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COMMISSION STAFF WORKING DOCUMENT

ECONOMIC REFORM PROGRAMME

OF

BOSNIA AND HERZEGOVINA
(2020-2022)

COMMISSION ASSESSMENT

The Economic Reform Programmes (ERP) were submitted around end-January 2020 and the present Commission assessment was finalised shortly thereafter in February 2020, supported by a fact-finding mission in mid-February.

The Covid-19-related economic crisis has in the meantime rendered the macro-fiscal scenarios presented in the ERP and in the Commission assessment largely obsolete. The Commission will publish its updated macroeconomic and fiscal projections for candidate countries, reflecting the expected impact of the Covid-19 crisis, in its spring economic forecast in early May 2020.

While the short-term macro-fiscal outlook has profoundly changed, the present Commission assessment also identifies structural reform challenges and priorities, including in the area of fiscal governance, which remain largely valid. Addressing these structural issues will be essential to ensure a sustained economic recovery after the crisis. The Joint Conclusions to be adopted at the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey will accordingly focus this year on the short-term priorities to mitigate the socio-economic consequences of the Covid-19 crisis and on the medium-term priorities to strengthen the foundations of a sustained recovery thereafter. While the Commission assessment does not address weaknesses in the public health system and issues in the social protection system are assessed only as far as they are linked to the key structural challenges, these two areas will feature more prominently among the issues identified in the policy guidance.

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EXECUTIVE SUMMARY

The Economic Reform Programme's (ERP) baseline scenario projects output growth to accelerate slightly from 3.5% in 2019 to 3.8% in 2022. The programme assumes that there will a break in the political stalemate, which has strongly impeded the country's capacity to take policy decisions these past 2 years, and that the country will be able to achieve EU candidate status. This would lead to a marked improvement in the country's business environment and boost private investment after a weak performance in recent years. Private consumption would benefit from rising employment and continued low inflation. Key downside risks are a continuation of the country's political stalemate and a further deterioration in the country's external environment.

The fiscal framework continues to envisage increasing budgetary surpluses, based on significant expenditure-driven consolidation, but it lacks a pro-growth orientation. Revenue and expenditure growth is set to remain below nominal GDP growth. The already low share of public investment is set to fall further, from 3% of GDP in 2019 to 2.3% in 2022. This is not in line with the country's needs and is also in conflict with the jointly adopted policy guidance. The programme lacks a convincing approach to improve the quality of public spending, such as by allocating more resources to investment and education, tackling an oversized public sector, reforming state-owned enterprises (SOEs), and better targeting social transfers. Driven by fiscal surpluses and solid nominal output growth, public debt is forecast to fall from 31.7% of GDP in 2019 to slightly below 30% in 2022.

The main challenges include the following:

- **The programme suffers from a lack of countrywide political support, cooperation and coordination.** This results in a programme with an insufficient medium-term orientation and obvious inconsistencies between the various programme elements. Another important weakness is the lack and insufficient quality and timeliness of empiric data. The macroeconomic underpinning of the programme also needs to be strengthened, in particular for risk assessment.

- **The fiscal strategy does not devote sufficient attention to improving the quality of public finances.** Spending remains heavily biased towards consumption and redistribution, clearly neglecting the medium-term investment needs of areas such as education and infrastructure. Reforms related to public employment or social benefit systems should be reinvigorated to provide scope for moving towards a stronger pro-growth orientation of public budgets. Transparency and governance of public accounts is very limited, in particular for the health sector and publicly owned companies.

- **The absence of a single economic area within the country negatively affects the private sector's development.** A fragmented administrative structure, partly different legal frameworks and implementation practices, a weak rule of law, lengthy bureaucratic procedures and low quality public administration are among the main factors for the existing poor business environment. Country-wide strategies and coherent solutions to help businesses are long overdue. Such strategies and solutions include developing the system of quality infrastructure, reforming public financial management, introducing e-authentication, reducing para-fiscal charges, reforming procedures for entering and exiting the market, adopting policies for small- and medium-sized enterprises (SMEs) and the process of granting building permits.

- **Oversized, non-transparent and inefficient state-owned enterprises (SOEs) leave an important footprint in the economy, negatively affecting macroeconomic performance, fiscal sustainability, labour market outcomes and competitiveness.** SOEs are a heavy burden on the country's public finances and thus its taxpayers. Publicly owned enterprises account for 11% of total employment. Many of these companies have low productivity but, at the same time offer wages some 40% higher than in comparable private industries. Many public companies rely on state support or delay due payments to the social security systems or to private suppliers, creating substantial liquidity imbalances in other areas of the economy. The SOE sector causes great distortions and misallocation of production factors and deters the private sector from investing.

- **The participation rate of the labour force in Bosnia and Herzegovina is very low, with the country suffering from high levels of unemployment.** Women, young people, older and low-skilled people especially face difficulties. Nearly half of the working age population (aged 15-64) is inactive, pointing to an acute need to develop policies fostering transitions to employment. However, public employment services operate with low levels of funding and insufficient human resources. The outward migration of young people and high-skilled workers, in particular, and low birth rates pose a significant challenge to the labour market and to economic growth.

The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2019 has been implemented to a limited extent. Delays in forming a government have impeded progress with necessary reforms. Insufficient cooperation among the various stakeholders has been a key obstacle to improving the country's capacities for medium term fiscal planning and analysis. Also progress has remained limited in providing timely and reliable statistics. A common strategy to reform public financial management is yet to be developed and adopted. Limited progress was made in creating publicly available registers of public enterprises and in restructuring and/or privatising. Some efforts continued to simplify business registration procedures through one stop shops and online registration. A first trust service provider has been registered, but further efforts are required to introduce electronic signature. Secondary and higher education enrolment policies have not been reviewed. Progress to reduce the tax on income from labour (i.e. the tax wedge), especially for low-income workers, to eliminate disincentives to work and to relieve public employment services of the burden of administering health insurance has only been achieved in one of the country's two entities.

The ERP identifies reform challenges that are partly in line with those identified by the Commission. Macroeconomic projections are based on the optimistic assumptions that the country's political stalemate will end and that it will obtain the status of a candidate to EU membership. The fiscal framework again fails to shift towards a growth-enhancing spending structure. The measures to promote employment, social policies and education are not credible and lack a fiscal underpinning. More specific references should have been made to identify the fragmented and overly complex regulatory environment as a significant obstacle to competitiveness and inclusive growth. Most of the measures in the ERP are not countrywide and only include entity-specific activities. Adopting a whole-of-government approach is a pre-requisite for addressing the challenges. Bosnia and Herzegovina should put in place a well-functioning coordination and consultation mechanism for the ERP process.

1. ECONOMIC OUTLOOK AND RISKS

Following the economic slowdown in 2019, the ERP expects growth to pick up in 2020-2022, largely thanks to expanding private consumption and improving investment. GDP growth slowed down during 2019, from 2.8% in the first quarter to 2.6% in the third quarter, largely reflecting weaker external demand and decelerating private consumption and investment. Like last year, the ERP assumes that the political stalemate which impeded political decision taking during the last 2 years, will end and that the country will achieve candidate status for EU membership, while the external economic environment is seen as less benign than in previous years. Under these assumptions, the programme expects economic growth to accelerate from 3.5% in 2020 to 3.8% in 2022, mainly driven by solid domestic demand, with strong increases in employment and wages, low inflation and increasing worker remittances. The expected 2% annual increase in private consumption is slightly above the country's five-year average, but is in line with expected increases in employment and real wages, leading to a rise in real disposable income by some 4% annually. Public consumption growth is forecast to be moderate, reflecting commitments to contain the public-sector wage bill. Private and public investment is set to rise on average by about 7.5% and 18.2% per year, respectively. Export growth is expected to accelerate from 6.0% in 2020 to 7.1% in 2022, reflecting stronger tourism but also a recovery in the country's external environment in 2022. The programme expects import growth to remain below that of exports, possibly reflecting a lower import content of tourism and basic materials, which are projected to be the key contributors to export growth. Economic output is expected to remain largely at its potential throughout the programme, with a positive output gap of 0.3% of GDP emerging towards the end of the programme period in 2022.

The ERP's baseline scenario builds on optimistic assumptions. Compared to the last programme, the economic underpinning of the macroeconomic scenario has improved. However, although the presented scenario is largely plausible in the context of the underlying assumptions, the expected growth rates are optimistic when taking into account the country's track record of delaying overdue reforms and its limited progress in meeting the requirements for advancing on its EU accession path. The expected increase in private investment is only feasible in a positive, reform-oriented environment. Public investment growth also appears to be on the high side, even when taking into account its current low level. The programme would have benefited from a more detailed explanation supporting the assumptions on public investment. Nominal wages are forecast to increase by some 3.5% on average during the programme period, reflecting emerging labour shortages partly due to increased emigration. However, those growth rates appear not to be supported by productivity gains. Overall, output growth could be significantly lower than expected if less benign factors materialised, such as a marked deterioration in the country's export markets, a continued political stalemate, or a significant slowdown in workers' remittances.

Potential growth has been estimated at 3.6%. This appears to be on the high side, when taking into account average GDP growth of 2.9% during the last 5 years. Furthermore, indications of accelerating emigration leading to a shrinking labour force also point to a muted growth potential. Economic output is expected to remain largely at its potential. According to those estimates, the programme expects a small negative output gap in 2019 (-0.11 % of GDP) to turn slightly positive (0.32 % of GDP) in 2022. As a result, the expected cyclically adjusted fiscal surplus is slightly higher in 2020 (by

0.1 pps of GDP compared to the non-cyclically-adjusted balance), while in 2022, the cyclically-adjusted surplus would be 0.1 pps lower than the non-adjusted one. These estimates suggest that the projected fiscal stance is restrictive in all 3 programme years. Overall, the fiscal surpluses are expected to dampen growth during the programme period.

The programme provides an alternative macroeconomic scenario which assumes a combination of less benign external and domestic factors, that would only slightly reduce average yearly GDP growth. Key assumptions for the alternative scenario are: lower export growth during 2020-2022 (by 0.4 pps on average), lower foreign remittances, slightly lower import prices, delays in structural reforms and further political stalemates. This would lead to an average annual GDP growth of 3.2% in 2020-2022 compared to 3.6% in the baseline scenario. Unfortunately, the programme does not specify its assumptions on the drop in worker remittances nor does it explain the transmission mechanism of delays in structural reforms and the political stalemates on economic growth. Furthermore, the alternative scenario does not specify the impact of lower growth on the labour market. Interestingly, the scenario keeps investment growth rates unaffected, and also import growth appears not to be affected by lower domestic demand. It also would have been helpful to explain how the size of export growth shock (of 0.7 pps) has been chosen. Overall, due to the limited information on the various factors of which the alternative scenario is composed, it is not possible to assess whether the scenario is plausible.

Table:

Bosnia and Herzegovina - Macroeconomic developments

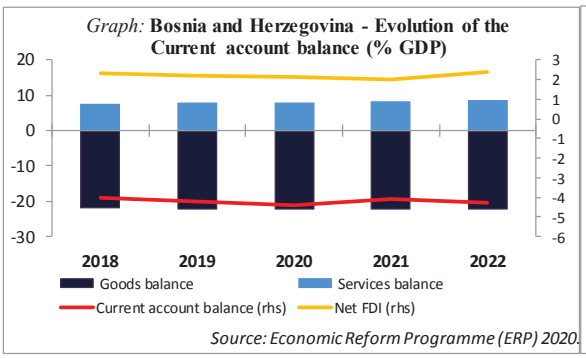
	2018	2019	2020	2021	2022
Real GDP (% change)	3.6	3.0	3.5	3.6	3.8
Contributions:					
- Final domestic demand	3.7	3.1	3.4	3.3	3.5
- Change in inventories	-0.7	0.0	0.0	0.3	0.1
- External balance of goods and services	0.6	0.0	0.1	0.0	0.2
Employment (% change)	0.8	-2.4	2.4	2.5	2.5
Unemployment rate (%)	18.4	15.7	14.7	13.9	13.1
GDP deflator (% change)	1.6	0.9	0.8	1.3	1.3
CPI inflation (%)	1.4	1.0	1.2	1.4	1.5
Current account balance (% of GDP)	-4.0	-4.2	-4.4	-4.1	-4.3
General government balance (% of GDP)	0.3	0.1	0.2	0.5	0.8
Government gross debt (% of GDP)	32.2	31.7	32.2	31.7	29.7

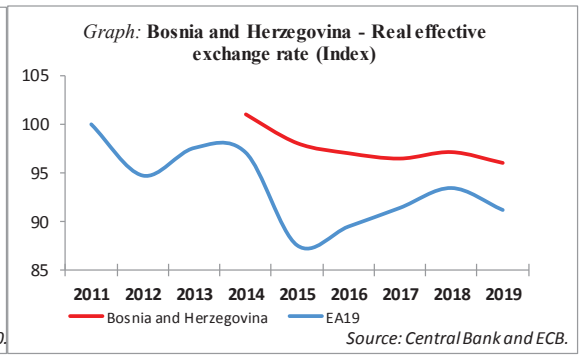
Sources: Economic Reform Programme (ERP) 2020.

Inflation is expected to remain low. In 2019, inflation remained at close to 1%, thanks to low prices for imports and weak domestic price pressures. For the programme period, the ERP continues to expect domestic and external price pressures to remain on the low side with annual headline inflation between 1.2% and 1.5%. Expectations of significant unemployment and moderate growth are likely to contain domestic price pressures. However, as skilled workers continue to emigrate, skills shortages could become worse,

creating upward pressure on wages. Furthermore, weaknesses in measuring inflation could lead to an incorrect assessment of inflationary pressures.

The external position and its financing are projected to improve slightly. The current account deficit is expected to narrow slightly to 4.1% of GDP in 2021, but to increase again in 2022, reaching 4.3% of GDP, reflecting strengthening domestic demand. This profile is largely in line with the underlying expected growth profile. A key contribution to the financing of the current account deficit is expected to come from net inflows in the form of foreign loans, while foreign direct investment (FDI) is expected to remain largely stable at some 2.2%-2.4% of GDP.





The country's financial sector has continued to consolidate, benefiting from a significant inflow of foreign exchange in the form of workers' remittances. This inflow supported a strong increase in deposits in 2018 and 2019, which helped to improve the loan-to-deposit ratio in the country's banks. The banking sector's soundness indicators continued to improve, while the percentage of non-performing loans fell below 8% at the end of September 2019. Furthermore, the liquidity position of the financial sector also improved, while the ratio of foreign denominated loans to total loans declined. The decline in this ratio will reduce exchange rate-related risks. Although the financial sector as a whole appears solid, some smaller banks are still struggling with high non-performing loan ratios and an insufficient capital endowment. Credit provision to households and enterprises has improved in recent years, reflecting both the favourable international environment, and the sector's increased liquidity due to strong inflows of capital. This inflow has also boosted the country's stock of foreign exchange reserves. However, small and micro-sized enterprises still face difficulties in accessing credit. One important aspect for those difficulties is the low degree of financial sector diversification, such as an underutilisation of factoring and leasing, which to a large extent is due to weaknesses in the underlying legal framework.

Table:

Bosnia and Herzegovina - Financial sector indicators

	2015	2016	2017	2018	2019
Total assets of the banking system (EUR million)	12 756	13 343	14 440	15 829	17 072
Foreign ownership of banking system (%)	82.2	83.5	84.9	86.0	84.7*
Credit growth	1.8	2.1	5.3	6.6	5.7
Deposit growth	6.2	7.8	10.3	11.3	9.3
Loan-to-deposit ratio	1.0	1.0	0.9	0.9	0.9
Financial soundness indicators					
- non-performing loans	14.1	12.8	11.3	9.8	8.6*
- net capital to risk-weighted assets	16.3	15.5	15.8	15.7	17.1*
- liquid assets to total assets	25.7	25.6	26.4	28.5	29.3*
- return on equity	8.7	9.2	11.9	11.3	11.1*
- forex loans to total loans (%)	62.4	58.5	55.9	54.0	52.2*

* 3Q

Sources: Central Bank, Macrobond, IMF.

2. PUBLIC FINANCES

The country's fiscal performance in the first three quarters of 2019 was characterised by slightly stronger-than-budgeted revenue growth, while spending remained largely on track. When adding up all available information, the countrywide fiscal accounts seem to have registered a surplus of about 0.5 % of GDP in January-September. However, this dataset is very provisional and incomplete. Furthermore, public spending usually accelerates at the end of the year, which would imply a less favourable fiscal position for the whole year. The main reasons for the strong revenue growth (+5.7%) in the first 9 months of the year are higher than budgeted revenue from excise taxes on customs, alcohol and tobacco, roads, etc. VAT revenues, the main source of revenues in the country, increased by 4.7%.

In the medium term, the country's overall fiscal objective appears to be fiscal consolidation, lowering the tax burden but also reducing spending as a percentage of GDP. Fiscal stakeholders at all levels envisage reducing the informal sector and improving public finance management. However, there are no explicit links to the reform measures in the structural reform part. In terms of fiscal targets, the framework envisages an increase in the budget surplus from an expected 0.1% of GDP in 2019 to 0.8% in 2022 and a decline in expenditure and revenue shares to GDP over the programme period. This drop in spending and revenue ratios is largely due to nominal revenue and spending increasing below nominal GDP growth rates. On the revenue side the authorities intend to strengthen measures to fight the informal economy, while lowering the tax burden, in particular for social contributions. The drop in the revenue-to-GDP ratio by 1.5 pps over 2020-2022 is mainly driven by low growth of indirect taxes and social contributions. Implicit revenue elasticities are relatively low, which is a bit counterintuitive in view of the indicated aim to fight informal activities. The low revenue elasticities might reflect intentions to lower the tax burden on labour and on incomes. However, the programme does not provide sufficient details on intended tax measures, nor does it present estimates of the fiscal effects of planned measures. On the spending side, low increases in spending for public consumption and social transfers are the main drivers. The already low share

of public investment is set to fall further, from 3% of GDP in 2019 to 2.3% in 2022. The planned fiscal adjustment is back-loaded, with some 90% of the adjustment taking place in the last 2 programme years. This profile might have to do with countrywide municipal elections in autumn 2020.

Table:

Bosnia and Herzegovina - Composition of the budgetary adjustment (% of GDP)

	2018	2019	2020	2021	2022	Change: 2019-22
Revenues	39.9	39.3	39.1	38.3	37.8	-1.5
- Taxes and social security contributions	35.3	35.4	35.3	34.7	34.4	-1.0
- Other (residual)	4.6	3.9	3.8	3.6	3.5	-0.4
Expenditure	39.6	39.2	38.9	37.8	37.0	-2.2
- Primary expenditure	38.9	38.4	38.1	37.0	36.3	-2.1
of which:						
Gross fixed capital formation	2.7	3.0	2.7	2.4	2.3	-0.7
Consumption	17.5	17.2	17.0	16.6	16.2	-1.0
Transfers & subsidies	16.2	16.5	16.5	16.1	15.6	-0.9
Other (residual)	2.5	1.7	1.9	1.9	2.2	0.5
- Interest payments	0.8	0.8	0.8	0.8	0.7	-0.1
Budget balance	0.3	0.1	0.2	0.5	0.8	0.7
- Cyclically adjusted	0.2	0.1	0.3	0.5	0.7	n.a.
Primary balance	1.0	0.9	1.0	1.3	1.5	0.6
- Cyclically adjusted	0.9	0.9	1.1	1.3	1.4	0.5
Gross debt level	32.2	31.7	32.2	31.7	29.7	-2.0

Sources: Economic Reform Programme (ERP) 2020.

The budgets of 2020 target largely balanced accounts, based on revenue increasing faster than spending, with the latter retaining a strong focus on transfers, subsidies and public sector wages. However, the integration of the Pension and Disability Insurance (DPI) scheme into the accounts of the Federation's state budget prevents the comparability with 2019 data. Unfortunately, information on the budgets for 2020 for the general government, but also for the entities, is incomplete. To some extent, this reflects the fact that the 2020 budgets had not yet been completely adopted when the programme was drawn up.

Public debt declined to less than 32% of GDP in 2019, and is set to fall further, mainly driven by sizeable primary surpluses and nominal output growth. Public debt doubled after the 2008 financial crisis, reaching its peak in 2015 at about 42 % of GDP. By 2019, public debt had declined to some 32% of GDP, mainly thanks to solid growth in nominal GDP and fiscal surpluses. Difficulties in accessing international financial markets, and the shallowness of the domestic financial market, mean that international financial institutions such as the World Bank, the European Investment Bank and the IMF are still key sources for financing. It is largely thanks to this financing structure that the average implicit interest rate has remained low at some 2%. This rate is projected to rise to nearly 3% by 2022. Despite this expected increase, the costs of debt servicing are likely to remain low, at 0.7% of GDP by 2022. Unless there are significant changes in the international financing conditions, this outlook of slightly increasing

financing costs is plausible and consistent with previous programmes. Overall, driven by fiscal surpluses and solid nominal output growth, public debt is forecast to fall from 31.7% of GDP in 2019 to slightly below 30% in 2022. The *Republika Srpska* entity faces a significantly higher level of public indebtedness, at some 48% of the entity's GDP.

Box: Debt dynamics

Table: **Bosnia and Herzegovina**
Composition of changes in the debt ratio (% of GDP)

	2018	2019	2020	2021	2022
Gross debt ratio [1]	**32.2**	**31.7**	**32.2**	**31.7**	**29.7**
Change in the ratio	-1.7	-0.5	0.5	-0.5	-2.0
Contributions [2]:					
1. Primary balance	**-1.0**	**-0.9**	**-1.0**	**-1.3**	**-1.5**
2. "Snowball" effect	**-0.9**	**-0.4**	**-0.6**	**-0.8**	**-0.8**
Of which:					
Interest expenditure	0.8	0.8	0.8	0.8	0.7
Growth effect	-1.2	-0.9	-1.1	-1.1	-1.2
Inflation effect	-0.5	-0.3	-0.3	-0.4	-0.4
3. Stock-flow adjustment	**0.3**	**0.8**	**2.1**	**1.5**	**0.3**

[1] End of period.
[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).
The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.

Source: Economic Reform Programme (ERP) 2020, ECFIN calculations.

The programme forecasts an accelerated reduction in the debt-to-GDP ratio. The key drivers of this reduction are expected to be primary surpluses and nominal growth. This will be only partly offset by interest costs whose upward impact on the debt ratio is expected to remain stable at less than 1 pp. Moreover, a breakdown of the debt dynamics into various components points to an additional factor that increases debt. This factor is presented in the table as the 'stock-flow adjustment'. The 'stock-flow adjustment' raises the debt-to-GDP ratio by 2.1 pps in 2020 and by 1.5 pps GDP in 2021. Unfortunately, the programme does not provide more details on the underlying assumptions behind this forecast debt profile. The data presented on debt is slightly different from the data provided by the central bank.

Risks to the fiscal scenario are non-negligible. On the revenue side, the programme assumptions are cautious and may provide a certain buffer against the failure to - reach targets on reducing spending. However, there are significant risks in the form of contingent liabilities related to public loan guarantees as well as substantial payment arrears in particular in the health sector. These risks are an impediment to the viability of private suppliers or negatively affect the financial situation of providers of social security. There are contingent liabilities in the form of guarantees for chronically non-viable SOEs, such as to the railway company in the Federation, which by 2021 are expected to amount to some 3% of GDP. The loan guarantee for the construction of a major coal-power plant could raise contingent liabilities by another 4% of GDP. The need to restructure unviable publicly-owned enterprises could also have significant budgetary implications. Poor transparency and weak reporting standards significantly reduce the reliability of risk assessments.

Box: Sensitivity analysis

The programme presents a sensitivity analysis of possible effects of the alternative, lower-growth scenario on tax revenues. The alternative scenario analyses the economic effects of export growth being 0.7 pps lower, which together with other factors would result in average annual GDP growth of about 0.4 pps lower than in the baseline scenario. According to the estimates of the Directorate for Economic Planning (DEP), the growth of total revenues would be some 0.3 pps lower, mainly as a result of lower VAT revenues. This is not surprising, given the limited direct effects of exports on indirect taxes and the assumed low sensitivity of imports to reduced exports. It might have been more interesting to look at shocks with a more significant effect on revenues,

such as the effects of lower consumption due to a drop in foreign remittances, or the impact of a reduction in social-security contributions on the financial situation of the social-security system.

The quality of public finances and budget planning remains weak. The programme does not contain sufficient plans to improve the spending structure, and lacks a pro-growth orientation. The programme's spending profile appears to have been strongly affected by the upcoming municipal elections in autumn 2020, keeping changes to consumption and transfers limited, while spending on investment is contained, in particular in the *RS* entity and the *Brcko district*. Like in the 2019 ERP, this planned reduction in investment is not in line with the Policy Guidance jointly adopted in the last 3 years. It is also in contrast to the projections in the macroeconomic part of the ERP, where public investment is forecast to increase. More information would have been welcome, particularly information elaborating on challenges such as the need to reform the often overstaffed public sector, where planned registers of public employment still appear not to have been completed. A significant issue is the broad use of para-fiscal fees at municipal and cantonal level: this practice impedes the establishment of new companies, and thus has strong negative implications for the country's business environment. Another area, which would have deserved a more elaborated discussion, is the overdue restructuring of state-owned enterprises and its fiscal impact. Finally, more details could have been provided on plans to improve the needs-based targeting of social spending, which appears to suffer from substantial inefficiencies.

The country's budgetary framework continues to be impeded by institutional fragmentation, the weak quality of fiscal data and a lack of cooperation among the various budget users. Alignment with EU reporting standards and budgetary frameworks is still very limited. So far, only one entity has adopted fiscal rules, and there is no independent fiscal council to monitor countrywide fiscal performance. The effectiveness of the medium-term fiscal framework is also very limited. In addition, the use of independent, unbiased forecasts for budget planning is still in its early stages. Finally, the availability and quality of fiscal data suffers from poor reporting standards, a lack of cooperation among the various budget users, and political resistance that impedes alignment with the standards of the European System of National Accounts (ESA). Due to these deficiencies, there could be a significant degree of fiscal underreporting. The programme refers to the importance of improving public financial management, but fails to initiate concrete reform projects and evaluate their expected fiscal impact.

3. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

Bosnia and Herzegovina's economy is developing at a rate that is below its potential and sustained reform measures are necessary to significantly improve the living standards of its people. The Commission has conducted an independent analysis of the economy to identify the key structural challenges to boost competitiveness and inclusive growth, drawing from Bosnia and Herzegovina's own ERP, but also using other sources. The economy's development is impeded by several structural weaknesses, leading to an underutilisation of the country's economic potential. High structural unemployment is a clear consequence of those weaknesses, rather than being only the result of an insufficient functioning of the country's education system. It also points to a poor business environment resulting from the country's institutional and economic fragmentation, a weak rule of law as well as an inadequate and inconsistent legal

framework. Furthermore, the economic activities of the public sector have a detrimental weight in the economy due to their inefficient management. The main challenges in terms of boosting competitiveness and long-term and inclusive growth are therefore to (i) increase employment, particularly of young people, women and other vulnerable groups, (ii) improve the business environment through closer cooperation and coordination at all levels of government and (iii) make the public sector more efficient, in particular improving the performance, transparency and accountability of public enterprises.

A thread common to all three challenges is the need for Bosnia and Herzegovina to tackle corruption, improve the rule of law and strengthen institutions in order to promote competitiveness. Addressing these fundamental concerns is a prerequisite for a successful development of the economy. The Commission is closely following the issues of strengthening the rule of law and fighting corruption in the annual Bosnia and Herzegovina report.

Key structural challenge #1: Increase employment, particularly of young people, women and other vulnerable groups

The very low rate of participation in the labour market and high unemployment remain major labour market challenges. The ERP does not propose any countrywide reform measure to tackle this key challenge. The labour force participation rate for people aged 20-64 is particularly low at 59% (2019) with virtually no change since 2016, when it stood at 58.8%, and well below the EU-28 average (78.3% in 2018). The underutilisation of human capital impedes economic growth. New opportunities for job creation are scarce and localised, while labour mobility within the country is low. The unemployment rate for people aged 20-64 fell from 24.7% in 2016 to 15.8% in 2019, while the employment rate increased from 44.2% to 49.7% over the same period. There has been a slight decrease in the share of long-term unemployed from around 83% in 2018 to 77.3% in 2019, but it still remains very high. There is low internal labour mobility among the entities and cantons. A significant difference between the two main entities can be noted in terms of key labour market indicators. This may be due to the absence of an employment strategy at the level of the *Federation* entity and the absence of a coordinated employment strategy at the state level, which would contribute to more even development across the country. Recently, activities have been launched concerning the development of employment strategies for the years 2021-2025 in both entities and consultations have started between the state and the entities over a coordinated employment strategy at the state level.

Moderate improvements in the labour market can only partially be attributed to the creation of new jobs. The recent increase in the employment rate has been moderate compared to the stronger decline in the unemployment rate. Data on the number of employed and unemployed people between 2016 and 2018[1] show a similar trend. The number of employed increased by 21,000 (from 801,000 to 822,000), while the number of unemployed dropped by 88,000 (from 273,000 to 185,000). The labour force shrank over the same period by 66,000 people. It is therefore evident that the significant drop in unemployment is not followed by a comparative increase in employment. A possible

[1] The Labour Force Survey of 2019 does not include figures on the absolute number of working-age population, employed and unemployed people, contrary to the previous editions of the survey.

explanation of this development could be labour emigration and withdrawal from the labour market, mainly due to retirement.

Women face particular challenges in employment. The gender employment gap in the age group 20-64 remains very high at 24.4 pps in 2019, twice as high as the EU average (11.5 pps for the EU-28 in 2018), but it slightly narrowed over the last year (26.7 pps in 2018). The gender employment gap of young people (15-24) was less pronounced at 8.8 pps in 2019 and decreased by 4.7 pps year-to-year. Low availability of childcare and elderly care is an additional obstacle to women's participation in the labour market and contributes to low levels of employment of women who predominantly assume the role of carer. Close family members (predominately women) providing care cannot enter full-time employment. Taking into consideration a lack of formal part-time engagement, carers often leave the labour market or work informally (Analitika - Centre for Social Research, 2016). The low enrolment in early childhood education at a mere 15% stands in stark contrast with the EU average of 95.4% (2017)[2]. Substantial active labour market measures targeting specifically women are also absent.

Young people continue to face difficulties in the labour market. Bosnia and Herzegovina has a very high youth (15-24) unemployment rate (33.8% in 2019 compared to 15.2% in the EU-28 in 2018), even though it decreased substantially by 20.5 pps between 2016 and 2019. The youth (15-24) employment rate increased by 9.6 pps between 2016 and 2019, but is still extremely low at 23.4% (2019), i.e. around 12 pps below EU-28 average (35.3% in 2018). The share of young people not in employment, education or training (NEET) dropped from 27% in 2014 to 21.2% in 2018, but still remains very high, reflecting the difficulties faced by young people in finding a job. The latter can to some extent be explained by mismatches between the education system and labour market needs and a weak business environment still significantly underdeveloped to generate employment. Employers note that vocational education and training does not provide students with the relevant and up-to-date knowledge and skills (World Bank 2019 report). Facing a lack of job opportunities, poor economic prospects and generally poor working conditions in the private sector, young people, including those well-educated, are migrating abroad. This contributes significantly to a fast ageing of the population in the country. More than one third of university graduates was living abroad in 2017 leading to domestic labour shortages, while more than half of the inactive population has at most a primary level of educational attainment (51.4% in 2019).

More than 40% of people aged 20-64 are inactive, pointing to an acute need to develop policies fostering transitions into the labour market and employment. Those particularly affected are the low-skilled and older workers (older than 40). According to the 2019 Labour Force Survey (LFS), people with a low level of education represent 51.4% of the inactive labour force, while their share among the active population is only 15.8%. The inactivity rate of older people (50-64) in 2019 at 53.3% was high, with the employment rate only at 42.2%.

Public employment services operate with low levels of funding and are insufficiently staffed. According to LFS 2019, there were 185 thousand unemployed people, while the number of registered unemployed at the employment bureaus amounted to 401,342 on 31

[2] For children aged 4 to compulsory education.

October 2019. According to LFS 2019, a large number of registered unemployed are in fact inactive (43.8%) and a considerable number of them are informally employed (23.7%), receiving free health insurance and other social benefits. The administration of these benefits limits the ability of public employment services to assist active jobseekers. In line with the policy guidance from 2019, the *Republika Srpska* entity adopted amendments to the Law on health insurance and removed the duties of administering health insurance from the public employment services as from January 2020. In the Federation entity this is still pending. The capacity of the public employment services to provide quality services to jobseekers is weak. The education profile of the unemployed is recorded, but there is not a specific skill set profile. The public employment services need to start working better with the unemployed (improve counselling and job placement services) and reach out more to employers. The number of registered unemployed per employment officer is, however, not yet conducive to a more active and client-based approach, especially in the Federation entity. While no recent data have been published, based on information on the number of employment officers in 2014 and the numbers of registered unemployed from 2019, the number of registered unemployed per one employment officer in the Federation entity is around 1,079, which is excessively high. Expenditure on active labour market policies (ALMPs) as a share of GDP has almost doubled since 2013 thanks to a €50 million World Bank/EBRD loan (0.19% of GDP in 2017). The goal is to reach 37,000 unemployed between 2017-2021. ALMPs are, however, too much driven by wage/tax subsidies (around 90%), and only less than 10% of expenditure goes to retraining/on-the-job training measures (Labour and Employment Agency of BiH 2018).

There are also significant disincentives to work. A larger part of non-contributory social transfers (1.9% of GDP) are grants to war veterans and only a small part (0.8%) is spent on people with disabilities and on means-tested social assistance and family benefits (World Bank 2019c). The non-means tested and relatively generous social benefits for war veteran categories might stimulate labour market inactivity. Social contribution rates contribute to a high tax on the labour earnings of low income earners resulting in a disincentive to work for this category and their employers to formalise employment, confining them often to informal work. Some initial steps were taken to tackle this issue in 2018 in the *Republika Srpska* entity; it adopted changes to labour and income tax legislation that reduced the tax burden on labour by raising the tax free threshold to KM 500 and increased worker's take-home pay, while the gross salary remained the same. Furthermore, since July 2019, the *Republika Srpska* entity has introduced two additional tax incentives, which stimulate employers to increase salaries for two groups of employees (those whose salary is between KM 450 and KM 550 and those whose salary is over KM 1,000). In the *Federation* entity, legislative proposals were made to reduce the tax burden on low-wage earners and to reduce social contributions. However, the proposals are still in the parliament and some amendments were presented in September 2019. It would be an important step forward if the legislation succeeded in increasing the take home pay of low-wage earners.

Outward migration and a low birth rate represent a significant challenge to the labour market and economic growth. Bosnia and Herzegovina was the leading country in the Western Balkans region in terms of absolute numbers of emigrants between 1990 and 2015, amounting to 1.3 million or 40% of the resident population (World Bank 2018). In relative size Bosnia and Herzegovina has one of the smallest youth populations (14.2%), and emigration seems to cause potential workforce shortages. Moreover, the

shrinking population is sustained by a low birth rate of 9.2%, which is significantly below the OECD and Western Balkans average of 12% (World Bank 2019d)[3]. Many jobseekers, including university graduates, were recruited into employment abroad by the public employment services. However, an even higher number of people – often people who are skilled and already in employment– found jobs abroad on their own initiative, contributing to high levels of labour force emigration.

Around 20% of workers are in vulnerable employment and about 30% are in informal employment. This concerns especially lower-skilled, young and older workers. Public sector employment (including state-owned enterprises) is more secure and generally better paid compared to the private sector. Working conditions (low wages, precariousness, working time and overtime, leaves), including health and safety, in the private sector are considered to be very weak. The minimum salary is low. In January 2020 it was increased in the *Republika Srpska* entity from KM 450 to KM 525, while in the *Federation* entity the minimum wage of KM 405 based on an expired collective agreement is being applied.

Consultations with the social partners on the design and implementation of economic, employment and social policies have weakened. In the *Federation* entity, the Economic and Social Council (ESC) restarted its work in January 2020, but there are issues with the representativeness of the trade unions involved in ESC. The Ministry of Labour and Social Policy forwarded a draft Law on Representativeness to the Parliament and the draft is open for public debate for 60 days, at the time of writing. In the *Republika Srpska* entity, the work of the ESC became more intense in 2018 compared to previous years. However, consultations in the ESC are limited to labour law and do not cover larger economic and social reforms. There are no general collective agreements in either entity. Sectoral collective agreements in the *Republika Srpska* entity are limited to the public sector and some state-owned enterprises. In the *Federation* entity, sectoral collective agreements spread also to some branches of the private sector. In either case, the texts of these agreements are not publicly available on the ministries' websites. The overall effectiveness of social dialogue has decreased and the labour dispute settlement mechanisms are pending reforms.

Key challenge #2: Improve the business environment through closer cooperation and coordination at all levels of government

The absence of a single economic area within the country, which is divided into separate administrative entities, negatively affects the development of the private sector. A fragmented administrative structure, partly different legal frameworks and implementation practices, a weak rule of law, corruption and red tape, lengthy bureaucratic procedures and low quality public administration are the main elements for the existing poor business environment. Frequent political stalemates and a lack of cooperation among key stakeholders not assuming their responsibilities lead to overdue reforms being frequenly delayed. When this business environment is combined with an inefficient and outdated education sytem, in particular one generating a skills mismatch, and a significant informal sector, the result is a high level of structural unemployment.

[3] According to the World Bank indexation, the crude birth rate indicates the number of live births occurring during the year, per 1,000 population estimated at mid-year.

The fragmented administrative structure (the poor quality of the institutional set up is reflected in the country's lowest ranking – 114th – in Europe on institutions in the World Economic Forum's Competitiveness Report 2019) puts an added burden on businesses through excessive regulation, taxes and local fees. Starting a business remains cumbersome.

Country-wide strategies and solutions to support business development are long overdue. This includes the quality infrastructure system, reforming public financial management; using e-signature; reducing para-fiscal fees; reforming insolvency procedures; adopting policies for small and medium enterprises (SMEs) and reforming the process for granting building permits. The country ranks lowest in the Western Balkans region under the World Bank Doing Business Index and remains the economy with the least favourable public services for business with 40% dissatisfied businesses (RCC, 2019). Private investment (both domestic and foreign) is comparatively modest as low labour costs fail to offset institutional weaknesses and a poor business environment (Coface, 2020). Delays in forming governments served as an excuse to block much needed reforms to enhance the business environment for more than a year and an IMF programme has been stalled since 2018.

The institutional, legal and regulatory environment continues to be a crucial weakness with adverse effects on the business environment, preventing a level playing field among companies. Despite some efforts regarding legislative simplification and regulatory impact assessment, the high degree of fragmentation requires companies to comply with different procedures in different parts of the country. The lack of proper cooperation and coordination among political stakeholders and an ambiguous interpretation of the rule of law contribute to insufficient political ownership of reforms. Institutional and government barriers are a significant obstacle to conducting business. The financial and administrative burden on business is characterised by high payroll taxes and an excessive number of administrative procedures at all levels. The complex legal and regulatory frameworks create opportunities for corruption.

Each level of governmental (and within the *Federation* entity, each of the 10 cantons) has its own business laws, regulations and procedures. Despite a number of similarities among the various regulations and procedures, differences often prevail, which complicates doing business in different parts of the country. Such high degree of legal fragmentation and inconsistency has a negative effect on the country's business environment, requiring companies to comply with different procedures in different parts of the country. The legal framework for market entry and exit[4] is largely defined at the lower levels of government. According to the Balkan Barometer, Bosnia and Herzegovina has the lowest score in the region on the "burdensome number of procedures, requirements, paperwork and costs" as well as on the criteria "excessive discretionary power of government officials and inconsistent application of regulations" (RCC, 2019). The very high burden of government regulation is also evidenced by the Global Competitiveness Report 2019 where the related ranking is 137th out of 141 countries.

[4] There is also no legal time limit to resolve market exit in case of insolvency in the *Federation* entity.

Weaknesses in the rule of law, including in the functioning of the judiciary, negatively affect the country's market economy and its business environment in particular. The constitutional and legal framework governing the judiciary is incomplete and does not provide sufficient guarantees of independence, accountability and efficiency. Inconsistent decision making undermines predictability and the harmonised application of legislation (World Bank, 2015). The legislative framework on preventing and combatting the widespread corruption presents significant gaps due to the non-harmonisation of legislation, strategies and action plans. Closer coordination and cooperation involving all levels of government, legal certainty to business through harmonised legislation across the country and a consistent application of the rule of law are prerequisites for countering corruption more effectively.

Technical barriers to trade are still substantial and both detrimental to trade as well as to an internal single economic area. There is a clear need to draw up a countrywide strategy on quality infrastructure and implement a mechanism to co-ordinate decision making between different levels of government. Initial steps were taken to establish a single economic area and to align the legislative and institutional framework with the free movement of goods *acquis* were taken, but further work was hampered by political disagreements between the *Republika Srpska* entity and the state level on competences. Due to competence related issues, the country's committee for technical regulations has not convened since 2012 and since then, EU legislation has not been aligned in a harmonised way throughout the country. The designation of conformity assessment bodies and the application of conformity assessment procedures are not ensured consistently. This ultimately leads to an inadequate level of harmonisation with the EU *acquis* and between the entities. As a result, enterprises can have difficulties in exporting to the EU single market and can be forced to perform double registrations if placing their products in both entities.

The ERP recognizes that the lack of a properly developed system of quality infrastructure and the lack of a strategy for quality infrastructure distort the country's internal market and hence stand in the way of a single economic area. *Reform measure 8 (Enhancing the quality infrastructure system according to the EU model)* aims at adressing this issue. This rolled over and long delayed measure on harmoning quality infrastructure is highly relevant in increasing the country's competitiveness and long-term growth potential. If implemented, the measure would help to create a single economic area and to facilitate trade. The measure is in line with the country's commitments under the Stabilisation and Association Agreement (Article 75). Cross-cutting coordination between the relevant institutions at different levels of government has not yet been ensured. In the absence of proper timelines, key result indicators, more concrete activities, costing or impact on competitiveness, it is difficult to assess to what extent this measure reflects a realistic commitment. The ERP fails to discuss the implications of the *Republika Srpska* entity's own quality infrastructure strategy adopted in October 2019.

E-authentication is critical for building trust in e-commerce and in government e-signature services. A first qualified trust service Provider for issuing qualified electronic certificates is now in place. Preparations are ongoing for other bodies[5] to get this status as

[5] Agency for Identification Documents, Registers and Data Exchange of BiH (IDDEEA) and the Indirect Taxation Authority.

well. However, countrywide harmonisation of e-signature and the related coordination, cooperation and data exchange between different administrations is still needed. A lack of interoperability of the e-signature system throughout the country limits the capacity to provide electronic services. Implementation of customs policy legislation (including the electronic transit procedure (NCTS), the authorised economic operators (AEO) scheme and electronic customs declaration for import and export customs procedures) is dependent on the foreseen accreditation of the Indirect Taxation Authority as Qualified Trust Service Provider and the subsequent issuing of e-signature by the Indirect Taxation Authority. To some extent, the ERP recognises the importance of implementing the law on e-signature and discusses related developments. However, the analysis is incomplete and presented in a fragmented way. Concrete activities related to the reform measure on "establishing an electronic signature system" do not cover the whole country as they are only related to one entity. The need to adopt the (long delayed) law on electronic identification and trusted services for e-transactions has been identified by the ERP.

Businesses are subjected to numerous para-fiscal fees and charges due to overlapping administrations and an inefficient delegation of powers to lower levels of government. Para-fiscal fees and charges are levied by all three levels of government, creating a complex web of non-tax charges that facilitate corruption. The large number of local fees and charges are also considered a significant obstacle to businesses and local development, in particular new companies wanting to set up operations in a different part of the country. Registries of para-fiscal fees have been created at entity level and both entities have published lists of para-fiscal fees. The registries, which cover all levels of government, will help eliminate fees deemed harmful for the business environment, once relevant legislation on the developed registers of fees and charges has been adopted in both entities and once the exchange of information is ensured across the country.

The lack of a unified countrywide approach to the planning and implementation of SME and industrial policy hinders the development of entrepreneurship and investments. Reporting on the principles of the Small Business Act is assigned to the state-level Ministry for Foreign Trade and Economic Relations. However, SME policies exist only at the entity level (OECD, 2019). The legal definition of SMEs is not harmonised throughout the country. Progress is lagging in the implementation of the Small Business Act. In all 12 SME policy dimensions, the country scores lower than the regional average. There is very little evidence of effective coordination across different levels of administration in this area. Bosnia and Herzegovina also lacks a countrywide industrial development strategy and there is no state-level body promoting consistency between industrial strategies or with other policies affecting industrial competitiveness. The Smart Specialisation process in Bosnia and Herzegovina is still in its initial stages of preparation.

The ERP recognises to some extent the need to create legal preconditions for keeping and updating the register of fees and taxes. The document also refers to needed improvements related to the tax burden on labour in the *Federation entity*, the informal economy, administrative barriers (without clearly specifying which ones) as well as in terms of support to SMEs including through wider access to finance and funding of entrepreneurial infrastructure. The challenges identified include some aspects related to the judiciary (such as the length of court proceedings) and the fight against corruption. While the related *reform measure 11 (Enhancing the business environment)* includes activities which are, themselves, to a good extent relevant, it is often unclear which

governmental level or institution is responsible for implementing these activities. The way the measure is structured reflects the high degree of fragmentation of the business environment and displays a lack of clarity, coherence and focus.

The business registration process is particularly troublesome, partly due to the separate laws and regulations that exist at different levels of government. There is no central registry of business entities and the company registers of the entities and of the Brčko District are not interconnected. Authorisation schemes, both cross-sectoral and sector-specific, are applied at different levels of authority. Businesses registered in one part of the country are not always automatically and unconditionally recognised in other parts, requiring a costly replication of registration procedures. There are additional registration requirements for companies with commercial presence in both entities which is an obstacle to creating a single economic area in the country. In areas where the entities have no mutually harmonized legislation (e.g. chemicals, food supplements and cosmetics), SMEs are asked to formally register in both entities to be able to place their products on the market. SMEs in this situation are audited by market surveillance authorities in each of the entities. The World Bank's Doing Business Report (2020 edition), ranks the country 184th (out of 190 countries) for starting a business. The Global Competitiveness Report (2019 edition) gives a particularly low ranking for the time it takes to start a business (137th out of 140).

Some reforms are continuing, such as the establishment of one-stop-shops for company registration and an online business registration system. The *Republika Srpska* entity has a one-stop-shop system and the registration procedure is performed by the Agency for Intermediary, Information Technolog, and Financial Services. Ideally, all business licences and permits (as well as rulebooks for their implementation) should be harmonised across the country (UNCTAD, 2015).

Construction permits create a particular problem for new businesses. The sub-national administration of business licences and permits is complex. By-laws governing licenses and permits are adopted at entity level. However, the application of these by-laws is the responsibility of municipalities, which also have the freedom to set corresponding fees. In spite of some progress aiming at issuing of building permits electronically in the *Republika Srpska*, obtaining construction permits (involving various public agencies) remains a significant obstacle to investment.

The ERP refers to the need to reform the business registration system and more generally to develop e-services. However, the issue is only mentioned in the context of both the reform measure to establish an electronic signature system and the measure to improve the communication and information society sector. In both cases, only reference to related reform efforts of one entity are made.

Key challenge #3: Make the public sector more efficient, in particular improving the performance, transparency and accountability of public enterprises

Bosnia and Herzegovina's public sector is oversized and inefficient, putting a significant burden on taxpayers and adversely affecting the business environment. State influence on the economy is significant and countrywide public spending remains at a relatively high level, while the quality of the services provided is low, in particular in the area of health, but also in education. Efforts to rebalance the country's current public sector-led growth model to a more private sector-led model are not sufficient, given that, according to official statistics, public spending accounts for more than 40% of GDP.

Bearing in mind the large tax contributions, the public sector provides little in exchange in terms of availability and quality of the country's public services (World Bank, 2019). The creation of a register of public sector employees has not yet been completed. Public procurement plays an important role for the private economy, but procedures are complex, prone to corruption and still contain a preference for domestic suppliers, which is incompatible with the *EU acquis*. Payment arrears of the public sector are substantial, in particular in sectors such as public health, creating a considerable burden for private companies, but also a high degree of uncertainty for other public services in terms of non paid contributions related to health and pension funds. Public financial management reforms are not addressed in a single strategic framework but through strategies at various governmental levels. The adoption of the strategy by the *Republika Srpska* entity is still pending, whereas all other levels are revising the current strategies. Consequently, there is currently no countrywide reform direction on public financial management.

Special attention needs to be paid to improving the efficiency and transparency of public companies as an oversized, non-transparent and inefficient state owned enterprises (SOE) sector has an important footprint in the economy. Existing registers of public companies are outdated, not comprehensive and not publicly available. According to estimates (IMF 2019), there are over 550 (majority public) SOEs employing around 80,000 persons, or around 11% of total employment (about a quarter of public sector employment). They control assets worth an equivalent of 100% of GDP. Among all SOEs, entity-owned SOEs (including the electricity companies of the entities, coal mines in the *Federation* entity, the *Republika Srpska* entity forest company, highway companies, railways) have the largest operations and account for most employment of the SOEs. Despite lower productivity[6], the average salaries of SOE employees are 40% higher than in private companies. Unlike other countries in the region, the relatively slow progress in privatisation may explain why employment in SOEs increased over the last 15 years (IMF 2019).

SOEs are negatively affecting the country's macroeconomic performance, fiscal sustainability, labour market outcomes and competitiveness. The SOE sector is characterised by weaknesses in transparency, accountability and performance. Productivity is low within many large SOEs and many of them are not profitable. SOEs and public enterprises dominate key sectors of the economy, including energy and telecommunications utilities (World Bank, 2018). Many SOEs are statutory corporations that are subject to preferential treatment deviating from ordinary corporate norms (OECD, 2018). Subsidies give SOEs a competitive advantage over the private sector, thereby negatively affecting the efficiency of resource allocation. As for the interaction of SOEs with the private sector, the poor quality and fairly high cost provision of inputs to private enterprises negatively impact the private sector's competitiveness. The higher wages in SOEs distort labour markets[7] and have the potential to increase wages in the economy as a whole. SOE's lobbying governments may prevent private actors from entering markets. Liabilities to suppliers (according to the IMF 4% of GDP) have

[6] Average revenue per worker (measuring productivity) is considered to be around eight percent lower than in the private sector.
[7] The country's SOEs have the third highest wage premium in the region (IMF, 2019).

negative repercussions on the private sector. Fiscal sustainability is undermined by tax and social security contribution arrears (amounting to 4% of GDP).

SOEs are a significant burden on the country's public finances. To a large extent, the country's SOEs are in poor financial shape: close to one half of them are illiquid and require both explicit and implicit budgetary support. Liquidity problems often result in tax and social security contribution arrears which render the financial situation of the entity's pension and health funds more difficult. About three quarters of the largest (20) SOEs face considerable financial risks. The costs of supporting public companies and guarantees, which often translate into substantial contingent liabilities, are a heavy burden on public finances and thus the country's taxpayers. Apart from direct subsidies and loan guarantees, government support is granted implicitly through tax and social security contribution arrears. Potential investors are required to assume these debts and maintain the existing workforce. These large payment arrears in SOEs impede the transparency of public sector accounting but are also a burden to private companies in the form of unpaid payment obligations. Some of the SOEs requiring subsidies are no longer operating, but still maintain workers. The (fiscal) costs of this approach are substantial and divert productive resources away from more productive uses. SOEs are unlikely to reduce debt levels without general governments support (including budget transfers and subsidies) which amounted in 2017 to 0.9% of GDP or 2.2% of expenditures. SOE total debts (including approximately 4% of GDP in tax and social contributions arrears) are around 26% of GDP (IMF, 2019). While the precise numbers have not yet been determined, total public sector debt is likely to be approximately 55-60% of GDP. The country will need to increase the transparency, fiscal sustainability and efficiency of SOEs, including through the adoption of OECD principles on corporate governance. Restructuring public companies and stimulating competition from the private sector could improve the quality of the services provided and relieve public finances from a recurring burden.

Governments do not exercise their ownership functions in line with World Bank/OECD guidelines. SOE registries/datasets are either not updated (*Republika Srpska* entity), display significant shortcomings (for instance, in the case of the *Federation* entity, there is a lack of information on financial statements and government's ownership stakes) or do not exist (state level). There are no ownership policy documents outlining the rationale for government ownership of SOEs. To separate oversight from policy and regulatory functions of the line ministries, centralised SOE oversight units are either not established (in the *Republika Srpska* entity) or need legislation to provide a more solid legal basis (in the *Federation* entity). The coverage of SOEs is limited in terms of financial audit by Supreme Audit Institutions.

In line with one of the priorities of the Commissions Opinion on the country's membership application, appointments to SOE boards will need to be de-politicised. SOE performance and board decision making are insufficiently separated from the political cycle. Provisions requiring independence of board members from political parties, prevention of conflicts of interest or competency requirements are either not existing or weakly defined and insufficiently applied. Vested interests are largely responsible for the slow privatisation process and attempts to sell shares in public companies earmarked for sale have been largely unsuccessful.

The rationale for SOE ownership is not clearly justified. While entity governments have determined "strategic companies", the rationale for public ownership is not based

on clearly defined policy objectives. Privatisation (and as appropriate a solid restructuring process as part of this process) may be considered when there is no policy rationale for continued public ownership. Plans for privatisation are set out in the entities' plans which are managed by the privatisation agencies, including cantonal ones. Despite recurring initiatives and significant progress in one entity, similar attempts have been less successful in the other entity. The *Federation* entity has taken steps to put its telecom sector on a path to sustainability. A report comprising the commercial, financial and technical due diligence of BH Telecom and HT Eronet has provided the Government of the *Federation* entity in autumn 2018 with recommendations on possible scenarios for the future development of the telecom operators. Privatisation of utilities is ongoing in the *Republika Srpska* entity and has taken place in some cantons. The *Republika Srpska* entity is also restructuring its railways. The privatisation process will need to be transparent (including parliamentary oversight) and proceeds to be prudently used. Major obstacles to privatisation are legal uncertainty, corruption and the unfavourable business environment.

Related to this key challenge, the ERP does not provide a thorough analysis nor any country wide measure. The existing references are limited to the need to restructure some public companies in the transport and energy sector. A few activities along these lines were included in the measures related to energy and transport market reforms. One measure, focusing on health care reform in the *Republika Srpska* entity, also includes the definition of models for the settlement of arrears. Finally, this entity also refers to reducing the share of public expenditure in public administration through the establishment of a register of employees and increasing efficiency. The ERP could have referred to relevant activities planned in the adopted socio-economic reform package. These include creating publicly available and harmonised registers of public companies, enhancing supervisory and management and appointment procedures and analysis of restructuring models for the two telecom companies.

Overall, a more fundamental reform of the SOE sector might increase GDP by 3% by year or € 127 per capita (IMF, 2019). The inclusion of SOE sector reform in the socio-economic reform package, adopted by entity and State level governments, is a welcome step in the right direction.

Box: **Monitoring performance in light of the European Pillar of Social Rights**

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion for the benefit of citizens in the EU. Since the 20 principles are essential for countries if they are to achieve fair and well-functioning labour markets and welfare systems, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes an increased focus on employment and social reforms through greater monitoring of relevant policies (EC, 2018). The Western Balkans Ministers' Declaration on improving social policy in the Western Balkans (6 November 2018) confirms that they will use the Pillar to guide the aligning of their labour markets and welfare systems with those of the EU.

Bosnia and Herzegovina performs weaker relative to the EU-28 average in most of the principles of the European Pillar of Social Rights, according to available indicators of the Social Scoreboard[8]. The employment rate remains very low, particularly for women and young people. A high 77.3% of unemployed people were long-term unemployed in 2019. The job creation is localised and the low mobility of workers limits the allocation of labour resources to emerging needs. The gender employment gap (people aged 20-64), still at 23.7 pps in 2018, was twice as high as the gap in the EU-28 (11.5 pps) and has only showed a slight decrease of 0.7 pps since 2016. This gap is exacerbated by the low availability of elderly care and early childhood education and care.

Education continues to be of low quality, and the country suffers from a continuing skills mismatch. There has been little change in levels of educational attainment in recent years. This indicates slow structural change in both the labour market and the education system. It is positive that the share of early school leavers is very low at 5.4% in 2018, which is half of the EU average (10.5%). However, there is a large share of low-skilled people in the population. Upskilling strategies to increase the skill levels of the workforce are not sufficiently developed to accompany a gradual move of the economy towards a structure that requires a more skilled workforce.

BiH		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Better than EU average, deteriorating
	Gender employment gap	Worse than EU, improving
	Income quintile ratio (S80/S20)	N/A
	At risk of poverty or social exclusion (in %)	Worse than EU average (proxy), trend N/A
	Youth NEET (% of total population aged 15-24)	Worse than EU average, improving
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU average, improving
	Unemployment rate (% of population aged 15-64)	Worse than EU average, improving
	GDHI per capita growth	N/A
Social protection and inclusion	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU average (proxy), trend N/A
	Children aged less than 3 years in formal childcare	Worse than EU average, trend N/A
	Self-reported unmet need for medical care	N/A
	Individuals' level of digital skills	N/A

Social transfers have a limited impact on reducing poverty. Means-tested social assistance does not cover basic living needs. Other non-contributory social benefits insufficiently target low income and vulnerable segments of the population. It is estimated that the reduction of the at-risk-of-poverty rate by social transfers is 9.16%, significantly lower than the EU average (33.2% in 2018). Participation in early childhood education and care is significantly lower than in the EU and elsewhere in the region. It stands at only around 5% for children under 3. Most children enrolled in early childhood education and care come from urban families where both parents are employed, while children from rural areas or whose parents are unemployed almost rarely attend.

Further efforts are needed to collect timely and reliable data. The availability of indicators is limited, particularly in the area of social protection and inclusion. First Statistics on Income and Living Conditions were planned for 2019, but were not published. A lack of data also holds back the development of evidence-based policies and measures. As of 2020, the Labour Force Survey (LFS) will be published on a quarterly basis.

[8] The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The 12 indicators are also compared for the Western Balkans and Turkey, with one small adjustment for the age bracket for the unemployment rate (reducing the upper age bracket to 64 instead of 74 years) due to data availability. The assessment includes the country's performance in relation to the EU-28 average (performing worse/better/around the EU-28 average, generally 2018 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). Data from 2016-2018 are used and can be found in Annex A.

4. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2019

Overall: Limited implementation (30.3%)[9]	
2019 policy guidance	**Summary assessment**
PG 1: Strengthen the ERP's medium-term macro-fiscal planning framework through enhancing the analytical and forecasting capacities at all levels with a view to presenting a consistent and consolidated country-wide analysis and policy document. Enhance public-sector transparency by completing the recording of public sector employment, by addressing payment arrears and by publishing the trend and origins of public guarantees. In order to better support policy analysis, improve the provision of timely, exhaustive and in particular country-wide statistics on government finance, national accounts and labour market statistics, in particular by implementing a quarterly labour force survey.	There was **limited implementation** of PG 1: 1) **Limited implementation**: There has been some training, e.g. provided by the IMF and better cooperation between the Central Bank and the ERP coordinating body, the Directorate for Economic Planning, which has enhanced the country's capacities. But due to insufficient cooperation between key stakeholders there has been no significant improvement in the quality of the overall policy document. 2) **No implementation.** 3) **Limited implementation:** The Central Bank and the statistical agencies undertook efforts to improve the reporting of general government data and to submit fiscal notifications to Eurostat. Furthermore, the implementation of a quarterly labour force survey has started.
PG 2: Increase public investment, based on an investment strategy and actual implementation. Contain spending on public sector wages, based on a complete recording of public sector employment. Improve the targeting of social transfers, based on needs.	There was **limited implementation** of PG 2: 1) **No implementation**: Based on available data, public investment appears not to have been increased. 2) **Limited implementation**: Overall, public administration wages have remained below average wage growth, although for some groups (police and security) wages increases were substantial. 3) **No implementation.**
PG 3: Safeguard the integrity of the currency board arrangement and the independence of the Central Bank in order to maintain monetary stability. Enhance the analytical and forecasting capacity of the central bank, and develop its toolkit by	There was **partial implementation** of PG 3: 1) **Substantial implementation:** The Central Bank continued to ensure the full convertibility of the domestic currency by backing net monetary liabilities with foreign exchange reserves. Nevertheless, the removal of two members of the Governing Board in 2019 without due process casts shadows on the independence of the Central Bank. 2) **Partial implementation:** The Central Bank has successfully conducted two inflation expectations

[9] For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2017 Economic Reform Programmes available at https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en.

establishing a bank lending survey and by developing a macroprudential framework. Address remaining obstacles hindering the resolution of non-performing loans, and closely monitor the emergence of potential financial stability risks related to the consumer loan segment, deploying appropriate micro- and macroprudential policy tools if needed. Strengthen the bank resolution framework by adopting the law on deposit insurance.	surveys (in March and October 2019), and published the results in November 2019. The CBBH is preparing to launch a bank lending survey in March 2020 with the intention to publish it shortly thereafter. There is no centralised macroprudential framework in place. 3) **Partial implementation:** The framework of recovering and resolving NPLs needs to be improved by facilitating out-of-court restructurings and amending the tax treatment of NPL sales to specialised companies. Prudential measures have been deployed for some small banks facing profitability issues. The bank lending survey has been done and the Central Banks's macroprudential analysis has been strengthened. 4) **Limited implementation:** Implementing laws have been prepared but not yet adopted. Some monitoring of financial stability risks might have taken place.
PG 4: As a step to improve governance and transparency, create publicly available registers of public enterprises providing up to date information on ownership, employees and comprehensive financial statements, including the companies' debt situation. And adopt and implement a credible and relevant countrywide public financial management strategic framework with a performance based monitoring and reporting system. Advance restructuring and/or privatisation of public enterprises and improve their efficiency and corporate governance, including the two telecom companies in the *Federation* entity.	There was **limited implementation** of PG 4: 1) **Limited implementation:** This activity has been included in the socio-economic reform package adopted by the entity and state level governments. The *Federation* entity published a list of public companies. The existing registry in the *Republika Srpska* entity has not been updated since nearly a decade. Hence, there are shortcomings in the comprehensiveness, quality and accessibility of these databases. 2) **No implementation**: No countrywide strategic framework for public financial management has been adopted. The adoption of the public financial management strategy by the *Republika Srpska* entity is still pending, whereas all other levels are revising the current strategies. Work in drafting an "indicator passport" as a basis for a monitoring system continued. 3) **Limited implementation**: The due diligence report was completed for the two telecom companies of the *Federation* entity and the Government of the *Federation* entity has instructed the two companies to follow the conclusions and recommendations of the due diligence. A related reference can also be found in the socio-economic reform package adopted. Nevertheless, no additional specific efforts have been made for the restructuring and/or privatisation of these companies. Very limited progress has been made with restructuring and/or privatization of other public companies. .
PG 5: With a view to creating a single economic space, simplify and harmonise business registration, licensing and permit procedures between entities.	There was **partial implementation** of PG 5: 1) **Partial implementation:** This activity has been included in the socio-economic reform package adopted by the entity and state level governments. To improve access to information on requirements for setting and running a business, the *Republika*

	Srpska entity established a web portal as an electronic single contact point encompassing administrative procedures and formalities for starting and performing business activities. Furthermore, it created the legal basis for the electronic registration of companies, whose implementation is planned to start in the near future (testing is ongoing). A set of laws setting up a one-stop shop system in the *Federation* entity is pending adoption. Overall, the *Republika Srpska* entity is more advanced, including digitalisation of business registers at municipal courts.
Fully implement the law on electronic signature.	2) **Partial implementation**: the BiH Ministry of Communications and Transport registered the Slovenian Halcom Company as the first qualified trust service provider for the issuance of qualified electronic certificates (e-signature). The accreditation process of other bodies, including the Indirect Tax Authority is still pending. Further efforts are required to eliminate administrative burdens in order to ensure interoperability and a harmonised countrywide system of e-signature. Legislation on electronic identification and trust services for electronic transactions compliant with the relevant EU *acquis* has still not been adopted.
With a view to reducing para-fiscal fees and charges, put legislation in place giving legal force to the developed registers of fees and charges.	3) **Limited implementation**: This activity was included in the socio-economic reform package adopted by the entity and state level governments. The *Federation* entity's legislation on the existing register of fees and charges has not yet been adopted by the Parliament. In the *Republika Srpska* entity such legislation has been in place since 2017 and the Register was published on a governmental website end 2019. In addition and in view of reducing the fees and charges, this entity has embarked on a related analysis of the economic burden.
PG 6: Undertake a review of secondary and higher education enrolment policies in order to improve their links to the current and prospective needs of the domestic labour market.	There was **partial implementation** of PG 6: 1) **Limited implementation:** This recommendation has not been followed up (although it does feature in plans by *Republika Srpska* for the period 2020-2022). Nonetheless, the issue remains important for all entities due to the extent of youth unemployment (39%) and the delay of young people entering the labour market. Updating the enrolment policies to improve the labour market relevance of programmes in both high schools and universities is critical. Recent reforms addressed mostly the labour market needs through the development of national qualifications framework for all levels of education. However, enrolment policies are inefficient in channelling students to fields of study which are on demand on the domestic labour market.
Reduce the tax wedge, especially for low-income workers, and disincentives to work in order to	2) **Partial implementation:** The *Republika Srpska* entity has adopted laws which foresee the increase

incentivise formal employment.	of the tax-free threshold (from KM 200 to KM 500) and tax incentives for the wages of two groups. In the first group are employers whose employee has a salary of KM 450 to KM 550 and for each wage increase will be paid back 30% of contributions, while employers whose worker has a salary of KM 1,000 and receives a salary increase of at least KM 100 from July 2019 will be returned 70% of the contributions paid for this increase. In the Federation entity, the legislative proposals to reduce the tax wedge and social contributions are still pending before the Parliament.
Disburden public employment services from administrative duties related to health insurance for registered unemployed in order to free their capacities for more active support to jobseekers.	3) **Partial implementation:** The *Republika Srpska* entity's Law on Health Insurance, which entered into force in January 2020, implements the delinking of public employment services from the related health insurance duties. The implementation is in the early phases and the effects remain to be seen. The Federation entity and its cantons have not yet provided the necessary legislative frameworks for separating health insurance duties from the employment services.

5. ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE 2019-2021ERP

Most measures presented in the ERP are not countrywide and only include entity-specific activities in a fragmented way. There is often insufficient indication as to which level of government or institution the activities are related. The planned processes and expected outcomes of measures are often not specific. In many cases, the activities planned do not appear to be in line with, or address, the main obstacles identified for the various sectors. There are only seven reform measures in the ERP that have the potential to cover the country as a whole and only these have been assessed.

Business environment

The business environment is adversely affected by a number of factors: political instability, the weak rule of law, a fragmented, overly complex and non-harmonised regulatory framework resulting in high compliance costs, a large and inefficient public sector, widespread informality and corruption as well as a significant tax burden on labour. The fragmented regulatory and institutional framework creates obstacles to the free movement of goods and services, preventing the establishment of a single economic area. All these factors restrict private sector development. Bosnia and Herzegovina ranked 90th among 190 countries in the World Bank's *Doing Business 2020* report, dropping one place from the year before as no major reforms took place. While it ranked relatively well on trading across borders and resolving insolvency (27th and 37th, respectively), the areas in need of a major push are starting a business (184th), dealing with construction permits (173rd) and paying taxes (141st).While bank lending to the private sector has gained pace and the loan procedure was shortened by 4 days (RCC, 2019), access to finance continues to be a problem, particularly for micro businesses and small companies. Programmes linking domestic businesses with foreign investors should be improved. The entity and state governments adopted in October 2019 and January 2020 respectively a document outlining a socio-economic reform programme for the period 2019-2022. Among other issues, the package provides for measures to improve the business environment, to stimulate growth and competitiveness, and to de-politicise SOEs. Furthermore, in February 2020, Bosnia and Herzegovina committed to develop and implement a common action plan of socio-economic reforms in line with key short-term Socio-Economic recommendations derived from the Commission's Opinion, accompanying Analytical Report and the Joint Conclusions of the Economic and Financial Dialogue.

Informal economy

The widespread informal economy poses another burden on business in Bosnia and Herzegovina as the size of the informal economy has remained significant and underminined fair competition. Estimates (2014-2016) range between 25% to 35% of GDP (EFENDIC, 2018). Despite some limited progress in addressing the informal economy, such as improving the degree of registration in the labour market, the informal sector is still substantial, with informal employment estimated to account for nearly one third of total employment. Apart from low tax morality due to the presence of corruption inadequate tax policy and a fairly high income inequality in society, the different types of institutional failings appear to be an important factor fostering the informal economy and undeclared work. In a recent working paper, the IMF, using the "multiple indicator – multiple cause approach" to re-estimate the size of the informal economy, quantifes it at

34.4 % of GDP (2016). Policy recommendations to address the informal economy, also broadly relevant for Bosnia and Herzegovina, require a comprehensive package of reforms, including reducing regulatory and administrative burdens, promoting transparency and improving government effectiveness, as well as improving tax compliance, automating procedures, and promoting electronic payments (IMF, 2019). While recognising informal economy as an obstacle to competitiveness, the ERP diagnostic is weak and limited.

Measure 12: Reducing the informal economy

The measure to reduce the informal economy too narrowly focuses on a better control of recorded business transactions and the adoption of related legislation and bylaws. In addition, it is not always clear which level of government or institution is responsible for which activity. Result indicators and potential risks are poorly identified and insufficient. There is no proper analysis of the expected impact on competitiveness. The lack of a cost estimate and timeline for legislative changes and the impact on employment reflect a lack of real commitment to this measure for it to have any significant impact on the competitiveness of the economy as a whole.

Research, development and innovation

Bosnia and Herzegovina still has limited capacity for technological absorption and for research, development and innovation. This is mainly due to its fragmented national research landscape. The institutional set-up for innovation policy is highly decentralised. The entity level deals with research and development (R&D) and innovation policy, and coordination is poor. The legislative framework regulating science and research development, based on a 2009 framework law, is fragmented and needs to be improved throughout the country. Key obstacles include low investment in R&D; a very low number of researchers per head of population; very few innovation-related policies or strategies and very limited cooperation between academia and the private sector. The Global Competitiveness Report ranks Bosnia's innovation capability (including research and development) 117th out of 141 countries. The country is estimated to spend around 0.2% of GDP on research and development. The revised strategy for scientific development sets the goal of having 0.8% of GDP investment in research and development by 2022, which would still be far from the EU´s 2020 average of 2%. The lack of funding for R&D limits the potential for innovation and promotes brain drain. The country's research capacities are very limited with a total of 1 422 (FTE) researchers in 2016, while the trend of a brain drain has been observed, most notably in the health and medical sector, with no systematic measures to address the issue. A smart specialisation strategy is part of Bosnia and Herzegovina's commitments under the regional economic area multi-annual action plan (REA MAP) but its development has still not started. The process by which scientific knowledge is fed into policy-making is rather weak, not comprehensive and not inclusive. There needs to be a more systemic collaboration and interaction between 'triple helix' actors - academia, industry and governments According to the 2019 Balkan Barometer, technological innovation and capabilities score is among the lowest in the region (RCC, 2019). The country's innovation system is also characterised by a significant brain drain. The ERP recognises that the system of managing research, science and innovation is ineffective. The need to strengthen innovation, develop institutional capacities and identifies the need to increase financing of science, technology and innovation. However, in terms of concrete activities, the ERP appears to only mention the *Republika Srpska* entity.

Digital economy

The country is still at a very low level of digitalisation[10], performing well below the average of the economies of south east Europe (SEE) when it comes to using and accessing information communication technologies. The Global Competitiveness Report (2019 edition) ranks Bosnia and Herzegovina 80th out of 140 countries for adopting ICT. Legislation to liberalise the telecommunications and electronic media sector is not yet in place. The country has introduced the 4G network but does not have a national broadband strategy. There are 67 internet providers and 3,080,859 internet users (87.25% penetration rate), with a penetration rate of 20.05% for broadband internet. There is no institution promoting e-commerce. No financial support tools have been developed to accelerate adoption of ICT and digitial services. The availability of a government digital service to complete administrative procedures is among the lowest in the region (RCC, 2019). The fragmentation of responsibilities among different levels of authorities has a direct impact on e-government services. Creating a single portal and expanding digital services will allow enterprises to complete processes online (OECD, 2019). This would make it possible to reduce the cost and number of required procedures, while diminishing the opportunities for corruption. The country is currently focusing on implementing e-signature; adopting a broadband access strategy; adopting a strategy to develop the information society; and adopting a law on electronic communications and electronic media. The ERP does not provide for a thorough analysis of this sector and is limited to general statements, including the need to enhance the ICT sector by aligning the regulatory framework with EU standards.

Measure 13: Improving the communication and information society and aligning of the regulatory framework with EU standards

This rolled over measure is indeed very relevant for economic growth and increased productivity. Various activities planned under this measure, such as adopting the broadband internet access strategy and the Law on electronic communication and electronic media are consistent with commitments undertaken under the multiannual action plan on the regional economic area and are overdue. Moreover, there is the potential to increase the economy's overall competitiveness with the planned strategy for developing the information society, the implementation of an e-government strategy and the adoption of planned legislation on electronic identification and trust services for electronic transactions aiming at a single supervisory body for trust services for the whole country. The lack of progress in implementing this measure is compounded by an insufficient lack of indications of budgetary appropriations and an insufficient indication of result indicators. The measure would benefit from a clearer attribution of responsibilities of various governmental levels or institutions.

Bosnia and Herzegovina is encouraged to implement all the aspects of the regional economic area multiannual action plan (REA MAP). The REA MAP is based on EU standards and will facilitate Bosnia and Herzegovina's integration in regional and European value chains and will also help increase the economy's attractiveness for foreign direct investment in tradable sectors, notably by extending the market size. Further connectivity with neighbouring countries in transport and energy will strengthen

[10] 1.6 out of 5 according to the OECD Competitiveness Outlook (2018).

Bosnia and Herzegovina's access to, and integration in, the regional market. The creation of a regional digital area and more integrated labour markets with neighbouring economies will offer new possibilities for the country's young people, which is important in light of the high youth unemployment.

Trade performance

Trade integration with the EU increased markedly, but trade with neighbouring non-EU countries was also up. Exports to the EU-28 accounted for 73% of total exports in 2019, which is slightly higher than the previous year. Exports to countries of the Central European Free Trade Agreement (CEFTA) rose slightly during 2019, by about ½ pp to 16.6% of total exports, as increases in exports to some CEFTA countries, such as Serbia, largely compensated for the sharp drop in exports to Kosovo resulting from the hike in tariffs. The openness to trade has increased over the last few years, with a rise in the share of total exports and imports in GDP from about 88% in 2014 to nearly 95% in 2019. However, given the country's relatively small economic size, these ratios are still relatively low. The range of export commodities is not very sophisticated. While some further progress has been achieved in addressing non-tariff barriers to trade with the EU, such as an agreement on required sanitary and phytosanitary standards, overall compliance with these requirements remains a problem. There is a need to foster mutual recognition of (i) certificates, (ii) testing facilities, (iii) risk management systems and (iv) pre-arrival processing of documents. There is also a need to make progress in implementing the customs policy law, which includes introducing the concept of authorised economic operators. Given the different specialisations for exporting products among Western Balkan countries, there are significant potential opportunities for increasing trade integration in the form of regional value chains that could link up with global value chains, especially in sectors such as food and car manufacturing (World Bank, 2018). Imports are expected to rise in response to the need for public investments. The recent slowdown of German industry, especially car production which reached 2009 levels (mostly driven by a fall in demand for diesel cars), poses a downside risk for economies with strong automotive and automotive parts industries, such as Bosnia and Herzegovina. (World Bank, 2019). Bosnia and Herzegovina is not a member of the World Trade Organisation (WTO), although membership negotiations have been at a very advanced stage already for some time. The ERP fails to provide any proper analysis of this sector. The measure provided for is only related to real estatate brokerage and covers only one entity.

Energy

The energy sector is hampered by political interference and a legislative framework that is fragmented, inconsistent and uneven between different levels of governance. This results in an unfavourable investment climate and insufficient regulatory independence. The *Republika Srpska* entity contests the state-level comptetence to develop policy, legislate and regulate in most of the energy sub-sectors, particularly for natural gas. This includes contesting the power to adopt legislation at state level or establish a state-level gas regulator. To create an internal energy market, an electricity and gas law at state level will need to be adopted in line with the requirements of the Energy Community. Subsequently, laws at entity level should be adopted and amended in order to ensure overall harmonisation and compliance with the EU third energy package. The lack of a legislative framework significantly impedes the country's effective integration in the regional energy markets. It also acts as an obstacle to further

reforms and economic development. Major energy sources for gross inland consumption were coal (61.2%), oil (36.5%) and hydro (10.2%[11]). In spite of legislative support by the Energy Community Secretariat, work has not yet started to adopt revised renewable energy laws that include a market-based approach for granting support (ECS, 2019). As for energy efficiency, increased investments will help to create new jobs and reduce harmful air emissions[12]. The countrywide strategic framework for energy identifies planned new investments in electricity generation from domestic resources, including renewables[13], but with a clear focus on coal. In March 2019, the EU Energy Community opened an infringement procedure against Bosnia and Herzegovina over State aid to the Tuzla 7 coal power plant. The new facility (with other planned units) would make Bosnia and Herzegovina even more reliant on highly polluting lignite-based power generation, result in expensive stranded assets at a later date (EBRD, 2019). It is important that investments in energy infrastructure, including thermal and hydro power plants, be made in compliance with Bosnia and Herzegovina's obligations under the Stabilisation and Association Agreement and the Energy Community Treaty. These include, in particular, EU standards on public procurement, State aid and the environmental impact assessment. The ERP partly recognises some of these challenges, particularly the requirement to align the legislative framework for gas and electricity with the third energy package, which still needs to be fulfilled.

Measure 1: Energy and gas market development

The measure is consistent with Bosnia and Herzegovina's commitments under the Energy Community Treaty and the Connectivity agenda, both of which aim at gradually integrating Bosnia and Herzegovina into European energy markets. It is also a priority of the country's framework energy strategy. The measure is relevant to the development and functioning of an internal energy market**,** unbundling the transmission system operator and setting up organised markets, i.e. power exchange or market coupling. However, bearing in mind in particular the continued politically motivated delays, the measure is inconsistent and uneven. There is no clear reference that state-level legislation should then be followed by compliant entity legislation. For instance, the measure fails to indicate that the existing *Republika Srpska* entity Law on Gas will have to be amended and harmonised with the state-level legislation, once adopted. The planned activities suffer from the sector still being hampered by political interference and failure to allocate necessary resources. The measure does not provide clear and consolidated information for the country as a whole in terms of economic indicators, implications and effectiveness for achieving greater competitiveness.

[11] 2016 figures.
[12] Bosnia and Herzegovina may lose up to 20% of GDP due to air pollution (WHO).
[13] Electricity generated from renewable sources relative to gross electricity consumption dropped from 40.4% in 2016 to 27.5% in 2017 (latest figure available).

Transport

Transport infrastructure in Bosnia and Herzegovina is insufficiently developed[14] and structural adjustment is slow, impeding the country's growth potential and competitiveness. The country faces challenges due to: (i) large-scale damage from the war; (ii) inadequate maintenance of infrastructure; (iii) changes to the institutional set-up; (iv) insufficient funding despite the need for substantial investment and an economy that is not sufficiently developed to generate the required financing; and (v) the consequences of major flooding in 2014. The necessary investment is delayed by the absence of a single or harmonised legal and regulatory framework, insufficient administrative capacities, poor implementation and coordination, inadequte cooperation between government levels and delays in securing agreed external financing. The highway network is limited (172 km in 2017), making it more difficult for companies to export, and increasing their costs and transport time. The legislative framework on concessions and public-private partnerships remains highly fragmented. There has been no progress in implementing measures to reform the country's connectivity, which would be a significant driver of economic growth (at a much lower cost)The transport sector is dominated by poorly managed and often inefficient SOEs which exercise monopolies in roads, railways and airports. The entity railway companies are classified at very high risk. The railway company of the *Republika Srpska* entity is undergoing operational and financial restructuring with support from a World Bank programme. The risk score for the railway company of the *Federation* entity suggests that financial and operational restructuring may also be warranted to reduce financial risks for the *Federation* entity (IMF, 2019). Bosnia and Herzegovina has to gradually open its railway market, which is hampered by unsafe, outdated and unreliable railway infrastructures on at least half of the core railway network and practically on most railway sections outside this network. Two railway companies of the entities need to complete the process of separating infrastructure management from transport services to ensure their full independence. Competitiveness is affected by overemployment in the main rail transport operators. Economic cost of road crashes and the environmental costs of transport activity are very high (OECD, 2018). To some extent, the ERP recognises the main challenges and refers, among other issues, to underinvestment in railway and road infrastructure, high number of road accidents and the need to restructure public railway companies.

Measure 3: Development and improvement of transport infrastructure

The measure lacks a strategic vision and a structured approach to sector reforms, presenting activities in a fragmented and sometimes repetitive way and sometimes referring to micro-interventions. Various relevant issues related to a more countrywide approach have still not been addressed, such as the need to establish a national system for the continuous collection of road crash data, improved cooperation and coordination between government levels and the related need to overcome delays in securing agreed external financing. In general, activities are presented in an asymmetric manner. For instance, activities related to the financial and operational restructuring of public railway companies and the need to complete the process of separating infrastructure management from railway undertaking functions are incomplete and incoherent as they have only been

[14] The 2019 Global Competitiveness Report ranks Bosnia and Herzegovina's quality of road infrastructure and efficiency of air transport services 121st (out of 141 countries).

mentioned in the case of one entity while related activities would have been relevant for both entities. Equally, in terms of investment programmes to address infrastructure deficiencies, reference is only made to one entity without clear costing. Overall, the measure is not sufficient to have a significant impact on the economy as a whole.

Agriculture

Bosnia and Herzegovina faces many obstacles to increasing agricultural productivity and opportunities for its agriculture. These obstacles include low overall investment and administrative capacities, land fragmentation, low productivity, and outdated facilities for manufacturing and processing. Forests are underexploited, partly following a ruling by the Constitutional Court annulling the entity Law on Forestry, and the forestry sector in the *Federation* entity is not duly regulated. Small farms and plot fragmentation predominate in Bosnia and Herzegovina's agriculture. In 2016, the country had 90,092 farms whose size averaged 2.96 hectares. Due to the structure of farms, there is little specialised agricultural production. Agriculture, forestry and fisheries continue to play a significant role in economic growth, job creation and social stability. These sectors account for 7% of gross value added (2018) and 15.7% of employment (2018), although an estimated 60% of Bosnia and Herzegovina's population live in rural areas (UNDP), which is very high compared to the OECD average of 20%. As the last agricultural census was conducted in 1960, the absence of up-to-date data on agriculture is a stumbling block to policy making in this sector. The largest share of support for agriculture and rural development (88.7% in 2017) is through direct production support measures. Support measures are not harmonised nor implemented at an even pace across the country. They are not effective enough to increase the sector productivity and competitiveness and direct payments should be gradually brought into line with EU rules, decoupling direct aid payments from production. The *Republika Srpska* entity contests certain state-level competences and legislation relating to food safety and veterinary and phytosanitary issues. For this reason, no further alignment of the state-level legislation with the EU *acquis* has been achieved in recent years. The EU is Bosnia and Herzegovina's key trading partner for agricultural goods. In the area of general food safety, food safety rules and specific rules for feed, Bosnia and Herzegovina increased its export of a number of commodities to the EU by complying with some EU rules and requirements (e.g. industrial eggs as well as poultry meat and poultry meat products). Before it can export other categories of meat, the country first needs to carry out complex preparatory activities. The country has adopted a strategic plan for rural development for 2018–2021 which has the potential to create more synergies between food safety policy, veterinary policy, phytosanitary policy, agricultural policy and rural development policy; this is necessary for the country's overall sustainable economic growth. However, the first implementation report remains to be completed. The ERP recognises the challenge that a lack of harmonised policies and standards in the country poses for this sector, resulting in highly decentralised and fragmented agricultural production, limited economies of scale and therefore limited growth in the sector. The document also rightly stresses that such an approach also prevents an agreement to comply with complex requirements in view of IPARD assistance and more generally refers to lack of funding and investment.

Measure 4: Improve the competitiveness of agriculture, forestry and water management

The measure has mostly been rolled over. It is relevant and has the potential to improve agricultural productivity and increase exports of a number of commodities to the EU. Among other aspects, the measure includes setting up administrative structures for the common agricultural policy, which include a paying agency, elements of an integrated administration and control system, a land parcel identification system and a farm accountancy data network. There is some welcome reference to starting alignment of direct payments with EU rules by decoupling these payments from production. The plan to establish relevant registers could help to develop the necessary farm advisory services. The envisaged adoption of the long delayed state-level regulatory framework on food and veterinary medicine can increase competitiveness by providing for food safety legislation that is more harmonised with the EU *acquis* as well as across the county. However, and as largely recognised by the ERP, the measure appears too ambitious and lacks a structured approach to reforms, given the still prevailing issues related to coordination of this sector, the already accumulated long delays, the high number of activities planned and the sometimes not harmonised presentation of activities (e.g. in terms of a new forestry information system or a water information system). A post-2021 strategy for agricultural and rural development, included under this measure, needs to be prepared in this context and should be coordinated with an industrial/manufacturing strategy regarding food processing and related machinery. There is insufficient information on timelines and budgeting.

Industry

The industrial sector still suffers from the absence of a single economic area. Industry accounted for 23% of GDP in 2018, remaining largely unchanged over the past 5 years and the sector was the main contributor to the country´s exports over that period. Manufacturing accounts for over 60% of industrial production. Industry´s share of employment stands at 23.5% (2018). Bosnia and Herzegovina does not have a unified approach to enterprise and industrial policy, as this is an exclusive competence of the entities, the Brčko District and the cantons in the *Federation* entity. There is no state-level body promoting consistency between industrial strategies and other policies affecting industrial competitiveness. The fragmented institutional framework is not conducive to business creation, investment, entrepreneurship, innovation and the promotion of SMEs. The ERP fails to provide a specific diagnosis of this sector. No reform measure is envisaged in the ERP in this area. Addressing the issues of key challenge #2 is critical and the implementation of the ERP measures on business environment, energy, transport and innovation are crucial for industrial development.

Services

The service sector, including public administration, health and education, is the largest in terms of employment and value generation, accounting for nearly two-thirds of the gross value added (65.3% in 2018). During 2019, most new jobs were created in services and most of the active labour force was employed in this sector (52.1% in 2018). Bosnia and Herzegovina usually achieves a surplus in the service balance, a reflection of the effect of providing construction services abroad, as well as substantial net inflows from tourism. Tourism has a significant growth potential with high growth in visitor rates, e.g. 12.1% in 2018 according to the BiH Agency for Statistics. According to 2016 figures, the direct contribution to GDP amounts to 2.5%, and the total contribution of tourism to GDP amounted to 9.2%. The direct contribution of tourism to employment amounted to 3%, and the total contribution of tourism to

employment amounted to10.6% (OECD, 2018). Services exports represent a significant part of the country's international trade. Nevertheless, the country could gain from a liberalisation of the services sector and by addressing the complex regulatory environment in provision of services even among entities. The ERP fails to provide a specific diagnostic of this sector. A reform measure related to tourism does not cover the whole country as it is only related to one entity.

Education and skills

Education continues to be of low quality, and the country suffers from a continuing skills mismatch. Bosnia and Herzegovina participated for the first time in PISA in 2018 and ranked among low performers at 62nd place out of 77 countries. These results unveil that every second student is functionally illiterate and cannot apply in practice the acquired knowledge. A countrywide dialogue promoting inter-institutional cooperation in education is not in place. This limits the cooperation among institutions and stakeholders, restricting opportunities for discussions on the effectiveness and accreditation of education institutions, policies and programmes. While the Conference of Ministers of Education did not manage to meet in 2019 waiting for the establishment of new governments at all levels, the Rectors' conference managed to meet seven times with five decisions approved. Enrolment policies are inefficient in channelling students to fields of study which are on demand on the labour market. There is a rigid allocation of resources to schools based on historical planning, including enrolment, as opposed to ensuring finance is prioritised and targeted at those schools/training programmes that prepare graduates in professions that are on demand on the labour market. There has been no comprehensive countrywide strategy for vocational education since 2015. Adult education remains weak at 1.8% compared to 10.9% in the EU-28 (2017 figures).

Employment and the labour market

This sector is analysed above in section 4 under key challenge #1.

Social protection and inclusion

Poverty estimates show that the country faces challenges. Household Budget Surveys (HBS) conducted since 2004 are the main reference point for poverty analysis in the absence of Statistics on Income and Living Conditions (SILC). Latest estimates made on HBS 2015 income data show an at-risk-of-poverty rate of around 27% when using measurement methods similar to those used in EU indicators. Only 9.16% of people living at risk of poverty are estimated (based on HBS 2015 data) to be lifted above the poverty line due to social transfers, which is in strong contrast with 33.2% of people in the EU-28 (2018). Unemployment benefits in 2018 were received by only a small share (2.8%) of those registered as unemployed at the public employment services, which was mainly due to a high amount of long-term unemployed and other eligibility issues. Access to health care is a challenge for a significant part of the population. According to Bosnia and Herzegovina's Agency for Statistics (2018), only two thirds of all households have easy or very easy access to primary health care services.

ANNEX A: OVERVIEW OF THE MAIN INDICATORS PER AREA/SECTOR OF THE ECONOMY

Area/Sector	2018	2017	2016	EU28 Average
Energy				
Energy imports dependency (net imports/consumption, %)	N/A	34.0%	31.5%	55.1% (2017)
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand euro GDP	N/A	458.03	473.40%	117.69
Share of renewable energy sources (RES) in final energy consumption (%)	N/A	N/A	N/A	17.98%
Transport				
Railway network density (meters of line per km^2 of land area)	N/A	20.0	N/A	49.9 (2016)
Motorisation rate (Passenger cars per 1000 inhabitants)	N/A	252	N/A	507 (2017)
Agriculture				
Share of gross value added (Agriculture, forestry and fishing)	7.0%	6.6%	7.5%	1.6%
Share of employment (Agriculture, Forestry and Fishing)	15.7%	16.2%	N/A	4.0%
Utilised agricultural area (% of total land area)	N/A	34.4%	N/A	40.0% (2017)
Industry				
Share of gross value added	23.0%	23.3%	22.6%	19.1%
Contribution to employment (% of total employment)	23.5%	22.7%	22.0%	17.3%
Services				
Share of gross value added	65.3%	65.4%	65.3%	73.8%
Contribution to employment (% of total employment)	52.1%	51.6%	50.8%	71.9%
Business environment				
Rank in WB Doing Business (Source: World Bank)	86	81	79	N/A
Rank in Global Competitiveness Index (Source: World Economic Forum)	91	103	111	N/A
Estimated share of informal economy in GDP (as % of GDP) (Source: IMF)	N/A	N/A	Up to 34.4%	
Research, development and innovation				
R&D intensity of GDP (R&D expenditure as % of GDP)	N/A	0.20%	0.24%	2,12%
R&D expenditure - EUR per inhabitant	N/A	N/A	N/A	656.5€
Digital economy				
Percentage of broadband	69%	N/A	N/A	86%

penetration (Mobile and fixed) [NB: households]				
Share of total population using internet [NB: population 16-74]	70%	N/A	N/A	85%
Trade				
Export of goods and services (as % of GDP)	41.4%	40.1%	35.6%	46.2%
Import of goods and services (as % of GDP)	56.9%	56.4%	52.3%	43.0%
Trade balance (as % of GDP)	-22.5%	-24.2%	-23.6%	
Education and skills				
Early leavers from education and training (% of population aged 18-24)	5.4%	5.1%	4.9%	10.5%
Youth NEET (% of population aged 15-24)	21.2%	24.3%	26.4%	10.5%
Formal child care - children aged less than 3 years (% of total)	N/A	N/A	N/A	35.1%
Individuals' level of digital skills (% of individuals aged 16-74 who have basic or above basic overall digital skills by sex)	N/A	N/A	N/A	57% (2017)
Employment				
Employment rate (% of population aged 20-64)	47.7%	46.6%	44.2%	73.2%
Unemployment rate (% of labour force aged 15-64)	18.4%	20.5%	25.4%	7.0%
Gender employment gap (Difference between the employment rates of men and women aged 20-64)	23.7%	23.0%	24.4%	11.6%
Social protection system				
% of population at risk of poverty or social exclusion	N/A	N/A	N/A	21.9%
Impact of social transfers (Other than pensions) on poverty reduction	N/A	N/A	N/A	33.2%
Self-reported unmet need for medical care (of people over 16)	N/A	N/A	N/A	2.0%
Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	N/A	N/A	N/A	5.17

Sources: EUROSTAT and Agency for Statistics of Bosnia and Herzegovina, unless otherwise indicated.

ANNEX B: Progress with structural reform measures from the 2019-2021 ERP

Reporting on the implementation of the structural reform measures of the 2019-2021 ERP did not follow the guidance note: this reporting is inadequate, inconsistent and partly incomplete. It also focuses mostly on non countrywide measures and only partially reflects the current state of play. In many places, the reporting on the stage of implementation is overstated. There is limited reporting at state level. Overall, progress in implementing structural reforms has not advanced much, also due to the long political stalemate after the October 2018 general elections.

ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Council of Ministers adopted the 2020-2022 ERP on 30 January 2020. It was submitted to the Commission on 31 January. The document still falls short of being comprehensive and internally consistent and lacks an overall strategic vision. The readability of the document remains to be further improved. Insufficient time has been left to finalise the ERP as some contributions were submitted late. Bosnia and Herzegovina will need to strengthen its coordination capacity on economic policy and to ensure consistent political support, high visibility and coherence of the ERP.

Inter-ministerial coordination

The preparation of the ERP was centrally coordinated by the Directorate for Economic Planning (DEP). Contributions to the ERP were prepared and endorsed at entity level. No single countrywide programme was presented.

Stakeholder consultation

As last contributions from entities to the DEP were only received a few days prior to the adoption of the ERP, no public consultations were held (some consultations were, however, made at entity levels).

Macroeconomic framework

Recent macroeconomic performance is adequately described. The macroeconomic framework is sufficiently comprehensive. Consistency with other parts of the programme, particularly with the fiscal framework, but also with the external balance data provided in the annex is still limited. The reasoning behind the chosen policy approach and the links to the overarching policy strategy are not sufficiently elaborated.

Fiscal framework

The programme continues to lack a consistent, complete and sufficiently detailed presentation of countrywide fiscal data both for the country's actual fiscal performance in 2019 and also for budgetary plans for 2020. This strongly impedes the analysis of countrywide fiscal developments. Public investment plans are not consistent with the macroeconomic framework. The fiscal section still remains largely silent on the links with structural reforms. The rationale and underlying measures of the chosen policy approach of significantly reducing the revenue and spending ratios are not sufficiently elaborated upon. The programme provides hardly any quantitative analysis of measures. The compilation and presentation of fiscal data is not yet in line with ESA 2010.

Structural reforms

Sections 5, 6 and 7 do not follow the programme requirements, which reflects the absence of proper coordination on country-wide challenges and reform priorities. In many cases, policy goals are vaguely formulated and are not supported by implementable measures and activities. Key result indicators are not always present and potential risks frequently indicate frequently political obstacles. Reporting on the implementation of the policy guidance is largely missing. Tables 10a, 10b and 11 do not follow the guidance note. Table 11 is inadequate, inconsistent and partly incomplete. More efforts are required to improve the ERP process, which means more senior policy makers also need to participate in its formulation. The identification of key obstacles often lacks clarity and consistency with the reform measures and activities.

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