard financial sector stability through strengthening supervisors' corrective and enforcement powers, strengthening of governance and risk management practices in select banks, and improvements in the financial safety net framework. 	<ul style="list-style-type: none"> Expanding access to finance especially for SMEs and the B40 Potentially lower cost public debt financing, freeing resources for health, education and other key investments. Maintaining the stability of the financial system, protection of insured depositors and limiting fiscal implications.
Greening BiH: reducing pollution and protecting the environment	<ul style="list-style-type: none"> Tidying rural and urban areas of waste, including in water · Sustainable use of resources · Reduce urban pollution, which is among the highest in Europe · Ensure sufficient protection for forested areas where soil erosion or risk of flooding is greatest 	<ul style="list-style-type: none"> Sustainable use of resources · Boost to tourism which will generate employment · Reduce negative impacts of flooding, as reduced water waste enters urban and agricultural areas · Improved health in urban areas, which is badly impacted by pollution · Reduced negative impacts from climactic shocks
Boosting agriculture: increasing agricultural productivity and opportunities	<ul style="list-style-type: none"> Understand better rural land issues to identify ways to improve rural livelihoods · Find ways to allow the rural poor to engage in a growing agricultural sector · Boost smallholder productivity Ensure adherence to EU standards 	<ul style="list-style-type: none"> Boost rural agricultural incomes · Help rural dwellers access employment in towns, access to adult education in rural areas may help to boost income-earning opportunities

Source: BHAS LFS (September 2014);

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ANNEXES

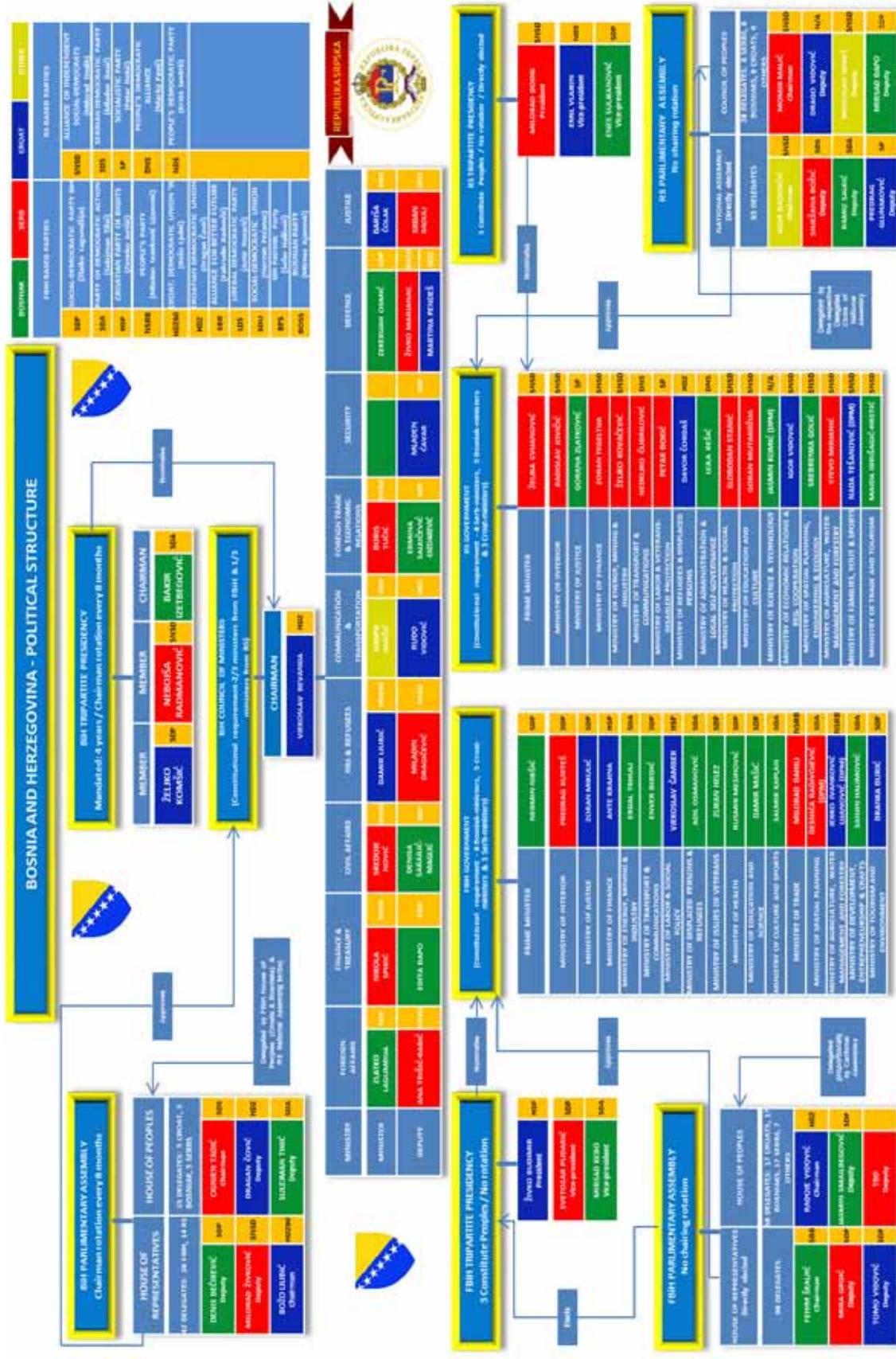
Annex I: Institutional Structures and Weaknesses

7.1 BiH institutions comprise the Council of Ministers, a rotating State Presidency, a two chamber legislature, a central bank and a constitutional court.¹⁶⁶

- The Council of Ministers consists of the chairman and nine ministers. The Council's responsibilities include the following areas: foreign policy, defense, security, justice, foreign trade and economic relations, transport and communication, civil affairs, human rights and refugees, and finance and treasury.
- The Parliamentary Assembly is bicameral, with a House of Peoples and a House of Representatives, each consisting of two-thirds of delegates from FBiH (divided equally among Croats and Bosnians) and one-third from RS. The Parliament's responsibilities include: enacting legislation to implement decisions of Presidency or to carry out constitutional responsibilities; deciding on revenue sources and amounts for institutional operations and international obligations; approving a budget for government institutions, etc.
- The Presidency consists of three members: one Bosniak and one Croat, each directly elected from the territory of FBiH, and one Serb directly elected from RS. Presidency powers include: foreign policy; representing country in international forums and European organizations; treaties; proposing annual budget to Assembly; reporting to Assembly on expenditures, etc.
- The Presidency nominates the Chair of the Council of Ministers, who in turn nominate governmental Ministers and Deputy Ministers (but not from their same constituency). No more than two-thirds of all Ministers may be appointed from the territory of FBiH.
- The Constitutional Court has nine members, with four members selected by the House of Representatives of the Federation, and two members by the Assembly of RS. The remaining three members are selected by the President of the European Court of Human Rights after consultation with the Presidency.
- The Central Bank is the sole authority for issuing currency and for monetary policy throughout Bosnia and Herzegovina. It operates a currency board with the Euro.

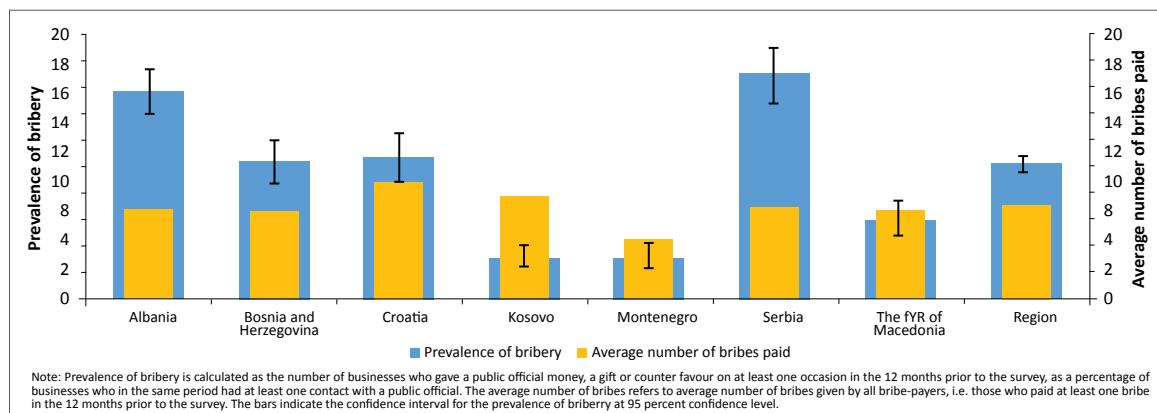
¹⁶⁶ This information is drawn from Annex 4 of the General Framework Agreement, Dayton Accords.

Figure 7.1: Institutional Structure of BiH



- 7.2 **The international community established the Office of the High Representative (OHR) in 1995 to oversee civilian peace implementation and administration.** This included economic reconstruction, humanitarian aid, protection of human rights, and the holding of free elections. One of the OHRs aims was to help the country develop into a peaceful, democratic state. Importantly, in 1997, the OHR was also given the executive authority to impose decisions, push reforms and remove government officials from office (Bonn Powers). The Peace Implementation Council (PIC), a group of 55 countries and international organizations, oversees the OHR. From 2002-11, the High Representative also served as the European Special Representative to BiH. The OHR remains in place.
- 7.3 **A NATO-led peacekeeping force (Implementation Force- IFOR) was also put into place to implement the military aspects of the agreement, taking over from the UN Protection Forces (UNPROFOR).** It was followed in 2004 by a smaller European Union military force, EUFOR. The Organization for Security and Co-operation in Europe was charged with organizing the first free elections in 1996. Refugees and displaced persons were given the right to vote.
- 7.4 **The Dayton Accords succeeded in their aim of bringing peace but the institutional arrangements were not meant to be permanent.** Richard Holbrooke, an American diplomat who brokered the accords, noted that “the most important thing was to stop the killing”. However, while they succeeded in this, John C. Kornblum, a retired United States ambassador” who drafted the Dayton accords as the diplomat Richard C. Holbrooke negotiated them, noted that the complex mechanisms they put in place were intended primarily to secure peace, but they were also supposed to be replaced in three years with a more streamlined governmental structure.

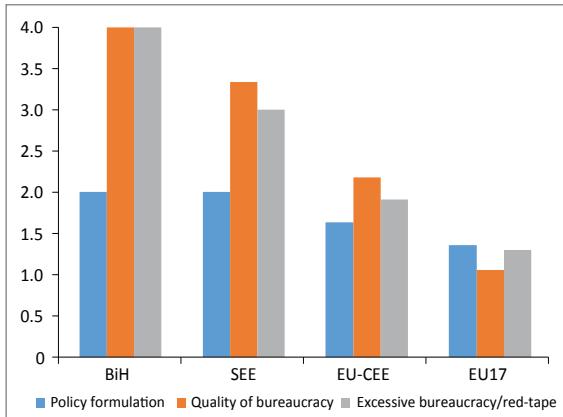
Figure 7.2: Prevalence of Bribery and Average Number of Bribes Paid



Source: UNODC Business, Corruption and Crime in the Western Balkans, 2013:
http://www.unodc.org/documents/corruption/Publications/2013/Western_balkans_business_corruption.pdf

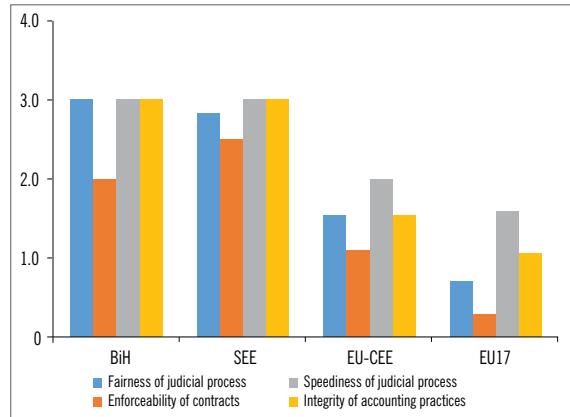
¹⁶⁷ “Roots of Bosnian Protests Lie in Peace Accords of 1995.” New York Times. February 14, 2014.

Figure 7.3: EIU Political efficacy risk, Nov 2014-Underlying indicators, 0 (low risk), 4 (high risk)



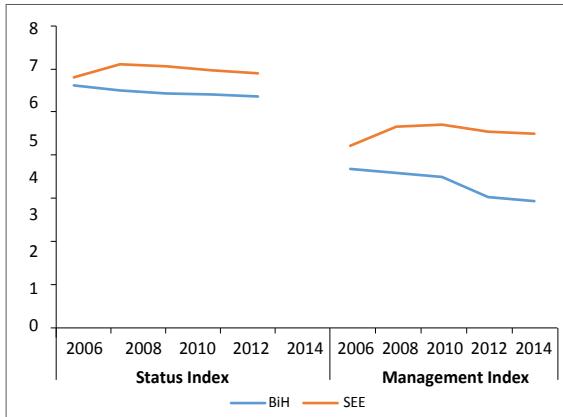
Source: Economist Intelligence Unit, 2015

Figure 7.4: EIU Legal & regulatory risk, Nov 2014-Underlying indicators, 0 (low risk), 4 (high risk)



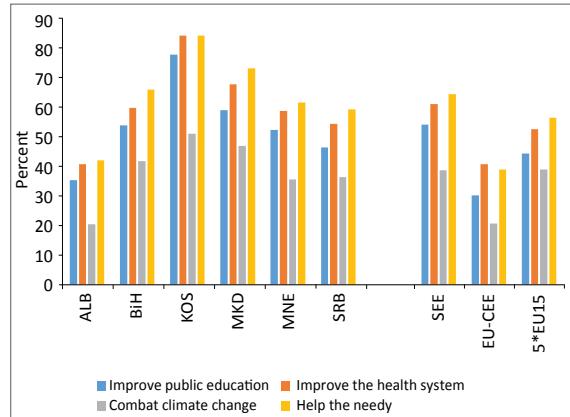
Source: Economist Intelligence Unit, 2015

Figure 7.5: BTI Status and Management Indices



Note: Status Index= Average of Democracy status and Market economy status; Management index= management performance weighted by level of difficulty
Source: Bertelsmann Transformation Index, 2014

Figure 7.6: Would you be willing to give part of your income or pay more taxes, if you were sure that the extra money was used to...



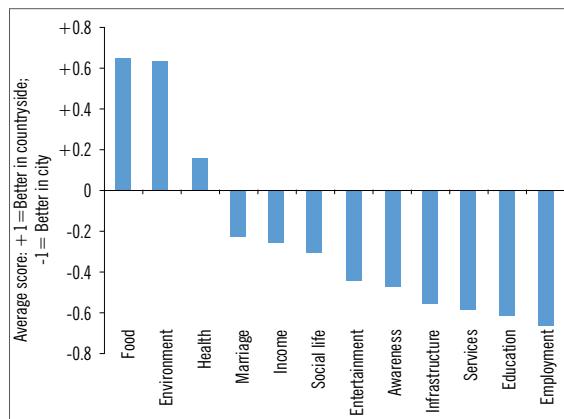
Source: LITS

Note: Only five EU17 countries were surveyed. They were: France, Germany, Italy, Sweden and UK

Annex II: Urban advantages?

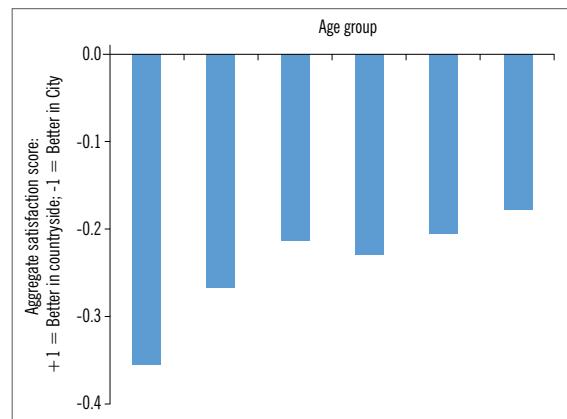
- 7.5 **Most rural dwellers expect to remain in the countryside and are attached to it.** According to the RHS, around 84 percent expect that they will still live in the countryside in 2020, though just 44 percent expect their children will be in the countryside. Only 41 percent of rural residents would be prepared to change their place of residence “if the need arises”, while over half would continue to live in the countryside and commute if they got a job in a city. Just 18 percent would be prepared to sell agricultural land to invest in a business proposed by their child.
- 7.6 **Rural residents would jump at the chance of a state job.** Despite their attachment to the land and unwillingness to invest in a business, 60 percent of rural dwellers would leave their current job if they were offered a job in a state institution.
- 7.7 **Rural residents consider some aspects of life to be better in rural areas.** The food, environment, and health are all considered to be better in rural areas by rural dwellers (Figure 7.16). However the young rural are much more likely than their older counterparts to favor urban areas (Figure 7.8).

Figure 7.7: Quality of life in rural vs urban areas



Source: UNDP 2012 Rural Household Survey

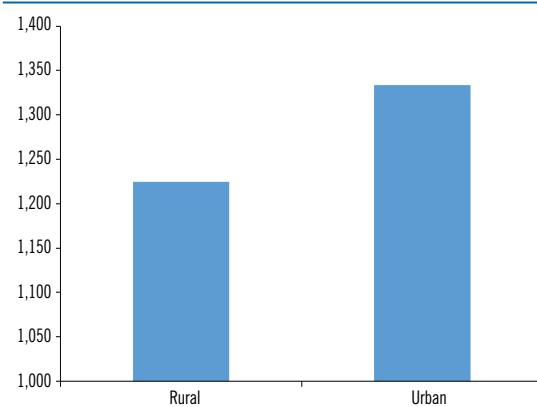
Figure 7.8: Quality of life in rural vs urban areas by age



Source: UNDP 2012 Rural Household Survey

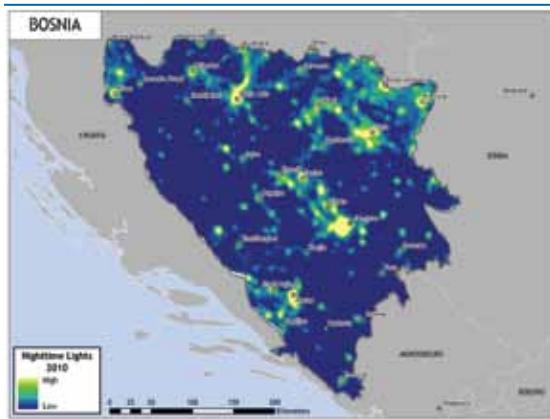
- 7.8 **A reasonable quality of life combined with urban challenges likely keep people in rural areas.** Rural households have reasonable (if improvable) access to services, an agricultural safety net, high social protection payments, better food, environment and health than urban dwellers. Rural wages in the RS were only 8.9 percent lower than urban ones (KM 1334 versus KM 1225) and this gap has reduced from 11.5 percent in 2007 (Figure 7.9). Moving to a city with high unemployment, low wages and a belief that connections are important to obtain jobs (see Box 1.1) is probably too risky for most rural dwellers.

Figure 7.9: Average rural and urban monthly wages in RS (2011, KM)



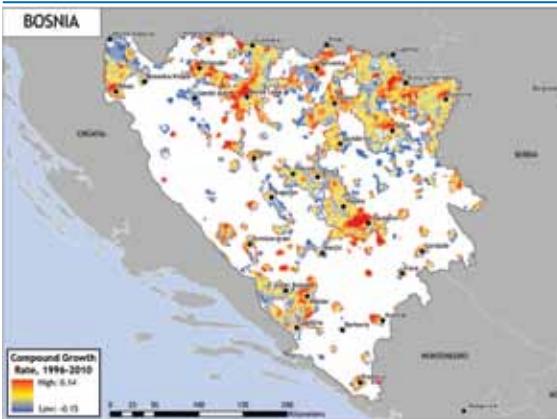
Source: RS Statistical Agency

Figure 7.10: Night time lights, 2010



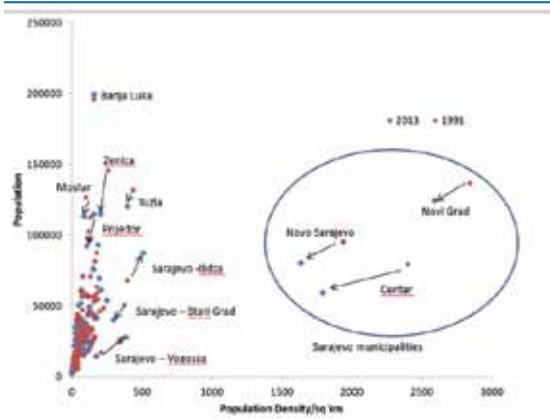
Source: Staff calculations based on Night time lights data provided by NOAA: <http://ngdc.noaa.gov/eog/>

Figure 7.11: Change in night time lights, 1996-2010



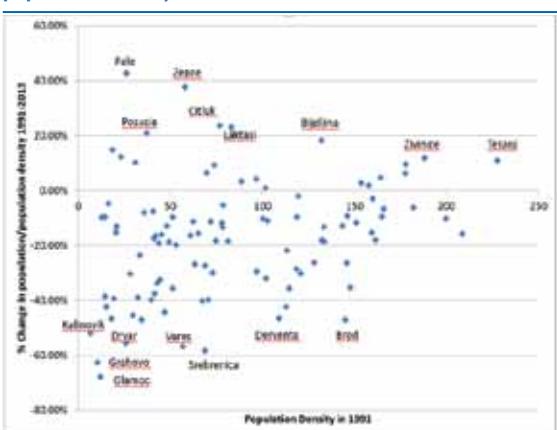
Source: Staff calculations based on Night time lights data provided by NOAA: <http://ngdc.noaa.gov/eog/>

Figure 7.12: Population versus population density, 1991-2013



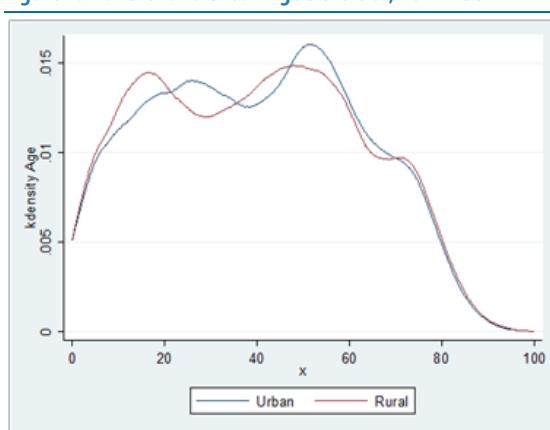
Sources: 1991 and 2013 census

Figure 7.13: Change in population (1991-2013) versus population density (1991)



Sources: 1991 and 2013 census

Figure 7.14: Rural and Urban Age Densities, 2011 HBS



Sources: 2011 EHBS and staff calculations

Table 7.17: Rural vs Urban living standard indicators

	Cities	Towns & villages
Net migration per 10,000 people	+36	-14
Economically active share of population	35%	29%
Unemployment rate	35%	29%
Per capita GDP (USD)	10,460	4,730
Child illness in previous two weeks	4.3%	4.7%
Received five immunisations	91.9%	91.7%
Child malnutrition	4.8%	4.0%
Early childhood education	22.8%	7.9%
Secondary school attendance	90.7%	92.3%
Youth literacy - male	100.0%	99.9%
Youth literacy - female	99.9%	99.1%
Use of improved drinking water	99.7%	99.5%
Use of improved sanitation	98.7%	92.0%

Source: UNDP Bosnia and Herzegovina Rural Household Survey, 2012

Table 7.18: Regression models for Rural-Urban Income Differentials

Year (2011)	(I)	(II)	(III)	(IV)	(V)
Rural	b/se 0.098** *	b/se 0.098** *	b/se 0.049*** (0.010)	b/se 0.042** * (0.010)	b/se 0.023** (0.010)
Controls	None	(I) + Entity	(II) + education	(III) + labor force status	(IV) + age, sex, household size, number of children
R-squared	0.018	0.019	0.059	0.076	0.123
Obs	7400	7400	7400	7400	7400

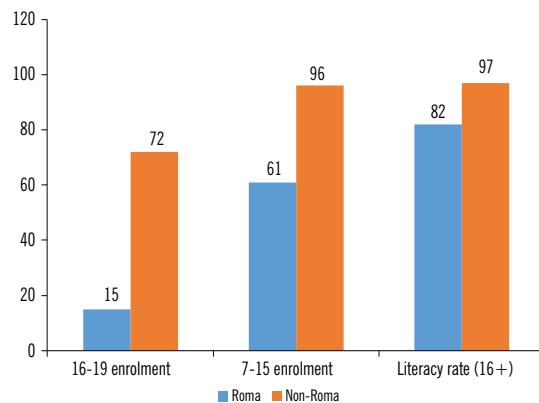
Notes: Population weighted estimates. Robust standard errors in parentheses. Significance levels: *** 0.001, ** 0.05, * 0.01.

Year (2007)	(I)	(II)	(III)	(IV)	(V)
Rural	b/se 0.096** *	b/se 0.095** *	b/se 0.057*** (0.009)	b/se 0.054** * (0.010)	b/se 0.027*** (0.010)
Controls	None	(I) + Entity	(II) + education	(III) + labor force status	(IV) + age, sex, household size, number of children
R-squared	0.018	0.019	0.045	0.051	0.101
Obs	7468	7468	7468	7468	7468

Notes: Population weighted estimates. Robust standard errors in parentheses. Significance levels: *** 0.001, ** 0.05, * 0.01.

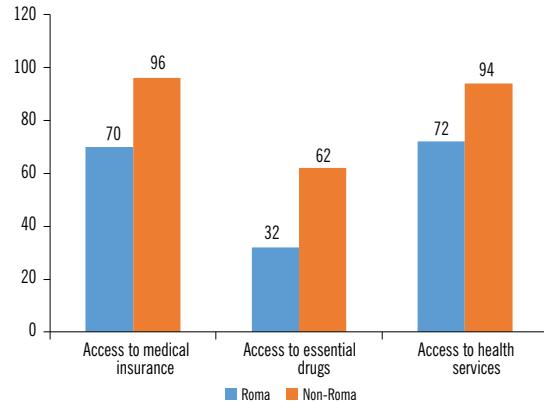
Annex III: Social exclusion – Roma and other at-risk groups

Figure 7.15: Enrollment in education, Roma vs Non-Roma



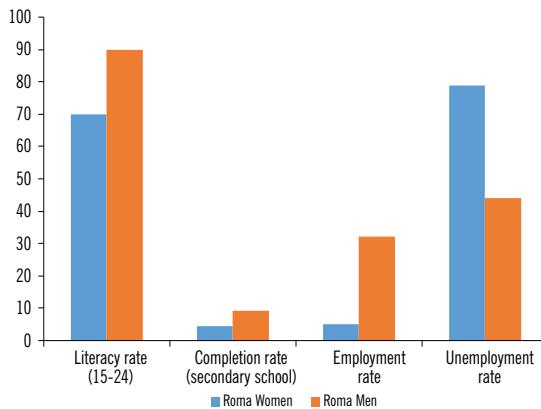
Source: UNDP/WB/EC Regional Roma Survey 2011

Figure 7.16: Access to healthcare, Roma vs Non-Roma



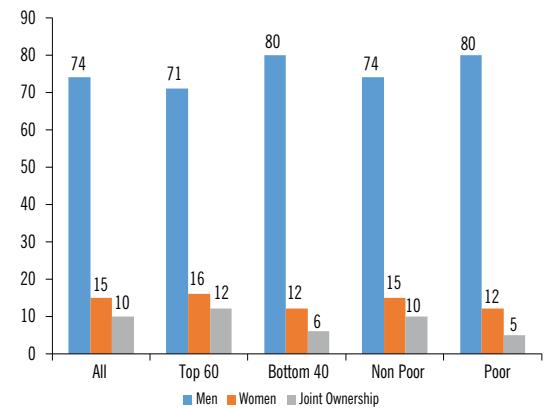
Source: UNDP/WB/EC Regional Roma Survey 2011

Figure 7.17: Gender differences in Roma population



Source: UNDP/WB/EC Regional Roma Survey 2011

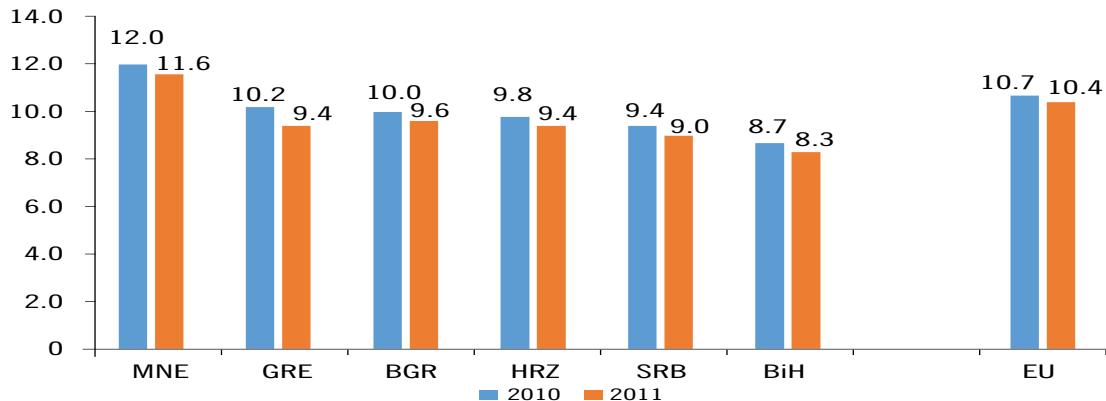
Figure 7.18: Dwelling ownership by quintile



Source: BiH Household Budget Survey 2011

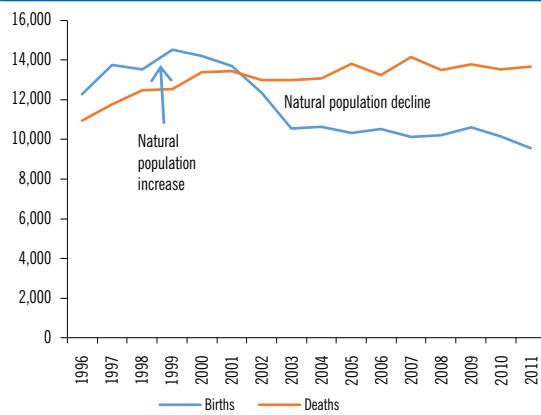
Annex IV: Population dynamics

Figure 7.19: Birth rates in selected Balkan countries and EU (births per 1000 people)



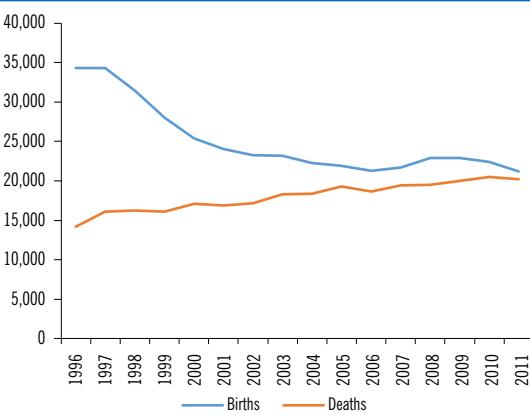
Source: BHAS 2013¹⁶⁸

Figure 7.20: RS has been shrinking since 2002 ...



Source: FBiH statistical agency

Figure 7.21: ... while in FBiH births are now almost equal to deaths



Source: RS statistical agency; Note: outmigration also creates net-negative population growth

Table 7.3: Main Ethnicities in Yugoslav Republics in 1991 Census, % Population

	BiH	HRZ	SRB	MNE	SLV	MKD	KOS
Muslims/Bosniaks	43.5	0.9	2.3	14.6	1.4	1.5	3.4
Croats	17.4	78.1	1.2	1.0	2.8	0.1	0.4
Serbs	31.2	12.2	79.9	9.3	2.5	2.1	9.9
Montenegrins	0.2	0.2	1.5	61.9	0.2	0.1	1.1
Slovenes	0.1	0.5		0.1	88.3		
Macedonians	0.0	0.1	0.6	0.2	0.2	65.3	
Albanians	0.1	0.3	1.0	6.6	0.2	21.7	81.6
Yugoslavs	5.5	2.2	4.1	4.3			0.2
Roma	0.2	0.1	1.2	0.5	0.1	2.6	2.3
Others	1.8	5.4	8.1	1.6	4.3	6.6	1.1
Total	100	100	100	100	100	100	100

Sources: National Statistical Offices, 1991 Yugoslav Census

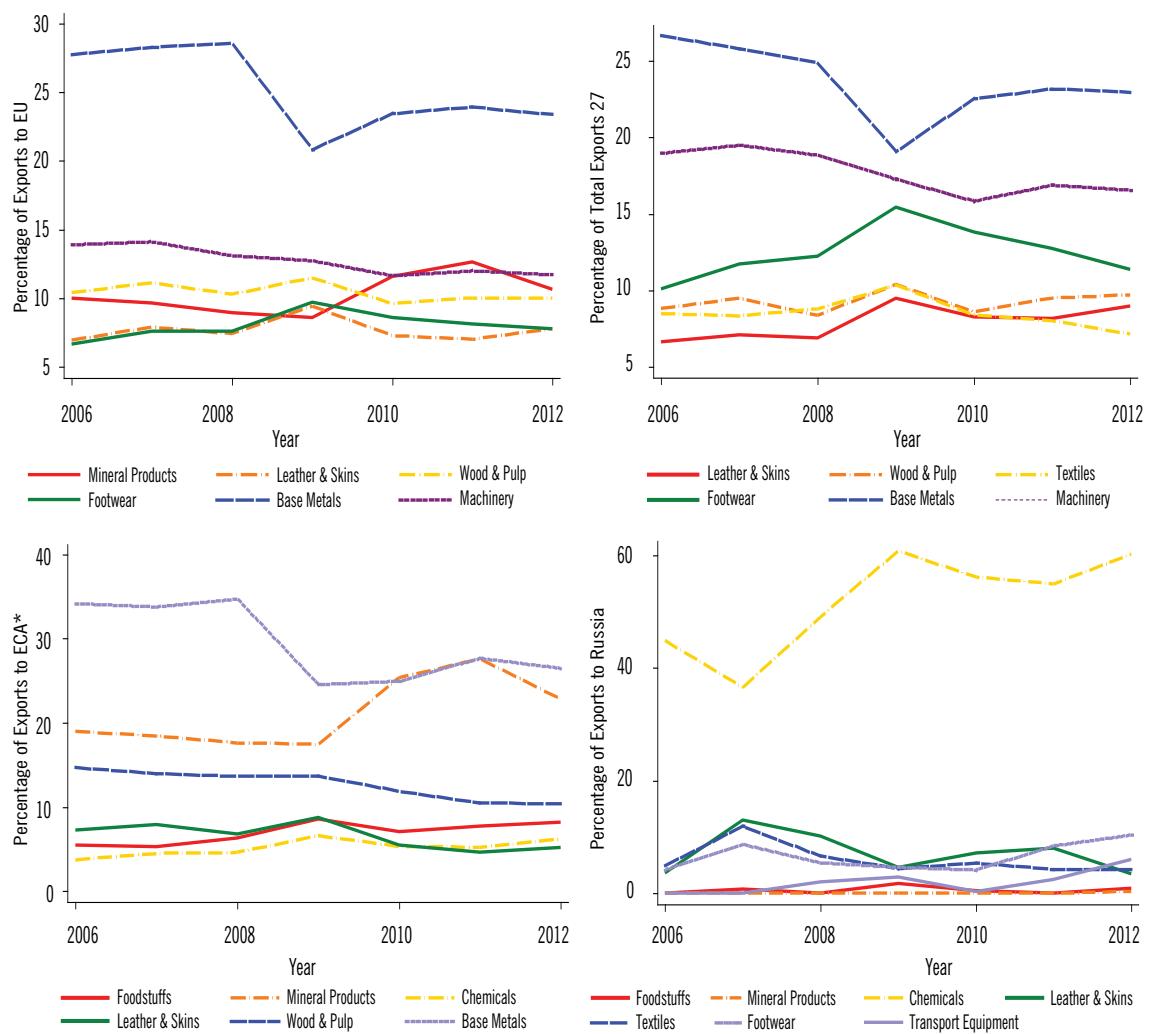
¹⁶⁸ BHAS (2013) Bosna i Hercegovina u brojevima 2013. http://www.bhas.ba/tematskibilteni/BH_u_brojkama2013_bh.pdf

Annex V. Comparative advantage, survival in export markets

BiH export composition trends

7.9 UN Comtrade data show that BiH exports are dominated by base metals and machinery although their share has seen a slight decline. At the same time, mineral products have increased (Figure 7.22). Disaggregating by destination market, whereas base metals and machinery account for the largest share of exports to the EU, footwear accounts for 10-15 percent of total exports to the EU (although much of this is re-exports with only assembly taking place in BiH), followed by wood and leather (each approaching 10 percent). Base metals and mineral product exports dominate BiH exports to ECA as a whole. There were some minor trend variations in export composition around the 2008 financial crisis period, but the effects for the most part appear to be transitory.

Figure 7.22: Sectoral composition of Bosnia and Herzegovina's export basket over time and by destination market



Source: World Bank Staff calculations based on mirror data from UN Comtrade.

Revealed comparative advantage

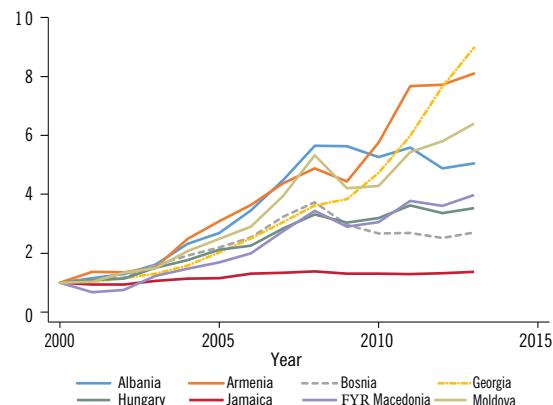
Table 7.4: Bosnia and Herzegovina's revealed comparative advantage (2002-2013)

Product Types	2002/03	2004/05	2006/07	2008/09	2010/11	2012/13	CAGR	Value of Exports in 2012/13 (thousand dollars)
01-05 Animal	0.21	0.47	0.51	0.7	0.85	0.78	33.2%	72,325
06-15 Vegetable	0.37	0.63	0.62	0.66	0.73	0.85	30.2%	137,290
16-24 Foodstuffs	0.81	1.12	1.05	1.16	1.25	1.17	23.3%	189,096
25-27 Minerals	0.58	0.89	0.7	0.75	0.84	0.58	26.6%	632,560
28-38 Chemicals	0.16	0.79	0.69	0.69	0.55	0.5	33.4%	239,236
39-40 Plastic / Rubber	0.38	0.4	0.3	0.48	0.43	0.61	24.7%	138,799
41-43 Hides, Skins	4.03	2.84	3.28	2.69	3.46	3.84	14.5%	118,598
44-49 Wood	3.68	4.07	3.67	3.63	3.62	4.18	14.9%	491,572
50-63 Textiles, Clothing	1.31	0.93	1.15	1.37	1.17	1.19	13.0%	238,490
64-67 Footwear	6.04	3.76	7.48	7.85	7.98	8.45	20.4%	347,889
68-71 Stone / Glass	0.32	0.31	0.36	0.33	0.2	0.3	19.2%	53,337
72-83 Metals	4.23	3.13	3.12	2.84	3.08	3.29	16.5%	1,175,181
84-85 Mach/Elec	0.46	0.51	0.48	0.47	0.42	0.46	16.6%	570,013
86-89 Transportation	0.32	0.3	0.19	0.34	0.28	0.33	16.6%	157,570
90-97 Miscellaneous	1.77	1.29	1.51	1.62	1.87	2.02	18.7%	578,790

Source: Authors' calculations based on UN Comtrade.

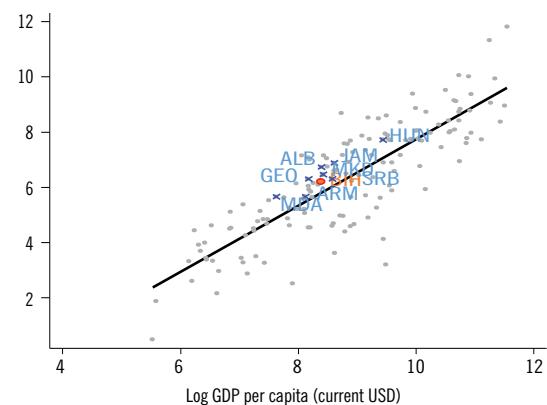
- 7.10 Services exports grew in line with comparator countries during the 2000s but showed significant weaknesses since the crisis.** Prior to the crisis, services export growth was strong and at levels comparable with peer countries. (BiH's per capita exports of services are high for the country's stage of development.

Figure 7.23: BiH: Services represent a larger share of total exports (2000=1)



Source: Staff calculations based on UN Comtrade

Figure 7.24: Per capita services exports are high given the country's size and stage of development

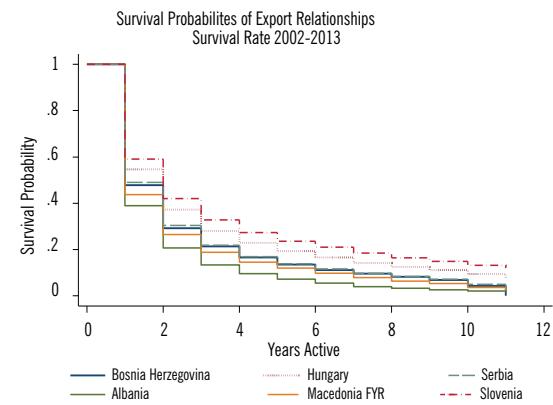


Source: Staff calculations based on UN Comtrade and WDI

Survival in export markets

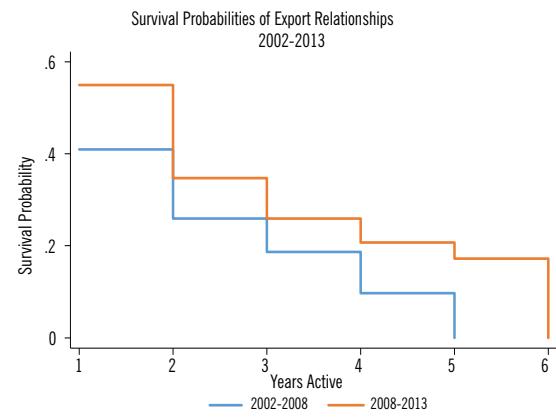
- 7.11 For countries to achieve fast export growth and diversification, both successful entry into export markets and survival of export flows are crucial.** In fact, the literature finds exporting to be an extremely hazardous activity, and particularly so in less advanced countries.
- 7.12 Among BiH exporters, less than half (48 percent) of export activities that are initiated in a given year remain active past the first year.** This compares with almost sixty percent in Slovenia, 54 percent in Hungary, 49 percent in Serbia, and 44 percent in FYR Macedonia (Figure 7.25 and Figure 7.26). Interestingly, survival chances for BiH exporters increased over the period. One year survival probabilities during 2002-2008 were close to 40 percent, and picked up to over 55 percent in the period 2008-2013 (Table 7.5).

Figure 7.25: Chances of survival of export relationships in international markets in line with level of development... (BiH and Comparators, 2002-2013)



Source: Authors' calculations based on UN Comtrade.

Figure 7.26: ...and have increased during the period. (BiH 2002-2008 vs 2008-2013)



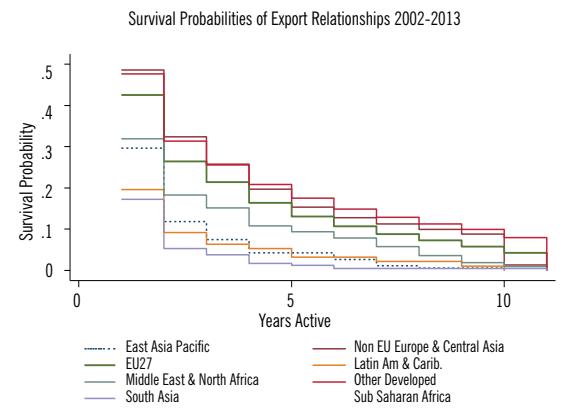
Source: Authors' calculations based on UN Comtrade.

Table 7.21: Survival Probabilities for Bosnia and Comparators (2002-2013)

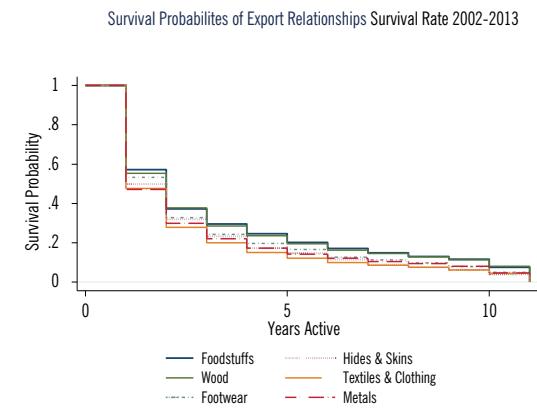
Spell Length	BIH	ARM	ALB	GEO	HUN	MDA	MKD	SRB	SVN
1 year	47.8%	36.8%	38.9%	39.5%	54.6%	45.9%	43.7%	48.9%	59.1%
2 years	29.2%	16.8%	20.7%	19.9%	37.3%	26.9%	26.5%	30.4%	42.0%
5 years	13.4%	5.0%	7.1%	5.5%	19.2%	11.4%	11.9%	13.9%	23.6%
10 years	4.2%	1.3%	2.1%	1.2%	9.4%	3.7%	3.5%	5.0%	13.1%

Source: Authors' calculations based on UN Comtrade.

7.13 The chances of survival of export relationships in the global marketplace depend on the destination of the export flow and on the type of product being traded. BiH exports to non-EU developed countries and to the non-EU region have the highest chances of remaining active for longer, followed by flows to the EU. Those to South Asia and to Latin America and the Caribbean show the lowest survival chances. At the same time, exports of foodstuffs, and wood seem to be the most resilient, while those of textiles and clothing the least resilient. Survival probabilities vary substantially more across destinations than across products (Figure 7.27 and Figure 7.28).

Figure 7.27: Export survival is higher with more 'familiar' markets... (BiH, 2002-2013)

Source: Authors' calculations based on UN Comtrade.

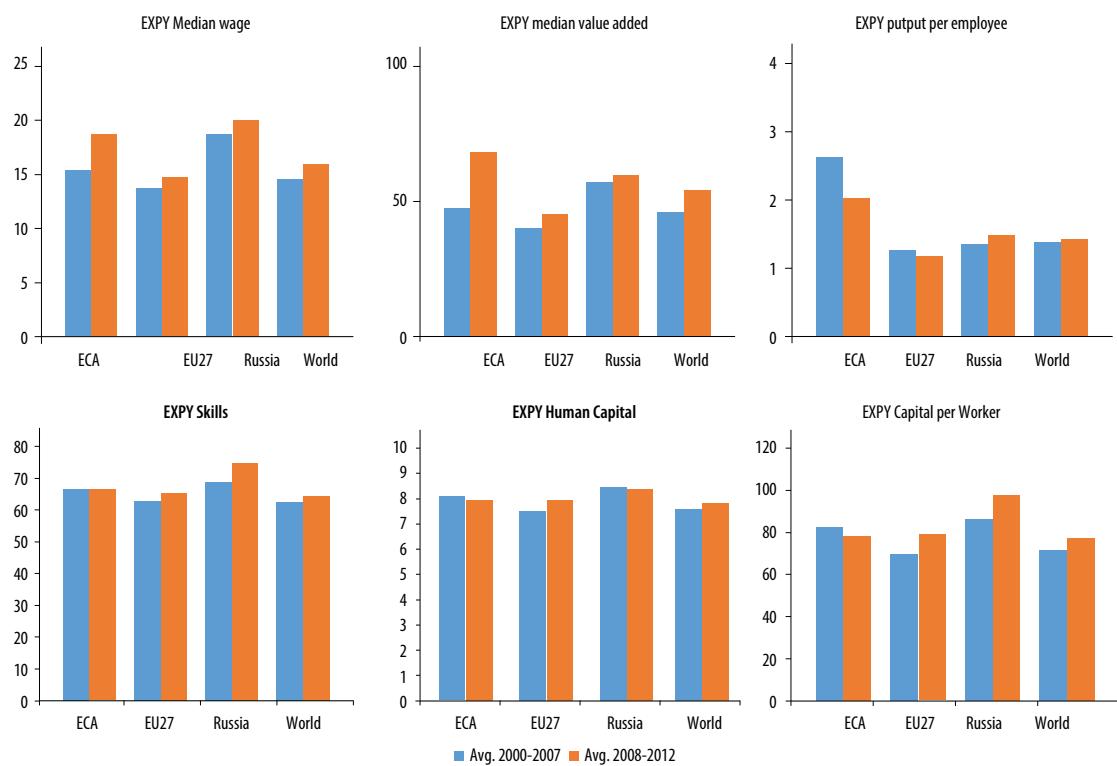
Figure 7.28: ...and for less sophisticated products. (BiH, 2002-2013)

Source: Authors' calculations based on UN Comtrade.

Annex VI. Labor sophistication of exports

7.14 This annex assesses the evolution of BiH's export basket in terms of product mix, product sophistication and destination markets to estimate its labor content. This can help to understand the scope for diversifying BiH's export markets and products with a view to increasing export-driven labor demand. It does not, however, derive precise measures of the labor market impact of BiH export performance. Adapting the Hausmann, Hwang and Rodrik (2007) measure of export sophistication, we develop indirect measures of the labor-related sophistication of BiH's export basket. We construct five indices or "EXPYs"¹⁶⁹ that measure the following aspects of labor sophistication: (i) median wage, (ii) median value added per worker, (iii) ratio of skilled to total workers, (iv) years of schooling, or "human capital", and (v) capital stock per worker. For each of the five EXPY indices, we compare the time trends of their level across destination markets, comparing the average for all Bosnian exports (i.e., destined to the "world") to those destined to the European Union (EU27), ECA* (i.e., non-EU non-Russia ECA countries), and Russia. The results for each of the five EXPYs for BiH are shown in separate panels in Figure 7.29.

Figure 7.29: Labor sophistication of Bosnia and Herzegovina's export basket over time and by destination market

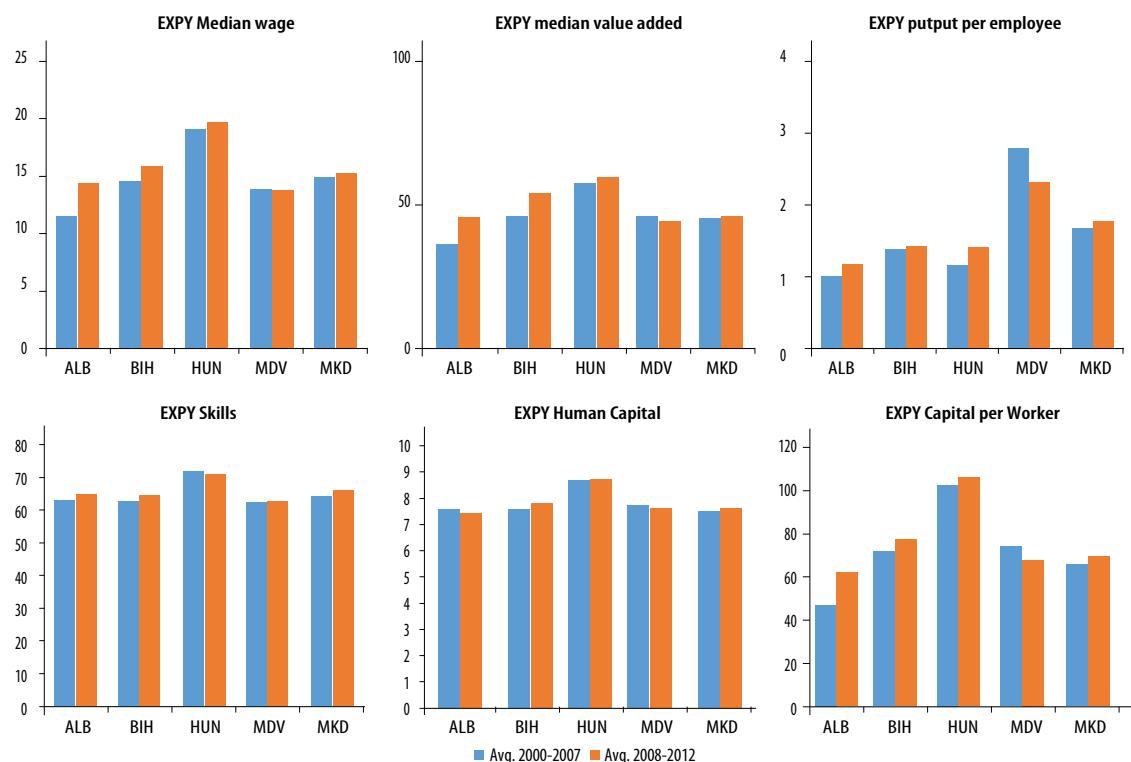


Source: World Bank Staff calculations based on mirror data from UN Comtrade, World Bank Business Environment and Enterprise Performance Surveys, and Shiroitori, Tumurchudur, and Cadot (2010).

¹⁶⁹ EXPYs can be interpreted as the export share-weighted average labor market outcome associated with BiH's export basket, and are calculated using two-steps. The first associates to each product the global trade-weighted average wage, value-added, skill ratio, or physical capital covering all countries in the world that export the product, denoted PRODY. The second step then weights the PRODYS appearing in BiH's export basket by the share of each product in BiH's total exports, denoted EXPY. These resulting EXPYs reflect the global average labor content of goods that appear in BiH's export basket.

- 7.15 **Comparing EXPYs over time and with other countries provides insight into the labor sophistication of regional exports.** Using these labor-related EXPYs for BiH, we (i) look at their change over time, (ii) compare these time trends with other ECA countries such as Albania, Hungary, Moldova and FYR Macedonia, (iii) consider variations in labor-content across different destination markets and how these have evolved since 2000, and (iv) make bilateral comparisons of labor content with Albania, Hungary, Moldova and FYR Macedonia across the distribution of export products. The logic behind these measures is that labor market and other characteristics of the economies that intensively export a given product provide information about the implications of specializing in certain products exported to certain markets, and will determine how export growth will contribute to job creation, wages and skill mix. Based on our observations, we can draw inferences about how the shift in product and regional trade patterns can impact employment, wage and skill demand in BiH.
- 7.16 **BiH exports to Russia and ECA are characterized by relatively high wages and high value added per worker compared to exports to the EU.** The share of skilled workers has increased for exports to Russia, but exports to other destination markets embody a lower skilled-to-unskilled labor ratio and do not show much variation over the last decade. BiH exports to Russia embody slightly higher-than-average human capital compared to other destinations, while exports to Russia reflect a high level of physical capital (partly due to high chemical exports).
- 7.17 **BiH has seen some moderate improvements in export sophistication since 2000.** Taking the BiH export basket as a whole, BiH exports to the world exhibit modestly increasing sophistication in terms of median wage, value added and skill, but relatively less progress in terms of human and physical capital content since 2000.
- 7.18 **Comparing the labor content of BiH exports to other emerging economies (Figure 7.30), we observe increasing trends between 2000 and 2012 for Bosnian exports in terms of wage and value added content, but at levels lower than for exports from Hungary (an early reformer).** On the other hand, BiH exports compare favorably to those from Albania, Moldova and FYR Macedonia in terms of their higher quality and sophistication with respect to wages, value addition, human and physical capital content, having increased their relative competitiveness in recent years.

Figure 7.30: Labor sophistication of Bosnia and Herzegovina's export basket to the world over time compared to other emerging markets



Source: World Bank Staff calculations based on mirror data from UN Comtrade, World Bank Business Environment and Enterprise Performance Surveys, and Shirotori, Tumurchudur, and Cadot (2010).

Annex VII. Private sector performance, constraints and business environment

Firm size and characteristics: Evidence from BEEPS

7.19 **The Business Environment and Enterprise Performance Survey (BEEPS) is imperfect but can be revealing.** The latest BEEPS round of surveys were conducted in 2013 in ECA countries, including BiH. 360 formal firms were surveyed in BiH across the manufacturing, construction, transport, wholesale/retail, hotels/restaurants, IT and other service sectors (Table 7.6). In total, around 15,000 firms were surveyed across ECA. While the sample size for ECA may be considered large, caution should be taken when interpreting the results for BiH due to the small sample size. Nonetheless, the results are instructive for the sectors covered and results presented below are weighted to the population.

Table 7.22: Percent of firms surveyed in each sector

	BiH	SEE	BGR,HRV,ROM	EU-CEE	Rest of ECA
Manufacturing	34	31	25	32	29
Construction	10	4	15	13	16
Transport	9	2	9	6	7
Retail and wholesale	42	56	41	38	41
Hotels and restaurants	2	5	7	5	5
IT	2	1	3	3	2
Other services	1	0	1	3	0

7.20 **Some of the key findings related to employment, exports, firm age and gender are summarized below:**

- **Employment**

- According to the BEEPS, the average formal firm in the sectors covered employed around 32 permanent full-time workers in 2012. This was higher than the SEE average of 25 but lower than EU-CEE countries (around 41 employees) Figure 7.31.
- While other countries appear to have “bulges” of firms at around 15 employees and again at around 25 employees, BiH lacks this second “bulge”. Rather than have many medium-sized firms boosting employment, as in other countries, BiH has a long “left tail” of large employers (Figure 7.33). It is possible that these are a protected group preventing medium-sized firms from entering.
- Unlike in other SEE or EU-CEE countries, firms did not report growth in employment between 2010 and 2012.

- **Exports**

- 16 percent of firms are classified as “exporters” (more than 10 percent of output is exported) in BiH compared to 19 percent for other SEE countries. 23 percent of EU-CEE firms surveyed were exporters (Figure 7.32).

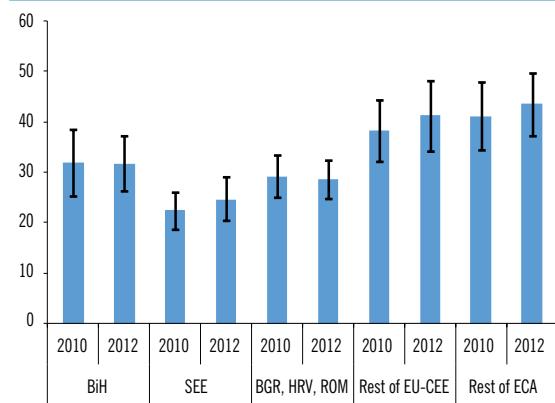
- **Age**

- o BiH firms tend to be older than those in other regions, at 17 years versus 15 on average in SEE. This suggests a post war flurry of new business creation followed by a significant lull.

- **Gender**

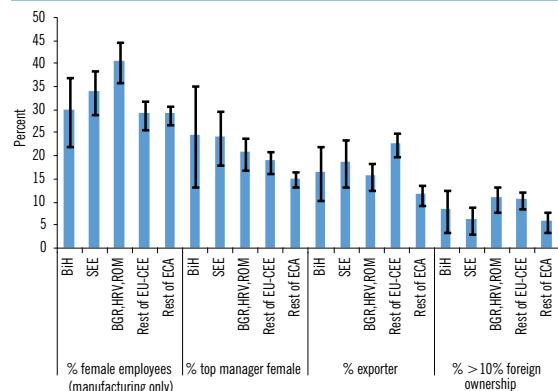
- o Around 24 percent of firms reported that their top manager was female, in line with the SEE average but 5 percentage points higher than the EU-CEE and 9 percentage points higher than the ECA average.
- o However, as a share of total employees, the manufacturing sector employs fewer females than the SEE average (30 versus 34 percent) but is around the EU-CEE average.

Figure 7.31: Average firm size (no. employees) by region, 2010 and 2012



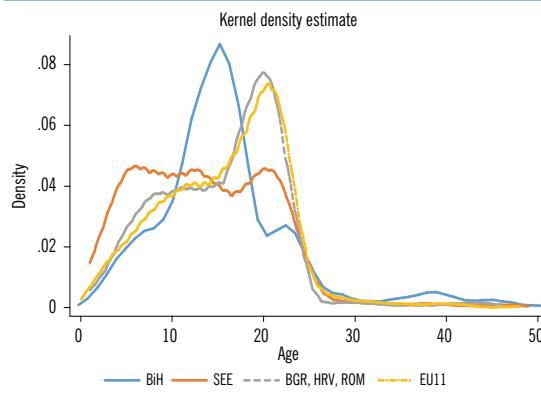
Source: BEEPS and staff calculations. Note: bar represents 95% confidence interval.

Figure 7.32: Selected firm characteristics



Source: BEEPS and staff calculations. Note: bar represents 95% confidence interval.

Figure 7.33: Distribution of number of employees



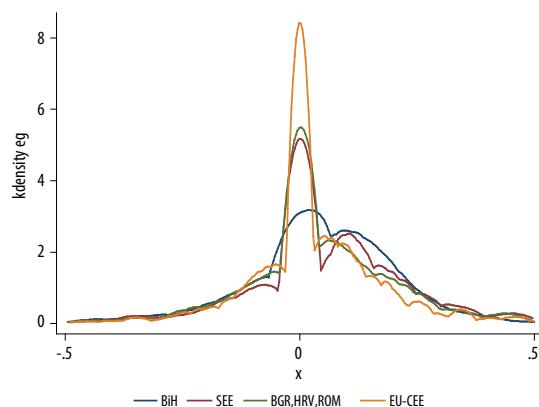
Source: BEEPS and staff calculations

Table 7.7: Multivariate analysis of firm growth (2009-12)

	OLS. Dependent variable: Employment growth				OLS. Dependent variable: Sales growth				OLS. Dependent variable: Growth in Sales per Worker			
	ECA	ECA	BiH	ECA	ECA	ECA	BiH	ECA	ECA	ECA	ECA	BiH
log(size)	0.04*** (-5.16)	-0.04*** (-4.71)	-0.00 (-0.54)	-0.00 (-0.37)	-0.01 (-1.35)	-0.01 (1.39)	0.02 (3.76)	0.03*** (3.37)	0.03*** (3.37)	0.03*** (3.37)	0.03*** (3.37)	0.02 (1.18)
log(age)	-0.04*** (-5.26)	-0.05*** (-5.64)	-0.05*** (-4.17)	-0.09*** (-7.81)	-0.08*** (-7.92)	-0.04 (-1.21)	-0.04 (-5.73)	-0.05*** (-6.41)	-0.05*** (-6.41)	-0.05*** (-6.41)	-0.05*** (-6.41)	0.02 (0.49)
Female manager	-0.02** (-3.15)	-0.02* (-2.67)	-0.02 (-0.87)	-0.02 (-1.56)	-0.02 (-0.73)	-0.01 (-0.63)	-0.04 (0.49)	0.01 (1.14)	0.01 (1.14)	0.01 (1.14)	0.01 (1.14)	-0.02 (-0.45)
Large city	0.01 (0.65)	0.00 (0.28)	-0.03 (-1.21)	0.01 (0.43)	-0.01 (-0.32)	-0.01 (-3.52)	-0.14*** (-0.06)	-0.00 (-0.45)	-0.00 (-0.45)	-0.01 (-0.45)	-0.01 (-0.45)	-0.13*** (-3.61)
Sector dummies (baseline=Manufacturing)												
Construction	-0.00 (-0.35)	-0.01 (-0.77)	0.07** (2.65)	-0.00 (-0.20)	-0.00 (-0.15)	-0.00 (-1.13)	-0.08 (0.54)	0.01 (0.69)	0.01 (0.69)	0.01 (0.69)	0.01 (0.69)	-0.14* (-2.16)
Transport	-0.01 (-0.93)	-0.01 (-1.29)	0.04 (1.01)	-0.02 (-0.76)	-0.04* (-2.26)	-0.04 (-0.52)	-0.04 (-0.45)	-0.01 (-1.63)	-0.01 (-1.63)	-0.03 (-1.63)	-0.03 (-1.63)	-0.06 (-0.92)
Retail and wholesale	-0.01 (-0.86)	-0.01 (-1.89)	0.02 (0.82)	-0.01 (-0.39)	-0.01 (-0.65)	-0.01 (-1.69)	-0.07 (-0.01)	-0.00 (-0.20)	-0.00 (-0.20)	-0.00 (-0.20)	-0.00 (-0.20)	-0.07 (-1.77)
Hotels and restaurants	-0.03 (-1.64)	-0.02 (-1.96)	0.04 (0.98)	-0.02 (-0.77)	-0.02 (-1.13)	-0.02 (-2.04)	-0.10* (-0.03)	-0.00 (-0.17)	-0.00 (-0.17)	-0.00 (-0.17)	-0.00 (-0.17)	-0.09 (-1.87)
IT	-0.02 (-1.38)	-0.02** (-3.04)	0.05 (1.13)	-0.05 (-0.93)	-0.05 (-1.11)	-0.05 (0.72)	-0.06 (-0.95)	-0.05 (-1.03)	-0.05 (-1.03)	-0.04 (-1.03)	-0.04 (-1.03)	-0.03 (-0.39)
Other services	-0.01 (-0.61)	-0.01 (-0.72)	0.03 (0.28)	0.04 (0.99)	0.04 (1.30)	0.04 (0.96)	0.31 (2.19)	0.07* (2.73)	0.07* (2.73)	0.07* (2.73)	0.07* (2.73)	0.28 (1.13)
Exporter	0.04*** (4.15)	0.04*** (5.70)	-0.03 (-1.06)	0.06** (3.11)	0.06** (2.89)	0.04** (-0.78)	-0.04 (1.46)	0.02 (0.60)	0.02 (0.60)	0.01 (0.60)	0.01 (0.60)	-0.02 (-0.46)
Country dummies	No Yes	No Yes	No No	No Yes	No Yes	No Yes	No Yes	No Yes	No Yes	No Yes	No Yes	No Yes
Constant	0.24*** (4.77)	0.21*** (5.80)	0.16*** (4.02)	0.33*** (7.94)	0.16*** (6.37)	0.15* (2.22)	0.10** (3.22)	0.15* (2.22)	0.10** (2.22)	0.10** (2.22)	0.10** (2.22)	0.02 (0.23)
N	12924	12924	338	8601	8601	276	8599	8599	8599	8599	8599	276
r2	0.09	0.11	0.09	0.02	0.05	0.07	0.01	0.03	0.01	0.03	0.01	0.07

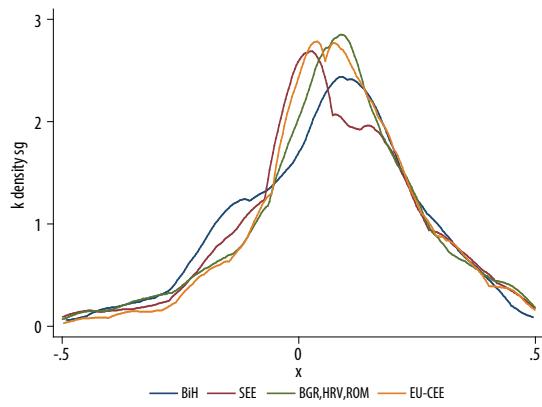
Source: WBG SCD Team

Figure 7.34: Distribution of average annual employment growth (2010-12)



Source: BEEPS and staff calculations

Figure 7.35: Distribution of average annual sales growth (2010-12)



Source: BEEPS and staff calculations

Business Environment

- 7.21 **Accessing credit became more difficult in DB2015.** This was driven by worsening Depth of Credit Information index, Credit Registry Coverage and Credit Bureau Coverage. However, the global rank improved in 2015 due to even larger backward steps in other countries.
- 7.22 **Even in areas in which BiH has made some improvements, other countries have advanced quicker.** BiH made improvements to business environment by reducing a number of costs, such as: costs for starting a business, costs for registering a property, costs in dealing with construction permits, costs in getting electricity, costs to exports and imports (deflated US\$ per container); and lowered minimum paid-in capital to start a business. However, the ranking of the main indicators worsened due to larger improvements in other countries.
- 7.23 **BiH does perform relatively well in a number of areas.** BiH ranks 34th in the world in Resolving Insolvency and 36th in Accessing Credit. Within SEE, BiH performs second best in Enforcing Contracts (but worst in Protecting Minority Investors) (Table 7.8).

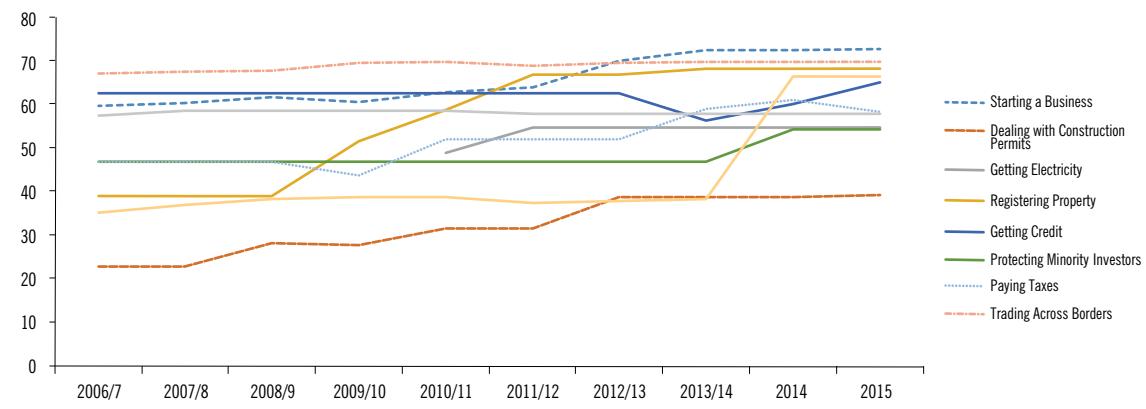
Table 7.8: Ranks and changes in DB 2015-2014 categories

Topics	DB2015 Rank	DB2014 Rank	Change in Rank
Starting a business	147	142	↓-5
Dealing with Construction Permits	182	180	↓-2
Getting Electricity	163	160	↓-3
Registering Property	88	89	↑-1
Getting Credit	36	45	↑-9
Protecting Minority Investors	83	81	↓-2
Paying Taxes	151	142	↓-9
Trading Across Borders	104	103	↓-1
Enforcing Contracts	95	95	-
Resolving Insolvency	34	32	↓-2

Source: Doing Business 2015

7.24 BiH improved in all DB indicators between 2010 and 2015 except in Enforcing Contracts (Figure 7.36). BiH improved more than any other country in SEE in Getting Credit, and was second best in four categories (Resolving Insolvency, Starting a Business, Registering Property, and Getting Electricity) and below worse than the SEE average in other indicators.

Figure 7.36: Distance to frontier changes by indicator



Source: Doing Business reports 2010-2015

Note: Data for FDI are presented with a lag such that 2007 data are compared with 2006 DB indicators etc.

7.25 The DB reports note several positive reforms between 2010 and 2013, a negative reform DB2014, and neither significant positive nor negative changes in DB2015 (Table 7.9). In fact there were few positive changes done in DB2015 as mentioned in previous paragraphs but they were not considered significant enough to be recorded as reforms. Across the DB reports there was only one topic by which BiH was considered to have good practices in place and that was 'Maintaining a Unified Registry', which made it easier to get credit.

Table 7.9: Improvements and deteriorations in business environment 2011-2014

Positive reforms	Negative reforms
In 2010 was one reform which improved dealing with construction permits.	In 2014 introduced new tax making paying taxes more difficult. It introduced a penalty for failure to employ the required minimum number of people in special categories—though it also temporarily abolished the forestry tax.
In 2011 were 2 reforms: 1) Reduced delays in property registration and the land registry in Sarajevo by increasing administrative capacity; and 2) made easier paying taxes by simplifying labor tax processes, reducing employer contribution rates for social security and abolishing payroll tax.	
In 2012 were 2 reforms: 1) Starting a business-by replacing the required utilization permit with a simple notification of commencement of activities and by streamlining the process for obtaining a tax identification number.; and 2) Dealing with construction permits - by fully digitizing and revamping its land registry and cadaster.	
In 2013 were 2 reforms: 1) Registering property became easier by computerized commercial registries, cutting registration time by 8 days; 2) Paying taxes become easier by introducing or enhancing electronic systems.	

Source: Doing Business reports 2010-2015

Sub-national business environment

7.26 A regional Doing Business survey ranked 22 cities in South East Europe 2011 and the three BiH cities included were ranked as 18-20 among the 22 cities. This is a slight improvement compared to similar report from 2008 when they were in the last three positions, and the change came due to deterioration of ranking of Kosovo cities (Table 7.10). Registering Property, Starting a Business and Enforcing Contracts were among the worst ranked, while dealing with construction permits was relatively good.

Table 7.10: Ranking by cities in sub-region doing business report 2011 (from 1=best to 22=worst)

City	Ease of starting a business	Ease of dealing with construction permits	Ease of registering property	Ease of enforcing contracts
Banja Luka	18	3	21	15
Sarajevo	19	9	19	19
Mostar	20	13	22	20

Source: Doing Business in South East Europe 2011

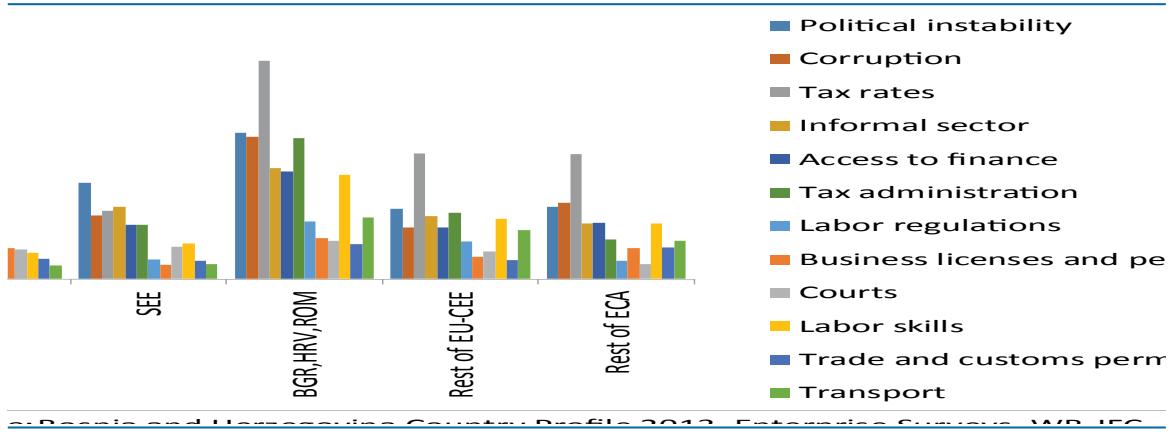
7.27 Some reforms prior to 2011 were noted in the report but were relatively minor. All three cities made it easier to start a business by eliminating municipal or entry permits and decreasing their fees. All three digitalized Cadaster and Land Registries and Banja Luka adopted and implemented a new construction law. Banja Luka also reduced court fees and improved court efficiency. Yet these reforms only lifted the three BiH cities slightly in the rankings. It should be noted that any reforms since 2011 are not reflected in this analysis due to lack of new data.

7.28 Detailed analysis reveals that business environment was not very friendly in any of the BiH observed cities. Banja Luka had 18 pre-construction procedures followed, while Sarajevo and Mostar each had 19 procedures. Sarajevo performed the least worst in dealing with Construction Permits, requiring “just” 182 days, compared with 228 in Banja Luka and 554 in Mostar. The property transfer fees were highest in Mostar and Sarajevo at 5 percent of property value and somewhat lower in Banja Luka at 3 percent. Banja Luka was ranked 15th in Enforcing Contracts, while Sarajevo and Mostar were ranked 19th and 20th, respectively. Mostar and Banja Luka had the slowest courts in all of the cities included requiring 1,653 and 1,220 days respectively to complete enforcement of judgment. In Sarajevo it takes 595 days to complete the process. The court costs are quite high at 40.4 percent of the claim in Sarajevo, 31.5 percent in Mostar and 27.7 percent in Banja Luka.

Firm-reported obstacles to doing business

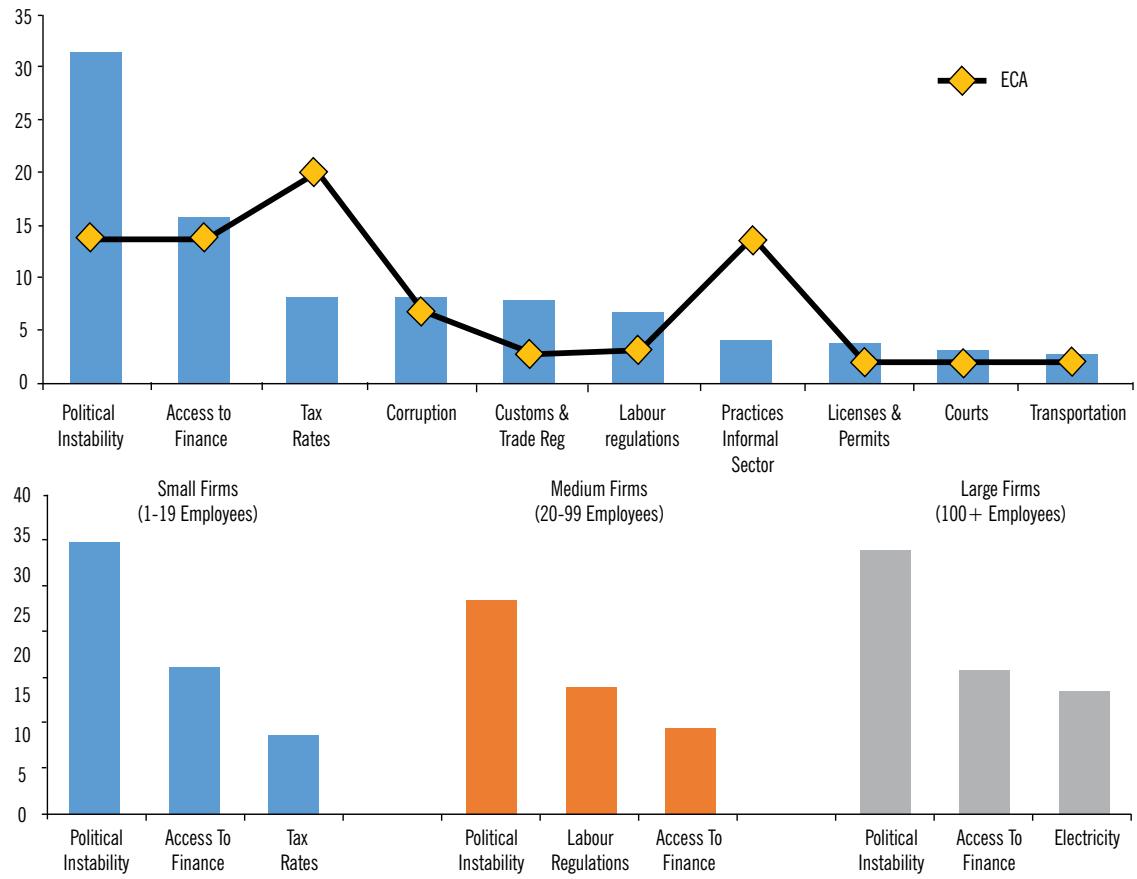
- 7.29 The BEEPS identifies political instability and corruption were identified as “major” or “very severe” constraints to doing business by more firms than any other presented obstacles. Around 32 and 26 percent of firms cited these constraints, respectively. Access to finance, tax rates, tax administration and labor regulations also featured prominently (Figure 7.37). When firms were asked to cite a single major obstacle, similar concerns emerged. 32 percent of respondents cited political instability as the most important obstacle, while access to finance was cited by 16 percent. Tax rates, corruption, labor regulations and customs and trade regulations were each perceived to be the most important obstacle by between 7 and 9 percent of respondents.

Figure 7.37: % firms reporting constraint as “major” or “very severe”



Source: Bosnia and Herzegovina Country Profile 2013, Enterprise Surveys, WB-IFC

- 7.30 There are some differences in perceived obstacles depending upon firm size. While political instability was identified by all types of firms as the main obstacle, small and large firms identified access to finance as the second main obstacle, but the medium enterprises ranked it as the third problem while labor regulations were in second place. While access to electricity was the third main problem for large enterprises, small enterprises felt higher burden from the tax rates (Figure 7.38).

Figure 7.38: Percent of firms identifying the problem as main obstacle

Source: Bosnia and Herzegovina Country Profile 2013, Enterprise Surveys, WB-IFC

Table 7.11: Probit models (=1 if firm reported obstacle "major" or "very severe", 0 otherwise)

	Business licenses and permits									
	Political instability	Corruption	Labor regulations	Tax rates	Tax administration	Informal sector	Access to finance	Trade and customs permits	Courts	Transport
log(size)	0.02 (0.03)	-0.03 (0.03)	0.01 (0.01)	0.04** (0.01)	0.02 (0.02)	0.02 (0.02)	-0.06* (0.02)	-0.04 (0.02)	0.02 (0.01)	-0.00 (0.01)
log(age)	0.10* (0.05)	0.06 (0.05)	-0.00 (0.02)	-0.01 (0.03)	0.01 (0.04)	-0.01 (0.03)	0.06 (0.04)	0.06 (0.03)	-0.01 (0.02)	0.05 (0.02)
Female manager	0.07 (0.08)	0.01 (0.07)	0.02 (0.03)	-0.02 (0.04)	0.06 (0.06)	-0.06 (0.04)	0.00 (0.06)	0.11 (0.06)	-0.05 (0.03)	0.03 (0.05)
Large city	0.18* (0.08)	0.22** (0.08)	-0.03 (0.02)	-0.01 (0.04)	-0.04 (0.06)	-0.01 (0.05)	0.18* (0.08)	0.03 (0.05)	-0.05 (0.03)	-0.00 (0.04)
Exporter	-0.05 (0.08)	-0.04 (0.08)	-0.01 (0.03)	0.03 (0.05)	0.09 (0.07)	0.12 (0.07)	-0.02 (0.07)	0.11 (0.06)	0.06 (0.05)	-0.04 (0.02)
Sector dummies (baseline=Manufacturing)										
Construction	0.09 (0.12)	0.24* (0.12)	0.09 (0.12)	0.04 (0.08)	-0.08 (0.08)	0.17 (0.11)	0.12 (0.11)	-0.13** (0.03)	-0.01 (0.07)	-0.02 (0.05)
Transport	-0.06 (0.12)	0.03 (0.12)	0.23 (0.16)	-0.03 (0.06)	0.12 (0.11)	0.04 (0.09)	-0.09 (0.05)	0.16 (0.11)	0.00 (0.07)	0.00 (0.06)
Retail and wholesale	0.09 (0.07)	0.04 (0.06)	0.13** (0.04)	0.01 (0.04)	-0.01 (0.05)	0.05 (0.04)	0.06 (0.06)	-0.11* (0.04)	0.07 (0.04)	0.00 (0.03)
Hotels and restaurants	0.23 (0.18)	-0.06 (0.16)	0.28 (0.25)	0.04 (0.13)	0.19 (0.18)	0.20 (0.19)	-0.07 (0.13)	0.05 (0.14)		
IT	0.10 (0.26)	0.40 (0.26)		0.21 (0.25)	0.08 (0.24)					
Other services	-0.00 (0.30)				0.13 (0.28)		0.48 (0.30)	0.32 (0.31)		
N	338	332	331	334	337	331	308	334	319	322
										250
										323

Table 7.12: Firm performance, characteristics and constraints

	OLS. Dependent variable: Employment growth			OLS. Dependent variable: Sales growth			OLS. Dependent variable: Growth in Sales per Worker		
	ECA	ECA	BiH	ECA	ECA	BiH	ECA	ECA	BiH
log(size)	-0.04*** (-5.14)	-0.04*** (-4.74)	-0.01 (-0.93)	-0.00 (-0.83)	-0.01 (-1.66)	0.03 (1.69)	0.03** (3.25)	0.02** (2.88)	0.03 (1.70)
log(age)	-0.04*** (-6.27)	-0.03*** (-7.10)	-0.04** (-3.04)	-0.08*** (-6.99)	-0.08*** (-7.63)	-0.04 (-1.33)	-0.05*** (-4.51)	-0.04*** (-4.94)	0.00 (0.15)
Female manager	-0.02** (-2.82)	-0.02* (-2.61)	-0.02 (-0.81)	-0.02 (-1.23)	-0.01 (-0.64)	-0.02 (-0.33)	0.00 (0.06)	0.00 (0.39)	-0.01 (-0.21)
Large city	0.01 (0.84)	0.00 (0.12)	-0.02 (-0.94)	0.01 (0.44)	-0.01 (-0.43)	-0.15** (-3.11)	-0.00 (-0.01)	-0.01 (-0.36)	-0.15** (-3.13)
Sector dummies (baseline=Manufacturing)									
Construction	-0.01 (-0.92)	-0.01 (-1.20)	0.06 (1.87)	-0.00 (-0.20)	0.00 (0.20)	-0.09 (-1.28)	0.01 (0.61)	0.02 (0.86)	-0.13* (-2.06)
Transport	-0.02 (-1.47)	-0.02 (-1.58)	0.00 (0.05)	-0.03 (-0.89)	-0.04 (-2.02)	-0.08 (-0.79)	-0.01 (-0.41)	-0.03 (-1.52)	-0.06 (-0.69)
Retail and wholesale	-0.01 (-1.63)	-0.01* (-2.11)	0.01 (0.45)	-0.02 (-0.76)	-0.01 (-0.78)	-0.06 (-1.65)	-0.01 (-0.31)	-0.01 (-0.48)	-0.05 (-1.46)
Hotels and restaurants	-0.02 (-2.04)	-0.02 (-2.04)	0.05 (1.21)	-0.01 (-0.22)	-0.00 (-0.13)	-0.08 (-1.20)	0.02 (0.57)	0.01 (0.64)	-0.07 (-1.13)
IT	-0.02 (-1.54)	-0.02 (-1.94)	0.02 (0.34)	-0.07 (-1.30)	-0.06 (-1.53)	0.06 (0.59)	-0.06 (-1.39)	-0.06 (-1.66)	-0.00 (-0.02)
Other services	-0.01 (-0.88)	-0.01 (-0.84)	0.06 (0.45)	0.02 (0.45)	0.03 (0.72)	0.31 (0.89)	0.02 (0.35)	0.02 (0.46)	0.27 (0.99)
Exporter	0.04** (3.60)	0.04*** (4.38)	-0.02 (-0.92)	0.05* (2.51)	0.04 (1.93)	-0.06 (-1.10)	0.02 (0.97)	0.01 (0.33)	-0.04 (-0.78)
Constraints									
Political instability	-0.01 (-1.39)	-0.01 (-1.07)	-0.03 (-1.64)	0.01 (0.35)	0.00 (0.09)	0.01 (0.19)	0.01 (0.70)	0.01 (0.40)	0.03 (0.73)
Corruption	-0.00 (-0.66)	-0.00 (-0.13)	0.02 (0.82)	-0.03 (-1.80)	-0.01 (-0.42)	0.03 (0.50)	-0.02 (-1.59)	-0.00 (-0.23)	0.01 (0.26)
Labor regulations	0.00 (0.03)	0.01 (0.53)	0.04 (1.18)	-0.00 (-0.02)	0.01 (0.20)	-0.14 (-1.40)	-0.02 (-0.46)	-0.01 (-0.38)	-0.19 (-1.88)
Labor skills	0.03** (3.00)	0.02** (2.98)	0.04 (1.70)	0.02 (1.18)	0.02 (1.22)	-0.00 (-0.02)	0.00 (0.13)	0.00 (0.20)	-0.03 (-0.53)
Tax rates	0.01 (1.35)	-0.00 (-0.57)	0.02 (0.82)	-0.00 (-0.07)	0.00 (0.10)	0.02 (0.47)	-0.00 (-0.30)	0.00 (0.27)	-0.00 (-0.02)
Tax administration	-0.01 (-1.20)	0.00 (0.17)	-0.04 (-1.11)	-0.02 (-0.89)	-0.02 (-0.13)	-0.00 (-0.01)	-0.01 (-0.70)	-0.01 (-0.29)	0.02 (0.28)
Informal sector	-0.02** (-2.94)	-0.02*** (-3.84)	-0.01 (-0.29)	-0.02 (-1.00)	-0.03 (-1.38)	0.01 (0.18)	-0.00 (-0.05)	-0.00 (-0.07)	0.01 (0.13)
Access to finance	-0.02*** (-3.96)	-0.02*** (-4.21)	-0.05* (-2.27)	-0.03 (-1.86)	-0.03 (-1.95)	-0.02 (-0.41)	-0.02 (-0.76)	-0.01 (-0.82)	0.03 (0.59)
Trade and customs permits	0.03* (2.24)	0.03* (2.36)	0.01 (0.44)	0.03 (1.61)	0.04 (1.87)	-0.00 (-0.05)	0.00 (0.05)	0.00 (0.14)	-0.02 (-0.29)
Courts	-0.02** (-3.38)	-0.03** (-3.36)	-0.03 (-1.44)	-0.04 (-1.55)	-0.04 (-1.60)	0.01 (0.10)	-0.03 (-1.25)	-0.03 (-1.40)	0.04 (0.46)
Transport	0.02 (1.93)	0.01 (1.52)	-0.07* (-2.03)	0.05 (1.66)	0.04 (1.46)	-0.00 (-0.03)	0.03 (1.08)	0.03 (0.99)	0.06 (0.40)
Business licenses and permits	0.00 (0.32)	-0.00 (-0.25)	0.07* (2.28)	0.02 (1.27)	0.01 (0.59)	0.13 (1.17)	0.03 (1.69)	0.03 (1.22)	0.06 (0.51)
Country dummies	No	Yes	No	No	Yes	No	No	Yes	No
Constant	0.23*** (5.73)	0.20*** (6.65)	0.16*** (3.80)	0.33*** (8.45)	0.14*** (6.17)	0.12 (1.68)	0.12** (3.67)	-0.03 (-1.37)	-0.02 (-0.28)
N	9857	9857	322	6734	6734	263	6732	6732	263
r ²	0.09	0.11	0.15	0.02	0.05	0.10	0.01	0.03	0.10

Annex VIII. Lessons for BiH from other countries

- 7.31 While it is difficult to find a perfect comparison for BiH history, social composition and institutional structures in the rest of the world, several other countries offer some imperfect lessons. Below we highlight some potentially relevant ones from Lebanon, Belgium and Cyprus.

Lebanon

"The Lebanon of my birth is probably the most emblematic example of a country dislocated by 'confessionalism', and as a result I feel no sympathy for this pernicious system. Perhaps it was once the answer to an ill, but in the long term it has turned out to be more harmful than the malady itself, like a drug that was administered to a patient to calm his suffering, but which created an irreversible addiction, which debilitated his body and mind a little more each day to the point where it repaid him a hundredfold for all the pain it had temporarily spared him." Amin Maalouf, Lebanese-born, French author, Disordered World

- 7.32 Lebanon represents an extreme cautionary tale for BiH. Lebanon, a tiny country comprised of 18 confessional groups,¹⁷⁰ gained its independence from France in 1943. According to the unwritten 1943 National Pact, a system was created whereby all governmental posts would be distributed according to confessional group. The idea was that political competition would take place within groups rather than between them, thereby lessening the likelihood of confessional conflict. As such, the President was to be a Maronite Christian, the Speaker of the Parliament a Shiite Muslim, the Prime Minister a Sunni Muslim, and the Deputy Prime Minister and Deputy Speaker of Parliament Greek Orthodox.
- 7.33 Although it was conceived as a temporary solution—as the Dayton Accords were — "Until such time as the Chamber enacts new electoral laws on a non-confessional basis', more than eighty years later confessionalism is still the system of government implemented in Lebanon."¹⁷¹ Since independence, the country has undergone drastic shifts in population due to migration, wars,¹⁷² an influx of refugees and asylum seekers, etc., these governing arrangements have held. No official census has been conducted since 1932 because of fears of confessional conflict.
- 7.34 Efforts were made to modernize the system. After the brutal 1975-1990 civil war— which left 150,000 dead, 200,000 wounded and a million displaced— Lebanese political elites reached the Taif Agreement, which transferred some powers away from the Christians (Presidency) in favor of the Muslims (Prime Minister and Speaker of the Parliament) to provide for a more balanced system between Christians and Muslims. "The Chamber of

¹⁷⁰ Lebanese confessional groups include: Maronite, Greek Orthodox, Melkite Catholic, Roman Catholic, Protestant, Armenian Orthodox, Syriac Catholic, Armenian Catholic, Syriac Orthodox Christian, Chaldean, Assyrian, Coptic, Sunni Muslim, Shiite Muslim, Druze, Sufi, Alawite, and Jewish. http://en.wikipedia.org/wiki/Lebanese_people

¹⁷¹ Lebanese Constitution, Article 24. [http://en.wikipedia.org/wiki/Confessionalism_\(politics\)](http://en.wikipedia.org/wiki/Confessionalism_(politics))

¹⁷² Between 1975 (when the civil war began) until 2011, 1.8 million Lebanese have emigrated. The Lebanese Demographic Reality. Lebanese Information Center. 2013.

Deputies was increased in size to 128 members, shared equally between Christians and Muslims, rather than elected by universal suffrage that would have provided a Muslim majority (excluding the expatriate community, a majority of which is Christian). A cabinet was established similarly divided equally between Christians and Muslims.”¹⁷³ The Taif Agreement stated that “the abolition of political sectarianism is a fundamental national priority.”¹⁷⁴ Sectarianism was to be abolished in all government fields and jobs. However, no specific time frame was delineated for achieving this goal. The Taif Agreement was incorporated into a revised Constitution in 1990.

- 7.35 **Lebanon has undergone many more upheavals since the civil war**, including the assassination of Prime Minister Hariri and other prominent political figures of various sects, the subsequent Cedar Revolution which triggered the withdrawal of the Syrian occupying army, the rise of Hezbollah,¹⁷⁵ conflicts between Lebanon/Hezbollah and Israel, Sunni-Shiite political tensions, spillover effects from the Syrian civil war, and a massive influx of a million Syrian refugees. As a result of its turbulent history, there are now more Lebanese living outside the country (8-14 million) than inside (4.2 million).
- 7.36 **Confessionalism and its pernicious discontents continue to pervade the Lebanese polity, society and economy.** Indeed, there is a confessional capture of the state and its socio-economic and political policies. There is no political consensus among confessional groups on national priorities, and patronage, nepotism, clientalism, and bribery dominate public service (at the expense of merit) and investment. Most of the country’s public services and utilities have become sources for rent-seeking and redistribution. The result is a fragmented, inefficient, non-transparent government lacking in accountability. The judiciary, which could potentially function as a check on the system, is also regarded as corrupt, inefficient and weak. Allegiance to non-state actors remains a problem.
- 7.37 **Lebanon serves as a cautionary example for BiH in other respects.** It has become the playground for regional states and actors looking to export their troubles and/or use Lebanon as a proxy to fight their religious, ideological and territorial battles. Regional states and actors use confessional groups for their own purposes; confessional groups in turn try to recruit external forces to support and strengthen their internal position within the Lebanese polity. In short, confessionalism remains a deep and dangerous fault line in Lebanon, leaving the country perpetually unstable and at risk of further conflict.
- 7.38 **In practical terms, the dysfunctional government has adversely impacted the country’s economic outlook and capacity to reform, build and modernize.** For example, there has been no approved budget since 2006. A credible Single Treasury Account has not yet been achieved. Donor-financed projects which produce common public benefits are often not regarded as achievements; confessional groups want projects that benefit them directly and look to their political representatives to deliver them.¹⁷⁶ Lebanon’s investment climate is poor, as reflected in its rating for the ease of doing business: it was ranked 111 (out of a total

¹⁷³ http://en.wikipedia.org/wiki/Taif_Agreement

¹⁷⁴ The Taif Agreement. <http://www.monde-diplomatique.fr/cahier/proche-orient/region-liban-taef-en>

¹⁷⁵ Hezbollah has become, in effect, a “state within a state,” with its own militia, social and political organizations. The existence of a separate militia is against the Taif Agreements, which provided for “the disarmament of all national and non-national militias.”

¹⁷⁶ Author interviews, public officials, Lebanon, 2001.

of 189 countries; BiH ranks somewhat worse, at 131) in 2014, down from 105 in 2013.¹⁷⁷ For one recent ten-month period, there was no government (some claimed that the country ran better without one).

- 7.39 **The parallels between Lebanon and BiH are striking. In Lebanon, we can see a possible future for BiH and it is not a good one.** The longer the confessional system remains in place, the more entrenched it becomes, the more it pervades all of society, and the more difficult it comes to dislodge it.
- 7.40 **One significant difference (and there are others, e.g. Lebanon was a state for a longer period of its history and there is still strong support for the state) is that BiH has the possibility to become a member of key Euro-Atlantic institutions such as the EU and NATO, with attendant economic assistance.** Thus far, however, these incentives have not served as sufficient inducement to pull BiH out of its ethnic conflicts and political deadlock.

Belgium

Belgium is the most successful ‘failed state’ of all time. German newspaper, Die Tageszeitung, 2008

- 7.41 **What insights does multi-ethnic and linguistic Belgium hold for BiH’s political system and future? “Belgium and BiH can be understood as ‘divided house’ states, which contain proportionally similar groups with opposing views regarding whether the state should be more unitary or more decentralized.** The Belgian example demonstrates that even where groups disagree on state structure, (the francophones tend to prefer a centralized state, whereas the Flemish prefer a decentralized state structure) a mixture of various forms of group autonomy may facilitate stability and compromise within the state.”¹⁷⁸ Belgium provides for linguistic communities without territorial autonomy.
- 7.42 **Belgium has another unique feature of assigning competencies to different groups.** “The three territorial regions of Flanders, Wallonia, and Brussels capital hold powers over economic issues and development related to their territories, including environmental and agricultural policy, research, and external commerce. The primary powers for the three non-territorial communities (Flemings, Francophones and Germans) include educational policy and linguistic and cultural matters. In addition, communities may engage in some foreign relations directly.”¹⁷⁹ The Belgian example is relevant to BiH in that it demonstrates the power of various forms of group autonomy in facilitating stability and potential compromise.
- 7.43 **Belgium is a cautionary case for BiH in other ways.** For instance, “Both countries have broken the existing records for the time it took their political elites to form a government after the general elections. The Belgian elections took place in June 2010; the government was formed in early December 2011. The BiH elections took place in October 2010; the government was formed only in late December 2011. If there were a contest for the duration of post-election negotiations, Belgium would be the winner, with 541 days of post-election vacuum without a government.”¹⁸⁰

¹⁷⁷ World Bank. Doing Business 2014.

¹⁷⁸ “What Belgium Can Teach Bosnia: The Use of Autonomy in ‘Divided House’ States,” Sherrill Stroschein, European Center for Minority Issues. Issue 3/2003.

¹⁷⁹ “What Belgium Can Teach Bosnia: The Use of Autonomy in ‘Divided House’ States,” Sherrill Stroschein, European Center for Minority Issues. Issue 3/2003, p. 14.

7.44 Indeed, Belgium differs from BiH in significant ways. It is the home of the European Union and many of its institutions. BiH has come through a difficult war and is still in the process of democratic evolution and transition to a market economy. And, of course, BiH is not an EU member with all of its attendant benefits. Belgium is certainly peaceful, but it is not the most functional democracy, having experienced long periods of instability and stasis.

Cyprus

“The EU’s failure to facilitate the resolution of the Cyprus problem is long-standing.”¹⁸¹

7.45 Following its independence from Britain in 1960, the constitution granted powers to the Greek and Turkish Cypriot communities. “The constitution of the Republic of Cyprus, adopted in 1960, provided that executive power be exercised by a Greek Cypriot president and a Turkish Cypriot vice president, elected to five-year terms by universal suffrage, and that there be a Council of Ministers (cabinet) comprising seven Greek Cypriot and three Turkish Cypriot members. It also called for an elected House of Representatives with 50 seats, divided between Greek and Turkish Cypriots in the proportion of 35 to 15 and elected for terms of five years.”¹⁸² Greek Cypriots preferred a union with Greece over independence. Tensions and conflicts between the Greek majority and the Turkish minority became more prevalent. Since the Turkish invasion in 1974, the island has been divided between Greek Cypriots who control 63 percent of the island, and a separate Turkish Republic of Northern Cyprus, which controls 37 percent. Turkey is the only country that recognized the Turkish Republic since its declaration of independence in 1983.

7.46 In 2004, Cyprus became a member of the EU, but as a divided island. “One of the protocols on Cyprus that was annexed to the Treaty provides for the suspension of the application of the acquis in the northern, Turkish-occupied part of the island, to be lifted in the event of a solution. It also states that the EU is ready ‘to accommodate the terms of a settlement in line with the principles on which the EU is founded’, and expresses the desire that the accession of Cyprus should benefit all Cypriots.”¹⁸³

7.47 Despite many international political initiatives over the year to mediate the conflict and reunify the island, none have been successful. A key lesson from the Cyprus experience that is relevant to BiH concerns EU membership. In the case of Cyprus, potential EU membership did not serve as sufficient inducement to Cypriot conflict resolution, reconciliation and unity. “Cyprus is the closest model, but Nicosia joined the EU in 2004 without resolving or even ameliorating the relationship with the Turks in the North of the divided island. In the years since, even full EU membership and associated investment and development has not resolved the standoff between Greek and Turkish Cypriots (though there have been some positive developments of late).”¹⁸⁴ Therefore, EU accession, while attractive, may not be sufficient to untie the Gordian knot of BiH’s ongoing ethnic conflicts.

¹⁸⁰ The Art of Political Crisis: Can We Compare Belgium and Bosnia?” Eldar Sarajlic. Citizenship in Southeast Europe. March 14, 2012. <http://www.citsee.eu/citsee-story/art-political-crisis-can-we-compare-belgium-and-bosnia>

¹⁸¹ “EU and Cyprus: Still a problem.” George Kyris. EurActiv. <http://www.euractiv.com/countries/eu-cyprus-problem-analysis-511285>

¹⁸² Cyprus. Encyclopedia Britannica, <http://www.britannica.com/EBchecked/topic/148573/Cyprus/33853/Finance-and-trade#toc33855>

¹⁸³ Cyprus in the EU, <http://www.aboutcyprus.org.cy/en/member-of-the-european-union>

¹⁸⁴ “Making Bosnia Work: Why EU Accession is Not Enough.” Edward Joseph and R. Bruce Hitchner. US Institute of Peace. USIPeace Briefing. June 2008.

Annex IX. Financial sector performance

Table 7.13: Structure of the Financial System, 2005-2014 (Q1)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014Q1	
Number											
Banks 1/	33	32	32	30	30	29	29	28	27	27	
of which: Foreign-majority owned banks 2/3/	20	22	21	21	21	19	19	19	17	15	
Domestic private banks 3/	7	5	8	7	7	9	9	8	8	10	
Domestic state-owned banks	6	5	3	2	2	1	1	1	2	2	
Insurance and reinsurance companies	24	24	26	26	27	26	26	25	25	...	
Investment funds (asset management companies)	24	24	28	32	33	32	32	33	34	...	
Leasing companies	6	6	8	9	9	9	9	9	8	...	
Microcredit organizations	50	...	24	27	26	25	25	22	19	...	
Stock exchanges	2	2	2	2	2	2	2	2	2	...	
Brokerage houses	17	18	27	26	23	20	17	15	13	...	
Financial system assets (millions of KM)											
Banks 1/ Financial system assets (percent of total assets)										21,862	
of which Banks 1/	77.3	79.5	79.8	80.8	82.7	85.6	86.0	86.3	87.1	82.4..	
Insurance and reinsurance companies	4.5	3.8	3.5	3.5	3.7	3.9	4.4	4.8	4.9	15.6..	
Investment funds (asset management companies)	11.8	8.4	7.2	4.8	3.5	3.7	3.3	3.2	3.0	2.1..	
Insurance	Leasing companies	4.4	5.5	5.6	6.2	5.7	3.1	3.1	2.9	2.4	...
Investment	Microcredit organizations	2.1	2.6	3.9	4.7	4.4	3.6	3.0	2.8	2.6	...
Leasing c	Stock exchanges	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...
Microcre	Brokerage houses	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...
Stock exc										...	
Brokerag	Nominal GDP (mln KM)	17,148	19,567	22,065	24,984	24,307	24,879	25,772	25,734	26,297	6,091..
Financial syst	Exchange rate (KM/USD, eop)	1.66	1.49	1.33	1.39	1.36	1.47	1.51	1.48	1.42	1.42

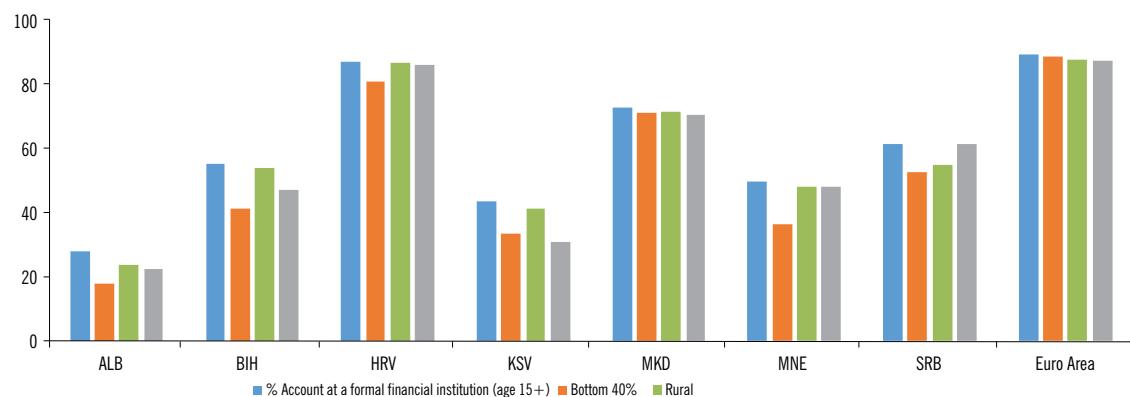
Sources: Central Bank of Bosnia and Herzegovina (CBBH); Banking Agency of FBiH; Banking Agency of RS; and Agency for Statistics of Bosnia and Herzegovina.

1/ Data of bank are from the supervisory data, and data of non-banking institutions are from the statistical MFS data.

2/ The foreign-owned banks are subsidiaries of large foreign banks.

3/ One bank's ownership changed from foreign to domestic in Q3 2014. Another foreign bank (according to CBBH) is classified as a domestic private bank here because it is a "round-trip" investment.

Figure 7.39: Women and B40 less likely to have an account at a formal financial institution (percent)



Source: Financial Sector Assessment 2015

Annex X. Health

Table 7.14: Heckman model in the probability of smoking and the intensity of smoking

	Ind Var	Female		Male	
		smoking	Num of cig	smoking	Num of cig
ref=primary	Secondary	0.173*** [0.060]	0.59 [0.971]	-0.286*** [0.057]	-2.898*** [0.743]
		-0.130* [0.078]	-2.387** [1.211]	-0.706*** [0.090]	-7.914*** [1.272]
	Higher	0.132*** [0.019]	1.603*** [0.384]	0.149*** [0.017]	2.561*** [0.250]
		-0.002*** [0.000]	-0.019*** [0.005]	-0.002*** [0.000]	-0.033*** [0.004]
	age	-0.202*** [0.058]	-3.465*** [0.952]	-0.135** [0.054]	-0.373 [0.709]
		-0.245*** [0.094]		-0.258*** [0.078]	
	BD	-0.213* [0.114]		-0.242*** [0.086]	
ref=q1 (b20%)	2.quintile	-0.164** [0.077]	-1.546 [1.140]	-0.087 [0.072]	0.323 [0.857]
		-0.223*** [0.077]	-1.456 [1.154]	-0.131* [0.069]	0.486 [0.962]
	3.quintile	-0.091 [0.081]	0.129 [1.204]	-0.1 [0.078]	-0.687 [0.984]
		-0.209** [0.087]	-1.85 [1.414]	-0.198** [0.080]	-0.776 [1.033]
	4.quintile				
Ref=Bosniak	Croat	0.387*** [0.080]	3.719*** [1.273]	0.178** [0.075]	3.049*** [1.163]
		0.248** [0.103]	0.368 [0.835]	0.137 [0.086]	-0.167 [0.749]
	Serb	0.526 [0.376]	8.988** [3.825]	0.201 [0.212]	-0.34 [4.474]
	Other				
Ref-married	Widower/divorced	0.397*** [0.090]	5.221*** [1.303]	0.468*** [0.132]	6.916*** [1.813]
		0.003 [0.080]	0.538 [1.109]	-0.136** [0.060]	-0.625 [0.800]
	Single	-2.897*** [0.337]	-31.415*** [8.296]	-2.221*** [0.302]	-34.486*** [4.742]
	Constant				
obs		4,234	4,234	4,285	4,285

Annex XI. Education

Table 7.15: Public and private higher education institutions

Entity/Canton/District	Public	Private
Canton Herzegovina-Neretva	2	5
Canton Tuzla	1	2
Canton Sarajevo	1	4
Canton Zenica-Doboj	1	-
Canton Una Sana	1	1
Canton Central Bosnia	-	6
Canton Bosnia Podrinje	-	1
Republika Srpska	4	17
District Brcko	-	1
Total	10	37

Source: Centre for Information and Recognition of Qualifications in Higher Education

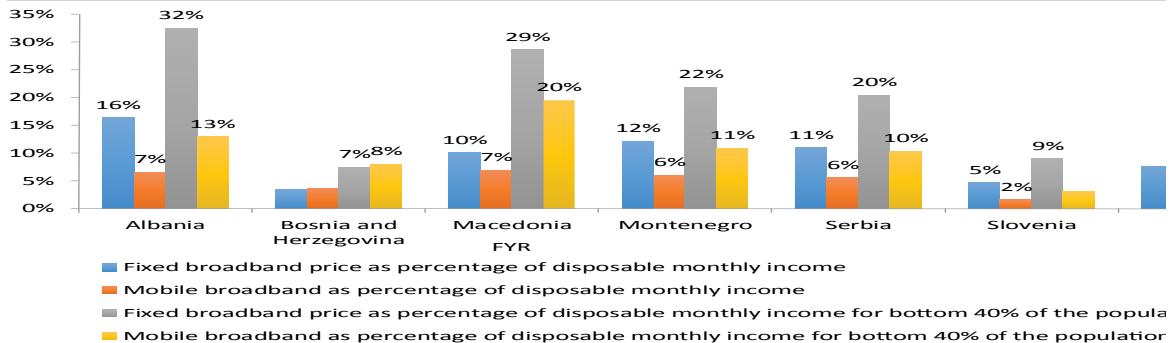
Annex XII. Selected economic and social indicators

Table 7.10: Ranking by cities in sub-region doing business report 2011 (from 1=best to 22=worst)

Selected Indicators	2006	2007	2008	2009	2010	2011	2012	2013
Income and Economic Growth								
GDP Growth (% change, y-o-y)								
GDP Growth (% change, y-o-y)	5.7	6.0	5.6	-2.7	0.8	1.0	-1.2	2.5
GDP Per Capita Growth (% change, y-o-y)	10.4	14.4	33.5	-7.4	-1.6	9.1	-6.5	5.0
GDP Per Capita (US\$)	3,137	3,590	4,793	4,437	4,365	4,760	4,448	4,669
GDP Per Capita, PPP (current international \$)	7,517	8,186	8,825	8,666	8,862	9,147	9,214	9,563
Private Consumption Growth (% change, y-o-y)	4.5	5.9	5.5	-4.6	0.1	-0.1	-0.8	0.3
Gross Investment (% of GDP)	21.4	27.4	28.2	21.0	17.1	18.1	18.1	18.2
Public (% of GDP)	6.2	7.4	6.9	7.4	7.0	6.3	6.3	6.4
Private (% of GDP)	15.2	20.0	21.3	13.6	10.1	11.8	11.8	11.8
Money and Prices								
Inflation, Consumer Prices (% change, y-o-y, end of year)	4.5	4.9	3.8	0.0	3.1	3.2	1.7	-1.4
Inflation, Consumer Prices (% change, y-o-y, period average)	6.1	1.5	7.4	-0.4	2.1	3.7	2.0	-0.1
Nominal Exchange Rate (LCU/US\$, end of period)	1.5	1.3	1.5	1.3	1.5	1.5	1.5	1.5
Real Effective Exchange Rate Index (2005=100)	101	98	101	102	98	100	100	99
M2 (% GDP)	51.4	54.9	50.3	52.8	55.0	55.9	57.9	61.0
Fiscal (% of GDP, unless otherwise indicated)								
Revenues	48.2	47.0	46.0	45.0	47.0	45.9	46.3	45.1
Expenditures	46.1	46.8	49.5	50.5	51.1	48.8	48.9	47.0
Current	39.7	39.8	43.0	43.1	43.2	42.5	42.6	40.6
Capital	6.4	7.0	6.5	7.4	7.9	6.3	6.3	6.4
Overall Fiscal Balance After Grants	2.2	0.2	-3.5	-5.5	-4.1	-2.8	-2.7	-2.0
Primary Fiscal Balance	2.9	0.8	-3.0	-5.0	-3.5	-2.2	-1.9	-1.2
Total Public Debt	21.4	32.9	30.8	35.4	39.3	40.8	44.6	42.2
Debt Service Ratio (% of revenues)	3.1	2.4	2.1	2.4	2.8	3.0	3.6	6.0
External Public Debt	21.1	18.2	17.2	21.7	25.4	25.8	27.8	28.1
External Accounts (current US\$ millions, unless otherwise indicated)								
Export Growth (% change, y-o-y)	36.5	15.0	13.1	-17.6	28.3	15.9	-4.4	6.6
Import Growth (% change, y-o-y)	1.9	22.0	17.2	-24.2	10.3	14.0	-1.8	-0.5
Merchandise Exports	...	2,087	2,333	2,403	2,891	3,465	3,320	3,699
Merchandise Imports	...	8,743	9,655	8,227	8,042	9,098	8,887	8,970
Services, Net	...	1,726	1,637	1,423	1,457	1,428	1,442	1,509
Workers' Remittances, Net	...	2,064	1,732	1,504	1,340	1,355	1,380	1,450
Current Account Balance	-1,035	-1,734	-2,414	-1,115	-918	-1,695	-1,570	-970
as percent of GDP	-8.0	-10.7	-14.2	-6.2	-5.5	-9.7	-9.3	-5.4
Foreign Direct Investment	803	1,721	983	244	360	476	379	293
External Debt, Total	6,096	7,814	8,299	9,731	8,631	8,540	8,855	9,057
as percent of GDP	46.9	48.2	48.9	54.1	51.6	49.1	52.2	50.8
Multilateral Debt (% of total external debt)	82.5	82.7	82.2	84.0	85.5	90.6
Debt Service Ratio (% of exports goods and nfs)	5.8	5.3	5.4	6.6	19.7	14.9	12.6	13.7
Population, Employment and Poverty								
Population, Total (millions)	3.8	3.8	3.9	3.9	3.8	3.8	3.8	3.8
Population Growth (% change, y-o-y)	0.0	-0.1	2.1	-0.2	-0.2	-0.2	-0.1	-1.0
Unemployment Rate (% of labor force)	31.1	29.0	23.4	24.1	27.2	27.6	28.0	27.5
Poverty Headcount Ratio at National Poverty Line (% of population)	...	18.2	17.9
Poverty Headcount Ratio at US\$1.25 a day (PPP) (% of population)	...	0.04
Poverty Headcount Ratio at US\$2 a day (PPP) (% of population)	...	0.13
Inequality - Income Gini	...	33.0
Life Expectancy	75.2	75.4	75.5	75.7	75.8	76.0	76.1	...
Other								
GDP (current LCU, billions)	19.6	22.1	25.0	24.3	24.9	25.8	25.7	26.3
GDP (current US\$, billions)	13.2	16.4	17.2	18.2	16.8	17.4	17.0	17.8
Doing Business Ranking	87	95	105	119	116	110	125	126
HDI (Human Development Index) Scores	0.726	0.729	0.729	0.731
CPIA (overall rating)	3.7	3.7	3.7	3.7	3.7	3.6	3.6	3.6

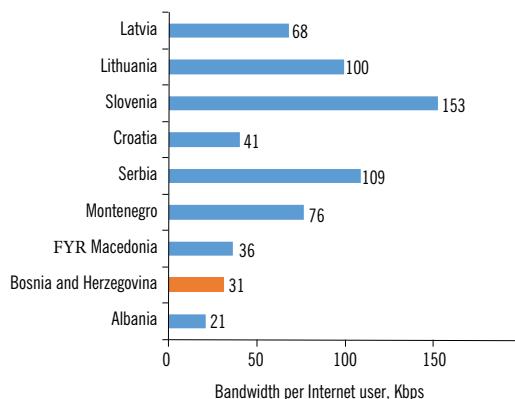
Annex XIII. ICT

Figure 7.40: Prices of retail broadband services as percentage of disposable monthly income, 2014



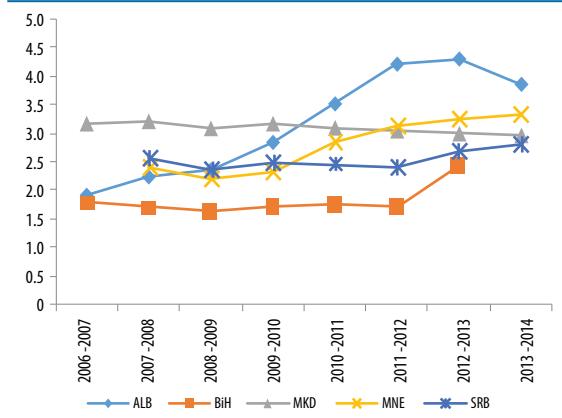
Source: Staff calculations

Figure 7.41: International Internet Connectivity, 2013



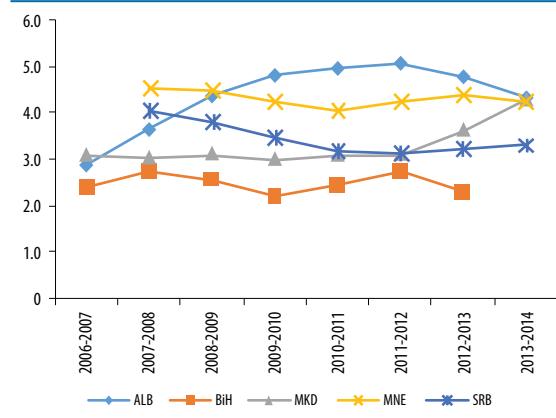
Source: International Telecommunications Union

Figure 7.42: Quality of road infrastructure (0-7)



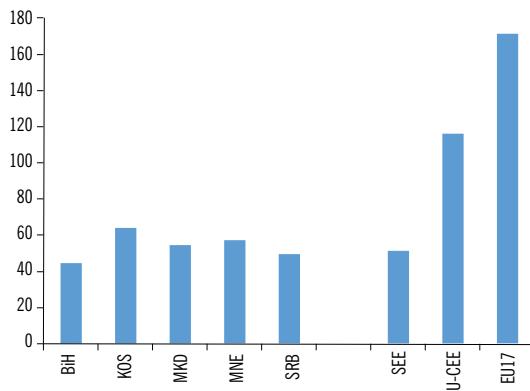
Source: World Economic Forum, Global Competitiveness Indicators

Figure 7.43: Quality of air transport infrastructure (0-7)



Source: World Economic Forum, Global Competitiveness Indicators

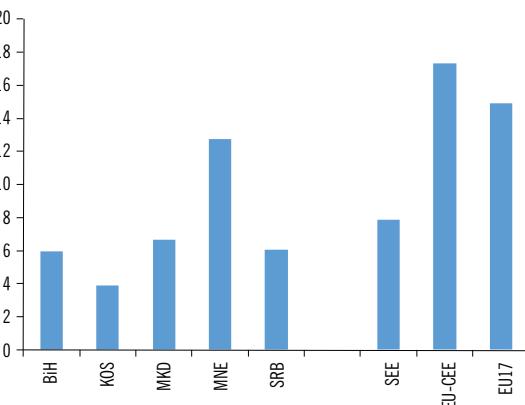
**Figure 7.44: Road density
(km of road per 100 sq. km of land area)**



Source: WDI

Note: 2011 except KOS=2010 (ALB data missing). Averages are unweighted.

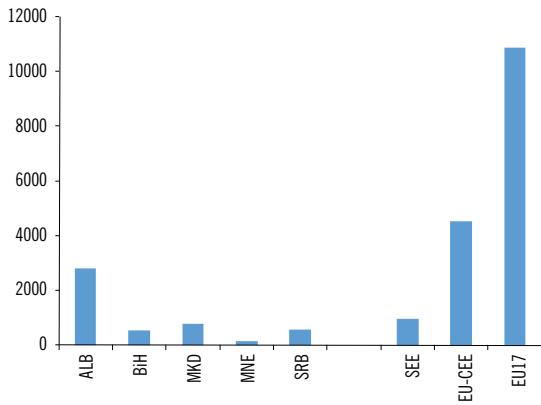
Figure 7.45: Meters of road per person



Source: WDI and staff calculations

Note: 2011 except KOS=2010 (ALB data missing). Averages are unweighted.

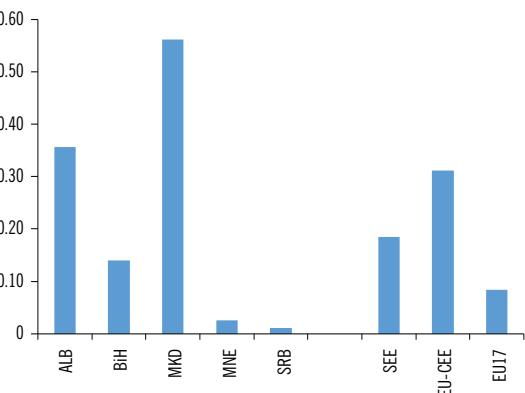
Figure 7.46: Passenger kilometers per person



Source: WDI and staff calculations

Note: 2011 except (KOS data missing). Averages are unweighted.

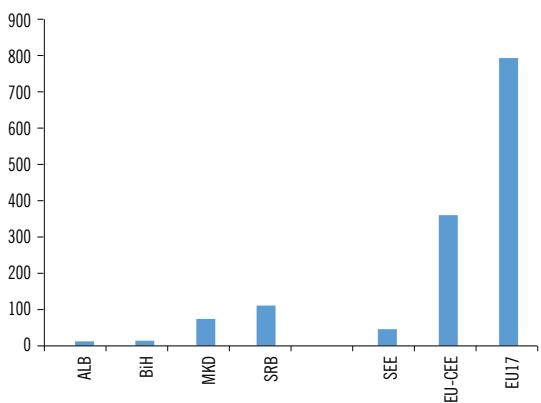
Figure 7.47: Ton-km of road transport per \$ of GDP



Source: WDI and staff calculations

Note: 2011 except KOS=2010 (ALB data missing). Averages are unweighted.

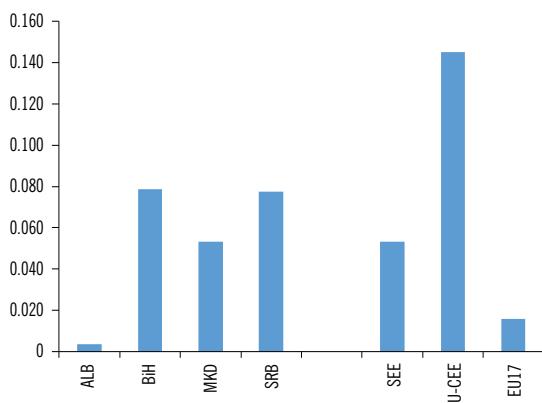
Figure 7.48: Rail passenger kilometers per person



Source: WDI

Note: 2012 except MKD=2010. (KOS and MNE missing)

Figure 7.49: Ton-km of rail transport per \$ of GDP

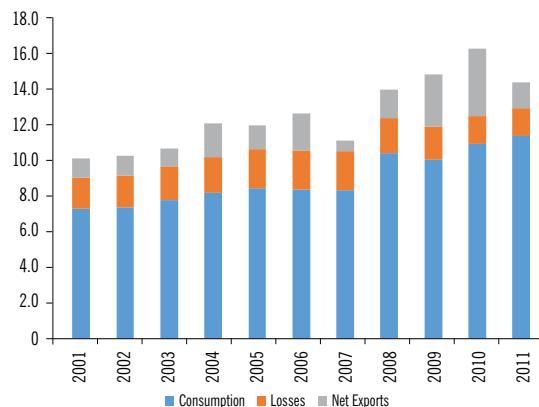


Source: WDI and staff calculations

Note: 2012 except MKD=2010. (KOS and MNE missing)

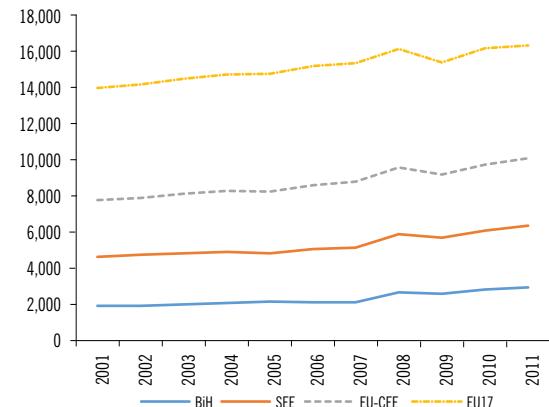
Annex XIV. Energy

Figure 7.50: Power consumption, GWh



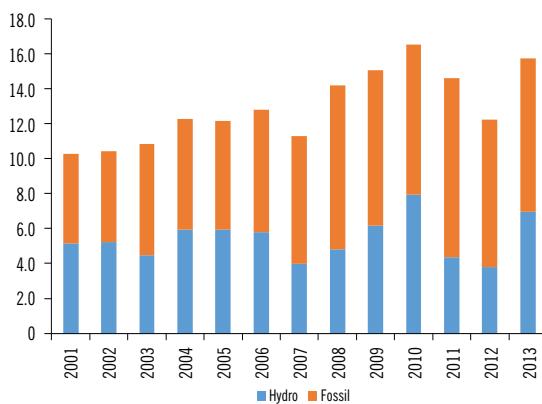
Source: U.S. Energy Information Administration

Figure 7.51: Power consumption per capita, kWh



Source: U.S. Energy Information Administration and Staff Calculations

Figure 7.52: Power generation, GWh



Source: U.S. Energy Information Administration

Annex XV. Prioritization methodology

7.48 This annex provides details of the approach taken in conducting the priority setting exercise in this SCD. With imperfect information there will always be a degree of judgment in determining the priority reform areas that could achieve the greatest progress toward achieving the Twin Goals. Nonetheless, the core SCD team based its analysis on the available evidence and used several methods in the prioritization exercise.

Prioritization process

7.49 The prioritization process was completed in several steps:

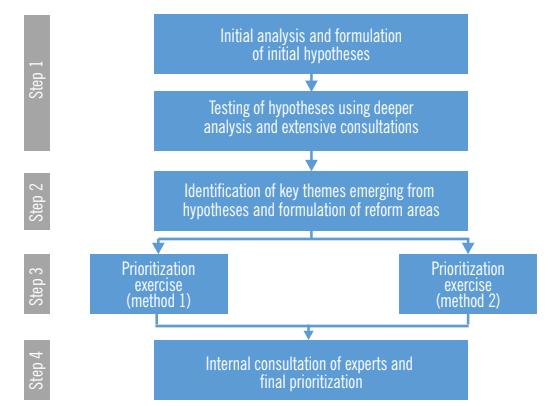
Step one: The team identified a series of seven initial hypotheses designed to help understand better the key issues in. The team then tested these hypotheses based on extensive consultations and deeper analysis.

Step two: Based on the deeper analysis – presented in this report – and the extensive consultations, the team identified the key themes emerging from these hypotheses. These were then used to formulate the reform areas.

Step three: The team used two complementary methodologies to identify the most important priority reform areas.

Step four: The team compared the results of the different methodologies, discussed with internal experts on BiH (who did not have a direct interest in the results of the findings of the SCD) and identified the priority reform areas and secondary priorities, which are reported in section 6. Figure 7.53 illustrates these steps and further details of each step are provided below.

Figure 7.53: Formulation of policy priorities



Prioritization methodology

Steps one and two

- 7.50 **As part of the SCD process, the team formulated seven hypotheses based on initial analysis.** These were designed to help the team understand better the situation in BiH. The hypotheses were: (1) Increasing employment requires much higher economic growth and significant labor market reform; (2) BiH can only reduce poverty and achieve shared prosperity by exporting significantly more; (3) The public sector is too large and inefficiently delivers public services, harming economic growth, employment and shared prosperity; (4) The political economy is unfavorable, which makes it difficult to enact reforms and contributes toward elite capture; (5) BiH faces pronounced spatial imbalances and social segregation, which impacts shared prosperity; (6) BiH faces the double demographic challenge of a shrinking and aging population, making the reform process and achieving shared prosperity more urgent and challenging; and (7) BiH is prone to, but ill-equipped to deal with, external shocks. The team tested these hypotheses using further analysis and extensive consultations. The team then identified the key themes emerging from these hypotheses and these correspond to the reform areas analyzed in the SCD.
- 7.51 **The team conducted extensive consultations with stakeholders based on these hypotheses.** The major aims of the consultations were: (i) to verify whether, or the extent to which, the hypotheses were correct; (ii) to understand better the causes and consequences that matter most for achieving the Twin Goals related to each hypotheses; and (iii) to ascertain whether there were important factors that the team had failed to identify that had significant impacts on the likelihood of achieving the Twin Goals. The team held meetings with key public sector officials, the private sector, local government, NGOs, other donors, representatives of various interest groups including, but not limited to youth, employers, and war veterans.
- 7.52 **In parallel, the team conducted deeper analysis and based on this and the consultations, identified the key reform areas that emerged.** This was designed to achieve the same aims as the consultations and this analysis is reflected throughout the SCD. Based on the results of the consultations and the deeper analysis, the team identified the key themes emerging and formulated reform areas. These were:
- Putting BiH to work: reforming the labor market, improving social protection and reducing the cost of labor;
 - Making it easier to do business: improving competitiveness, entrepreneurship and the investment climate;
 - Creating an efficient and effective government: reducing the size of the public sector while ensuring fiscal sustainability and improving public service delivery;
 - Building economic infrastructure for growth and inclusion: powering and connecting BiH to the world;
 - Building resilience: helping BiH cope with adverse natural events;
 - Boosting brains: improving education services and labor market skills;

- Living healthy lives: improving health services and access to water and sanitation;
- Adding financial firepower: maintaining financial stability and expanding access to finance;
- Greening BiH: reducing pollution and protecting the environment; and
- Boosting agriculture: improving agricultural productivity and opportunities. Greater information on each is provided in section 6.

Step three

7.53 **Having identified the key reform areas, the team used two separate methodologies to identify reform priorities.** The first methodology was a qualitative assessment of the evidence by core team members. The second was a quantitative ‘ratings’ methodology. In both cases, the team also considered complementarities between reform areas. Below we discuss both methods and provide more detail on the quantitative method. The results from both are broadly aligned.

Qualitative method

7.54 **As in many other SCDs, one prioritization method was qualitative but based on the underpinning analysis.** Using the analysis and evidence gathered during consultations, the team took a brainstorming approach to considering possible reforms. During this stage, the team discussed which reforms would have the most impact on achieving the Twin Goals. This method allowed for a nuanced approach to prioritization, including considering reform sequencing, complementarities of different reforms, and prioritizing particular components of some key reform areas over others.

7.55 **This approach led the team to consider “waves” of reforms based partly on available resources.** In particular, the team prioritized reforms that reduced expenditure or would ensure increased revenue or carried minimal costs. In addition, the team considered reforms that could be undertaken in the short-term, which would act as a basis for future reforms.

7.56 **Top priority or “first wave” reforms under this approach were:**

- Labor market reforms including reducing labor taxes;
- A broad-based approach to business and investment climate reforms;
- Pharmaceutical procurement reforms;
- Drafting detailed and prioritized investment plans for the main investment sectors;
- Identifying potential EU resources for investment and ensuring training in efficiently disbursing these resources;
- Begin construction or planning for construction of relevant infrastructure;
- Identifying SOEs that do not function, formally closing them, selling land or buildings, and agreeing a settlement with workers for missing benefit contributions;
- Identifying areas that required additional data or information (education/skills and SOE management are notable ‘gaps’ and beginning to collect relevant data).

7.57 **High priorities or “second wave” reforms under this approach were those that tended to be more expensive or are more politically difficult.** They included:

- Using some of the fiscal savings to ensure a ‘buffer’ to protect from external economic shocks or adverse natural events;
- Privatization or private management of functioning SOEs;
- Efforts to improve education and skills;
- Re-focusing social protection on the poor.

7.58 **These priorities are not significantly different from those identified – and discussed in more detail below – by a more quantitative method.** Quantitative method

7.59 **The second methodology consisted in using quantitative ratings to score the impact of reform areas based on their ability to contribute toward sustainably achieving the twin goals.** The core team rated each reform area based on their ability to generate economic growth, which this SCD has argued is important to achieving shared prosperity, and the extent to which the resulting prosperity is likely to contribute toward achieving the Twin Goals. In addition, the team considered the extent to which each key reform area contributed toward the medium to long term sustainability of progress toward the Twin Goals. The following rating scale and scoring methodology were used:

7.60 **The rating scale was as follows:**

- The team rated on a scale of 1-5 (1=minimal impact, 5=most beneficial impact) for each of the three components.
- The team use “positive ratings” – i.e. we began from a baseline of 1 and increased, rather than beginning at 5 and decreasing.
- The team agreed that if there were large differences in means, we would standardize but this was not necessary.
- The team agreed that, since we had already pre-selected the reform areas (which had already emerged as some of the key challenges for tackling poverty and boosting shared prosperity), the average ratings would likely be above three.

7.61 **The rating methodology was as follows:**

- Economic growth pathway
 - Economic growth has tended to benefit both the B40 and the T60 during the pre-crisis period, with the B40 benefiting slightly more. In addition, with one of the largest public sectors in the world, there remains no space to increase tax revenues to boost expenditure on areas that benefit the B40. Growth is therefore essential to increase public sector resources for health, education, social protection, etc. Reforms in most areas tend to be easier during periods of an expanding “pie”, helping to create a virtuous circle. Since the crisis, the economy has been sclerotic, under-performing even by the SEE’s dour standards.

- o The team considered how much the reform area could boost growth or shared prosperity above a baseline (of 1.5 percent per year) over the medium term (i.e. 5-7 years). That is, the team did not only consider growth in the year following the reform. Reforms that could either boost this average or prevent it from declining was rated positively.
- Shared prosperity and poverty pathway
 - o Even though growth on average benefited the B40 during the pre-crisis period, some future reforms would be positive for this group and some negative. Others may be negative in the short-term but eventually more positive.
 - o The team considered whether reforms over the medium term would be more, equal or less positive for the B40 than for other groups. Any reforms that were considered to impact more positively the B40 than the average received a rating higher than that for growth, while any reforms that impacts them less positively than the economy-wide average received a lower rating than growth.

7.62 In rating for sustainability, the SCD considered the following factors:

a. Fiscal, financial and macro sustainability

Key factors considered: (i) The macro and financial climates are reasonable but BiH is highly vulnerable to external shocks; (ii) Any policy set that threatens to push the macro or financial climate into danger would cause this to become an important issue; (iii) The fiscal stance has been reasonable up to the crisis but public debt has doubled since 2008; (iv) and BiH taxes its citizens more as a share of GDP than any country that is not rich western European, oil-dependent, or a small island state dependent on donors, leaving no room to increase public sector resources through taxation; (v) Opening up fiscal space is going to be key to allow the country to cope with external economic or weather shocks, as well as to re-focus public resources on things that can generate growth and improve the lives of poorer citizens.

b. Social sustainability

Key factors considered: (i) Reforms that can lead to excessive social unsustainability in the short-run could be considered less sustainable; (ii) however, it is also necessary to consider the short- and long- term consequences of not making reforms; (iii) and society shouldn't be "held at gunpoint" by a small group of special interests; (iv) the institutional sustainability of the reforms.

c. Environmental sustainability

Key factors considered: (i) BiH has been shown over recent years to be highly vulnerable to weather shocks (floods, droughts and a harsh winter in recent years have had large negative GDP impacts); (ii) but at the same time, building in flood plains is an issue – including both residential and firms; (iii) BiH is Europe's most energy inefficient country in terms of its carbon intensity and one of its worst in terms of its energy use per unit of GDP; (iv) Some cities have pollution several times WTO recommended safety limits; (v) untreated sewage water and trash threatens to pollute rivers.

- 7.63 The ratings were ranked to find the reform priorities, and were robust to a number of slightly adjusted approaches. The results were tested for robustness by using several weights for growth, shared prosperity and sustainability. Weightings of 50, 30, and 20, were applied to growth, shared prosperity and sustainability, respectively, and 40, 40, 20, respectively were applied, among others. Results were robust to these changes.

Step four

- 7.64 **Based on the outcome of the above methods, the team discussed the identified key reform areas with internal experts.** The experts were drawn from the pool of individuals within the WBG who had extensive experience in BiH but who do not manage projects. The aim was to ensure knowledge and understanding of BiH but, at the same time, to ensure independence vis-à-vis the prioritization process. The SCD team discussed the results extensively with the experts and ensured that there was coherent understanding and agreement on the prioritization.

Prioritization results

- 7.65 **The prioritization process, which is based on extensive analysis and internal and external consultations, helped the SCD to identify which key reform areas are expected to have the highest impact on achieving the Twin Goals.** Based on the prioritization process, the key reform areas can be formed into three groups of priorities. These are discussed in more detail in section 6 and are summarized in Table 6.2.
- **Top priorities:** These are the key reform areas assessed to have high overall impact on achieving the Twin Goals in both the short to medium term and the medium to long term. They cover the areas of labor market and social protection reform, business environment, role and size of the state and fiscal management, and infrastructure.
 - **High priorities:** These are the key reform areas assessed to have significant impact on achieving the Twin goals. They cover the areas of resilience to natural disasters, education and skills, and improving health and water/sanitation.
 - **Medium priorities:** These are the key reform areas assessed to have an impact on achieving the Twin Goals but in some cases the focus needs to be more on maintaining the current achievements or where reforms need to begin by gathering more data or information. They cover the areas of financial sector reform and inclusion, environmental protection, and agriculture.

Table 7.33: Summary of key constraints, reform areas and policy actions to achieve Twin Goals in BiH

Putting BiH to work: reforming the labor market, improving social protection delivery and reducing the cost of labor		
Top priority	Key constraints The high cost of employment combined with rigid labor laws and insufficient ALMPs reduce employment and increase unemployment, with the B40 suffering in particular.	Policy actions <ul style="list-style-type: none"> Reduce the tax wedge, particularly on lower paid workers could help to boost (formal) employment. Introduce phased withdrawal of social assistance would encourage employment among poorer groups and help to boost the prospects of the B40. De-link unemployment benefit and health insurance to discourage abusive use of the public employment services, encourage people to make SSC contributions, reduce cost, and allow the PES to concentrate on employment services, including training. Increasing private sector provision of employment services to potentially improve the coverage, and breadth and quality of services provided by public employment services and thereby improve employment outcomes. Re-focusing social benefits on the poor would save public resources and encourage employment.
Making it easier to do business: improving competitiveness, entrepreneurship and the investment climate		
Top priority	Key constraints Laws and regulations fail to provide an enabling environment for doing business, harming wealth generation and employment.	Policy actions <ul style="list-style-type: none"> Improve the business environment across the board to boost growth, exports and employment. Simplify some business practices including better regulation of insolvency and introduction of out-of-court legal procedures Focus in particular on paying taxes, property registration, construction permits and getting electricity. Take steps toward harmonization with EU standards to reduce the need for some licenses and make it easier for some firms to export. Introduce e-services for business licensing, procedures and inspections to speed up processes and reduce opportunities for corruption.
Creating an efficient and effective government: reducing the size of the public sector while ensuring fiscal sustainability and improving public service delivery		
Top priority	Key constraints The over-sized public sector is Scandinavian sized but fails to deliver quality public services. High taxes stifle the private sector and employment, while expenditure is largely focused on public sector wages and transfers rather than investment, reducing work incentives.	Policy actions <ul style="list-style-type: none"> Grow public spending at a lower rate than economic growth. Reform the tax system to reduce taxes on tradables (especially labor) and shift them toward consumption taxes, particularly on "bads" such as fuel or tobacco. VAT could also be increased to co-finance a more ambitious reduction in labor taxes. This would help to tackle unemployment, contribute to reducing the unsustainable consumption and tackle the issues posed by being Europe's most energy-inefficient economy, and among the world's heaviest smokers. BiH could economize public expenditures without hurting public service delivery, especially as the country's wealthiest people are important beneficiaries of the "social protection" budget. The fast rise in public debt levels and debt servicing since the financial crisis risk crowding out other essential expenditures if they are not contained and well-managed. Improving debt management and extending maturities would help to reduce this risk.

Building economic infrastructure for growth: powering and connecting BiH to the world		
	Key constraints	Policy actions
Top priority	<p>Key constraints</p> <p>Businesses face some of Europe's poorest road infrastructure, limited port access, and complex trade import/export procedures. Rural dwellers are not always well connected to urban jobs. Energy infrastructure requires significant investment to prevent this sector from turning from an asset into a liability.</p>	<ul style="list-style-type: none"> • Improve national and regional roads / motorways to support the promotion of exports and facilitate trade and integration into EU trade corridors. Improving railways would also help to promote trade, for example by helping to link ports with the rest of the country. • Improve regional and local roads as well as by-passes to improve access-to-services in rural areas (which have higher rates of poverty), make it easier for small agricultural producers (where many people in the B40 work) to access markets, and reduce pollution in towns. Investment in local roads and by-passes would likely offer better value-for-money than new highways, despite a long-term need for these. • Tackle the “soft challenges” including recuperating expenses through the use of tolls to ensure well-maintained highways; reducing bottlenecks at borders and even between Entities through streamlined regulations. This would help to make it easier to export, boosting employment, a determinant of creating prosperity for the B40. • Focus on upgrading the port at Brcko and the Sava River to allow access by larger vessels. • Use existing telephone infrastructure to expand rural broadband provision and ensure private sector leads these efforts. • Increase competition in the ICT market to further reduce cost and improve quality and penetration. This will be particularly important for start-up firms, which need to access international clients. • Ensure sufficient investment in power generation, including renewables, to meet growing demand • Stimulate private sector participation in appropriate infrastructure development projects • Upgrade the transmission network including for import and export • Scale up energy efficiency through sustainable financing and implementation mechanisms • Introduce more cost-reflective tariffs and speeding up market liberalization.
Building resilience: helping BiH cope with adverse natural events		
High priority	<p>Key constraints</p> <p>BiH has been shown to be highly vulnerable to adverse natural events such as flooding, some of which may result from climate change or environmental degradation. Boosting its resilience would help to reduce the set-backs such shocks lead to.</p>	<ul style="list-style-type: none"> • Address BiH's vulnerability to the risks of environmental shocks, external economic shocks and social instability to achieve sustainable growth and shared prosperity. • Reduce the risks associated with environmental shocks by building a coherent strategy for reducing existing risk, avoiding the creation of new risk and responding more efficiently to such shocks, as well as building further the institutional ability to deal with such shocks. This would include ensuring sufficient flood water defenses, improved agricultural irrigation, an effective social safety net, robust transport infrastructure, an expanded insurance mechanism and, crucially, building sufficient fiscal space to cope with disaster. • Build sufficient fiscal space to cushion adverse natural shocks. • Improve the quality of life of people who depend on agriculture for their livelihoods, many of whom are in the B40 will require ensuring support for small-scale agriculture. • Reduce the risk of social instability by walking the thin line between labor market, business environment and SOE reforms that create a more inclusive society, while mitigating negative impacts on vulnerable groups and communicating well with those who benefit from the status quo.

Boosting brains: improving education services and labor market skills

	Key constraints	Policy actions
High priority	A lack of information makes it difficult to assess the key reform areas in education. However, available evidence suggests that skills do not match employer needs and there is a lack of quality control at most levels of education.	<ul style="list-style-type: none"> Reorient funding towards early childhood education due to its importance in escaping intergenerational poverty. In addition, investment in ECE is particularly beneficial for children from poorer families, as they are less likely to receive sufficient support in the home with respect to social, communication and cognitive development. Expanding ECE and pre-primary education would lead to societal-wide benefits in the medium to long term benefits in terms of higher employment and worker productivity and contribute to a positive fiscal dynamic. Improve transparency and equity in spending by introducing per capita financing (PCF) so that funding can follow the student. This becomes even more important in light of the demographic shifts in population. Improve the quality and efficiency of higher education by strengthening quality assurance mechanisms, and improving planning and financing would help to ensuring that employers can be sure of minimal standards. Ensure that the skills provided to students match those required by employers could help to reduce unemployment make it easier for the private sector to grow and compete internationally. Set up standardized nation-wide external student assessment and examination system (such as grade 12 Matura), and participate in international student assessments would provide much needed focus for parents and policy decisions. Improve data quality and availability to guide education policy and decision making.

Living healthy lives: improving health services and access to water and sanitation

	Key constraints	Policy actions
High priority	Health care is expensive by international standards but many health outcomes are poor. There is significant under-provision of sanitation facilities, particularly in rural areas and for the B40.	<ul style="list-style-type: none"> Discourage smoking to increase life expectancy, improve quality of life and reduce the health-related bills. Increasing tobacco taxes and better enforcement of anti-smoking regulations would contribute. Pool resources and adjusting procurement practices could reduce costs significantly. Decouple unemployment benefit from health insurance, while finding other ways to finance health insurance for the needy, would discourage people from falsely registered as unemployed saving money and increasing social security contributions and taxes. Focus water supply efforts toward the B40, who are disproportionately impacted by lower access to piped water compared to the rest of the population. Focus sanitation efforts more broadly with many in the population (not only the B40) with subpar access to waste water treatment, which is important for limiting contamination with soiled water (health impact, food safety impact) as well as from the perspective of moving toward the EU acquis. Reduced water wastage through prioritized investments that are financially sustainable and adequate maintenance in a complex institutional arrangements, and a difficult below cost recovery tariff setting. Ensure that tariffs should reflect costs and the resources used to improve the water infrastructure where required.

Maintaining financial stability: adding financial firepower and expanding access to finance		
Medium priority	Key constraints Financial stability is reasonable though with pockets of weakness such as high NPLs, a small insurance sector and slow credit growth.	Policy actions <ul style="list-style-type: none"> Seek to reduce NPLs while boosting credit for investment and maintaining a stable banking and financial sector. Ensure that BiH adheres to international financial reporting standards to help ensure the country has access to international financial flows, including remittances. Deepen domestic debt markets to help to finance growth as well as public finance deficits, when required. Safeguard financial sector stability through strengthening supervisors' corrective and enforcement powers, strengthening of governance and risk management practices in select banks, and improvements in the financial safety net framework.
Greening BiH: reducing pollution and protecting the environment		
Medium priority	Key constraints Air pollution in some urban areas is among the worst in Europe, with international evidence suggesting the poor suffer most. The health impacts are large. Trash in the environment, including water, is pervasive, potentially harming tourism and creating risks when the trash finds its way to agricultural or urban areas after floods. Wooded areas have been cut down in flood plains.	Policy actions <ul style="list-style-type: none"> Reduce urban pollution through more efficient use of energy and by internalizing negative externalities. Clean waterways of trash. Ensure forests/wooded areas are protected in areas prone to floods or landslides.
Boosting agriculture: increasing agricultural productivity and opportunities		
Medium priority	Key constraints People in rural areas tend to be poorer than those in urban areas, employment is significantly lower, and many rely on agriculture.	Policy actions <ul style="list-style-type: none"> Understand better rural land issues—for example fragmentation of agricultural plots—to identify ways to improve rural livelihoods. Find ways to allow the rural poor to engage in a growing agricultural sector could help to boost rural incomes. Efforts to boost smallholder productivity would help improve rural livelihoods. Ensure EU standards are adhered to and the accreditation process for the standards working.

Source: Doing Business in South East Europe 2011

Bosnia and Herzegovina

Systematic Country Diagnostic





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