

Bosnia and Herzegovina

Growth and Jobs

Reform Priorities for Promoting Better Private Sector Jobs

December 2019

GOV



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Executive Summary

1. **Reducing unemployment and inactivity are urgent priorities for Bosnia and Herzegovina (BiH).** Key labor indicators lag compared to other countries in the region.¹ BiH's high unemployment rate is of concern because, despite recent improvements, it appears to be long term in nature. An estimated 80 percent of unemployed have been out of work for longer than 12 months. Limited job opportunities have fueled emigration, especially among the educated, skilled, and youth.

2. **Unlocking Bosnia and Herzegovina's economic potential requires rebalancing its growth model and boosting the contribution of the private sector to job creation.** Growth averaged at a moderate rate of 3 percent from 2014 to 2018. However, at the current growth rate, income convergence with advanced European countries will take 50 years, all else equal.² Domestic consumption boosted by remittances and public spending drive growth. The investment contribution to gross domestic product (GDP) growth continues to be one of the lowest in the region. Doubling the rate of GDP growth would halve the time for convergence but will entail adopting an economic model that relies on an internationally competitive private sector and investment as the primary engine of growth.³ For BiH to achieve sustainable and private-sector-led economic growth, substantial reforms are needed in the medium term to realign incentives and policies towards improving the business environment, addressing low competitiveness, fostering innovation and entrepreneurship, and progressing towards regional and international integration.

3. **This report presents the findings of a multisectoral assessment and consultations with entity governments, civil society, and the private sector.** The assessment considers the policy fundamentals for growth and job creation and focuses on the following areas: (i) labor supply, labor market frictions, and human capital; (ii) human capital and skills; (iii) public sector employment practices; and (iv) the business environment and access to technology and finance. These topics were selected because BiH's persistent job challenge derives primarily from high levels of public transfers and remittances that raise reservation wages, skills mismatches, the large footprint of the State as an employer and economic actor, and an unfavorable business environment that dampens private sector growth. Additionally, the report highlights the existing shortcomings in the monitoring of labor market trends and the evaluation of programs (public sector spending efficiency, labor intermediation, and business support and development services). It is important

¹ The World Bank's Report "Western Balkans Labor Market Trends 2019" estimated for 2018 Q2 that 34.3 percent of adults (822 thousand out of 2.4 million) have jobs, 54.2 percent (equivalent to 1.3 million) of adults are inactive, and 18.4 percent of the labor force is unemployed. The 2019 Labor Force Survey report estimated 35.4 percent of adults have jobs and 15.7 percent of the labor force is unemployed.

² World Bank (2017) Revving up the Engines of Growth and Prosperity in Western Balkans.

³ See World Bank (2015) Rebalancing Bosnia and Herzegovina - A Systematic Country Diagnostic; World Bank (2018); Bosnia and Herzegovina's Economic Journey: Through Peace and Transition to Prosperity; and, World Bank (2017) Revving up the Engines of Growth and Prosperity.

to note, nonetheless, that the report does not address other important topics such as foreign direct investment.

4. **BiH's labor market performance has been weak regarding the number of private-sector jobs created, their quality, and the ability of women and youth to access them.** The low activity rate of the working-age population and the high unemployment rate are the results of mismatches between the supply and demand for skilled labor that restrict development opportunities. BiH's workforce is underutilized. There is a large number of long-term unemployed individuals⁴, who are discouraged from seeking employment, while employers are not able to find the skilled workers that they need.

5. **Underlying the labor market outcomes are skills mismatches, high levels of public transfers and remittance that raise reservation wages, the State's large footprint as an employer and economic actor, and business environment obstacles.** The lack of skills and low labor participation constrain the supply of labor. Besides, firms face a difficult business environment and limited access to financing and technology. Public sector employment practices create substantial distortions. The public sector is overstaffed and unproductive. And, there are deepening fiscal challenges due to the high public wage bill and subsidies to state-owned enterprises including pension arrears.

6. **The assessment identifies priority reforms**, for the next three years, needed to: (a) strengthen labor supply and human capital to increase productivity in jobs; (b) equip citizens with the right skills; (c) reduce the distortionary effects of public sector employment on the labor market and increase the efficiency of spending and service delivery; and, (d) support the private sector to create more and better jobs. A set of cross-cutting recommendations focus on the urgency of introducing an evidence-based approach to the design of interventions. The recommendations include the strengthening of monitoring of labor market trends and evaluation of programs.

7. **Incentivizing job creation and labor market participation requires reducing the mismatch between labor demand and supply.** Tax reform, social assistance reform, and the delinking of health and unemployment insurance are critical to integrate the less employable and improve the targeting of social assistance and active labor market policies. Reforming the labor market, enhancing social protection delivery, and reducing the cost of labor will help BiH citizens find work, in particular women and young people. Improving the targeting, coverage, and design of social protection would improve the supply of labor, promote work, and reduce risks of inter-generational poverty transfer. Also, the menu of active labor market programs needs to be broadened and reoriented to better respond to the needs of both the private sector and job seekers.

8. **Investing in human capital through education and skills development is vital for increasing BiH's productivity and growth over the long-term.** Improving access and upgrading the quality of early childhood care and education should be prioritized because of its long-term impact on cognitive and socioemotional skills development and its shorter-term role in facilitating

⁴ The 2019 Western Balkans Labor Market Trends reports 15.2 for Q2 of 2018.

the participation of mothers in the labor market. Investing in the quality and relevance of secondary general and vocational education and training to support a successful school-to-work transition should be another key priority for the education sector.

9. **Addressing gaps in planning and monitoring systems in public sector employment practices is critical, but also important to help reduce the use of patronage and politics in human resource management.** The public sector has an outsized role as a direct employer, with implications for labor markets. In the medium-term, both entities should create public pay and employment registries in RS and FBiH and institutionalize regular monitoring of pay and employment trends. A shift to more meritocratic and transparent recruitment practices at all levels of BiH's public sector will be a key priority. The Civil Service Agencies should have a stronger role in setting recruitment standards and monitoring compliance with HRM rules through periodic audits. Strengthening human resource management is expected to improve the productivity of the public sector and improve the quality of services to citizens and the private sector. A better and more strategic workforce planning and the establishment of controls in the public sector are important to improving the labor market performance. Streamlining and rebalancing compensation in the public sector (at all government levels) and SOEs would be critical for improving labor market outcomes and reducing key distortions.

10. **Improving the business environment and addressing bottlenecks to efficiency and productivity require structural improvements.** Tackling these constraints would lead to an upgraded institutional and regulatory framework that provides a predictable and increasingly transparent, efficient, and accountable government to support the needs of the private sector. Reducing the number of authorization procedures (e.g., permits, licenses, inspection-related requirements) is critical to improving the business environment. Moreover, for BiH to progress toward a private sector- and innovation-driven economy, it must reform its innovation and entrepreneurship ecosystem and put the enterprise innovation agenda front and center.

11. **Financial sector diversification and supporting the development of a stronger microcredit industry is expected to improve access to finance of micro-enterprises.** A clear legal and regulatory framework would be needed to help spur the development of this industry. Factoring and leasing are underutilized, partly because of shortcomings in the underlying legal frameworks, the need for electronic signatures to become legally binding, and adverse tax treatment of leasing. Private equity and venture capital are still nascent, and so is fintech; however, there is a strong need for these alternatives to traditional financing to support start-ups and promote innovation. A reform of the largely ineffective development finance framework could improve the impact of development finance in the future.

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Acronyms

7STEE	Seven Small Transition Eastern European Economies
ALMP	Active Labor Market Programs
BiH	Bosnia and Herzegovina
CSAs	Civil Service Agencies
EBFs	Extra-Budgetary Funds
ECA	Europe and Central Asia
ECCE	Early Childhood Care and Education
ECE	early childhood education
EU	European Union
FBiH	Federation of Bosnia and Herzegovina
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit
HCI	Human Capital Index
HRM	Human Resource Management
I&E	Innovation and Entrepreneurship
I&E	Innovation and Entrepreneurship
KM	<i>Konvertibilna Marka</i> or Convertible Mark
LFS	National Labor Force Survey
MSMEs	Medium, Small And Micro Enterprises
NEET	Not in Education, Employment, or Training
OECD	Organization of Economic Cooperation and Development
PARCO	Public Administration Reform Coordination Office
PISA	Program for International Student Assessment
PIT	Personal Income Tax
R&D	Research and Development
RS	Republika Srpska
SOEs	State-owned Enterprises
SSC	Social Security Contributions
TVET	Technical and Vocational Education and Training
VET	Vocational Education and Training

Promoting Better Private Sector Jobs in Bosnia and Herzegovina

I. Introduction: Bosnia and Herzegovina's growth and jobs challenge

12. **Reducing unemployment and inactivity are urgent priorities for Bosnia and Herzegovina (BiH).** Key labor indicators lag compared to other countries in the region. According to the 2017 National Labor Force Survey (LFS), only an estimated 32.2 percent of adults (970 thousand out of 3 million) have jobs, 56.9 percent (equivalent to 1.7 million) of adults are inactive, and 25.4 percent of the labor force is unemployed.⁵ These indicators compare unfavorably to the European Union's (EU) respective averages of 53 percent, 27 percent, and 7.7 percent. BiH's high unemployment rate is of concern because, despite recent improvements, it appears to be long term in nature. An estimated 80 percent of unemployed have been out of work for longer than 12 months.⁶ Limited job opportunities have fueled emigration, especially among the educated, skilled, and youth.

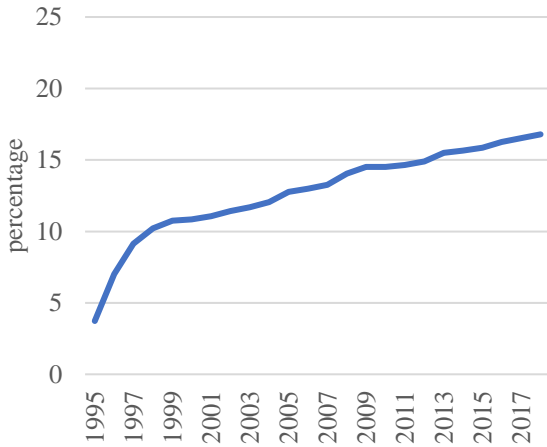
13. **Unlocking Bosnia and Herzegovina's economic potential requires rebalancing its growth model and boosting the contribution of the private sector to job creation.** Growth averaged at a moderate rate of 3 percent from 2014 to 2018 (see Figure 1). However, at the current growth rate, income convergence with advanced European countries will take 50 years, all else equal. Domestic consumption boosted by remittances and public spending drive growth (see Figure 2). The investment contribution to gross domestic product (GDP) growth continues to be one of the lowest in the region. Doubling the rate of GDP growth would halve the time for convergence but will entail adopting an economic model that relies on an internationally competitive private sector and investment as the primary engine of growth.⁷ For BiH to achieve sustainable and private-sector-led economic growth, substantial reforms are needed in the medium term to realign incentives and policies towards improving the business environment, addressing low competitiveness, fostering innovation and entrepreneurship, and progressing towards regional and international integration.

⁵ The World Bank's Report "Western Balkans Labor Market Trends 2019" estimated for 2018 Q2 that 34.3 percent of adults (822 thousand out of 2.4 million) have jobs, 54.2 percent (equivalent to 1.3 million) of adults are inactive, and 18.4 percent of the labor force is unemployed. The 2019 Labor Force Survey report estimated 35.4 percent of adults have jobs and 15.7 percent of the labor force is unemployed.

⁶ World Bank (2017). Revving up the Engines of Growth and Prosperity in Western Balkans.

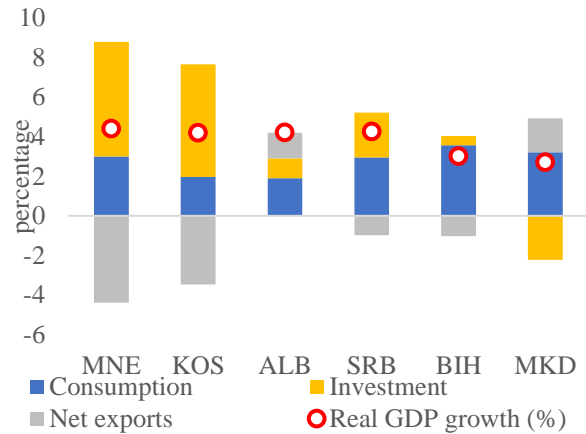
⁷ See World Bank (2015) Rebalancing Bosnia and Herzegovina - A Systematic Country Diagnostic; World Bank (2018); Bosnia and Herzegovina's Economic Journey: Through Peace and Transition to Prosperity; and, World Bank (2017) Revving up the Engines of Growth and Prosperity.

Figure 1: BiH GDP Per Capita Relative to EU Average (percentage), 1995-2017



Source: World Bank, 2018.

Figure 2: Factors in Real GDP Growth (percentage), 2018



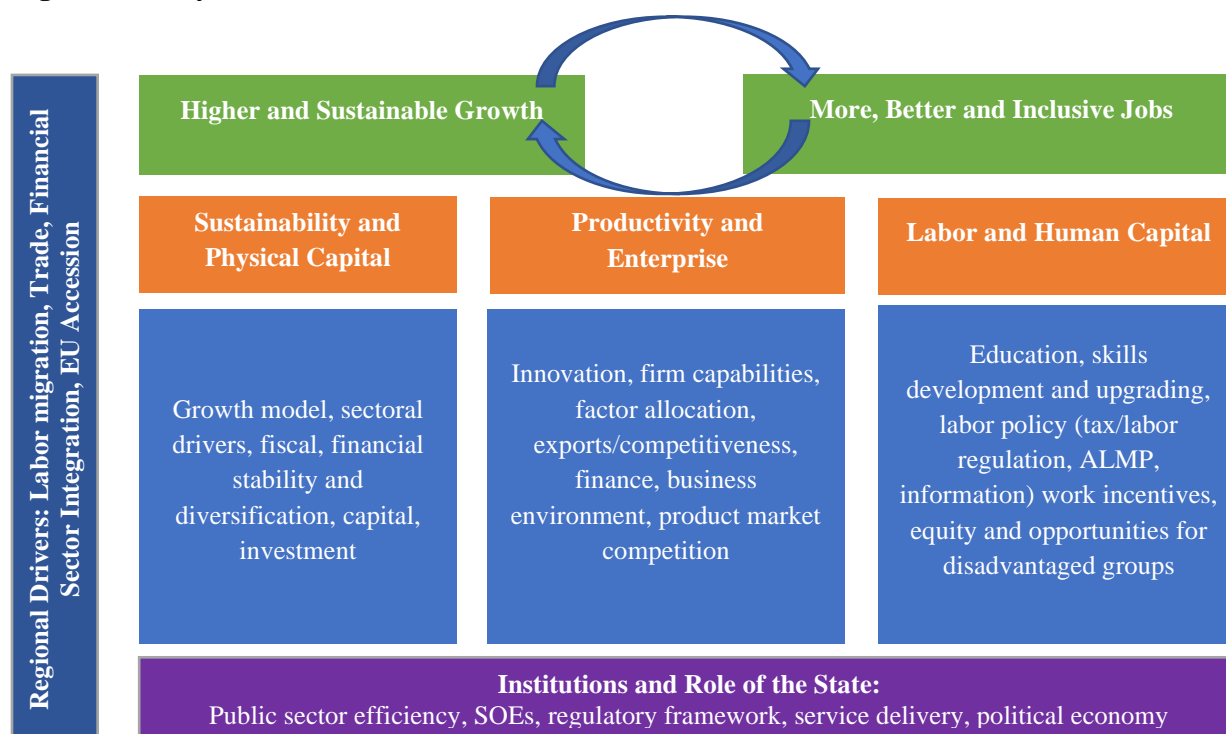
Source: World Bank Regular Economic Report, 2019.

14. **This report presents the findings of a multisectoral assessment and consultations held with entity governments, civil society, and the private sector.** The assessment considers the policy fundamentals for growth and job creation (see Figure 3)⁸ and focuses on the following areas: (i) labor supply, labor market frictions, and human capital; (ii) human capital and skills; (iii) public sector employment practices; and (iv) the business environment and access to technology and finance. These topics were selected because BiH’s persistent job challenge derives from high levels of public transfers and remittances that raise reservation wages, structural skills mismatches, the large footprint of the State as an employer and economic actor, and an unfavorable business environment that dampens private sector growth. Additionally, the report highlights the existing shortcomings in the monitoring of labor market trends and the evaluation of programs (public sector spending efficiency, labor intermediation, and business support and development services). It is important to note, nonetheless, that the report does not address other important topics such as foreign direct investment (FDI) and infrastructure.

15. **The report summarizes the existing knowledge and evidence to provide a comprehensive diagnosis of the jobs challenge that can inform the priorities and sequencing of a BiH’s reform agenda.** It brings together the most relevant data and policy recommendations. First, the analysis considers labor outcomes related to job creation, quality, and access. Second, the report examines the main drivers underpinning the observed problems, and, for each of the policy dimensions, it identifies the priority short-term reforms.

⁸ The Assessment was conducted following the framework that guides the regional study on Growth and Jobs.

Figure 3: Policy Fundamentals of Growth and Jobs Creation in the Balkans



Source: Concept Note Regional Growth and Jobs Study, 2018.

II. The jobs challenge: creating more and better private-sector jobs for all

16. **BiH’s labor market performance has been weak regarding the number of private-sector jobs created, their quality, and the ability of women and youth to access them.** The low activity rate of the working-age population and the high unemployment rate are the results of mismatches between the supply and demand for skilled labor that restrict development opportunities. BiH’s workforce is underutilized. There is a large number of long-term unemployed individuals (16.9 percent of the total labor force in 2017)⁹, who are discouraged from seeking employment, while employers are not able to find the skilled workers that they need.

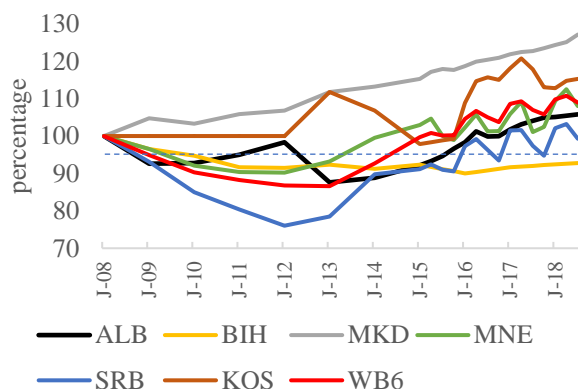
a. Jobs Creation

17. **The job creation has improved slightly since 2016 but remains below the level of 2008.** The recovery has been much slower than the rest of the Western Balkan countries. BiH is the only country in the region where the employment rate remains lower than the pre-crisis level, approximately 8 percent lower than in 2008 (see Figure 4). In 2016, the public sector employed 29 percent of all workers and 39 percent of all formal sector workers, which is very high by

⁹ The 2019 Western Balkans Labor Market Trends reports 15.2 for Q2 of 2018.

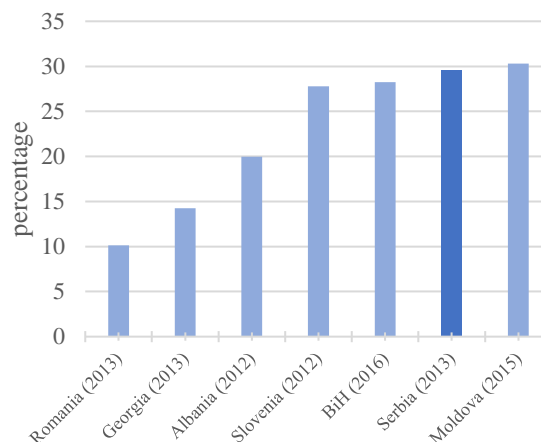
international standards (Figure 5). In the long term, the overreliance on the public sector employment will be fiscally unsustainable.

Figure 4: Number of Jobs Created Compared to Base Year 2008 (percentage, 2008=100), 2008-2018



Source: World Bank Regular Economic Report 2019.

Figure 5: Public Sector Employment as Share of Total Employment (percentage), latest available year



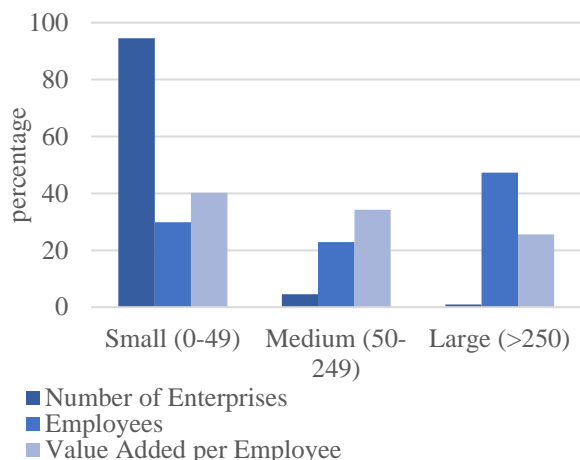
Source: BiH Central Bank, Worldwide Bureaucracy Indicators (most recent, available years)

18. **Most private-sector jobs are created by large companies or small and micro enterprises, while medium-sized enterprises contribute a relatively low share of jobs.** The private sector is made of a few large enterprises and many micro firms. Large and small enterprises account respectively for 38 percent and 33 percent of the total number of people employed in the private sector (see Figure 6). Conversely, medium-sized companies, which generally have the greatest potential for job creation, only account for 11 percent of employment.

19. **The high tax wedge increases the cost of labor and discourages the formalization of jobs.** For every 100 KM spent in salaries by an employer, an employee receives only an average of about 40 KM.¹⁰ This relatively substantial tax wedge is the result of high social security contributions. In BiH, there are only eight private-sector workers per pensioner to finance pensions and health contributions, a much lower ratio than in Western Balkans and OECD European countries. This results in relatively high social security contributions (at around 42 percent of the total labor cost). FBiH is presently considering a proposal to reduce the tax burden from 41.5 to 33.5 percent (see Figure 7). At the same time, the tax base would be widened by taxing fringe benefits (hot meal and vacation allowances).

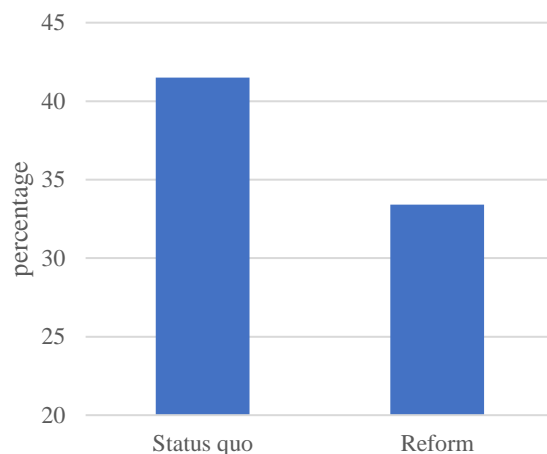
¹⁰ World Bank staff calculations.

Figure 6: Number of Firms, Employees, and Value Added by Firm Size (percentage), 2017



Source: BHAS(2018).¹¹

Figure 7: FBiH Tax Wedge Reform Proposal (percentage), 2018



Source: World Bank staff calculations.

b. Jobs Quality

20. **The significant outmigration and brain drain are associated with a lack of well-paying, formal jobs.** BiH has the highest number of emigrants in absolute terms of the region, 1.3 million in 2017 (equivalent to more than 40 percent of the resident population).¹² Emigrants tend to be young and of working age, the bulk being between 20 and 39 years old. Outmigration is higher among high-skilled and lower-skilled compared to medium-skilled.¹³ While outmigration started in the 1990s because of the political and economic turmoil in the region, now it continues mostly because of the lack of work prospects. BiH unemployed are 61.5 times more likely to express a desire to emigrate than government employees, and seven to eight times more likely than private formal and informal workers (LiTS 2016.)

21. **Informal employment remains substantial and concentrated in rural areas and among less-educated workers.** Informality, meaning that employees have no pension or health insurance, has remained relatively stable (see Figure 8). In 2017, approximately 26 percent of total employment was informal, mainly in agriculture and forestry.¹⁴ Informality is particularly prevalent in rural areas, where 41.7 percent of employed are in the informal sector, in comparison with 11.5 percent in urban areas. Informal employment is concentrated primarily among people with primary education or less.

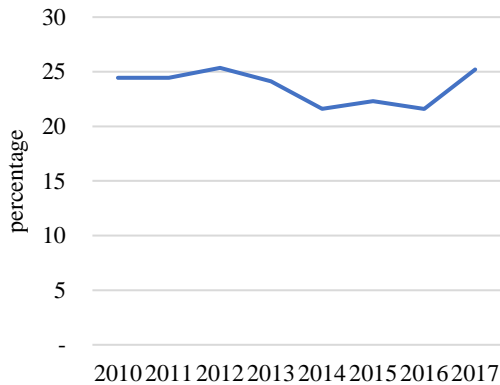
¹¹ http://www.bhas.ba/saopstenja/2018/SBS_00_2017_Y1_0_BS.pdf

¹² Western Balkans Labor Market Trends, 2018.

¹³ Western Balkans Labor Market Trends, 2018. A study estimates that in 2010 BiH lost 43% of their high-educated population (aged 25+) which emigrated to OECD countries. IAB Brain Drain database, Brucker et al., 2013.

¹⁴ Based on LFS 2017 data, informal employment rate ranges between 25.4 percent (using definition “no pension contribution and no health insurance”) and 27.7 percent (using definition “no pension contribution or no health insurance”).

Figure 8: Informality (Percentage), 2017



Source: SEE Jobs Gateway Database.

c. Jobs Access

22. **Labor force participation is the lowest in the region and exceptionally low among women.** The labor force participation rate among people age 15 to 64 was 54.5 percent in 2017.¹⁵ The rate has remained at the same level for the last decade because the number of unemployed has fallen at the same pace as the number of inactive people.¹⁶

23. **The aging population and substantial outmigration have led to a shrinking working-age population.** BiH’s working-age population has declined in absolute numbers, especially in the last two years. The total working-age population was 2.1 million in 2010, but by 2017 it had shrunk to 1.8 million. The decrease in unemployment and inactivity is due to BiH’s sharp demographic decline, which is, in turn, due to fertility rates (estimated at 1.25 in 2017) that are considerably below replacement level and outmigration.

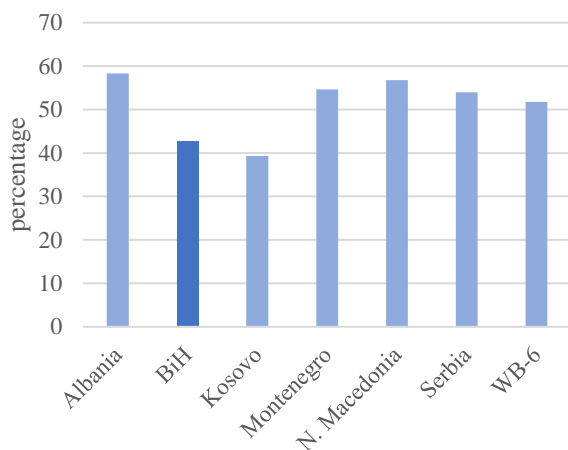
24. **The gender gap in labor force participation is large.** In 2017, the activity rate for all individual older than 15 was 42.6 (see Figure 9), but a breakdown by gender shows that the labor force participation of women was 23 percentage points lower than for men. BiH has one of the lowest rates of female labor market employment rate in the region (32 percent among women older than 15 compared to a regional average of 43 percent; see Figure 10).¹⁷ There is also a disproportionately large share of highly educated women (26 percent compared to 15 percent among men) among the unemployed.

¹⁵ The 2019 Western Balkans Labor Market Trends report estimated 54.2 for Q2 2018.

¹⁶ The labor force participation rate is $\frac{\text{employed} + \text{unemployed}}{\text{working age population}} = \frac{\text{employed} + \text{unemployed}}{\text{employed} + \text{unemployed} + \text{inactive}}$. Because both the number of unemployed and inactive declined, the overall ratio did not change. See footnote 2 for more year by year details.

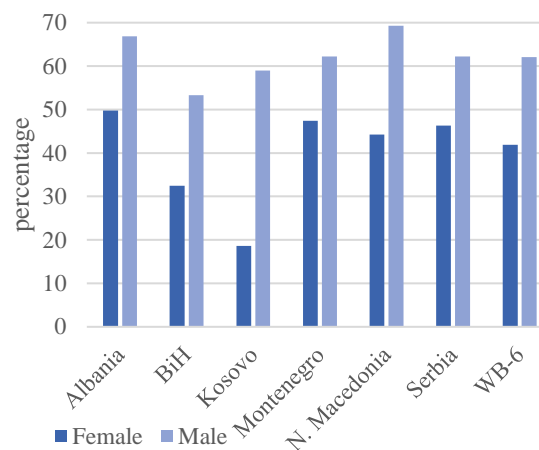
¹⁷ The 2019 Western Balkans Labor Market Trends report estimated an activity rate for women older than 15 of 31.4 for Q2 2018 while the most recent Labor Force Survey Report estimated a rate of 32.9 for 2019.

Figure 9: Activity Rate 15+ (Percentage), 2016-2017



Source: SEE Jobs Gateway Database.

Figure 10: Activity Rate 15+ by Gender (Percentage), 2017



Source: SEE Jobs Gateway Database.

25. **BiH's high unemployment rate is of concern because, despite recent improvements, it appears to be long term in nature.** Unemployment remains above the regional average (see Figure 11). In 2017, an estimated 80 percent of unemployed have been out of work for longer than 12 months (see Figure 12. There is a large number of long-term unemployed individuals (16.9 percent of the total labor force in 2017)¹⁸.

26. **While unemployment declined sharply between 2015 and 2017, this decline cannot be credited to job creation as the number of jobs over the period also fell.** The unemployment rate stayed constant at around 29 percent between 2010 and 2015 but declined to 22 percent in 2017. The preliminary data for 2018 and 2019 confirms the declining trend.¹⁹ However, this reduction cannot be attributed to an increase in employment every year. Between 2010 and 2014, the number of unemployed people decreased, but so did the number of jobs, resulting in negligible changes in the unemployment rate. In 2015, the reverse occurred, with an increase in the number of jobs and the number of unemployed, again resulting in a similar level for the unemployment rate. The unemployment rate finally went down in 2016 and 2017. In 2016, both the unemployed and the number of jobs decreased, the latter was in a smaller proportion. Yet, in 2017, the number of unemployed decreased (60,078 people), and the number of jobs increased (5,626 new jobs), leading to a substantial drop in the unemployment rate.²⁰

27. **The decrease in unemployment was larger for men than for women, but overall female employment did increase while male employment decreased in 2017.** The decrease in the unemployment rate is more pronounced for men than for women. The female unemployment

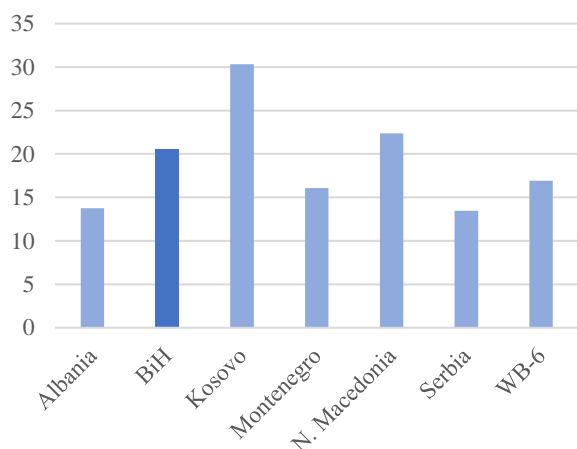
¹⁸ The 2019 Western Balkans Labor Market Trends reports 15.2 for Q2 of 2018.

¹⁹ The 2019 Western Balkans Labor Market Trends report estimated unemployment rate for of 18.4 for Q2 2018 while the most recent Labor Force Survey Report estimated a rate of 18.9 for 2019.

²⁰ The 2019 Western Balkans Labor Market Trends report estimated that the number of unemployed individuals had a decrease of 26 thousand between 2017 and Q2 2018, while the number of the employed increased by six thousand in the same period. This dynamic is similar to the one observed in 2017.

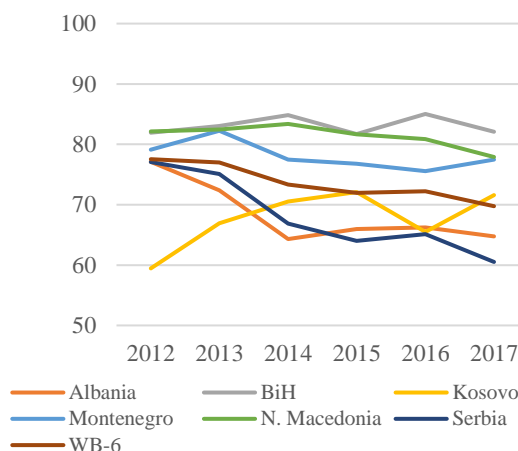
rate declined from 32 percent in 2015 to 25 percent in 2017, while the one for males from 27 percent to 20 percent.²¹ However, because more women have left inactivity than men, the unemployment rate shows a similar decrease for females than for males.

Figure 11: Unemployment (Percentage), 2017



Source: SEE Jobs Gateway Database.

Figure 12: Long-term Unemployment as Share of Unemployed (Percentage), 2012-2017



Source: SEE Jobs Gateway Database.

28. **Youth unemployment rate remains high by European standards, with a rate of 38.8 percent of the labor force between 15 to 24 in 2017.**²² Of the unemployed youth, 86 percent have less than tertiary education. Another sign of the weak labor market for youth is that one out of four individuals between 15 and 24 years old were not employed, not pursuing education, or in training (NEET) in 2017.²³

III. Drivers of the mismatches in the labor market and policy options to address them

29. **Underlying the labor market outcomes discussed above are several key factors that hamper the ability of the private sector to create good jobs.** Structural skills mismatches, high levels of public transfers and remittance that raise reservation wages, the State's large footprint as an employer and economic actor, and business environment obstacles are behind BiH's job challenge. The lack of skills and low labor participation constrain the supply of labor. Besides, firms face a difficult business environment and limited access to financing and technology. Public sector employment practices create substantial distortions. The public sector is overstuffed, unproductive, and fiscally constrained. And, there are deepening fiscal challenges due to the high

²¹ The 2019 Western Balkans Labor Market Trends report estimated an unemployment rate of 20.3 for women and 17.2 for men for Q2 2018 while the most recent Labor Force Survey Report estimated a rate of 18.5 for women and 17.2 for men for 2019.

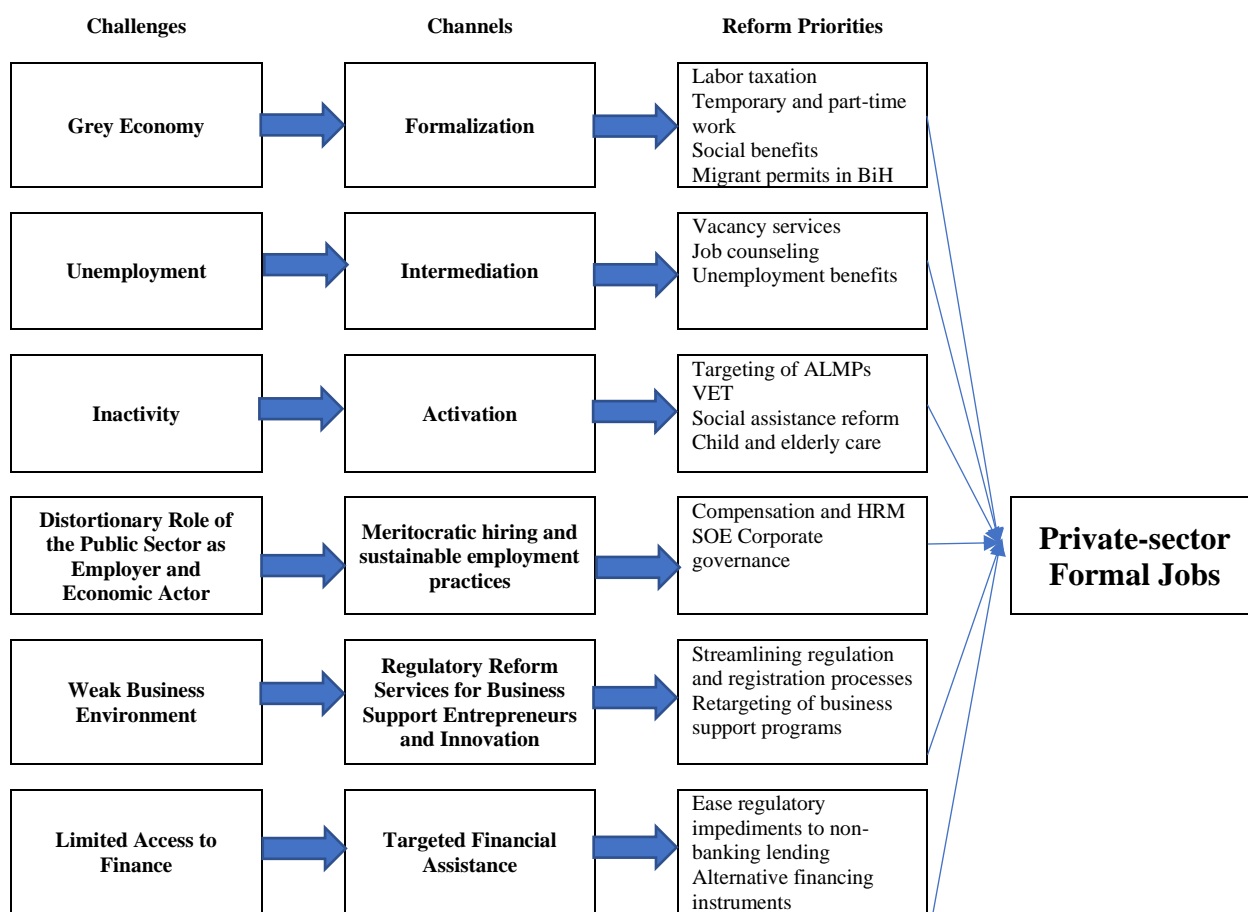
²² The 2019 Western Balkans Labor Market Trends report estimated a rate of youth unemployment of 35.4 for Q2 2018 while the most recent Labor Force Survey Report estimated a rate of 23 for 2019.

²³ LFS data (2017) and Western Balkans Labor Market Trends, 2019.

public wage bill, subsidies to state-owned enterprises (SOEs) including pension arrears, and social assistance expenditure on unemployed.

30. **This section highlights the most urgent reforms related to each of the drivers analyzed.** The assessment identifies priority reforms (see Figure 13), for the next three years, needed to: (a) strengthen labor supply and human capital to increase productivity in jobs; (b) equip citizens with the right skills; (c) reduce the distortionary effects of public sector employment on the labor market and increase the efficiency of spending and service delivery; and, (d) support the private sector to create more and better jobs. Their expected impact categorizes the potential entry points. The full set of recommendations, including also medium-term reforms, are detailed in Annex I.

Figure 13: Channels to Support Private Sector Jobs



31. **A set of cross-cutting recommendations focus on the urgency of introducing an evidence-based approach to the design of interventions.** The recommendations include the strengthening of monitoring of labor market trends and evaluation of programs.

a. Social protection and labor market institutions

i. Drivers of limited labor participation and informality

32. **The current labor regulations are cumbersome, create incentives for informality, and increase labor costs.** The high tax wedge and non-wage portion of wages (social security contributions) generate incentives for informality. These incentives are especially present for low skilled and short term/seasonal employment, as the minimum wage serves as the base for calculating taxes and social contributions. Moreover, there are no special regulations on personal income tax (PIT) or social security contributions (SSC) for seasonal or part-time workers.

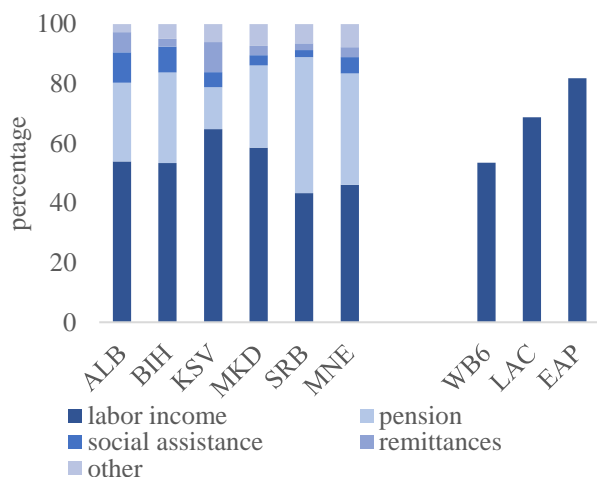
33. **The social protection system (comprising social assistance, unemployment benefits, maternity benefits, and health insurance) creates disincentives for labor market participation.** Social assistance is currently withdrawn at a rate of 100 percent of any formal income—meaning that for every KM earned, beneficiaries lose one KM in benefits. The high withdrawal rate, combined with a tax system that penalizes low-income workers (with relatively low nontaxable minimum threshold and a flat personal income tax), contributes to keeping unemployment and inactivity high.

34. **Pensions and social assistance represent close to half of the household income** (see Figure 14). Approximately 40 percent of the population below 65 years old is eligible to receive pension benefits. The generous war veterans' benefits, which also include the children and wives of deceased war soldiers and veterans, are not poverty-targeted and create additional disincentives to work.

35. **The fact that health insurance is tied to unemployment benefits creates additional incentives for informality in jobs.** The large majority of those informally employed are registered as unemployed solely to obtain health insurance coverage. There is also a non-negligible percentage of the employed who have temporary contracts, of whom 47 percent are not entitled to pension insurance, and 46 percent are not entitled to health insurance.

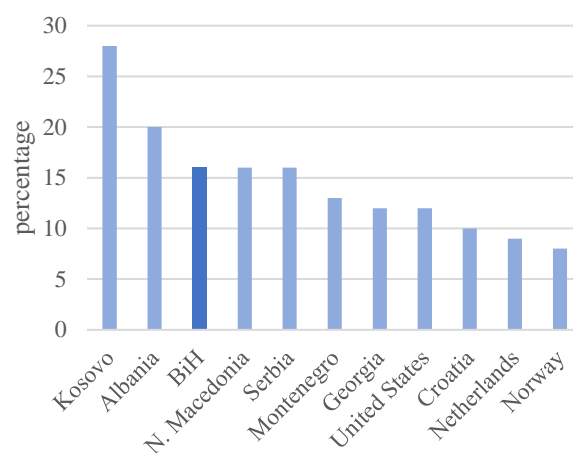
36. **Limited institutional capacity and linkages across social assistance and labor programs present serious challenges in serving the populations at risk.** Centers for social work lack technical and administrative capacity to improve targeting of social benefits or offer substantive assistance and counseling to populations at risk of poverty. Besides, there is a lack of coordination and data sharing between social assistance and employment services. The public employment services (PES) are overwhelmed with registering unemployed who are not looking for work but want free health insurance. Furthermore, the workload per counselor is one of the highest in the region, with 1,400 job seekers per counselor in the Federation of Bosnia and Herzegovina (FBiH) and 1,000 per counselor in the Republika Srpska (RS).

Figure 14: Household Consumption by Income Source (percentage), 2017



Source: World Bank 2018

Figure 15: Loss of GDP Due to Gender Gap (percentage), 2014



Source: Cuberas and Teignier 2015

37. **A lack of work flexibility and child and elderly care, together with unequal opportunities and social norms that burden women with household work, limit female employment.** The low participation of women in the female force is estimated to cost BiH 16 percent of its GDP (Cuberas and Teignier 2015, Figure 15). There are also some explicit job restrictions for women.²⁴

ii. *Policy priorities and recommendations to strengthen social and labor market institutions in support of jobs*

38. **Incentivizing job creation and labor market participation requires reducing the mismatch between labor demand and supply.** Tax reform, social assistance reform, and the delinking of health and unemployment insurance are critical to integrate the less employable and improve the targeting of social assistance and active labor market policies. Reforming the labor market, enhancing social protection delivery, and reducing the cost of labor will help BiH citizens find work, in particular women and young people. The key priorities in these areas are presented in Table 1. Annex I provides additional medium-term policies.

Table 1: Priority Short-term Reforms in Labor Regulations and Intermediation

Reforms Areas	Impact	Responsible Agency
Labor Market Regulation/Intermediation		

²⁴ Women cannot work the same night shift hours as men nor can women do some of the same jobs as men. For more details see Women, Business and the Law Library. <https://wbl.worldbank.org/en/data/exploretopics/getting-a-job#a>

Reforms Areas	Impact	Responsible Agency
<ol style="list-style-type: none"> 1. Adopt and implement the Social Security Contribution and Personal Income Tax laws and implement amendments to the FBiH labor law on minimum wage approved and gazetted on November 9, 2018 to reduce the burden on labor and increase workers' take-home pay, while leaving the gross salary the same. 2. Streamline and strengthen labor inspections/audits by introducing a risk-based approach to labor inspections. 3. Adjust the labor code and labor taxes to create incentives to formalize temporary jobs (i.e., duration of temporary contracts, social security deductions, and benefits, introduce vouchers for SSC for seasonal and temporary workers). 	High Impact	Ministries of Labor and Finance
Activation		
<ol style="list-style-type: none"> 1. Revise the definition of “unemployment” in the draft Intermediation and Unemployment law of FBiH to allow the reform of the rulebook. 2. Revise unemployment benefits to improve incentives for work through the new Intermediation/Unemployment Law (changes in the base—average wage or last wage—and other parameters of the scheme). 3. Review/adjust maternity benefits to improve incentives for work and re-entry to the labor market. 4. Introduce targeted work permits for migrants. 5. Align the design of social assistance to encourage labor market participation: improve the targeting of social assistance to remove incentives for informality and inactivity, introduce in-work benefits, and orient social assistance policy towards “activation.” 6. Improve access to child-care and elderly-care by expanding public supply and subsidies for private care (see also Table 2 on Early Childhood Education). 	High Impact	Ministries of Labor
Labor Participation of the Less Employable and Youth		
<ol style="list-style-type: none"> 1. Delink access/delivery of health insurance from unemployment registration to reduce incentives for informality and improve equity in access to benefits through amendments to Intermediation Law, Health Insurance Law, and other administrative changes. 2. Reorient/reinforce employment services towards less employable and youth. 3. Improve the quality of policy evidence generated, building on the impact evaluations of ALMPs currently led. 4. Re-orient ALMPs to support groups in needs of/readjustment of skills given the structural change and the higher level of vulnerability (related to SOEs, see Table 3). 	High Impact Medium Impact	Ministries of Labor
Facilitating Matching and Intermediation between Labor Demand and Supply		
<ol style="list-style-type: none"> 1. Establish a Labor Market Observatory and develop the Labor Market Information System, including collecting and analyzing data on occupations and skills on demand and growth sectors.(*) 	High Impact	Ministries of Labor
(*) Cross-cutting recommendations		

39. **Reducing the mismatch between labor demand and supply requires a reform of the Social Security Contribution and Personal Income Tax laws.** Employment in BiH is hindered by high taxation. Moreover, high labor taxes combined with low thresholds mean that lower-

income groups are particularly hit by high taxation. Some of this tax burden could be shifted away from labor and toward other areas, such as tobacco and fuel (increasing prices back to pre-oil price crash levels), which alone could raise over 5 percent of GDP in revenue, the equivalent of a third of that currently raised from social security contributions. Reducing the tax burden on jobs would help to improve the competitiveness of most productive sectors in the economy (including manufacturing, and tourism). Shifting the tax burden away from the bottom 40 percent of the population should help boost shared prosperity.

40. Improving the targeting, coverage, and design of social protection would improve the supply of labor, promote work, and reduce risks of inter-generational poverty transfer. Social protection is currently not well-targeted and designed to integrate the less employable, with a majority share absorbed by only specific population groups and those who are wealthier. At the same time, many people in need do not receive benefits. With many of the poor having larger families, the risk of intergenerational poverty transfer is high. Better targeting of social benefits could help to reduce poverty, promote work and, critically, help reduce inter-generational poverty transfer. Ultimately, the unemployed, many of whom are in the bottom 40 percent in the income distribution, would likely benefit greatly from such a reform.

41. Adjusting benefits for the unemployed, including health insurance, to incentivize labor participation and formalization requires administrative and policy changes. Entities can make internal processes more efficient through automation, and further strengthening the identification of the registered unemployed who are interested in employment support and focusing resources on them. In the medium term, entities could better target the benefits based on employment status by: (a) conditioning access to basic health care for registered unemployed by enforcing job search requirements, or by length of unemployment, or other characteristic associated to unemployment; or (b) moving health insurance to Centers for Social Work or Health Insurance Fund local offices.

42. Establishing a strong dialogue between educational institutions and the private sector on the current and forecasted skills demand is needed to reduce the mismatch and close the gap between labor supply and demand. The dialogue should also involve third parties such as business associations, chambers of commerce, and NGOs in the education and training sector. However, less than 20 percent of firms report having regular contact with education or training institutions.²⁵ Additionally, developing a well-designed labor market information system that provides timely information to end-users will help reduce the information asymmetry (between students/job seekers and employers) and better align expectations with market returns.

43. Public Employment Services must be re-oriented to promote skills development and tailored services and programs to strengthen labor supply according to private sector needs. At present, the level of job intermediation services is not satisfactory. A review of PES efficiency led in 2016 by the World Bank estimates that better services could increase total job placement by

²⁵ Data from STEP Employer survey, 2016.

25 percent while keeping staff costs and expenditures constant.²⁶ There are several areas that require improvements. Platforms supporting PES need to improve business processes to provide support (increased coverage) to more employers and job seekers. A better effort needs to be made to establish stronger and continuous relationships with the private sector. Currently, this relationship is very limited and opportunistic with few vacancies registered with PES, and most businesses come into contact there to take advantage of wage subsidies rather than seeking intermediation services.

44. **The menu of active labor market programs (ALMP) needs to be broadened and reoriented to better respond to the needs of both the private sector and job seekers.** Most of the resources for ALMPs are presently allocated to wage subsidies targeting employers and not to other types of programs that promote “activation.” The targeting of ALMPs is inadequate as there is no proper profiling based on assessed needs and employment probability. Therefore, although some efforts need to be focused on those who have the highest potential to be activated, job seekers should be directed to differentiated services, and ALMP resources should be channeled towards programs with higher impact.

b. Human capital and skills

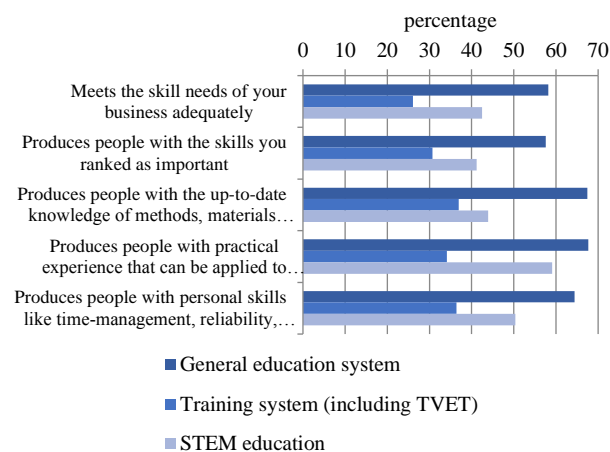
i. Drivers of the lack of adequate skills and low efficiency of spending in education

45. **The inadequate supply of skilled workforce is a hindrance to firm growth and job creation.** Employers note skills shortages across educational profiles, suggesting that the linkages between education institutions and the labor market should be strengthened at all levels. The difficulty in finding skilled workers is due to various reasons, including out-migration and lack of experience and market-relevant skills.

46. **Employers consider that the education system does not equip students with the relevant skills and up-to-date knowledge.** A recent survey of employers (STEP 2016-17) indicates that over 50 percent of reporting firms think that the general education system fails to produce the right skills needed for productivity (see Figure 16). Employers note that Technical and Vocational Education and Training (TVET) and skills training providers often do not provide students with up-to-date knowledge and technical skills, while nearly 60 percent of employers think that STEM education does not provide sufficient opportunities for acquiring practical experience, which can be applied to real-life working situations. These findings indicate that efforts are needed to bring the education system and labor market closer together to ensure that graduates have the necessary skills to find work and be productive. Consulting and involving employers in the design of curricula would ensure that curricula are aligned with their needs.

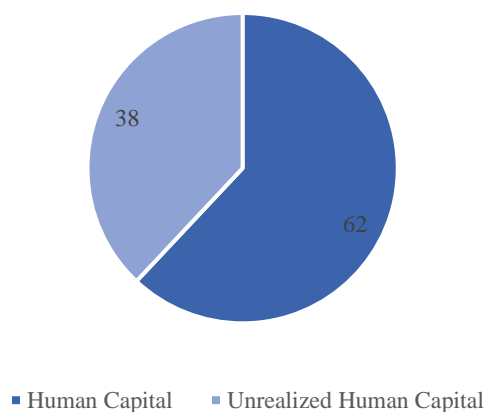
²⁶ Bosnia and Herzegovina Functional Review: Efficiency Analysis of the Public Employment Services 2016, Summary note, May 2018. However, these estimates need to be taken with caution since the exercise conducted for BiH is more illustrative than reliable given the limited and low-quality indicators provided by the employment bureaus.

Figure 16: Firm Satisfaction with the Education (percentage that disagrees with the statement), 2016



Source: STEP Employer Survey 2016

Figure 17: Human Capital Index (percentage), 2018



Source: World Bank, 2018

47. **The training provided by firms could partially compensate for the low level of skills at hiring, but the overall provision of training is low.** Technical training is mostly done on-the-job (60 percent of firms) on an informal basis. Firms have no economic incentives to train workers on non-specific firms' skills and/or no capacity to do so. Around one-third of firms consider that labor issues are a severe constraint for growth. More specifically, lack of adequate skills and lack of relevant work experience are the two main problems reported by employers trying to hire across all types of occupations. This constraint is especially binding for labor market entrants (youth).²⁷

48. **Lack of adequate skills reduces the potential wage of workers and may result in more inactivity.** Inadequate skills may also prolong the job search period and discourage unemployed workers from continuing searching for a job or induce them to take a job for which they are not a good match, and hence may result in an even lower wage. Inadequate skills may also be found among potential entrepreneurs, which also result in lower levels of self-employment, and higher rates of business startup failures.

49. **In BiH, low levels of human capital, particularly education and skills, will pose a major constraint for economic development.** According to the World Bank's Human Capital Index (HCI), the average child in BiH born today can expect to grow up to be about 62 percent as productive as they could be if they had access to complete education and full health status (see Figure 17). BiH has one of the lowest HCI scores in the Europe and Central Asia (ECA) region, even compared to other countries in a similar income group, such as Bulgaria (0.68), Croatia (0.72), and Serbia (0.76).²⁸

50. **Few children in BiH—particularly those from vulnerable backgrounds—participate in early childhood education (ECE).** There is a low supply of early childhood care and education

²⁷ Data from STEP Employer survey, 2016.

²⁸ World Bank. 2018. *Bosnia and Herzegovina: Human Capital Index Rank 58 out of 157*. Retrieved October, 2018 from http://databank.worldbank.org/data/download/hci/HCI_2pager_BIH.pdf

(ECCE) offerings relative to demand, leading to low participation rates relative to peer countries and a system that disproportionately benefits the better-off children rather than children from poor households. At 13.1 percent as of 2011, BiH has one of the lowest ECE enrollment rates for children age 3 to 5 in the Western Balkans, significantly below rates in North Macedonia (21.8 percent) or Serbia (44 percent). ECE enrollment rates were especially low in rural areas where fewer than 8 percent of children attend ECE.²⁹ There are also differences in ECE access between the entities, with enrollment rates of 14.4 percent in the Federation of Bosnia and Herzegovina (FBiH) and 10.3 percent in Republika Srpska (RS). ECE financing is further fragmented as it is under the responsibility of municipalities.

51. Learning outcomes in basic education are poor and highly inequitable. In spite of relatively high expected years of schooling by the time boys and girls reach age 18 (approximately 11.7 years), after accounting for educational quality, they can expect to receive an equivalent of 8.6 years of schooling. This learning gap of approximately 3.1 years of schooling represents a significant missed opportunity to develop the human capital and skills needed for the labor market and is a contributing factor in the high youth unemployment of 55 percent in 2017.³⁰

52. Secondary education and vocational training face significant quality and relevance issues, which encourage student dropout and hinder skills development for the labor market. A USAID survey conducted in 2016 found that only 29 percent of BiH citizens are satisfied with secondary schooling, and 70 percent believe that education should be reformed to better meet market needs. This lack of perceived value of secondary education is also evidenced by the lower enrollment in upper secondary education (77 percent in 2009), which is when education ceases to be compulsory in BiH. In 2015, the proportion of young people aged 15-24 not in employment, education or training (NEETs) was about 28 percent and slightly higher for men (29 percent) than for women (26 percent).

53. Close to two-thirds of pupils at the secondary level enroll in technical and vocational schools, despite the misalignment between school offerings and the needs of the labor market. While there is some variation within BiH, most students across the country are enrolled in secondary Vocational Education and Training (VET) profiles. However, available information indicates that many VET profiles are outdated and/or poorly equipped to provide the skills needed by employers.

54. There has been an increase in enrollment in tertiary education over time and a proliferation of tertiary institutions, but the quality is a concern. The available data points to weak higher education performance, with high repetition and dropout rates, as well as a low overall rate of enrollment relative to ECA and EU averages. Internal efficiency is very low, with nearly

²⁹ For Roma children, a striking 3 percent were enrolled in preschool education in 2017, down from 11 percent in 2011 (access and educational outcomes for Roma children are especially problematic not just in ECE, but also in primary and secondary levels).

³⁰ World Bank. 2018. *Unemployment, youth total (% of total labor force ages 15-24) (modeled ILO estimate)*. Accessed November 2018 from <https://data.worldbank.org/indicator/SL.UEM.1524.ZS>

24 percent of students repeating an academic year, nearly 13 percent dropping out completely (2008), and only roughly 50 percent of students who enroll in universities graduating. Because of the high repetitions, it takes an average student almost seven years to complete a four-year degree in BiH. Moreover, despite recent increases, gross enrollment rates in tertiary education in BiH (37 percent in 2009³¹) are lowest among peer countries and fall behind the average rates for the region and the EU, which in 2010 were 61 percent and 64 percent, respectively.

55. **Cooperation between higher education and employers remains limited.** Some universities have included internship programs in their study curricula. Numerous faculties (especially technical professions) have their centers to establish connections with industrial enterprises where students can pursue a traineeship program. Furthermore, some universities have career guidance centers, which help students find jobs or improve their qualifications to increase their employability. Most universities in the process of creating new or making changes to existing academic programs involve stakeholders from industry to improve their curricula; however, this is not enough to achieve a strong partnership between higher education institutions and the labor market. Consequently, graduates in mathematics and ICT find jobs more easily, while students who graduate from the life sciences (biology and environmental protection), arts, and medical sciences find it more difficult to land a job in their field. Cooperation with the labor market needs to be improved through careful research of the labor market and industry sector needs, as well as through a connection of learning outcomes with curricula and assessment methods.³²

ii. Policy priorities and recommendations to increase human capital and skills

56. **To help tackle BiH’s human capital challenges and enhance the skills of the labor force, it is important to improve quality, equity, efficiency, and governance within the education system.**³³ The most pressing reforms are listed in Table 2 and further elaborated in Annex I.

Table 2: Priority Short-term Reforms to Improve Human Capital and Supply of Skills

Reform Areas	Impact	Responsible Agency
Higher Education		
1. Advance quality assurance and accreditation reforms in line with the Bologna Process. 2. Create incentives and establish a feedback loop with the private sector by implementing graduate tracer studies.	High Impact	Ministries of Education
Technical Skills Supply		

³¹ Ibid.

³² Ibid.

³³ Arias, Omar S. and Sanchez-Paramo, Carolina. 2014. Back to Work: Growing with Jobs in Europe and Central Asia. Washington, DC: World Bank.

Reform Areas	Impact	Responsible Agency
<ol style="list-style-type: none"> 1. Expand access to career counseling and guidance in final classes in primary school and job information in secondary schools. 2. Modernize VET curricula and consolidate profiles with input from employers. 3. Increase access to opportunities for work-based learning (apprenticeships). 	High Impact	Ministries of Education and Labor
Early Childhood Care and Education (ECCE)		
<ol style="list-style-type: none"> 1. Increase the number of spaces in pre-school education 2. Initiate a program to measure the quality of ECCE services by tracking child development and school readiness outcomes using validated instruments 	High Impact	Ministries of Education and Finance

57. **Investing in human capital through education and skills development is vital for increasing BiH’s productivity and growth over the long-term.** Human capital consists of the knowledge, skills, and health that people accumulate throughout their lives, enabling them to realize their potential as productive members of society.³⁴ Countries need to invest more in human capital to sustain economic growth, prepare workforces for the more highly-skilled jobs of the future, and compete effectively in the global economy.³⁵ Skills encompass fundamental cognitive skills, such as math and reading, socio-emotional skills (i.e., perseverance and social interaction), as well as job-related technical skills.³⁶ Skills constraints become more acute as the economy grows and moves up the global value chain.

58. **Improving education services and labor market skills is the key to escaping poverty.** Education is closely linked to employment and being in the B40. Quality education, especially preschool, is essential for escaping from poverty. Despite the importance of education, there is a lack of focus on the quality of education, with no national-level exams guaranteeing learning standards and a proliferation of under-regulated universities. Some firms complain of skills constraints, with there being some evidence that larger firms are much more likely to suffer from skills shortages than smaller ones. Improving education and skills training would benefit the whole population but would have particular advantages for the poor, the B40 and rural dwellers, who have a poverty incidence twice as high as their urban counterparts, around half of which is explained by education differences. Providing access to opportunities for adult training would help the rural poor. Improved quality of education for their children—particularly early childhood education—would also be a significant step toward ensuring that inter-generational poverty transfer is reduced.

³⁴ World Bank. 2018. *Human Capital Project*. Accessed November, 2018 from <http://www.worldbank.org/en/publication/human-capital>

³⁵ World Bank Group. 2018. *The Changing Wealth of Nations*. Retrieved October, 2018 from <http://pubdocs.worldbank.org/en/115091521533836464/032218-seminar-the-changing-wealth-of-nations-2018.pdf>

³⁶ UNESCO. 2017. *Reducing Global Poverty through Universal Primary and Secondary Education*. Retrieved October, 2018 from <http://unesdoc.unesco.org/images/0025/002503/250392E.pdf>

59. **Improving the efficiency of resource distribution within the sector could create the fiscal space for investments needed for BiH to strengthen and modernize its education system.** The latest available data indicate that in total BiH spent about 5 percent of GDP on education, which is slightly higher than the regional median of 4.2 percent and that of other countries in the region, such as Croatia (4.4 percent), Kosovo (4.2 percent), and FYR Macedonia (3.5 percent). While the overall level of spending on education may be sufficient, given the low preschool coverage, the inequality of learning outcomes, and the poor linkages between education institutions and employers, the distribution of spending needs to be adjusted to bring outcomes closer to peers in the Western Balkans and the EU. Given the fragmented processes of resource allocation and decision-making, rebalancing of expenditures across the levels of education will require a consensus of the different decision-makers (i.e., the Ministries of Finance, Ministries of Education, and municipalities) and a more transparent financing model, such as introducing a per-student financing mechanism and harmonizing systems for collecting administrative and financial data for education.

60. **Improving access and upgrading the quality of early childhood care and education (ECCE) should be prioritized because of its long-term impact on cognitive and socioemotional skills development and its shorter-term role in facilitating the participation of mothers in the labor market.** Even when ECE shapes a child’s long-term trajectory, few children in BiH—particularly those from vulnerable backgrounds—participate in ECE. Children benefiting from quality early interventions—which cover the physical, socio-emotional, language, and cognitive development—learn better when they enter primary school and earn higher wages as adults. The return on investments is even higher for disadvantaged students and helps to level the playing field.³⁷

61. **Investing in the quality and relevance of secondary general and vocational education and training (VET) to support a successful school-to-work transition should be another key priority for the education sector.** The project “VET in Bosnia and Herzegovina” (2017-2019) implemented by the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) is supporting ongoing VET reforms in the country and aims to develop: 1) occupational standards, competency-based and labor-market oriented curricula, 2) regulations for conducting technical and vocational training in VET schools and companies, 3) professional development of VET teachers, and 4) improve the image of VET in general. Nevertheless, according to a Tracer Study completed by GIZ in 2018, 67 percent of VET graduates indicated a lack of practical skills training, 63 percent indicated a lack of equipment and training materials, while only 51 percent of the employed graduates had a job related to their profession that half of them found through personal relations as opposed to career counseling.

62. **The country needs to systematically measure and monitor education quality at all levels to monitor progress and ensure transparency and accountability.** Although the legal

³⁷ World Bank. 2015. *Investing in Young Children: An Early Win*. Retrieved November, 2018 from <http://www.worldbank.org/en/news/infographic/2015/08/26/investing-in-young-children-an-early-win>

framework regulating collection and systematization of data for the country is in place at state and entity levels and most cantons have adopted and harmonized their laws accordingly,³⁸ education statistics and data are scattered.

63. **Moving away from inputs-based financing to a per-student formula could establish better planning and transparency in the allocation of resources for the higher education sector.** Some efforts have been made to improve the financing of higher education at public universities/colleges, which is made from both the budget of education authorities and from students' fees, yet there has not been much progress in this area. For instance, in 2014 the EU funded a project entitled "Reform of Higher Education Financing in BiH", which proposed a student-based allocation model or "a model of financing public universities to be defined as the principle of higher education financing according to which the basis for financing would be represented by costs per student of a certain study program, within a certain study cycle." It also developed a tailored software enabling universities to calculate costs of operations, to establish actual and optimum costs per student and study program, as well as to identify deficit or surplus study programs, examine how cross-subsidization works or needs to work between the public and university income sources and among study programs. However, this proposed model has not yet been implemented.

c. Public sector employment practices

i. Drivers of a large, complex and inefficient public sector that distorts the labor market

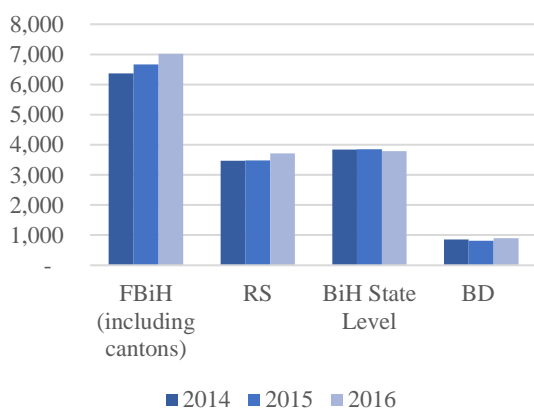
64. **An overarching driver of the observed labor market challenges is the distortionary role of the public sector as an employer, service provider, and economic actor.** The public sector, comprising the General Government and SOEs, continues to have a large footprint. The distortions are created by technical challenges and low institutional capacity aggravated by how patronage and politics affect human resource management in the public sector and compromises the quality of public services. An additional challenge is fiscal. The overall share of the wage bill in GDP and government expenditures is very high relative to comparators (although there is a substantial subnational variation). The high wage bill spending crowds out more productive spending and undercuts fiscal performance.

65. **The public sector has an outsized role as a direct employer, with implications for labor markets as well as fiscal sustainability and growth.** The public sector supports approximately one out of three BiH workers in 2017, a very high share by global and regional standards. Despite repeated attempts to freeze hiring, enforcement has proved challenging, particularly in SOEs and the education and health sectors. During the most recent attempted hiring freeze as part of the EU-led Reform Agenda 2015-2018, at least two-thirds of public institutions at state and entity levels continued hiring, and the net number of civil servants rose by between five to 10 percent (see

³⁸ Law on Statistics in BiH, Law on Statistics in Federation of BiH and Law on Statistics of Republika Srpska.

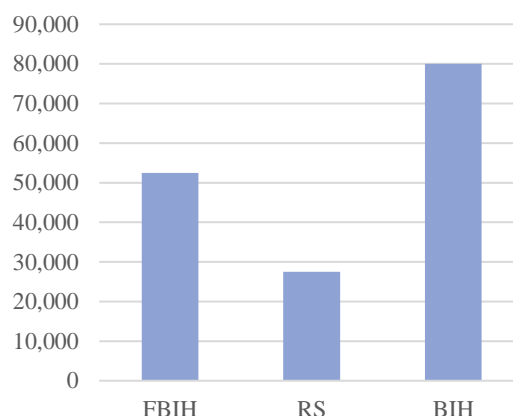
Figure 18.)³⁹ Approximately 14 percent of all wage workers work in the SOEs sector (Figure 19). Unrestrained recruitment reinforces citizens’ perception of the public sector as the employer of first and last resort, and raises its attractiveness relative to the private sector, although only the private sector is capable of sustained job creation in the long term.

Figure 18: Number of Civil Servants, 2014-2016



Source: Civil Service Agencies

Figure 19: Number of Jobs in SOE Sector, 2018



Source: IMF 2019.

Note: Since there is no comprehensive registry of SOEs or SOE workers, the estimates are likely the lower bound.

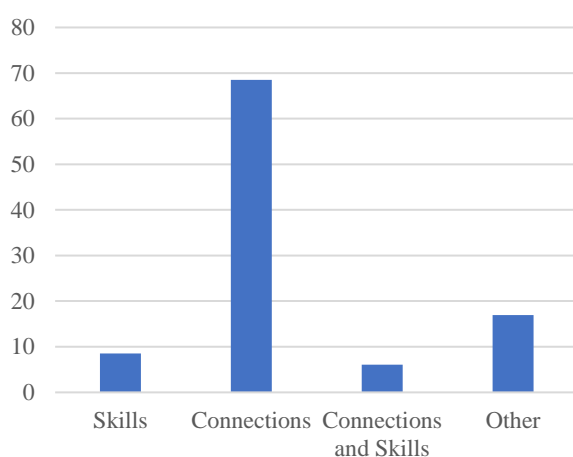
66. Opaque, discretionary, and politicized recruitment processes for public sector positions have several negative effects on the labor supply and demand. Political parties frequently use government and SOE jobs as tools of patronage, so in many public institutions, key procedures such as the formation and operation of selection commissions, conducting of interviews, and the final selection of candidates are subject to significant informal pressures and ethnopolitical favoritism.⁴⁰ The practices introduce several distortions in the labor market. First, they lead to suboptimal job search behavior. By screening and selecting candidates on the basis of personal and political connections, they encourage workers to rely primarily on informal channels for accessing public-sector openings. The large majority of job seekers (over 65 percent) report that the most important criterion for finding a job is having the right connections, while less than 10 percent say the same of job-appropriate skills and qualifications (Figure 20). As a result, qualified candidates without connections are discouraged from applying. A second effect is of the mentioned public employment practices that, by encouraging future job seekers (i.e., youth) to prioritize networking over skill investments, they contribute to economy-wide skill mismatches. On the demand side, by privileging the recruitment of the most connected but not necessarily the ablest candidates, current recruitment practices weaken the capacity of public sector institutions.

³⁹ SIGMA 2017. “The Principles of Public Administration: Bosnia and Herzegovina.” The report draws on original data from the state and entity Agencies for Civil Service.

⁴⁰ Meyer-Sahling et al (2015). According to Meyer-Sahling’s detailed study, screenings are so easy that 80 percent of candidates in FBiH and over 90 percent in RS successfully pass. Oral interviews lack consistency.

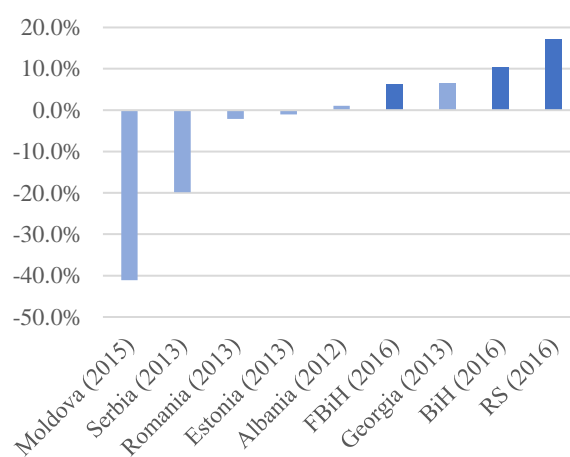
67. **Generous, highly fragmented, and discretionary compensation in the public sector affects employment outcomes by creating suboptimal worker incentives and distorting choices about whether and where to work.** The public sector pays a large and statistically significant compensation premium on all measured dimensions—including hourly wages (10 percent adjusted wage gap), allowances (108 percent raw premium), work hours (8 percent shorter), and job security.⁴¹ The adjusted public-private wage gaps for BiH and FBiH and RS entities exceed regional comparators in the Western Balkans and Eastern Europe with available data (see Figure 21.)

Figure 20: Jobs Seekers Perception of Most Important Criteria for Finding a Job (Percentage), 2017



Source: EuroBarometer, 2017.

Figure 21: Adjusted public-private wage premium (Percentage), most recent available years



Source: Sources: BiH Labor Force Survey, 2017, Worldwide Bureaucracy Indicators

68. **The compensation premia adversely affect labor market outcomes in several ways.** They skew worker preferences towards public sector careers. Public opinion polls suggest that, even though many public sector workers find their jobs un motivating or unfulfilling due to poor management and widespread unethical and non-meritocratic practices, 89 percent of BiH adults still prefer government jobs due to higher compensation and job security. Given the size and pull of the public sector, this preference imbalance measurably reduces the supply of workers for private-sector jobs and contributes to significant skill shortages among private firms that, in turn, reduce firm competitiveness and job creation. Another impact is “wait unemployment.” The public sector’s more generous compensation, combined with the condition that first-time applicants for government positions and internships cannot hold a job before applying, incentivizes job-seekers to stay unemployed while waiting for a public sector job to open up. As over 80 percent of BiH

⁴¹ BiH Labor Force Survey 2016, authors’ calculations. The wage, allowance, work effort, and job security premia are statistically significant and robust to inclusion of personal characteristics. Similar results reported for other years in IMF 2015, WB 2017a. Wage gap estimates use the latest available data for BiH and comparator countries and are calculated using the WWBI estimation method, for comparability. They measure the percentage difference in weekly wages between public sector employees (both general government and SOEs) and all private sector workers (including formal and informal), controlling for gender, age, age squared, level of education, and type of settlement.

adults express a preference for government jobs,⁴² the overall negative effect on employment, particularly in the private sector, can be substantial.

69. Performance management systems in BiH public institutions are weak. The application of professional goal setting, rewards, promotions, disciplinary measures, and training nurture performance and productivity. But in BiH, employees are rarely evaluated, rewarded, or punished on their performance and ethical conduct. Performance appraisals, which are required for civil servants by Civil Service Laws and secondary legislation at all levels, are mostly box-checking exercises that are not based on clear performance goals and not used to identify strengths or areas for improvement and guide work programs. Promotions, which by law should be merit-based are in practice usually awarded by seniority or political considerations. Professional training is not institutionalized, and standards are not coordinated across institutions and entities and levels. Few public organizations have human resource management (HRM) units to support departmental managers on HRM matters, and oversight bodies like the Civil Service Agency, which cover only a small slice of the public sector, namely the civil service, are poor. HRM practices in SOEs are even less regulated and more ad hoc than in the civil service. The weak HRM practices contribute to BiH's labor market challenges by reducing the quality of public service delivery and business environment. They do so by lowering the productivity of public employees by neglecting key mechanisms for motivating performance and discipline as well as underinvesting in vital professional training and skills.

70. The public sector role as an economic actor also affects the labor market. Commercial enterprises with direct and indirect state ownership (SOEs) employ approximately 14 percent of all workers (in roughly the same proportion in both entities)⁴³ and are present in almost every sector. The main source of distortions is not the SOEs' large size but their extremely weak corporate governance, particularly their internal financial and human resource management processes, which reduce productivity, estimated at one-third of the private sector average. Most SOEs are loss-making and have accumulated significant tax and pension arrears. Privatization has stalled, and there are no substantive efforts to improve SOE monitoring or corporate governance practices.

ii. Policy priorities and recommendations to reduce the distortionary effects of the public sector role as employer and economic actor

71. Improving public sector employment practices requires several short-term and longer-term actions, starting from stronger monitoring and evaluation systems. The proposed solutions address gaps in planning and monitoring systems, but also how to reduce the use of patronage and politics in human resource management in the Government. The immediate

⁴² Balkan Barometer 2019.

⁴³ 2016 BiH Labor Force Survey; World Bank 2016.

reform priorities are listed in Table 3. Annex I provides additional medium-term recommendations.

Table 3: Priority Short-term Reforms in Public Sector Employment Practices

Short-term Policy Options	Impact	Responsible Agency
Compensation in the Public Sector		
1. Institutionalize annual analyses of public-private sector pay gaps by positions/occupations using the most recent LFS data, and use these analyses to benchmark public sector pay and plan wage budget allocations	High (Medium-term) Impact	RS MPALSG, CSAs, MoFs to take lead
Public Sector Recruitment		
<ol style="list-style-type: none"> 1. FBiH and RS: strengthen legal foundations for broad advertising of public sector positions. 2. RS: Revise Civil Service Law to make written tests a mandatory component of the selection process for civil servants. 3. FBiH and RS: Revise CS Laws to improve the quality of selection by: <ol style="list-style-type: none"> a. requiring selection committees, before advertising a job, to define and submit a copy of selection criteria to the CSA; and, b. giving at least 50% weight to job-related competencies in both written exams and interviews. 	High Impact	Ministries of Finance, CSAs
Public Sector Workforce		
<ol style="list-style-type: none"> 1. FBiH & RS: Implement central registries of all budget sector employees, including workers in cantons, municipalities, health institutions, and EBFs. 2. State, all entities, and cantons: Pass cabinet decrees to improve government monitoring of employment trends. 3. FBiH and RS: Complete horizontal and vertical functional reviews to identify institutional and staffing inefficiencies. 	High Impact	Ministries of Finance, CSAs
Human Resource Management		
<ol style="list-style-type: none"> 1. FBiH and RS: Amend CS Law and CS Rulebook to require: <ol style="list-style-type: none"> a. all new entrants into the Civil Service (with rare exceptions), regardless of level, to start on term contracts; b. conversion to permanent contracts to be made for only a small percent of workers each year, to reward exceptional performance over years of service; c. managers to complete and submit to CSA performance assessments for all staff, including fixed-term, based on detailed work programs jointly agreed by managers and worker; ratings to be made public and top performers recognized in annual public awards ceremonies; d. CSA to conduct periodic anonymous institution-wide surveys to verify workers' perception of usefulness and fairness of performance appraisals. 	High Impact	Ministries of Finance, CSAs, MPASLG, PMO
State-Owned Enterprises		
<ol style="list-style-type: none"> 1. FBiH and RS: Complete stock-taking on SOE performance initiated by the IMF and establish a permanent monitoring system covering aspects related to financial and operational performance, employment, and management. 2. FBiH and RS: Develop a vision and public policy for SOEs with a focus on strengthening the sector given its strategic importance to the economy and the public and private sectors – The vision should include identification of 	High Impact	Offices of the Prime Ministers, Ministries of Finance

Short-term Policy Options	Impact	Responsible Agency
<p>policy and reform options for SOEs; the adoption of corporate governance practices; and the setting of performance targets and KPIs for SOEs to remain in public ownership.</p> <p>3. Implementation of reform pilots in selected SOEs.</p> <p>4. FBiH and RS: Begin corporate governance and management reforms in SOEs selected to remain in state ownership per agreed KPIs.</p>		

72. **Cutting across all aspects of reform in the Government’s role as employers is a reform in the collection of relevant data.** This will ensure that policymakers have an accurate picture of current practices and their impacts on labor markets, as well as an ability to build reforms on the basis of solid evidence. A priority is collecting and making publicly available a core set of indicators on the internal public-sector labor market and the interactions between public and overall labor markets. Improving the RS and FBiH entities’ capacity for detailed regular monitoring of public sector employment (and pay) trends will require that FBiH passes a law on the central registry, to include all public sector employees at all levels including in cantons and municipalities, while RS amends the existing law on registries to include municipalities, health sector, extra-budgetary funds (EBFs). Importantly, both entities have to update and collect data on employment and pay trends in SOEs.

73. **Reducing and managing the distortions created in the labor market by the large public sector footprint necessitates a wide dialogue with stakeholders based on better data.** In the medium-term, both entities should create public pay and employment registries in RS and FBiH and institutionalize regular monitoring of pay and employment trends for public and decision-makers’ consumption (i.e., to inform the public sector wage bill monitoring/ budgeting). Besides, it is necessary to remove the legal barriers at all government levels to the operationalization of HRMIS for it to serve as a tool for strategic staff planning, and payroll management, monitoring, and control. Moreover, both entities should require reporting and institutionalize a mechanism to centrally collect and monitor detailed SOE payroll and employment administrative data at the entity-level. With this data, both entities should initiate a communication campaign and consultations to educate stakeholders, including citizens and the business community, on challenges in pay and employment in the public sector and SOEs.

74. **A shift to more meritocratic and transparent recruitment practices at all levels of BiH’s public sector will be a key priority.** The current politicized and non-meritocratic practices not only distort labor markets and quality of the public service but also entail significant fiscal and political costs, including lowered citizen trust in the state. While part of the reform effort will need to include measures to improve regulations, the main challenge will be in ensuring consistent enforcement of existing policies that, even if good on the books, are often bypassed in practice. The reform will likely generate opposition given the politicized nature of current recruitment practices but could mobilize a relatively wide reform coalition between citizens and the business community, which stands to benefit from a more capable and integral public service.

75. **The Civil Service Agencies (CSAs) should have a stronger role in setting recruitment standards and monitoring compliance with HRM rules through periodic audits.** Closer collaboration between CSAs and the FBiH/RS Civil Service Appeals Committee and FBiH/RS Supreme Audit Institution should be incentivized. The results of audits should be published. CSAs should share the oversight role with the Prime Minister Office and the Ministries of Finance, which have an interest in ensuring a well-functioning and non-distortive public sector employment practices from the perspective of the private sector.

76. **Publishing data on the disconnect between the law and practice in public sector recruitment can contribute to building political support for merit-based selection and SOE reform.** In 2018, the FBiH Labor Law introduced an obligation on all public institutions, including SOEs, to announce all positions publicly (not just internally). To yield results, namely improving the Government's ability to identify and address irregularities, it should incentivize compliance through monitoring and better oversight institutions like the FBiH CSA. RS should introduce, through an amendment to the Labor Law, an obligation on all public institutions to announce all positions publicly, which this is in line with current Labor Law's prohibition on discrimination in recruitment. Both entities, should simplify the selection criteria, and rebalance them to give more weight to job-related competencies and non-cognitive and behavioral qualities of candidates (predictors of productivity).

77. **Strengthening human resource management is expected to improve the productivity of the public sector and improve the quality of services to citizens and the private sector.** HRM remains a weak yet potentially very impactful reform area. In BiH, the reforms and related capacity (quality of workforce) gains could have important positive effects on the broader labor market. Introducing performance management offers a more feasible entry point to undoing some of the more egregious distortions from public employment practices. The institutional and regulatory framework for HRM reform in the public administration is already partially in place, with a dedicated national public administration reform coordination office (PARCO) and countrywide draft PAR strategy with a special focus on HRM.

78. **A better and more strategic workforce planning and the establishment of controls in the public sector are important to improving the labor market performance.** In addition to sustainably shifting worker and firm behavior, they would also give the Government more control over its human and financial resources, and yield budget savings. The reform would be sensitive, as public sector jobs are a major source of political patronage and have become seen as part of an implicit social contract. Radical measures, like mass layoffs, should be avoided if possible because they would not change underlying incentives (preference for public sector jobs) and would only cause hardship and inflame tensions. Instead, a much more forward-looking and gradual approach is necessary, and options should be carefully designed, sequenced, communicated, and implemented and with support from key stakeholders. Natural champions for the reform could include the business community and civil society.

79. **Streamlining and rebalancing compensation in the public sector (at all government levels) would be critical for improving labor market outcomes and reducing key distortions.** The reform would have a very high impact in the medium-long term but would require careful framing. In particular, the reform of SOEs' compensation practices are likely to yield a significant impact but need to be accompanied with labor transition policies for workers. Substantively, the focus should be not on cutting wages of current employees but rather on rebalancing compensation composition and levels for future employee cohorts, starting with steps to improve systems for reporting and monitoring compensation expenditures and strengthening regulations. A coalition for change could include the business community, public sector workers affected by pay inequities, and civil society.

d. Business environment

i. Drivers of the high cost of doing business

80. **The enterprise sector is not geared to provide the dynamism required to support private sector growth.** An incomplete transition to a market economy has hampered the growth of the private sector. The country misses new fast-growing companies that can successfully compete internationally, be part of a regional value chain, and boost productivity performance.⁴⁴ The new business density⁴⁵ is the lowest in the region (1.13 percent compared to 1.76 percent in Serbia, 1.35 percent in Albania, 3.14 percent in Kosovo, 3.88 percent in North Macedonia, or 6.7 percent in Montenegro).⁴⁶

81. **BiH faces the twin challenges of improving the business environment and addressing bottlenecks to efficiency and productivity among firms.** Firms face a business environment that is not conducive to firm entry, operations, and exit. Endemic corruption, complex legal and regulatory frameworks and government structures, non-transparent and often overlapping business procedures, insufficient property rights protection, and a weak judicial system discourage private investment. Moreover, inefficient, fragmented, and cumbersome business services limit the potential of digital and collaborative economy models, while digital government services for enterprises remain limited. In the 2019 BiH Enterprise Survey, firms identified as their major constraints high tax rates (36.5 percent), corruption (29.5 percent), business licensing and permits (21.1 percent), informal economy (28.6), and poorly educated workers (24.3 percent).

82. **Business environment constraints underly the high business operating costs for firms.** BiH ranks 92nd out of 141 countries in the Global Competitiveness Index and 89th out of 191 in the Doing Business Index, lagging behind regional peers. The low ranking in the Doing Business

⁴⁴ Bosnia and Herzegovina's Economic Journey: Through Peace and Transition to Prosperity. World Bank.2018.

⁴⁵ New business density represents new registrations of LLCs per 1,000 people ages 15–64.

⁴⁶ World Bank Group, Doing Business, Entrepreneurship data, available at: <http://www.doingbusiness.org/data/exploretopics/entrepreneurship>.

Index reflects the high complexity of even basic interactions between firms and the authorities and the regulatory burdens on firms. The time and costs related to starting a business, obtaining construction permits, property registration, and making tax payments are exceptionally high, compared both to Western Balkan and seven small transition eastern European economies (7STEE) peer countries. BiH far exceeds the number of procedures (13) and days (81) to start a business, compared to regional peers like Serbia at five procedures and five and a half days, North Macedonia at four and 14 days, and Kosovo at three procedures and five and a half days.⁴⁷ BiH firms' payments for taxes are some of the most cumbersome, totaling 411 hours and 33 payments annually.⁴⁸ There are also tax concerns faced by private enterprises, such as high social contributions to labor and unfavorable business tax conditions.

83. Institutional fragmentation and lack of a coordinated approach undermine reforms to ease the business environment. For example, the registration of companies is still under auspices of the courts, with the involvement of the BiH and entity-level government agencies.⁴⁹ Certain simplifications of the permitting and licensing processes led to the establishment of several municipal- and entity-level information portals detailing steps to obtain various permits and their costs. However, FBiH still has 355 separate business-related licenses, permits, approvals, and consents, and RS has 319. There are another 102 requirements at the BiH level.⁵⁰ Regulatory information available is often unsynchronized, making not only the overall understanding difficult for businesses but also compromising the compliance with regulations.

84. There has been limited progress in introducing digital transformation and improving integrated e-services for businesses. While BiH lacks integrated digital government procedures, processes, and services for the businesses, some progress has been achieved in the digitization of the court business registry data, a pre-requisite for the transactional register to support online business registration in each entity. There has also been some progress in improving the legislative framework for business registration and operation of companies, but it is yet to be adopted and implemented. Basic business needs like registration, building facilities, land ownership, importing, exporting, and paying taxes remain challenging, and modern ICT technologies are yet to be harnessed by the authorities to facilitate interaction with businesses.

85. Entrepreneurial outcomes are extremely weak in BiH and lag most Western Balkan and 7STEE peers. The low and declining share of the population engaged in entrepreneurial activity poses a serious concern for a country seeking to rebalance its growth model into a private sector-led one. The percentage of adult population engaged in early-stage entrepreneurial activity has dropped from 7.4 percent in 2014 to a mere four percent in 2017 compared to Estonia's 19 percent during the same year. There is also a substantially low incidence of new business entry,

⁴⁷ <https://www.doingbusiness.org/en/data/exploreconomies/bosnia-and-herzegovina>.

⁴⁸ In comparison, firms in Estonia conduct 8 tax payments totaling 50 hours only.

⁴⁹ For example, Tax Administration, Health and Pension Insurance Institutes, Indirect Taxation Authority.

⁵⁰ World Bank Group. 2017. *The Western Balkans: Revving Up the Engines of Growth and Prosperity*. Washington, DC: World Bank.

averaging just over one new registration per 1,000 active population in 2016. In comparison, Montenegro had over six applications during the same year.

86. **Weak innovation and entrepreneurship (I&E) outcomes in BiH are closely linked to the lack of a conducive business environment for firms to invest in innovative activities.** There is a low supply of knowledge and entrepreneurship, as reflected in the low stock of research and development (R&D) personnel and a small share of the population with completed tertiary education. The traditional regulation approaches, with prescriptive, “plan-based,” and command-and-control approaches used in BiH are increasingly outdated and cannot respond to the pace of innovation and dynamics of working relationships in the gig and sharing economy.

87. **The private sector lags in terms of adopting existing technologies to enhance productivity.** Firm managerial and technical capability is low, preventing the adoption of new technology and the digital economy business model. The country’s innovation system is nascent and characterized by low innovation performance and outputs compared to regional and structural peers, low public and private R&D spending,⁵¹ and a severe brain drain.⁵² Further, firm-level cooperation in innovation activities inside and outside firms (an important channel for knowledge transfer) is limited.⁵³

88. **There is, however, a high level of demand for incremental innovation among BiH firms, which is a positive sign.** Accumulating imitative and absorptive capabilities by investing in new technologies and implementing proven production methods are critical for increasing firms’ productivity levels. In 2018, 56 percent of firms in BiH reported introducing new or improved products or services in the last three years.⁵⁴ Further, there is a rather high share of firms using technology licensed from foreign companies and firms with internationally recognized quality certificates in BiH.

89. **The financial sector is an essential building block for fostering private sector-led growth but is currently not fully equipped to play that role.** The financial sector is dominated by banks that are characterized by high levels of liquidity, strong risk aversion after the financial crisis, increasingly conservative policies from their parent organizations, and lack of proper incentives or capacity to explore new and innovative approaches to finance. Although on a declining trend, non-performing loans remain high at around nine percent, burdening banks’ balance sheets and limiting their ability to lend. The financial stability of the banking sector overall has been improving in recent years. Liquidations of two small domestic banks and two mergers further contributed to banking sector stability, and considerable progress has been made in strengthening the supervisory and resolution frameworks in both Entities. At the same time,

⁵¹ BiH has the lowest gross expenditure in R&D intensity among peers at 0.2 percent of GDP (UNESCO 2016).

⁵² 29 percent of the total expenditure, compared to 69 percent in Slovenia and 47 percent in Croatia

⁵³ Towards a Private Sector led Growth Model. BiH: Innovation and Entrepreneurship Assessment. The World Bank. June 2019.

⁵⁴ Regional Cooperation Council (2018).

vulnerabilities persist in the domestic banking sector and as regards to the entity development banks' governance and business model. Given the size of the BiH financial sector, there is room for further consolidation, the entrance of reputable players, and banking sector efficiency gains.

90. **Commercial banks lend mainly to SOEs, large corporations, and individuals (consumer credit).** As a result, small and micro enterprises continue to have less access to credit. The small and micro-enterprise sector is characterized by informality (especially in agriculture), limited availability of collateral, low levels of financial capability, and limited uptake of digital transactions. In the 2019 Enterprise Survey, 13.5 percent of small firms (5-19 employees) identified finances as a major constraint. In particular, women entrepreneurs in BiH face constraints in access to assets like land, traditionally the collateral required by financial institutions, and are perceived to be disadvantaged in their ability to raise startup capital. Regarding micro-loans, banks are not interested in serving this segment of the market as the opportunities for cross-selling products and services are limited. Also, improvements in credit reporting and financial reporting are needed to reduce information asymmetries. Finally, public support instruments require better targeting and coordination to ensure the effectiveness and efficiency of their interventions.

ii. *Policy priorities and recommendations to improve the business environment and support private sector job creation*

91. **Improving the business environment and addressing bottlenecks to efficiency and productivity require structural improvements.** Tackling these constraints would lead to an upgraded institutional and regulatory framework that provides a predictable and increasingly transparent, efficient, and accountable government to support the needs of the private sector. The key short-term priorities are listed in Table 4, while Annex I provides additional medium-term recommendations.

Table 4: Priority Short-term Reforms in Business Environment and Innovation and Entrepreneurship

Reform Areas	Impact / Level of Feasibility	Responsible Agency
Business Environment		

Reform Areas	Impact / Level of Feasibility	Responsible Agency
<ol style="list-style-type: none"> 1. Undertake an in-depth legal review of relevance and necessity for selected business licensing requirements and identify: a) those that could be reduced to a notification, and b) those that could be abolished. 2. Streamline and simplify regulatory requirements for businesses: <ol style="list-style-type: none"> a. Conduct legal and ICT assessment activities needed for the digitalization of government services and elimination of paper-based documents; and, b. Strengthen capacities of the government offices at the entity level to support the implementation and operation of the integrated service delivery platform. 3. Introduce a framework for managing business authorizations and prepare recommendations for its implementation. 4. Finalize legal framework for e-registration (BiH) and e-construction permit issuance (RS pilot localities). 5. Make operational e-registration in both entities and Brcko District. 	High Impact/ Medium Sensitivity	RS Ministry of Economy & Entrepreneurship, Ministry of Justice, Ministry of Scientific Research, Higher Education and Information Society / FBiH Ministry of Development, Entrepreneurship and Crafts, Ministry of Justice, Ministry of Finance, Ministry of Transport and Communication
Entrepreneurship and Innovation		
<ol style="list-style-type: none"> 1. Improve governance, coordination and implementation of the I&E policies at the BiH and entity levels by: <ol style="list-style-type: none"> a. Developing BiH and entity-level I&E strategies to articulate a common vision based on BiH development aspirations; b. Increase and align public funding for support programs based on capability needs of the MSMEs; and c. Build institutional capabilities to design and implement innovation policy and support programs. 2. Stimulate business innovation and promote entrepreneurship: <ol style="list-style-type: none"> a. Develop and pilot instruments to address existing I&E gaps; b. Review, refocus and scale existing I&E government support instruments to introduce new products and processes; and c. Introduce M&E framework to maintain feedback loops and institutionalize I&E support. 	High Impact	RS Ministry of Economy & Entrepreneurship, Ministry of Scientific Research, Higher Education and Information Society / FBiH Ministry of Development, Entrepreneurship, and Crafts
Access to Finance		
<ol style="list-style-type: none"> 1. Strengthen non-bank credit institutions by amending FBiH Law on MCOs to ease transition from MCF to MCCs; 2. Deepen leasing, invoice finance and asset-based lending by: <ol style="list-style-type: none"> a. Addressing impediments to leasing; and, b. Removing constraints of invoice finance. 3. Develop policies and pilot financial instruments targeting specifically women-run/owned/inclusive enterprises. 4. Introduce better risk-sharing schemes and sufficient financing for targeted clients and projects. 5. Boost financial education and management capabilities of female entrepreneurs by providing targeted technical assistance linked to financial products 	High Impact	Entity Ministries of Finance

92. **Reducing the number of authorization procedures (e.g., permits, licenses, inspection-related requirements) is critical to improving the business environment.** The streamlining of authorization procedures needs to be a phased process, starting with predetermined priority sectors and authorizations with the highest impact on the business environment. The first stage would involve the consolidation of the inventory of authorizations in both entities, as with time, the initially formed registries became outdated. The second stage will include analysis of the authorizations, according to the priority sectors, applying risk management principles.⁵⁵ Also, the inspection-related requirements should be revised according to the same business sectors to introduce a risk-based inspection approach.

93. **Along with the review of the authorizations, the entity governments should define a mechanism for continuous improvements and adopt agile approaches to business regulation.** This approach would prevent future “mushrooming” of licenses in the future and allow introducing an agile and risk-based approach to the authorizations (e.g., licenses, permits, certificates, inspection-related requirements,) and moving away from the traditional “command and control” and prescriptive regulations. The new regulatory approach would allow a new technology-enabled business model to be introduced, without a need to adjust the rules every time an innovation occurs, or a new business model enters the market.

94. **For BiH to progress toward a private sector- and innovation-driven economy, it must reform its I&E ecosystem and put the enterprise innovation agenda front and center.** BiH faces major structural issues on both the supply and demand sides of the I&E ecosystem that need to be addressed to be able to develop a functioning I&E ecosystem in the long term. On the supply side, I&E activities are focused on public sector-led R&D that is delinked from the real economic sector. Structural issues on the supply side, such as lack of skilled labor, further dampen BiH’s growth prospects. On the demand side, many firms are disengaged from the global economy, thereby inhibiting prospects for learning and upgrading of capabilities. While there are reported incremental innovation outcomes among firms⁵⁶ (for example, adoption of existing technology), these have not necessarily translated into improved firm productivity. Further, the lack of collaboration between industry and academia inhibits innovation synergies between these actors.

95. **BiH’s financial sector is weakly diversified, limiting firms’ access to suitable financing.** The financial sector continues to be bank-dominated, with negligible pension and mutual fund sectors and small leasing, factoring, and insurance markets. This means that there are limited alternatives to bank financing if firms want to grow and expand. An analysis of demand and supply-side suggests that micro-enterprises especially face challenges when seeking bank financing as banks’ lending standards are strict, requiring good credit history, sufficient collateral,

⁵⁵ For example, the authorizations of small risk business activities and objects can be transformed into a simple notification mechanism, and the medium risk should avoid having any ex-ante inspection activities involved.

⁵⁶ There is a high level of demand for incremental innovation among BiH firms and this is a positive sign. In 2018, 56 percent of firms in BiH mentioned introducing new or improved products or services in the last three years. Further, there is a rather high share of firms using technology licensed from foreign companies and firms with internationally recognized quality certificates in BiH.)

and large turnovers. SMEs experience similar challenges when they are not able to provide sufficient collateral or good financial accounts. Also, SMEs are hardly making use of other sources of financing that may be more appropriate for their needs. This includes factoring, leasing, and private equity/ venture capital financing. The awareness and understanding of these alternatives are also limited, additionally affecting uptake.

96. Financial sector diversification and supporting the development of a stronger microcredit industry is expected to improve access to finance of micro-enterprises. A clear legal and regulatory framework would be needed to help spur the development of this industry. Factoring and leasing are underutilized, partly because of shortcomings in the underlying legal frameworks, the need for electronic signatures to become legally binding, and adverse tax treatment of leasing. Private equity and venture capital are still nascent, and so is fintech; however, there is a strong need for these alternatives to traditional financing to support start-ups and promote innovation. A reform of the largely ineffective development finance framework could improve the impact of development finance in the future.

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