Council of the European Union

Brussels, 12 April 2019
(OR. en)

8544/19

ECOFIN 414
UEM 124
COWEB 57

COVER NOTE

From:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	11 April 2019
To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union
No. Cion doc.:	SWD(2019) 167 final
Subject:	COMMISSION STAFF WORKING DOCUMENT ECONOMIC REFORM PROGRAMME OF BOSNIA AND HERZEGOVINA (2019-2021) COMMISSION ASSESSMENT

Delegations will find attached document SWD(2019) 167 final.

Encl.: SWD(2019) 167 final

EUROPEAN
COMMISSION

Brussels, 11.4.2019
SWD(2019) 167 final

COMMISSION STAFF WORKING DOCUMENT

ECONOMIC REFORM PROGRAMME

OF

BOSNIA AND HERZEGOVINA
(2019-2021)

COMMISSION ASSESSMENT

EN EN

Contents

1. EXECUTIVE SUMMARY

Economic activity is forecast to gain some momentum, with output growth accelerating rather modestly from 3.3 % in 2018 to 3.8 % in 2021. The main drivers of this are an inventory build-up and increased private consumption, thanks to rising employment and low inflation. Investment is forecast to increase after a weak performance in recent years. Overall, the ERP's baseline projection reflects the lack of government policies to lift the country's growth potential through stronger public and private investment. Key downside risks are a sharper-than-expected deterioration in the external environment, and a continuation in delays to implement reform measures. Upside risks in the form of stronger growth could materialise if the new government embarks on a more growth-supportive policy path, driven also by reforms related to the EU-accession process.

The fiscal framework forecasts increasing budgetary surpluses, based on significant expenditure-driven consolidation. Like in previous programmes, both revenues and expenditure are scheduled to fall substantially as a share of GDP. The already-low share of public investment is set to fall from its 2018 level. This is not in line with the country's needs. 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); or better targeting social transfers. Driven by fiscal surpluses and solid nominal output growth, public debt is forecast to fall from 33 % of GDP in 2018 to below 30 % in 2021.

The main challenges include the following:

- **Fiscal policy does not devote sufficient attention to improving the quality of public spending.** Public spending remains heavily biased towards public sector employment and redistribution through cash transfers, clearly neglecting medium-term needs in the areas of education and infrastructure.
- **The quality of short and medium-term fiscal planning still suffers from a weak statistical underpinning and a short-term orientation of policy making.** Limited administrative capacities and frequent political stalemates remain key constraints. Necessary reforms are often delayed by fragmented responsibilities and insufficient cooperation among the various stakeholders.
- **Bosnia and Herzegovina's competitiveness continues to be hampered by a multi-layered public administration and a fragmented economic space.** This is detrimental to the business environment. The fragmented administrative structure in Bosnia and Herzegovina puts an added burden on businesses through excessive regulation, taxes and local fees. Starting a business remains cumbersome. Country-wide strategies and solutions to help businesses are long overdue. This includes quality infrastructure; reforming public financial management; e-authentication; reducing para-fiscal fees; reforming insolvency procedures; policies for small and medium enterprises (SMEs) and reforming the construction permits process.
- **Oversized, non-transparent and inefficient state-owned enterprises (SOEs), have been running up considerable arrears in payments.** This leaves little room to increase growth-friendly public investment. The SOEs' lack of efficiency means that

significant state support is required for their survival. This causes great distortions and misallocation of production factors (labour, capital, land), and deters the private sector from investing.

- **Bosnia and Herzegovina suffers from very low labour force participation and high levels of unemployment.** Young people and skilled workers emigrate in large numbers. The level of informal employment is high. There is a high tax wedge on labour, particularly for low-wage earners, and other disincentives to formal work. Multi-layered social protection schemes are insufficiently targeted at those most in need; they are therefore ineffective in reducing poverty. Enrolment in pre-school education is particularly low, contributing to a lower employment rate of women. The education system is also not attuned to the needs of the labour market.

The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2018 has been implemented to a limited extent. Election related political gridlock for most of the year delayed further progress with necessary reforms. Limited progress has been achieved in improving the country's capacities for medium term fiscal planning and analysis. Also progress has remained limited in providing timely and reliable statistics. An energy framework strategy was adopted. However, there is still no legal framework in place that complies with the Energy Community Treaty. Some efforts were made to simplify business registration procedures through one-stop-shops and online registration. Mandatory electronic submission of VAT declaration was introduced on 1 January 2019. However, the Law on electronic signatures has not yet been fully implemented. No countrywide action has been taken with regard to reducing the tax wedge and disincentives to work. There was no real progress on better coordination between employment activation measures and social benefit schemes. No steps were taken to review enrolment policies in secondary and higher education.

The ERP identifies reform challenges that are partly in line with those identified by the Commission. Macroeconomic projections are largely plausible, with key assumptions strongly depending on the swift implementation of structural reforms. The fiscal framework is failing to shift towards a spending structure that does more to promote growth. The measures in the area of employment and social policies are relevant for addressing structural bottlenecks. However, there are many risks, including weak capacities and lack of priorities in practice, which put uncertainty on their effective implementation. More efforts should be placed on pre-school and higher education. More specific references should have been made to identify the fragmented and overly complex and non-harmonised regulatory environment as a significant obstacle to competitiveness and inclusive growth. Most measures presented in the ERP are not country-wide and only include entity-specific activities. Adopting a whole-of-government approach is a pre-requisite for addressing the challenges the country faces. Bosnia and Herzegovina should put in place a well-functioning coordination and consultation mechanism for the ERP process.

2. ECONOMIC OUTLOOK AND RISKS

The ERP forecasts a moderate acceleration of output growth in the coming years, relying largely on strong private consumption, a build-up of inventory, and a slight improvement in investment. The programme expects output growth to accelerate from 3.5 % in 2019 to 3.8 % in 2021. The main sources of growth are expected to be private consumption (benefiting from strong employment growth and low inflation), investment (reflecting an improved business environment), and a build-up of inventory. The expected annual increase in private consumption of 1.8 % is slightly above the country's five-year average, but this forecast is well supported by the expected increase in real disposable income. Private investment is expected to increase by 6.7 % per year on average, which is above the country's recent performance, but in line with the assumption of an improving business environment. However, during the programme period investment growth is projected to decelerate slightly, a projection that merited a more detailed explanation. Public consumption is expected to increase by some 0.2 % per year, reflecting commitments to contain public-sector wage spending. Inventories are forecast to increase, contributing nearly ½ percentage point to growth on average. This might reflect expectations of strengthening demand, but would have deserved a more detailed explanation in the text. Export growth is expected to decelerate somewhat, from 7.0 % in 2019 to 6.1 % in 2021, due to the expected slowdown in the main trade partners, in the EU, but also in non-EU countries, such as Turkey. With respect to imports, the programme forecasts a slight deceleration, which seems at odds with the faster pace of domestic demand and is not sufficiently explained in the programme. Economic output is expected to remain largely at its potential level throughout the programme, with a positive output gap of 0.3 % of GDP emerging in 2021.

Table 1:
Bosnia and Herzegovina - Macroeconomic developments

	2017	2018	2019	2020	2021
Real GDP (% change)	3.4	3.3	3.5	3.7	3.8
Contributions:					
- Final domestic demand	2.3	3.5	2.7	2.6	2.7
- Change in inventories	0.8	-0.1	0.2	0.4	0.6
- External balance of goods and services	0.3	-0.1	0.6	0.7	0.5
Employment (% change)	1.8	0.8	2.5	2.6	2.5
Unemployment rate (%)	20.5	18.4	17.4	16.4	15.5
GDP deflator (% change)	0.7	1.3	1.1	1.1	1.5
CPI inflation (%)	1.3	1.3	1.2	1.4	1.5
Current account balance (% of GDP)	-5.0	-5.0	-4.8	-4.6	-4.4
General government balance (% of GDP)	0.9	-0.7	0.0	0.4	0.8
Government gross debt (% of GDP)	33.9	32.9	32.1	31.1	28.9

Sources: Economic Reform Programme (ERP) 2019.

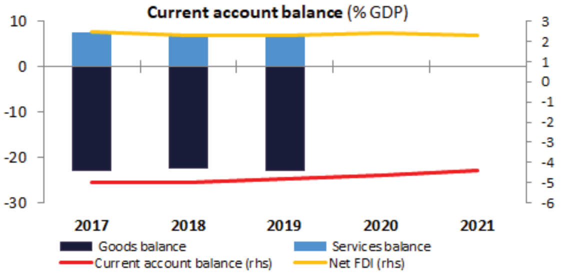
The programme contains an alternative scenario, which expects a potential external shock to strongly affect output growth. This scenario assumes lower export growth (1 pp. lower in 2019-2020 and 0.4 pps lower in 2021) as well as a decline (of unspecified magnitude) in foreign transfers. As a result, private consumption growth, the most affected domestic demand component, will be 0.2 pps lower than the baseline in 2019, and 0.5 pps lower than the baseline in 2021. Investment and imports are also expected to be negatively affected in this scenario, primarily in the first year. The overall effect in 2019-2021 is to reduce GDP growth by about 0.5 pps compared to the baseline scenario. This may appear quite a significant reduction, but it might be explained by the limited response of imports. If there was a larger import reaction, the negative impact on growth might be about half of the programme's calculations. The ERP does not assess domestic risks, such as lower private consumption and investment due to protracted political tensions, or lower employment growth due to continued emigration.

The programme's baseline macroeconomic scenario is plausible. This outlook is in line with the absence of a growth-supporting economic policy, and could change for the better or for the worse. For example, if there was a marked deterioration in the country's export performance, a continued political stalemate, or a significant slowdown in workers' remittances, output growth could be significantly lower. However, if the incoming government supported a more active, growth-supporting economic policy, output growth could also be markedly higher.

Inflation is forecast to remain under control. The ERP does not forecast significant domestic price pressures. This means that, in combination with expected low increases in international prices, there would be rather low increases in headline inflation of between 1.2 % and 1.5 % per year. High unemployment and moderate growth expectations are likely to contain domestic price pressures. However, if skilled workers continue to emigrate, skills shortages could become worse. This could lead to rising wage costs, which would erode the country's competitiveness and trigger domestic price pressures.

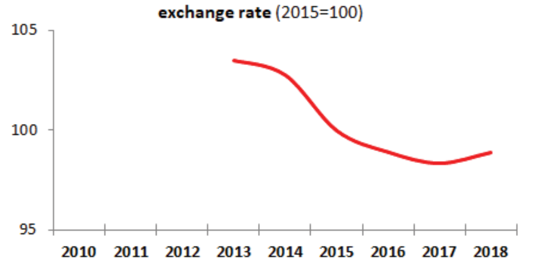
The external position and its financing are expected to improve. The current account deficit is expected to narrow slightly, from 4.8 % of GDP in 2019 to 4.4 % of GDP in 2021. This improvement is not in line with the assumption of accelerating domestic demand, and is largely explained by special factors, such as forecasts for stronger exports of electricity and services (in particular tourism). A key contribution to the financing of the current account deficit is expected to come from foreign direct investment (FDI). This FDI will come from planned projects in tourism and energy production, and planned privatisation projects (such as a possible sale of two telecoms companies). This stronger inflow of FDI would be a welcome change from previous years.

Graph 1: **Bosnia and Herzegovina - Evolution of the Current account balance** (% GDP)



Source: Economic Reform Programme (ERP) 2019.

Graph 2: **Bosnia and Herzegovina - Real effective exchange rate** (2015=100)



Source: Economic Reform Programme (ERP) 2019.

The country's financial sector has strengthened, benefiting from a significant inflow of foreign exchange in the form of workers' remittances. This inflow supported a strong increase in deposits in 2017 and 2018, 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 (NPLs) fell below 10 % at the end of 2018. 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 NPL 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 transfers. This inflow also boosted the country's stock of foreign exchange reserves. However, small and micro-sized enterprises still face difficulties in accessing credit.

Table 2:
Bosnia and Herzegovina - Financial sector indicators

	2014	2015	2016	2017	2018
Total assets of the banking system (EUR million)	12 299	12 756	13 615	14 639	15 200
Foreign ownership of banking system (%)	81.2	82.2	83.5	84.9	86.0
Credit growth	3.7	1.8	2.1	5.3	6.6
Deposit growth	8.4	6.2	7.7	10.4	11.3
Loan-to-deposit ratio	1.1	1.0	1.0	1.0	0.9
Financial soundness indicators					
- non-performing loans	15.4	14.1	12.8	11.3	9.6*
- net capital to risk-weighted assets	17.0	15.9	15.7	15.7	15.5*
- liquid assets to total assets	26.2	25.9	26.3	27.6	29.8*
- return on equity	5.4	2.0	7.3	10.2	11.1*
- forex loans to total loans (%)	68.0	67.1	62.6	60.1	57.7*

* Q3

Sources: National Central Bank, Macrobond, IMF.

3. Public finance

As in previous years, the programme lacks consistent and sufficiently detailed country-wide data on the country's actual fiscal performance in 2018 and on the 2019 budgets. The document presents a medium-term fiscal projection for 2019-2021. For 2019, the programme expects a balanced budget, after the deficit of 0.7 % in 2018. This balanced budget will be the result of a 2.4 % reduction in nominal spending combined with a slight decline in revenues of just 0.7 %. Data on the fiscal performance in 2018 are neither complete, nor aggregated at country level. Unfortunately, information on the budgets for 2019 for the general government, but also for the entities, is either lacking or incomplete. To some extent, this reflects the fact that the adoption of the 2019 budgets had not yet been completed when the programme was being drawn up.

Table 3:

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

	2017	2018	2019	2020	2021	Change: 2018-21
Revenues	37.8	39.2	37.3	36.0	34.9	-4.3
- Taxes and social security contributions	30.2	30.2	29.6	29.0	28.2	-2.0
- Other (residual)	7.6	9.1	7.6	7.0	6.7	-2.3
Expenditure	36.8	40.0	37.3	35.7	34.1	-5.8
- Primary expenditure	36.0	39.1	36.5	34.8	33.3	-5.8
of which:						
Gross fixed capital formation	1.8	4.2	2.8	2.1	2.0	-2.2
Consumption	16.6	17.5	16.6	15.9	15.2	-2.4
Transfers & subsidies	16.1	16.4	15.9	15.3	14.7	-1.7
Other (residual)	1.5	1.0	1.0	1.5	1.5	0.4
- Interest payments	0.8	0.9	0.8	0.9	0.8	0.0
Budget balance	0.9	-0.7	0.0	0.4	0.8	1.5
- Cyclically adjusted	0.8	-0.7	0.0	0.4	0.7	n.a.
Primary balance	1.8	0.1	0.8	1.2	1.6	1.5
- Cyclically adjusted	0.0	-1.6	-0.8	-0.5	-0.1	1.5
Gross debt level	33.9	32.9	32.1	31.1	28.9	-4.0

Sources: Economic Reform Programme (ERP) 2019.

The fiscal framework forecasts an increase in budget surpluses and a marked decline in expenditure and revenue ratios over the programme period. Such a decline would be unprecedented in the country's recent history. The fiscal balance is forecast to turn from a deficit of 0.7 % of GDP in 2018 to a surplus of 0.8 % of GDP in 2021. The switch to a surplus over the programme period is the result of: (i) a decline in the overall level of nominal spending by 0.5 % on average over the period; and (ii) an average increase in revenue of 0.9 % in nominal terms during the programme period. This increase in total revenue is relatively small, compared to an expected rise in nominal GDP of 4.9 % during the same period. This may reflect intentions to lower the tax burden on labour and to reduce direct taxes. However, the fiscal implications of tax reforms are not sufficiently addressed in the ERP. The significant drop in the revenue-to-GDP ratio of 4.3 pps over 2019-2021 is an important feature of the programme, although how this drop will be achieved is not properly discussed. On the spending side, freezing expenditure in some areas and cutting it in others will lead to a decline in the spending-to-GDP ratio of 5.8 pps.

On the structurally adjusted fiscal balance, the authorities expect the economy to register a small negative output gap in 2019 (-0.06 % of GDP). However, this gap will turn positive in 2021, reaching 0.33 % of GDP. The cyclically adjusted fiscal surplus will be slightly higher in 2021 (at 0.7 % of GDP compared to 0.4 % of GDP in 2018). Overall, the fiscal surpluses will dampen growth during the programme period, although this is in line with the programme's expectations for above-potential growth in 2021.

The ERP does not contain sufficient plans to improve the spending structure, and the fiscal programme lacks a pro-growth orientation. Spending on public consumption is projected to drop slightly in nominal terms in 2019 and 2020; it will return to 2018's nominal levels by 2021. Public investment is forecast to drop by half in nominal terms over the programme period, leading to a 2.2 pps reduction in GDP by 2021 compared to 2018. This planned reduction in investment is not in line with the Policy Guidance jointly adopted in the last 2 years. It is also in contrast to the projections in the macroeconomic part of the ERP, where public investment is forecast to increase. Spending on social transfers are forecast to increase by 1.5 % on average. Because of stronger nominal GDP growth, this increase would actually lead to a 1.4 pps drop in spending on social transfers as a share of GDP. The planned fiscal adjustment is frontloaded, with about half of the adjustment taking place in 2019. However, the largest contribution to this adjustment comes from a drop in public investment. Overall, as in previous years, the policy orientation of the medium-term fiscal framework does not comprehensively address the country's main policy challenges. These challenges include improving education and upgrading the country's infrastructure and capital endowment.

The quality of public finance and budget planning remains weak. The programme refers to the importance of improving the quality of public finance management, but fails to elaborate concrete reform projects and their expected fiscal impact. More information would have been welcome, particularly elaborating on challenges such as the need to reform the often overstaffed public sector, where planned registers of public employment appear to be still not completed and where there seems to be no medium-term strategy on how to address this issue. 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 how to improve the needs-based targeting of social spending, which appear to suffer from substantial inefficiencies. Compared to the previous programme, the revenue estimates are more elaborated. Medium-term budget planning remains weak and is impeded by fragmented responsibilities and insufficient cooperation across the country's entities.

Box: Debt dynamics

Table 4: Bosnia and Herzegovina
Composition of changes in the debt ratio (% of GDP)

	2017	2018	2019	2020	2021
Gross debt ratio [1]	**33.9**	**32.9**	**32.1**	**31.1**	**28.9**
Change in the ratio	-5.1	-1.0	-0.8	-1.0	-2.2
Contributions [2]:					
1. Primary balance	**-1.7**	**-0.1**	**-0.8**	**-1.2**	**-1.6**
2. "Snowball" effect	**-0.8**	**-0.7**	**-0.6**	**-0.6**	**-0.8**
Of which:					
Interest expenditure	0.8	0.9	0.8	0.9	0.8
Growth effect	-1.3	-1.1	-1.1	-1.1	-1.1
Inflation effect	-0.3	-0.4	-0.3	-0.4	-0.5
3. Stock-flow adjustment	**-2.6**	**-0.2**	**0.6**	**0.9**	**0.2**

[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) 2019, 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 offset to some extent by the costs of debt servicing, which increase the debt level by slightly less than 1 pp. of GDP per year. 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 0.6 % pps in 2019 and by 0.9 % pps GDP in 2020. 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 to the data provided by the central bank.

Public debt declined to less than 33 % of GDP in 2018, and is set to decline further, mainly driven by sizeable primary surpluses and growth in output. Public debt doubled after the 2008 financial crisis, reaching its peak in 2015 at about 42 % of GDP. By 2018, public debt had declined to some 33 % 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 2021. Despite this expected increase, the costs of debt servicing are likely to remain relatively low, at slightly less than 1 % of GDP. Unless there are significant changes in the international economy, this outlook of slightly increasing financing costs is plausible and consistent with previous programmes. There is a significant difference in the indebtedness of the country's two entities, with the Republika Srpska entity facing a significantly higher level of public indebtedness.

The main risk to the fiscal surplus targets for 2020 and 2021 is a possible slippage in planned spending constraints. The intended reduction in spending as a share of GDP appears quite ambitious. Unfortunately, the programme does not provide sufficient details on how those spending constraints will actually be implemented. On the revenue side, the programme assumptions are more conservative when compared to previous ERPs, but they also lack concrete details. A significant risk are substantial unrecorded fiscal imbalances, such as payment arrears, impeding the viability of private suppliers or negatively affecting the financial situation of social-security providers. A closure of unviable SOEs could also have significant budgetary implications. There are contingent liabilities in the form of guarantees for chronically non-viable SOEs, such as the railway company in the Federation, which by 2021 are expected to amount to some 3 % of GDP. The planned loan guarantee for the construction of coal-power plant could raise contingent liabilities by another 4 pps of GDP. Overall, the country's fiscal system is plagued by poor transparency and weak reporting standards. This greatly reduces the reliability of risk assessments based on officially recorded data. The achievement of the presented fiscal-surplus target is dependent on planned spending constraints, although the low revenue estimates provide a certain buffer against the non-achievement of savings targets.

The overall quality of public finances remains low. Comparing the planned spending structure for 2019-2021 with the 2018 budget points to a significant cut in overall spending. This cut in spending will affect not only general public services and social protection, but also health and education. 2018 was an election year, and spending plans for that year may therefore have been driven by short-term-oriented priorities. However, even taking this into account, the data for the whole programme period shows insufficient focus on the type of public spending that stimulates growth. It is true that the ERP contains some efforts to reduce activity in the informal economy. The programme also presents plans to decrease social-security contributions in order to reduce the disincentive to register in the formal sector. However, there seem to be no concrete plans to address inefficiencies in the social-security sector, such as the poor targeting of social transfers. It is critically important to address these inefficiencies to compensate for the lower revenues caused by reduced rates. More information would have been welcome on challenges such as the need to reform the often-overstaffed public sector. This challenge has not yet been fully addressed — planned registers of public employment appear still not to be completed, and there is no medium-term strategy to address this issue. A significant issue is the broad use of para-fiscal fees, such as excise taxes, 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.

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 1 pp. lower, and arrives at rather moderate results. These moderate results are based on the assumption that the impact on domestic demand (private consumption and investment) would remain very limited. Based on this scenario, the programme also finds only limited negative effects on tax revenues, amounting to slightly less than 0.2 pps of GDP at the end of the programme period. 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 a reduction in social-security contributions on the financial situation of the social-security system.

The country's budgetary framework suffers from institutional fragmentation, low reporting discipline 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 the Republika Srpska 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.

4. 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 indication of those weaknesses, and is not only a result of an insufficient function of the country's education system, but also points to a poor business environment as a result of a weak rule of law and an inadequate legal framework, consisting of overly numerous and complex market entry and exit procedures, which are further aggravated by the country's institutional and economic fragmentation. The main challenges in terms of boosting competitiveness and long-term and inclusive growth are hence (i) improving labour market integration, (ii) enhancing the business environment through the creation of a single economic space, (iii) facilitation of starting a business and (iv) making the public sector more efficient, in particular improving the performance, transparency and accountability of SOEs.

4.1. Key challenges

Key challenge #1: Improving labour market transition

Nearly half of the working age population is inactive, pointing to an acute need to develop policies fostering transitions into the labour market and employment. The labour force participation rate for 15-64 years old in Bosnia and Herzegovina is very low (54.2 % in 2018). It is 20 pps lower than the EU average and not showing any signs of improvement. Unemployment is very high (18.4 % in 2018) and capacities of employment offices to provide quality services to jobseekers are weak. The scope and targeting of active labour market policies are also weak. Very high unemployment among young people aged 15-24 (38.8 % in 2018), including university graduates, points to a problem in aligning the education and training system with the needs of the labour market and a weak business environment still significantly under-developed to generate employment. Overall, much of the workforce lacks the necessary skills to find work. New opportunities for job creation are also scarce and localised, while labour mobility within the country is low. A significant number of jobseekers, including university graduates, were mediated into employment abroad. Even more people, often skilled and already in employment found jobs abroad on their own. There are also significant disincentives to work. One such disincentive is the relatively generous non-means tested social benefits, in particular for war veteran categories. Another disincentive to hiring or formal work is high social security contribution rates that create a high tax wedge on low-wage earners. The share of informal employment in total employment is significant (around 30 %). Enrolment in early childhood education and care is particularly low. In addition to the low availability of elderly care this contributes to low employment levels of women who predominantly assume the role of carer.

Key challenge #2: Enhancing business environment through creation of a single economic space

The fragmented institutional set-up and the lack of proper cooperation and coordination among political stakeholders results in insufficient political ownership of reforms. It also results in a low speed in overcoming the poor and fragmented business environment characterised by complicated and lengthy procedures and significant red tape**.** Institutional and government barriers are a significant obstacle to conducting business. The financial and administrative burden on business is significant, with high payroll taxes and over 1600 administrative procedures at all levels. Regulations differ between the two sub-state entities and the Brčko district. Moreover, within the Federation of Bosnia and Herzegovina, regulations and procedures vary from canton to canton. Even when the relevant regulations and procedures are very similar, there are significant differences in their implementation. The complex legal and regulatory frameworks create opportunities for corruption.

Each governmental level (and within the Federation entity, each of the 10 cantons) has its own business laws, regulations and procedures. Market entry and exit regulations are decided upon at the lower levels of government. This leads to a large number of different rules and implementation methods. Insolvency is regulated at the entity level and there is no country-wide framework for insolvency. Although a new bankruptcy law is already in place in the Republika Srpska entity, the adoption of a more modern bankruptcy law has been delayed in the Federation of Bosnia and Herzegovina. Overall, the required procedures for entering or leaving the product market are still numerous and lengthy, creating a significant impediment to market entry and exit.

Furthermore, technical barriers to trade are still substantial. There is no countrywide quality infrastructure system. There is also no unified approach for deciding what national infrastructure is necessary and then building it (OECD, 2019). There is a clear need to draw up a countrywide strategy on quality infrastructure and implement a mechanism to co-ordinate between different levels of government. EU legislation is currently not being transposed or implemented in a uniform manner throughout the country. This ultimately leads to an inadequate level of harmonisation with the EU *acquis* and to inadequate harmonisation between the entities. As a result, SMEs 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. Given the limited resources of institutions in both entities, cooperation between them is important to further develop the quality infrastructure system and support SMEs in the country.

E-authentication is critical for building trust in e-commerce and in government e-signature services. However, e-authentication still has not been introduced because of the varying legal frameworks across the different administrative levels. Interoperability frameworks in IT systems allow different authentication schemes to interact and maintain high levels of trust. However, to have a harmonised, countrywide system, the country needs to address the issue of non-harmonised laws on electronic signature and lack of interoperability of e-signature schemes at various levels of the country. Ensuring data inter-operability through e-authentication would enable an increase in the number of online services, such as tax payments, for enterprises. The lack of e-signature has far-reaching consequences. Bosnia and Herzegovina's Law on customs policy scheduled to take effect on 1 August 2019, cannot go ahead without it which would have a negative effect on (i) the submission, acceptance and proceeding of electronic transit declarations for the electronic transit procedure (NCTS), (ii) the Authorised Economic Operators scheme and (iii) electronic customs declarations for import and export customs procedures as regulated by the Law on customs policy. The lack of e-signature also prevents the issuing of qualified digital certificates to taxpayers, and hence e-services on taxation as per the Joint Conclusions adopted at the Economic and Financial dialogue on 25 May 2018.

Businesses are subjected to numerous para-fiscal fees and charges emanating from overlapping administrations. 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. This makes it difficult to attract potential investors as the fees and charges increase the investor's cost of doing business in municipalities (NALAS, 2018). 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 has been adopted in both entities. The legislation will help ensure, as a first step, that no fees or charges can be levied unless they are part of the register. The legislation will also provide for the introduction of a methodology and proper procedure for the introduction of any new fees. At a later date, the country plans to gradually reduce para-fiscal fees and charges.

The lack of a unified country-wide approach to the planning and implementation of SME policy hinders the development of entrepreneurship and investments. Progress is lagging in the implementation of the Small Business Act. In all the 12 SME policy dimensions, the country scores lower than the regional average. There is very little evidence of effective co-ordination across different levels of administration in this area.

Key challenge #3: Facilitation of starting a business

The business registration process is particularly troublesome, partly due to the separate laws and regulations that exist at different levels of government. 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. In areas where the entities have no mutually harmonised 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 (2018 edition), ranks the country 183rd (out of 190 countries) in the time it takes to start a business, as it takes 81 days and 13 procedures to start a business. The Global Competitiveness Report (2019 edition) gives a particularly low ranking for the country for the time it takes to start a business (134th out of 140). The overly complex business registration and licensing process is vulnerable to corruption, according to the U4 Anti-Corruption Resource Center (2018).

Construction permits create a particular problem associated 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. Obtaining construction permits (involving various public agencies) remains a significant obstacle to investment. A missing link in the complex chain of decision making can stall construction for a long period, and no agency has oversight or supervision of the entire process.

Some reforms are being carried out, such as the establishment of one-stop-shops for company registration and an online business registration system. Setting up a one-stop-shop (OSS) or `single window´ is a good practice to facilitate investment. They provide a single entry point where businesses can obtain information and undertake administrative procedures. They can significantly cut down investors' transaction costs. In Bosnia and Herzegovina, there is no such agency at the state level, but a single business registration agency began operations in the Republika Srpska entity in 2014 (OECD, 2018). As a next step, entities should ensure that business registration data in these entity registries are fully integrated into a centralised register. Ideally, all business licences and permits (as well as rulebooks for their implementation) should be harmonised across the country (UNCTAD, 2015).

Key challenge #4: Making the public sector more efficient, in particular improving the performance, transparency and accountability of state owned enterprises (SOEs)

Country-wide public spending remains at a relatively high level, while the quality of provided services is low, in particular in the area of health, but also in education.

Payment arrears of the public sector are substantial, creating a burden for private companies. The public financial management (PFM) system is fragmented and is not in line with international standards, in particular the systems for budget formulation, budget execution, monitoring, transparency of budget data and forecasting. A country-wide programme to reform PFM has not yet been adopted. PFM reform strategies are in place at state level, in the Federation entity and in Brčko District, but not in the Republika Srpska entity. In the Republika Srpska entity, separate strategies for various aspects of PFM exist without clear consistency between them. The creation of a register of public sector employees has not yet been completed.

SOEs are a particular problem as they form a large part of the country's economy, affecting macroeconomic performance, fiscal sustainability, labour market outcomes and competitiveness. The SOE sector is characterised by weaknesses in transparency, accountability and performance. There is no single registry for SOEs, or at least not one that is updated regularly. Financial statements are incomplete and not easily available. No financial reports on the SOEs are submitted to the government. There is low managerial performance stemming from politically affiliated boards and executives lacking independence and appropriate professional background. Productivity is low within many large SOEs and many of them are not even profitable. Unlike its regional peers, many SOEs in Bosnia and Herzegovina are statutory corporations that are subject to preferential treatment deviating from ordinary corporate norms, i.e. they benefit from undue advantages compared to the private enterprises (OECD, 2018). SOEs and public enterprises dominate key sectors of the economy, including energy and telecommunications utilities (World Bank, 2018).

Vested interests are largely responsible for the slow privatisation process. The privatisation process is still not complete. Attempts to sell shares in public companies earmarked for sale have been largely unsuccessful. This is likely due to the influence of vested interests seeking to keep the status quo. There is a need to depoliticise the use of public resources and bring an end to political nepotism. There are no rules to ensure the presence of independent directors on the board of SOEs. In most cases, these boards are dominated either by civil servants or by people politically connected to the government. This leads to inefficiencies and conflict of interest. There is also a high degree of overemployment in public enterprises.

SOEs are a significant burden on the public finances. Some formerly successful SOEs have accrued significant arrears from unpaid health and pension contributions. 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. Various SOEs are loss making, requiring subsidies. Some of them no longer operate, but still maintain workers. The (fiscal) costs of this approach are substantial and divert productive resources away from more productive uses. SOEs are in a precarious financial situation. According to IMF estimates, there are no SOEs in the Republika Srpska entity that are considered financially sound while in the Federation entity only 4 % of SOEs are considered to be financially sound.

Overall, there are over 550 SOEs employing around 80,000 persons, or around 11 % of total employment. Together they are responsible for a third of outstanding tax arrears. In 2017, the governments received € 41 million in dividends from SOEs, but transferred EUR 109 million to them. Both revenues and losses are concentrated in a small number of public companies: around 95 % of dividends were paid by BH Telecom, Elektroprivreda BiH and RS Highways, while 20 companies are responsible for almost 90 % of arrears. The IMF estimates that SOEs are unlikely to reduce debt levels without government support. While the precise numbers has not yet been determined, consolidated debt is likely to be approximately 55-60 % of GDP. SOE total liabilities are around 26.4 % 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. 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.

4.2. Labour market, education and social policies

The very low employment rate and the high unemployment rate are some of the many labour market challenges. There has been no improvement in the activity rate of the 15-64 age group, which remains very low at 54.2 %. The recent increase in the employment rate (from 40.2 % in 2016 to 44 % in 2018) has been moderate compared to the stronger decline in the unemployment rate (from 25.4 % in 2016 to 18.4 % in 2018). Administrative data shows a similar trend: the increase in the number of employed between June 2017 and June 2018 was only half the decrease in the number of unemployed. While the underlying causes of this development are unclear, labour emigration may be one of them (see below). Almost 90 % of all unemployed are long-term unemployed and a large part of the working age population is inactive. There is a low internal labour mobility among the entities and cantons.

Women and young people face particular challenges in employment. The persistently high gender employment gap of over 20 pps has not improved in recent years, and is twice as high as the EU average. A particular obstacle to female employment is the low availability of childcare and elderly care. The youth (15-24) employment rate improved by 6 pps between 2016 and 2018, but is still extremely low at 19.7 % (2018), while the youth unemployment rate decreased substantially in the same period by 16.6 pps between 2016 and 2018 to 38.8 %. The share of young people not in employment, education or training dropped from 27 % in 2014 to 22.9 % in 2017, but remains very high. On the other hand, the gender employment gap for young people increased by 4 pps from 2016 to 13.5 pps (2018). More than half of the inactive population has at most primary level of educational attainment (52.6 %).

Public employment services operate with low levels of funding and insufficient human resources. The outreach and coverage of support services for jobseekers and the provision of active labour market programmes (ALMP) are limited. A large number of unemployed people do not actively search employment and are registered to receive free health insurance and other social benefits. The administration of these benefits limits the ability of public employment services to assist active jobseekers. Nevertheless, there has been some improvement in training on job mediation and advisory work of employment offices across the country. This has helped to improve service delivery, with a greater focus on work with clients. Expenditure on ALMP as a share of GDP almost doubled since 2013, but it still remains low (0.19 % of GDP in 2017). Many jobseekers, including university graduates, were mediated into employment abroad by the public employment services. However, an even higher number of people – often 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. Social contribution rates contribute to a high tax wedge for low-wage earners resulting in a disincentive on 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. The Republika Srpska entity adopted changes to labour and income tax legislation that reduced the tax burden on labour and increased worker's take-home pay, while the gross salary remained the same. In the Federation entity, legislative proposals were made to reduce the tax burden on low-wage earners and to reduce social contributions. However, non-means tested and relatively generous social benefits for war veteran categories might also stimulate labour market inactivity.

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) has not convened for the last 18 months following a disagreement over the minimum wage. Important amendments to the labour law and the Law on pension and disability insurance were therefore not consulted on with the social partners. In some cantons, the ESC works well. In the Republika Srpska entity, the work of the ESC gained pace 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. Overall in Bosnia and Herzegovina general collective agreements are not in place. The effectiveness of social dialogue has decreased and the labour dispute settlement mechanisms are pending reforms.

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 to benefit 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 the EU's.

Bosnia and Herzegovina faces challenges in a number of indicators of the Social Scoreboard[1] supporting the European Pillar of Social Rights. The employment rate remains very low, particularly for women and young people. Almost 90 % of unemployed people are long-term unemployed. The job generation is localised and the low mobility of workers limits the allocation of labour resources to emerging needs. The gender employment gap remains very high, at more than 20 pps for the population aged 15-64, and it has been deteriorating in recent years. 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 no 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 amount of early school leavers is very low at 4.9 % in 2018, less than half the EU average. However, there is a large share of the 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, no change
	Gender employment gap	Worse than EU, deteriorating
	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 15-64)	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. Although social expenditure is comparatively high, means-tested social assistance does not cover basic living needs. Other non-contributory social benefits insufficiently target poor and vulnerable segments of the population. 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 in employment, while children from rural areas or whose parents are unemployed almost rarely attend.

Further efforts are needed in the collection of timely and reliable data. The availability of indicators is limited, particularly in the area of social protection and inclusion. A lack of data also holds back the development of evidence-based policies and measures. First Statistics on Income and Living Conditions data is planned for 2019.

Social Protection System

Updated and conclusive data on poverty is not available. However, poverty estimates show that the country faces challenges. Household Budget Surveys (HBS) conducted since 2004 are the main reference point for poverty analysis. Statistics on Income and Living Conditions (SILC) data is planned for 2019, with two pilot projects already conducted in 2017 and 2018. Poverty measurement is also influenced by a high level of subsistence farming and the inflow of remittances (estimated to account for 11 % of GDP). According to the latest estimates made on HBS 2015 income data, the at-risk-of-poverty rate is around 27 % when using measurement methods similar to those used in EU indicators. Poverty is the highest among people with low educational attainment, the unemployed, large families and single-person households.

Social protection systems in Bosnia and Herzegovina are complex and multi-layered. In the Republika Srpska entity the system is centralised, while in the Federation entity it is decentralised with responsibility for social policy within a shared competence of the entity and its cantons. Overall, social protection expenditure is relatively high. Social insurance schemes include pensions, disability insurance, health insurance, unemployment insurance and in Republika Srpska entity also child and maternity benefits. Social insurance schemes make up the main part of the social protection systems in both entities. Payroll contributions provide the main source of financing for these schemes. In addition to social insurance schemes, there are also non-contributory social transfers. A larger part of these (1.9 % of GDP) are grants to war veterans and only a small part (0.8 % of GDP) is spent on disabled and on means-tested social assistance and family benefits. Poverty alleviation programmes are thus massively outspent by grants to groups falling beyond the scope of social assistance (World Bank 2019). While status-based war-related benefits are relatively generous, the amount of means-tested social assistance given to the poor is not sufficient to cover basic living expenses and only a small part of the poor is covered because of restrictive conditions.

Social transfers have a limited capacity to reduce poverty. Based on Household Budget Survey (HBS, 2015) data, the reduction of the at-risk-of-poverty rate by social transfers is estimated to be at 9.16 %, significantly lower than the EU average (33.2 % in 2016). According to the HBS 2015 estimate, only 36 % of all social transfers are directed towards people at risk of poverty, while only about 34 % of those that receive social transfers are lifted above the poverty threshold by the transfers. Unemployment benefits are received by only a small share (2.8 %) of those registered as unemployed at the public employment services.

Enrolment in early childhood education and care is particularly low. According to the Agency for Statistic of Bosnia and Herzegovina, in the school year 2017-2018, 25,889 children aged 0-6 were enrolled in 321 pre-school care or education institutions, which is a 3.9 % increase compared to the school year 2016-2017. Due to a lack of

---

[1] 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. The assessment includes the country's performance in relation to the EU-28 average (performing worse/better/around EU-28 average) and a review of the trend for the indicator based on the latest available 3-year period for the country (improving/deteriorating/no change). Data from 2014-2017 are used.

capacity, 2 790 children who applied could not be enrolled. Comparing the number of enrolled children in 2017-2018 to the number of children aged 0-6 based on data from the last population census of 2013 (245 149), the gross enrolment ratio (GER) would be very low, at around 10.5 %. For children aged 3-6 the GER would be at around 14.5 % which is very low compared to 93.2 % of children between 3 years old and the starting age of compulsory education who attend pre-school education in the EU. Using the same sources, for children below 3 years the GER in child care is particularly low at around 5 % only. Children from rural areas make up just 0.5 % of children attending pre-school education and care, and children from families with unemployed parents account only 2 %. However, children from urban areas with two working parents represent 75.5 % of children attending pre-school education and care (UNICEF, VBJK 2016). Despite being subsidised by local governments, the cost of attendance in public pre-school education and care represents a substantial burden for lower income families.

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. More than a half of households living in non-urban areas have difficult or very difficult access to primary health care. Households in the Federation entity have better access to primary health services compared to households in the Republika Srpska entity (70.1 % and 61.4 %, respectively). Other important challenges related to the health protection pertain to unequal provision of services in different entities and cantons, non-portability of insurance, significant out of pocket payments that affect the access to and affordability of health protection for the poor.

Education and skills

There is only limited country-wide information on the overall quality and outcomes of the education system. In 2019, PISA results for the country will be reported for the first time. This will establish quantitative and qualitative benchmarks for assessing the education system. A country-wide 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 of education policies and programmes. The system in the Federation entity is particularly fragmented: power lies with the 10 cantons, while the federal level has limited powers. However, Bosnia and Herzegovina has traditionally had a very low share of early school leavers (4.9 % in 2018), which is less than half the EU average (10.6 % in 2018).

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 as a function of 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. This results in a restricted choice for students and a continued weak availability of skilled labour to meet the needs of employers.

There has been no comprehensive countrywide strategy for vocational education since 2015. There have been various attempts to create such a strategy, involving support from international donors. However, these have not been successful. The existing country-wide framework curriculum provides the basis for secondary education (including VET). The curriculum is reported to have been rolled-out across the country. However, there is no reliable information about its effective implementation.

Efforts to consolidate some policy frameworks are under way. In 2018, policymakers and practitioners from both entities worked together on a set of countrywide priorities in entrepreneurship and digital competences. A next step is to have these priorities agreed at the state level. Secondly, plans are in place to update a countrywide Strategy for Entrepreneurial Learning which expired in 2015. It will take on board more recent EU policy recommendations, including entrepreneurship promotion across all levels of education and development of entrepreneurial experience for young people. Thirdly, a proposal was developed in 2018 for a countrywide VET quality assurance framework for initial and continuing VET that was based on the EU's EQAVET. Agreement between the entities has not yet been achieved and discussions are ongoing to secure agreement between all the education authorities.

Adult education remains weak. The implementation of the Strategic Platform for the Development of Adult Education in 2014-2020 suffers from a lack of resources and the absence of a countrywide qualifications system. This inhibits the development of up-skilling pathways for adults seeking to improve their opportunities on the labour market. Participation of adults in education and training remains very low, and has even fallen in recent years. Depending on the measurement method, the percentage of adults (25-64) engaged in education and training stands at between 1.8 % (LFS 2017) and 8.7 % (Adult Education Survey 2016). This is very low compared to the EU average of 10.9 % (LFS 2017) and 45.1 % (Adult Education Survey 2016). Those most likely to take up formal or non-formal education and training are young people (25-34), highly educated people or people already in employment.

4.3. Competitiveness and sectoral issues

Business environment

The business environment is adversely affected by a number of factors, including political instability; the weak rule of law; a fragmented, overly complex and non-harmonised regulatory framework translating in high compliance costs; a large and inefficient public sector[2]; widespread informality and corruption; and a significant tax burden on labour[3]. Progress with improving the business environment have been limited during last year, as indicated in the 2019 World Bank's Doing business report, where Bosnia and Herzegovina is on the 89th place out of 190 countries, and has the lowest ranking in the Western Balkans region. Compared to the previous year, the country's ranking even deteriorated by three positions. Particular challenges include \`starting a business´, \`dealing with construction permits´, \`paying taxes´ and \`getting electricity´. There are also issues with property rights (\`registering property´). The ERP partially recognises these challenges by referring primarily to \`distortion´ of the internal market and the single economic space. Nevertheless, the ERP generally takes a patchy approach to the reform priorities for the business environment. This patchy approach reflects the complex and fragmented character of the business environment itself. The

---

[2] Providing for 39 % of formal jobs with private firms having difficulties to compete with public salaries according to LFS 2017.

[3] High social security contributions, fiscal and para-fiscal fees.

lack of support for private and export-led growth is evidenced by the `missing middle´, with small-scale businesses and large state owned enterprises (SOEs) dominating the economy. While bank lending to the private sector has gained pace, access to finance continues to be a problem, particularly for micro and small companies. Programmes linking domestic businesses with foreign investors should be improved.

The effective application of the rule of law is key for improving the business environment. Effective and independent judicial systems are a prerequisite for creating an environment that is friendly to investment and businesses, as they instil confidence throughout the entire business cycle. Moreover, if not forcefully addressed, corruption will make Bosnia and Herzegovina a less attractive place to do business. Effective measures to further strengthen the rule of law, ensure appropriate and timely contract enforcement, and reduce the backlog in court cases could positively impact the business environment. This could in turn lead to an improvement in productivity and competitiveness in Bosnia and Herzegovina.

Informal economy

The widespread informal economy poses another burden on business in Bosnia and Herzegovina. Despite some limited progress in addressing informality (such as improving the degree of registration in the labour market), the share of informal employment in total employment is relatively high (around 30 % according to the ILO). The informal economy impedes the creation of jobs in the formal sector, as it created unfair competition to those companies which are registering their labour force. SMEs are more likely to be involved in the informal economy due to the higher costs of regulatory compliance for smaller firms (OECD, 2018). Public perceptions of government corruption and misuse of taxpayer money motivate many people to remain in the large informal economy (2019 Index of Economic Freedom). The ERP diagnostic is weak. It does not dedicate a specific section to this challenge, and refers to the issue primarily in the context of employment and labour markets (high share of undeclared work). Current efforts to address this issue focus on combining taxpayer information of the four tax agencies and enhanced regularly exchange of information. The combined database is now used for risk analysis and assessment to improve audit selection.

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. 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 country is estimated to have spent around 0.24 % of GDP on research in 2016 (the lowest gross expenditure on R&D in the region). 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 target of 3 %. The lack of funding for R&D limits the potential for innovation and promotes brain drain. 43 % of highly educated people have already left abroad (OECD, 2019; Landesmann, 2016). The legislative framework regulating science and research development, based on a 2009 Framework Law, is fragmented and needs to be improved throughout the country. A smart specialisation strategy is part of Bosnia and Herzegovina's commitments under the REA MAP but has not yet been developed.

The process by which scientific knowledge is fed into policy-making is rather weak, not comprehensive and not inclusive. The Global Competitiveness Index (2018 edition) ranks Bosnia and Herzegovina 114th (out of 140 countries with regard to their innovation capability). The country participates in the Horizon 2020 programme, which links its research community to European Partners. However, with the exception of a recently initiated donor programme, there are no public funds available to promote innovative projects of SMEs when those projects carry financial risks. Current efforts to boost the country´s innovation capability include strengthening participation in Horizon 2020, developing a national roadmap for research infrastructures, and developing a smart specialisation strategy. The Republika Srpska entity is aiming to establish a science and innovation fund. The country should significantly boost the role of private sector innovation in its overall economic policy It should also improve the formulation, coordination and implementation of policy. An innovation voucher scheme could be considered.

Digital economy

The country's digitalisation is still at a very low level[4] and falls well below the average performance of south east Europe (SEE) economies on the use and access of information communication technologies. The Global Competitiveness Report (2018 edition) ranks Bosnia and Herzegovina 86th out of 140 countries for adoption of information and communication technologies (ICT). Legislation which would enable the liberalisation of the telecommunications and electronic media sector is not yet in place. Further obstacles to competitiveness and growth of this sector include the absence of a broadband strategy and 4G network. 66 % of households have internet access at home (EUROSTAT, 2017). The penetration of broadband internet is 19.83 %. The policy of the electronic communication sectors of Bosnia and Herzegovina for 2017-2021 and the accompanying implementation action plan are in place. This policy is a prerequisite for the further development of the regulatory framework on radio frequency.

Bosnia and Herzegovina is lagging behind in the implementation of its policy for the information society until 2020 (adopted in May 2017).[5] The fragmentation of responsibilities among different levels of authorities has a direct impact in the area of e-government services. This leads to a dual barrier in the implementation of e-services. The first barrier is that there is no centralised portal providing e-services. The second barrier is that there is no central co-ordination body to oversee services provided in the entire territory. This means that the many benefits of e-government solutions and ICT-enabled services are not currently available (ITU, 2018) Digitalisation of government services for enterprises therefore needs to continue (OECD, 2019). Some conditions for the implementation of electronic signature in open systems are in place (such as the establishment of the Office for Supervision and Accreditation of Certifiers at the state level Ministry of Communications and Transport). However, electronic signature is still not implemented in practice. The country needs to adopt legislation on electronic

---

[4] 1.6 out of 5 according to the OECD Competitiveness Outlook (2018).

identification and trust services for electronic transactions compliant with the relevant EU *acquis*. Non implementation of the digital switchover (issues of jurisdiction and equipment ownership still cause significant delays) prevents the country from reaping the benefits of the digital dividend (OECD, 2018) and disturb the operation of certain radio frequency transmitters locally and regionally. The country is currently focusing on adopting a broadband access strategy; a strategy for information society development; and the adoption of a law on electronic communications and electronic media.

Investment activity

Domestic and foreign investment has remained subdued, reflecting a poor business environment and high political uncertainty. The country's physical capital stock is suffering from decades of underinvestment. Public and private investment has remained low during the last 10 years with private gross fixed capital formation dropping from 24.5 % of GDP in 2008 down to 17 % in 2017. This drop in private investment reflects the poor business environment and the low degree of certainty due to frequent political gridlock. Public investment accounted for 3 % of GDP on average in 2008-2017. Given the country's need to modernise its infrastructure, this investment rate appears low. It also reflects a public spending policy that prioritises spending on public sector employment and on transfers, while neglecting infrastructure investment. This makes it difficult to improve growth potential and labour productivity, impeding efforts to raise income levels and living standards.

At around 2 % of GDP, net FDI inflows are by far the lowest in the region, in spite of some regulatory improvements. The five year average flow of inward FDI is 2.2 % of GDP according to the Global competitiveness index 2018 edition. The main countries of origin for the FDI in 2017 were Austria (24.1 %), Croatia (13.1 %) Slovenia (13 %) and Switzerland (7.6 %).[6] Inflows increasingly consisted of reinvested earnings. In principle, the legal framework provides favourable treatment and protection guarantees for FDI. Bosnia and Herzegovina is among the most open economies to FDI[7]. There are no restrictions on FDI inflows and few limitations on foreign ownership. Nearly 63 % of the country's stock of FDI originates from EU countries; it is concentrated in the financial sector, retail and tourism. The low level of FDI clearly reflects the reality of the country's poor and fragmented business environment. Bosnia and Herzegovina faces a challenge to promote FDI in a uniform way and with the cooperation of all levels of government. There is no country-wide strategic framework to encourage FDI. There are also no comprehensive programmes to better connect foreign investors and domestic firms to enhance the impact of FDI. Another issue is "aftercare" support: once a commitment has been made to invest in the country, investors also need help to ensure their project is implemented in the way they planned. This aftercare support is insufficient at present.

Bosnia and Herzegovina is encouraged to implement all the aspects of the Regional Economic Area Multi-Annual Action Plan (REA MAP). The REA MAP is based on EU standards and will facilitate Bosnia and Herzegovina's integration in regional and

---

6 Bosnia and Herzegovina Central Bank statistics.

7 According to the OECD FDI Regulatory Restrictiveness Index (2016), the country scores 0.029 compared to an OECD average 0.067 (0=open, 1=closed).

European value chains and will also help increase the attractiveness of the economy for FDIs in tradable sectors. Further connectivity with neighbouring countries in transport and energy will further strengthen Bosnia and Herzegovina's access to, and integration in, the regional market. The creation of a regional digital space and of more integrated labour markets with neighbouring economies will offer new possibilities for the country's youth, which is important in light of the high youth unemployment.

Trade performance

The country's openness to trade is relatively low given the small size of its economy, with the sum of exports and imports accounting for about 90 % of GDP. In 2017, exports of goods and services accounted for 38.9 % of GDP, while imports of goods and services accounted for 54.8 % of GDP. The range of exported goods is very limited and the highest shares are as follows: "Base metals and articles of base metals (18 %), machinery and electrical equipment (12 %), miscellaneous manufactured articles" (11 %), "textile and footwear" (11 %), "mineral products" (9 %), and "chemical products" (9 %)[8]. The country's trade performance still lags behind its neighbours due to burdensome administrative procedures for trading and limited export promotion capacities. The main problems holding back trade are: (i) a fragmented domestic market, (ii) complex export procedures, (iii) the absence of coordinated border checks and (iv) the absence of a comprehensive approach to EU food-safety and sanitary and phytosanitary standards. Despite some recent successes by the country in meeting required standards for exporting to EU markets, non-tariff barriers to trade with the EU, in particular as regards sanitary and phytosanitary standards, remain a problem (OECD, 2018).

In international rankings, the country has the lowest scores in the region for the quality of its border administration, transport and communication technologies (WEF, 2016). 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 the implementation of the customs policy law, including by introducing the concept of authorised economic operators.

Nevertheless, the share of the goods export market accounted for by the EU-27 rose from 45 % in 2008 (when the EU-Bosnia and Herzegovina Stabilisation and Association Agreement/interim agreement entered into force) to 71.8 % in 2017. This rise was only partly accounted for by Croatia joining the EU and demonstrates the potential of trade integration with the EU. 96.3 % of Bosnian products can access the EU market without customs duties. In recent years, trade with neighbouring countries, such as Croatia, Slovenia, Serbia and Turkey, has increased markedly. Given the different exporting product specialisation 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).

Energy

The energy sector is hampered by political interference and by a fragmented, inconsistent and uneven legislative framework between different levels of

---

[8] WIIW database collected from Agency of Statistics of Bosnia and Herzegovina, 2017 latest available.

governance. This results in an unfavourable investment climate and insufficient regulatory independence. The creation of an internal energy market is being hindered, because Bosnia and Herzegovina has not fully aligned its legislative frameworks for gas and electricity with the third energy package. Bosnia and Herzegovina needs to adopt state-level legislation aligned with third energy package in the field of both electricity and gas and then followed by compliant entity-level legislation. The lack of a legislative framework significantly impedes the effective integration of the country in regional energy markets. It also acts as an obstacle to further reforms and economic development. The markets for electricity and gas remain fragmented and dominated by key incumbent companies. The current model for the legal and functional unbundling of the company for transmission of electricity from generation and supply is not in line with any of the unbundling models under the EU *acquis*. Bosnia and Herzegovina also lacks a single or harmonised legal and regulatory framework for tendering for new generation capacity**.** Energy tariffs are too low to foster private sector financing of many new power plants (World Bank, 2015). The problem of cross–subsidies in the electricity sector has not been adequately addressed.

However, a countrywide strategic framework for energy is in place. In 2018, Bosnia and Herzegovina adopted a framework energy strategy up to 2035. This strategy sets out objectives and implementation priorities to be reached in the years to come. The adoption of the strategy is an important step towards setting a vision for the future development of the energy sector in the country. The strategy will help tap into the country's potential, drive sustainable economic growth, and set up a framework for viable investments. A national renewable energy action plan is also in place. This action plan has set a national target of ensuring that (i) 40 % of final energy consumption comes from renewable energy sources and (ii) 10 % of energy used in transport comes from renewable energy sources by 2020. However, there is a lack of transparency in the operation of the responsible authorities tasked with implementing this plan. It is also unclear if enough funds have been collected for its implementation and no information has yet been made public on designated incentives for renewable energy. Bosnia and Herzegovina is still one of the most energy inefficient and carbon intensive countries in Europe. This harms its competitiveness and exposes it to increasing pollution. In spite of this, a national energy efficiency action plan was adopted in line with requirements of the Energy Community Treaty. This action plan is currently being updated because financing of the planned activities is proving problematic. Improving the connectivity of energy infrastructures will accelerate the integration of Bosnia and Herzegovina into pan European networks and will help increase the competitiveness of the country's energy market over time.

Transport

The transport infrastructure in Bosnia and Herzegovina is insufficiently developed, and improving only slowly. The highway network is limited, making it more difficult for companies to export, and increasing their costs and transport time. The transport sector is dominated by poorly managed and often inefficient SOEs. The legislative framework on concessions and public-private-partnerships remains highly fragmented, and private-sector involvement in public infrastructure is limited (World Bank, 2015). The necessary investment is delayed by (i) a lack of coordination between government levels, (ii) a lack of external financing, and (iii) the absence of a single or harmonised legal and regulatory framework. Implementation of the connectivity reform measures, which would be a significant driver of economic growth (with much less costs), is not progressing. Improving the connectivity of transport infrastructures will accelerate the integration of Bosnia and Herzegovina into pan European networks and will help further develop economic corridors over the region, which would benefit the country.

The authorities are very reluctant to open the railway market. This is due to unsafe, outdated and unreliable railway infrastructure. The 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. There has been no major increase in the volume of goods transported by railway since 2008, with 1.1 billion tonne km transported in 2016 (Eurostat). Economic cost of road crashes and the environmental costs of transport activity are very high (OECD, 2018).

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, the large proportion of small farms in the sector, low productivity, and outdated facilities for manufacturing and processing. Forests are underexploited, partly due to the absence of a harmonised legal framework across the country. Due to the structure of farms, there is little specialised agricultural production. The average farm holding size is approximately 2 ha. Agriculture, forestry and fisheries continue to play a significant role in economic growth, job creation and social stability. These sectors account for 7,5 % of gross value added (2016) and 18,9 % of employment (2017), 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 %. However, these figures are all estimates, since the last agricultural census was conducted in 1960. The absence of up-to-date data on agriculture is a stumbling block in itself, to policy making in this sector.

To improve competitiveness and growth prospects in agriculture, alignment with the EU *acquis* must be pursued, and state support to the sector must be reviewed. The EU remains Bosnia and Herzegovina's main trading partner for agricultural goods. In 2017, exports of agricultural products to the EU made up 35 % of total agricultural exports. There is a need for *acquis*-compliant state-level legislation on food, veterinary medicine, wine, organic farming, and harmonisation of agricultural information systems. The most widespread type of producer support in the country at present is based on output and variable input–use. This distorts the market, and does not promote long-term competitiveness[9]. The country should instead increase the share of producer support dedicated to general services for the sector, balanced across key areas such as infrastructure, knowledge, and inspection. This would strengthen the foundation for long-term productivity growth. The country has adopted a strategic plan for rural development 2018–2021,which has the potential to create more synergies between sectors of food-safety policy, veterinary policy, phyto-sanitary policy, agricultural policy and rural

---

[9] According to the OECD Competitiveness Outlook 2018, the composition of budgetary support to producers as percentage of gross farm receipts is as follows: 2,9 % of "most distorting support" and 2,1 % of "other support".

development policy, needed for the overall sustainable economic growth of Bosnia and Herzegovina.

Industry

The industrial sector still suffers from the lack of a single economic area. Industry's contribution to GDP has been around 20 % over the past five years, and the sector was the main contributor to the country´s exports over that period. Manufacturing accounts to for over 60 % to industrial production, while the most significant increases in production in 2017 were recorded in textiles and leather (17.2 %) and machines and devices (15.1 %). Industry´s share of employment stands at 26 %. 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, the promotion of SMEs. The ERP fails to provide a specific diagnostic of this sector.

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 (65.4 % in 2017). Most of the active labour force being employed in this sector (51.6 % in 2017). Tourism has an important growth potential with high growth in visitor rates. According to 2016 figures, direct contribution to GDP amounts to 2.5 %, and total tourism contribution to GDP amounted to 9.2 %. Direct tourism employment contribution amounted to 3 %, and the total tourism employment contribution amounted to10.6 % (OECD, 2018). Bosnia and Herzegovina usually achieves a surplus in the services trade balance, largely driven by the provision of construction services abroad, and substantial net earnings from tourism. Services exports represent a significant part of the country's international trade The ERP fails to provide a specific diagnostic of this sector.

ANNEX A: IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2018

Overall: Limited implementation (34.1 %)[10]	
2018 policy guidance	**Summary assessment**
PG 1: Improve the current medium-term fiscal planning framework to become an effective policy planning tool for public finance. Strengthen the analytical capacities of the various stakeholders producing macro-fiscal analysis and forecasts. In order to better support policy analysis, improve the provision of timely and exhaustive statistics, in particular government finance, national accounts and labour market statistics. Strengthen the country-wide public debt management capacities, at all levels, in particular the cooperation and flow of adequate and full information from all data providers.	There was **limited implementation** of PG 1: 1) **Limited implementation**: There have been some limited improvements in the ERP, but there are no signs of any strengthening in policy planning. 2) **Limited implementation**: The World Bank provided training on macro-fiscal forecasting, and the IMF and EU organised a training session to improve macro-fiscal programming. 3) **Limited implementation:** The central bank undertook efforts to improve the reporting of general government data and submitting a fiscal notification to Eurostat. Eurostat provided trainings on government finance statistics and National Accounts within IPA15. Labour market statistics still lack a new Master Sample Frame; its implementation is expected in the first half of 2019. 4) **Limited implementation:** The debt management strategy has been updated but no significant progress has been achieved in improving cooperation and the flow of information.
PG 2: Create fiscal space for public investment by containing spending on public consumption and improving the targeting of social spending. Furthermore, take steps to reduce public-sector payment arrears. Lower the tax burden on labour, including social security contributions while ensuring sustainable public finances.	There was **limited implementation** of PG 2: 1) **Limited implementation**: Spending on public consumption has been contained, but no progress has been achieved in improving the targeting of social spending. 2) **Limited implementation**: First steps have been taken to register existing payment arrears and to develop plans on how to reduce them. 3) **Limited implementation**: One entity has started in some areas to lower the tax burden.
PG 3: Safeguard the integrity of the currency board arrangement as the anchor of monetary stability.	There was **partial implementation** of PG 3: 1) **Full implementation:** The currency board continues to enjoy a high level of credibility with the general public. The central bank continued to ensure the full convertibility of the domestic currency by backing net monetary liabilities with foreign exchange reserves. The currency board's coverage of monetary liabilities remained broadly unchanged over past years, standing at 105.8 % in

[10] 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.

	December 2018, which is adequate.
Enhance further the analytical and forecasting capacity of the CBBH, and develop its toolkit by establishing a bank lending and inflation expectations survey.	2) **No implementation:** There has been no concrete progress on the part of the CBBH in developing further its analytical and forecasting capacity yet.
Follow up on ongoing legislative changes and develop a comprehensive strategy fostering the resolution of NPLs to help remove supply-side bottlenecks to credit extension.	3) **Partial implementation:** New laws have been introduced to facilitate NPL resolution (for example only specialised companies can buy NPLs). Nevertheless, 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.
Strengthen the bank resolution framework by ensuring sufficient coordination among the bodies entrusted with resolution.	4) **Partial implementation:** Although, new laws and by-laws have been introduced which improve cooperation and coordination among financial sector regulators and supervisors, the Law on Deposit Insurance is still pending, rendering the reform incomplete.
Develop a macroprudential framework so as to mitigate systemic risk in the financial system.	5) **Limited implementation:** Although the two banking supervision agencies have some macroprudential instruments and measures at their disposal, there is no centralised macroprudential framework in place.
PG 4: Adopt a credible and relevant country-wide Public Financial Management strategic framework with a performance based monitoring and reporting system.	There was **partial implementation** of PG 4: 1) **Limited implementation:** The Republika Srpska entity has committed to adopt its entity level strategy in spring 2019. This is a precondition for adoption of a country wide PFM strategy (the other levels of government have adopted PFM reform programmes already).
Adopt a countrywide energy sector reform strategy	2) **Full implementation:** A framework energy strategy for Bosnia and Herzegovina was adopted by the country's Council of Minister in August 2018.
and a legal framework in compliance with the Energy Community Treaty.	3) **No implementation:** No steps were undertaken by relevant authorities at different levels of governance to ensure required compliance with obligations stemming from the Energy Community Treaty
PG 5: Simplify and harmonise business registration procedures between entities.	There was **partial implementation** of PG 5: 1) **Limited implementation:** Little progress was made in introducing online registration as a way to simplify and harmonise business registration procedures. The Federation entity has adopted an action plan for introduction of a one-stop shop for electronic business registration. However, no progress was made on the creation of a software solution, because adoption of the required legislation is pending in the entity Parliament. The Republika Srpska entity is proceeding with preparations for on-line registration by introducing relevant legislation into the parliamentary adoption procedure. Overall progress is limited, as measures allowing companies to complete formalities fully online in the entire territory are still lacking.
Introduce e-payment services on taxation	2) **Substantial implementation**: electronic

and fully implement the law on electronic signature.	submission of VAT declaration has been introduced and is mandatory since 1 January 2019. The method used is web-based authentication as the Indirect Taxation Authority (ITA) has still not received certification from the Ministry of Communications and Transport (MCT) to start issuing e-signatures. 3) **Partial implementation**: The 2006 Law on electronic signature has not yet been fully implemented. Some conditions for the implementation of electronic signature in open systems are in place (such as the establishment of the Office for Supervision and Accreditation at the MCT), but electronic signature is still not implemented in practice. Institutions which have filed an application (ITA and the Agency for Identification Documents, Registers and Data Exchange) have still not received certification from MTC to start issuing e-signatures. Implementation of e-signature is also hampered by the different legal frameworks across the different administrative levels (OECD, 2019). Finally, legislation on electronic identification and trust services for electronic transactions compliant with the relevant EU *acquis* has not yet been adopted.
PG 6: Reduce the tax wedge and disincentives to work. Ensure better coordination between employment activation measures and social benefit schemes. Increase enrolment in preschool education. Undertake a review of secondary and higher education enrolment policies in order to improve	There was **limited implementation** of PG 6: 1) **Partial implementation:** The tax wedge remains high especially for low-wage earners, which has a negative impact on the demand for labour, stifling economic growth and promoting the growth of the informal labour market. Some progress can be noted in the Republika Srpska entity which passed changes to labour and income tax legislation. These changes reduced the tax burden on labour and increased worker's take-home pay, while keeping gross salary the same. In the Federation entity, legislative proposals were made to reduce the tax burden on low-wage earners and to reduce contributions. 2) **No implementation:** No real progress was made on better coordination between employment activation measures and social benefit schemes. 3) **Limited implementation:** In the school year 2017-2018, the number of preschool institutions decreased, while the number of children enrolled has slightly increased by 3.9 % year-to-year. The 2017-2022 Platform for the Development of Preschool Education in Bosnia and Herzegovina, which was adopted before the reference period, has among its objectives to increase the coverage of pre-school education. According to the information about the implementation of the Platform over the reference period, some of the competent authorities have adopted their own strategic objectives which are being implemented. Further information on the implementation is missing. 4) **No implementation:** No steps have been undertaken to review enrolment policies. The

their links with the labour market needs.	previous practice of annual consultations on the labour market to identify labour market needs before the enrolment of students for the school/academic year did not prove to be effective. There is high enrolment in occupations and study programmes for which there are no employment prospects. Enrolment in medical schools is increasing, with students planning to get employment abroad when they graduate.

Annex B1: Assessment of the structural reform measures included in the ERP

Most measures presented in the ERP are not country-wide and only include entity-specific activities in a fragmented way. There are only six reform measures in the programme that have the potential to cover the country as a whole and only these have been assessed. The Commission's recommendation to identify a list of 15-20 measures that address common country-wide obstacles to competitiveness and growth has been ignored.

Measure 1: Improving agricultural production and establishing an efficient system for food safety and quality

The measure has mostly been rolled over. It is relevant and has the potential to enhance agricultural productivity and increase exports of a number of commodities to the EU. However, in spite of the adoption in early 2018 of a Strategic Plan of Rural Development of Bosnia and Herzegovina, the measure is too ambitious. This is because there is no agreement on competencies, more specifically on the establishment of IPARD (IPA Rural Development) Paying Agency at state level. The planned activities are highly relevant, but there are too many of them. The activities are also mostly scattered between the two entities and they lack a harmonised approach within the country. To have a more significant impact on the competitiveness of the economy as a whole, the country will have to improve its institutional arrangements to avoid overlapping competences and strengthen its control and coordination chain. On the promotion of start ups and the modernisation of family farm businesses, these plans are relevant. However, there is too much focus on a protectionist approach to this sector, which is not conducive to enhancing competitiveness. Overall, there is insufficient information on timelines and budgeting.

Measure 2: Enhancing the quality infrastructure system according to the EU model

This rolled over measure on harmonisation of the quality infrastructure is highly relevant in raising the country's competitiveness and long-term growth potential. If implemented, it will contribute to creating a single economic space and to facilitating trade. As rightly mentioned in the ERP, this measure is also in line with the country's commitments under the SAA (Article 75). Cross-cutting coordination between the relevant institutions at different levels of government has not yet been ensured. The measure continues to contain several of the deficiencies mentioned in last year's assessment, which explains the absence of real progress in the activities that have been planned for 2018. The lack of real commitment to this measure is reflected in the absence of timelines, expected results, key performance indicators, concrete activities or impact. The implementation of this measure will require proper cooperation between all levels of government. No budget allocations are indicated and there is only a vague reference to the possibility of allocation of the Instrument for Pre-Accession (IPA) funds following the adoption of the strategy.

Measure 3: Improving the communication and information society along with the alignment of the regulatory framework with EU standards

This measure is indeed very relevant for economic growth and increased productivity. Various activities planned under this measure, such as the adoption of 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. The adoption of a new law on electronic communications and electronic media aligned with the EU *acquis* in this sector is long overdue. This is because the Stabilisation and Association Agreement stipulated that Bosnia and Herzegovina should have adopted such a law one year after the Agreement entered-into-force. Implementation of this measure could benefit from including references to the introduction of the 4G network, full implementation of electronic signature (including adoption of planned legislation on electronic identification and trust services for electronic transactions) and completion of the digital switchover. The lack of progress in implementing this measure is compounded by vague indications of budgetary appropriations and no indication of key performance indicators.

Measure 4: Reform in the area of research and innovation

The measure aims at improving the overall functioning of the research and innovation at the state level. The measure also mainly includes activities contributing to better governance and strategic planning. While the measure to some extent aims at increasing expenditure on R&D, there are no clear work plans, budgetary commitments or key performance indicators. The measure thus risks not having a significant impact on the competitiveness of the economy. Some of the planned activities aim at addressing the fragmented framework in this sector, but more efforts could be made. For example, it would be very helpful if the country drafted an Action Plan for the revised strategy for scientific development for 2017-2022.

Given the implementation of the Multiannual Action Plan for the Regional Economic Area, Bosnia and Herzegovina is encouraged to propose a country-wide/state-level framework for the digital economy. This framework should encompass various ERP reform measures on research, development, innovation and the digital economy.

Measure 5: Improving the labour market efficiency

The areas targeted by this measure are relevant. The overall aim is to reform labour market legislation to improve the functioning of the labour market. Employment service reforms are also planned to promote the client-based approach. No concrete steps have been developed overall for 2019-2021 and indicators are missing or inadequate. Given the delays in the past, the implementation has many risks. Costs for the reform measure are not mentioned. The Republika Srpska entity plans to adopt amendments to legislation to reform and redefine the role of the Public Employment Service (PES). However, these amendments depend on the adoption of the Law on health insurance, which is necessary to decrease the burden on the public employment services caused by the servicing of health care insurance. The ERP only outlines steps for 2019. For the Federation entity, the measure is underdeveloped and seems restricted to the adoption of an Employment Strategy and amendments in the area of occupational safety and health, peaceful resolution of disputes and work of private employment agencies.

Measure 6: Improving the social protection system

There is a relevant focus in all parts of the country on better targeting social benefits and better covering the poorest through ‘mapping’ and the creation of registers of benefit recipients. The Republika Srpska entity is planning a comprehensive ‘mapping’ (i.e. an inventory of all social benefits that are available), and developing its register of benefit recipients. It also plans to make a transition from statutory benefits to benefits disbursed based on needs. The activities planned for this measure are relevant and ambitious and have yet to be implemented. The Federation entity is currently setting up a register of cash benefit users, and is aiming at improving the targeting model to ensure better coverage of the poorest and most vulnerable categories of people. However, it is not well explained if war-related benefit recipients will be included in this exercise. The reform measure for the Federation entity also includes other current activities in the social protection field thus diluting the focus of the reform measure.

ANNEX B2: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2018-2020

Reporting on implementation of structural reform measures of the ERP 2018-2020 did not follow the guidance note: this reporting is inadequate and partly incomplete. It also focuses mostly on non-country-wide measures and only partially reflects the current state of play. In many places, the reporting on the stage of implementation is overstated. There is no reporting at state level.

ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Council of Ministers adopted the 2019-2021 ERP on 30 January 2019. The ERP was officially submitted to the Commission on 31 January. The programme is largely in line with medium-term budgetary frameworks, while at the time of the finalisation of the programme the adoption of the country's 2019 budgets had not been completed yet.

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 country-wide programme was presented.

Stakeholder consultation

The draft ERP was published on the DEP website on 23 January; a week before the deadline for submission to the Commission. Invitations to comment were sent out to relevant stakeholders, but no comments were received due to the very short deadline. The ERP was not discussed with the social partners.

Macroeconomic framework

The programme still does not provide the full set of required data. Recent macroeconomic performance is adequately described. The macroeconomic framework is sufficiently comprehensive. However, key features, such as labour-market developments, should have been explained in greater detail. Consistency with other parts of the programme, particularly with the fiscal framework, is still limited. The reasoning behind the chosen policy approach and the link to the overarching policy strategy are not sufficiently elaborated upon.

Fiscal framework

The fiscal framework is still not sufficiently integrated with the other parts of the programme. 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. There are hardly any references to the Commission's assessment in the 2018 Country Report. The ERP provides hardly any quantitative analysis of measures briefly mentioned. The compilation and presentation of fiscal data is not in line with ESA 2010. In particular, there is a lack of country-wide fiscal data.

Structural reforms

Sections 4, 5 and 6 do not follow the programme requirements, and do not present one consistent country-wide reform programme. This reflects the absence of proper coordination between the entities on country-wide challenges and reform priorities. Measures are often formulated too broadly, and the cost of activities (as well as source of financing) is insufficient. Key performance indicators are not always present and potential risks indicate frequently political obstacles. The reporting on the implementation of the policy guidance is largely missing. Tables 10 and 11 do not follow the guidance note. Table 10 hardly provides any information on budgetary implications. Table 11 is not complete. There are 15 reform measures listed, but only six measures can qualify as being country-wide.

References

Digital Innovation Profile Bosnia and Herzegovina – *ICT centric innovation ecosystem snapshot.*

European Commission (2018), *Commission Communication on "A credible enlargement perspective for and enhanced EU engagement with the Western Balkans",* COM(2018) 65 final.

International Monetary Fund (2018), *Country report Bosnia and Herzegovina, Country Report No. 18/39.*

International Monetary Fund (2019) *presentation at the high level retreat, Medjugorje/BiH, February 2019.*

International Telecommunications Union, Digital Innovation Profile BiH, Geneva (2018) (nat. expert assessment).

Network of Associations of Local Authorities of SEE: 2018 *NALAS' Fiscal Decentralisation Report.*

OECD (2018), *Competitiveness in South East Europe – A policy outlook 2018.*

OECD, European Commission, EBRD, ETF, SEECEL: *SME Policy Index Western Balkans and Turkey 2016.*

OECD, *OECD contribution to the 2019 European Commission Enlargement Package, Bosnia and Herzegovina*, January 2019.

The World Bank (2018), *Western Balkans Regular Economic Report.*

U4 Anti-Corruption Resource Center (2018), *Bosnia and Herzegovina: Overview of corruption and anti-corruption.*

UNCTAD (2015), *Investment Policy Review Bosnia and Herzegovina.*

UNICEF, VBJK (Vernieuwing in de Basisvoorzieningen voor Jonge Kinderen) (2016), *Quality of ECE Services, Albania, Bosnia and Herzegovina, Kosovo*, Montenegro.*

World Bank Group (2015), *Rebalancing Bosnia and Herzegovina, A systematic country diagnostic.*

World Bank Group (2019), *Doing Business 2019, Economy profile Bosnia and Herzegovina.*

World Bank Group (2019), *Western Balkans Regular Economic Report No. 15, Spring 2019: Reform Momentum Needed*.

World Bank Group, *The SAA between Bosnia and Herzegovina and the European Union – Impacts of the Adaptation Protocol on the Agriculture and Food Sector.*

World Bank/IFC presentation on business development, Teslic, December 2018.

World Economic Forum (WEF) and the Global Alliance for Trade Facilitation, *The Global Enabling Trade Report 2016.*

World Economic Forum, *Global Competitiveness Report, 2018 edition.*