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ECONOMIC REFORM PROGRAMME

OF

BOSNIA AND HERZEGOVINA
(2021-2023)

COMMISSION ASSESSMENT

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1. EXECUTIVE SUMMARY

The global health crisis sharply exacerbated the slowdown that was already in progress, leading to an output contraction of some 4½% in 2020. The areas most affected were private services, such as tourism, export-oriented companies and remittances, which are an important source of disposable income. The labour market benefitted from the government's job support measures. The country's economic reform programme (ERP) projects a subdued, domestic-driven recovery with slightly accelerating annual growth rates averaging at some 3% during 2021-2023. However, this benign scenario rests on the crucial assumptions that the country's persistent political stalemates, which largely paralysed reform implementation during the last years, will come to an end and that public and private investment will increase substantially. Key downside risks are a continuation of the country's political stalemate, which would impede reforms and investments, and a subdued global recovery from the COVID-19 pandemic.

After supporting the economy in 2020, the fiscal framework is maintaining a slightly expansionary fiscal policy throughout the programme period, but clearly without a pro-growth strategy. The pandemic resulted in a sharp drop in revenue and additional spending, transforming the surplus of 2.2% of GDP in 2019 into a deficit of some 4% of GDP in 2020. The programme provides only incomplete information on the actual response to the crisis. Overall, the authorities planned additional spending of about 2½% of GDP for health related spending and general support measures, such as providing support to troubled companies and subsidising wages and social security contributions. Furthermore, up to ½% of GDP was reserved for providing pandemic-related loan guarantees. This relatively limited approach probably reflects financing constraints in some parts of the country, administrative bottlenecks and in particular political stalemates, delaying the decision process and the implementation of spending decisions. The ERP envisages a reduction in the deficit to 0.6% of GDP by 2023, largely achieved through cuts in spending, in particular investment. On the revenue side, another drop in the revenue-to-GDP ratio of 2 pps. is expected for 2021-2023, requiring deep spending cuts in order to achieve the targeted reduction of the deficit. This points to the need to improve the quality of revenue collection, through a more efficient, diverse and growth-friendly revenue collection approach, reducing, in particular, the strong reliance on VAT revenues. The planned reduction in investment is not in line with the country's needs and the jointly adopted 2020 policy guidance. COVID-19 related revenue shortfalls and additional spending are forecast to increase public debt by 6 pps. of GDP, reaching 37.1% in 2021. From 2022 onwards, moderate and declining fiscal deficits and stronger nominal GDP growth are expected to bring the debt ratio down to close to 35% of GDP by 2023.

The main challenges include the following:

- **The quality of public spending and revenue collection remains very low.** The country's main priority appears to be maintaining the current spending structure, clearly neglecting the medium-term investment needs in areas such as education, infrastructure and environment. At the same time, the overall quality of health services remains inadequate, despite significant pandemic-related allocations. The targeting of social spending is very limited and impeded by the country's fragmented administration. The implementation of public investment appears to be mainly driven by the availability of external financing and would need a substantial boost in order to move the country's economy on a higher growth trajectory. The efficiency of tax collection is very uneven, with a strong emphasis on indirect taxes, such as VAT, which is disproportionately burdening lower income groups.

- **The country's medium-term, strategic fiscal planning capacities are very limited.** The high degree of institutional fragmentation, a lack of cooperation among key stakeholders and a highly politicised decision process have resulted in a strong short-term orientation of fiscal policy, primarily trying to maintain the status-quo instead of addressing longer-term issues. As a result, the country's economic reform programme suffers from the lack of a country-wide perspective, an insufficient medium-term orientation and obvious inconsistencies between the various programme elements. Furthermore, the economic analysis is heavily impeded by the lack of empirical data and by the insufficient quality and timeliness of what little empirical data is available.

- **The absence of a common internal market within the country negatively affects the private sector's development.** The COVID-19 pandemic has further increased the importance and urgency for addressing structural weaknesses related to the over-politicised business environment. Partly different legal frameworks and implementation practices, institutional weaknesses, high informality, a weak rule of law, lengthy bureaucratic procedures and low quality public administration are among the main factors for the existing poor business environment. Countrywide strategies and coherent solutions to help businesses are long overdue. Such strategies and solutions include developing the system of quality infrastructure, reforming public financial management, reducing para-fiscal charges, adopting policies for small- and medium-sized enterprises (SMEs) and implementing customs policy legislation and the green and digital transition, which include e-authentication and simplification of business registration, licensing and permit procedures.

- **Oversized, non-transparent and inefficient state-owned enterprises (SOEs) leave an important footprint in the economy, negatively affecting macroeconomic performance, fiscal sustainability, labour market outcomes and competitiveness.** SOEs are a heavy burden on the country's public finances. Many of these companies have low productivity but, at the same time offer significantly higher wages than in comparable private industries. Many public companies rely on state support or they delay due payments to the social security systems or to private suppliers, creating substantial liquidity imbalances in other areas of the economy. The SOE sector causes great distortions and misallocation of production factors and deters the private sector from investing. Reform efforts also need to target the substantial payment arrears of the public sector, in particular the health sector. The COVID-19 pandemic represents a significant additional burden on the health system, characterised by high spending inefficiencies.

- **The authorities by failing to have a unified and coherent approach to the labour market's development, have put people, especially young people, women, Roma and people in vulnerable situations, at particularly high risk of long-term unemployment and inactivity**. Stereotypes about the role of women persist and, together with the low availability of child and elderly care result in a wide gender gap in employment. The education system's lack of alignment with labour market needs creates difficulties for young people exposed to multiple risks of social exclusion while employers are facing difficulties to recruit skilled workers.

The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2020 has been partially implemented. Insufficient cooperation among the various stakeholders has been a key obstacle to improving the country's capacities for medium-term fiscal planning and analysis. Some progress has been achieved in improving statistics on the labour market as well as on historic general government data. Local banking supervisory agencies cooperated in order to support the economy in the wake of the pandemic and the requested measure to strengthen the banking sector resolution framework has been adopted. Furthermore, the convertibility of the domestic currency has been maintained. However, the circumstances of the appointment of three Board members in 2020 might raise questions about central bank independence. Limited progress was made in coordinating COVID-19 mitigating measures for businesses, in extending social protection coverage and in facilitating the transfer of economic activity to the formal economy. Efforts continued to simplify business registration procedures through online registration. Some funding was provided to the healthcare sector, but not in a sustainable way, as reforms in this sector are still limited. Centralised procurement of medical products, providing for economies of scale, was limited. In spite of some progress at various levels of government, a common strategy to reform public financial management is yet to be developed and adopted. A series of measures were adopted to preserve employment and support job-seekers, but were insufficient and showcased the unpreparedness of the country's labour market institutions to major shocks. There was an uneven implementation between entities when it came to dispensing public employment services carrying out administrative duties linked to health insurance and mapping social benefits.

The ERP identifies reform challenges that are partly in line with those identified by the Commission. Macroeconomic projections are based on the optimistic assumption that the country will overcome political stalemate. The fiscal framework does not sufficiently present the impact of COVID-19 nor does it provide sufficient information on fiscal plans for 2021. Overall, fiscal policy is set to support the economic recovery until 2023. The measures to promote employment, social policies and education are not credible and lack a fiscal underpinning. Given that the aim is to foster a common internal market in the country, more specific references should have been made to identify and address the structural weaknesses burdening the business environment. Many of the measures in the ERP are not countrywide and therefore lack consistency and coherence. Adopting a whole-of-government approach is a pre-requisite for addressing the challenges. Bosnia and Herzegovina should set up a well-functioning coordination and consultation mechanism for the ERP process.

2. ECONOMIC OUTLOOK AND RISKS

Economic activity contracted by about 4½% in 2020. Even before the COVID-19 crisis hit the country, the economic growth had already been on a decelerating path, resulting from a deteriorating international environment and persistent domestic political stalemates. In the second half of the year, economic activity remained subdued, resulting from weak export demand and domestic constraints partly caused by the ongoing COVID-19 pandemic. As a result, the two traditional sources of growth, private consumption and exports, remained weak. Investment dropped by some 13%, further contributing to the overall weak growth performance. The immediate impact on the labour market has remained limited so far, partly thanks to a large share of public sector employment and but also due to governmental employment support measures. Furthermore, the existence of a significant informal economy might lead to an underreporting of the actual economic costs of the pandemic.

The 2021 baseline scenario is more cautious concerning the country's post-crisis recovery. Compared to last year's ERP, the baseline scenario expects clearly weaker growth, in particular in 2020, when estimated growth has been revised downward from +3.5% in the 2020 ERP to -3.0% in the 2021 ERP. Despite the recession in 2020, the 2021 ERP expects a moderate recovery of 2.5% in 2021 and of some 3¼% in 2022 and 2023. As a result, average growth during the programme period is only 3.0%, compared to 3.6% expected in the previous programme. However, even this more moderate growth profile would require a significant increase in public and private consumption. Due to the lower post-crisis dynamics, the programme expects to reach the pre-crisis output level only during 2022, and the negative output gap to close and turn positive only in 2023.

The macroeconomic scenario expects a largely domestic-based recovery, relying in particular on private consumption and investment. The expectation that employment and wages will see strong growth, resulting in a significant increase in disposable income, is an important factor supporting the solid increase in private consumption. Investment is seen to benefit from an improved business environment thanks to structural reforms and increased public investment in transport and energy. The support from the external side is forecast to remain relatively solid, with annual increases of exports by some 6% on average. Unfortunately, the programme does not provide an estimate of the expected growth of the country's export markets. The baseline scenario is largely consistent with the underlying assumptions of a moderate recovery of the international economy, slow progress in fighting the COVID-19 pandemic, but also assumes a significant pick-up in structural reforms and public investment. The main risks to this scenario are related to a weaker than expected employment and investment dynamics, partly resulting from delays in implementing structural reforms. Unfortunately, the ERP does not provide information on the impact of structural reforms of ongoing or of planned recovery measures. Overall, the economic baseline scenario is feasible in the current situation, although some assumptions on the expected political climate as well as on the expected public and private investment appear optimistic. Furthermore, the macroeconomic and fiscal outlook continue to be affected by high uncertainty due to the COVID-19 pandemic.

The alternative macroeconomic scenario assumes a combination of less benign external and domestic factors, which would reduce average yearly GDP growth by about 1 pp. Key assumptions for the alternative scenario are: lower export growth during 2020-2023 (by ¾ pps. on average), lower foreign remittances, lower inflation, delays in structural reforms and further political stalemates. This would lead to an average annual GDP growth of 2.2% in 2021-2023 compared to 3.0% in the baseline scenario. Unfortunately, the programme does not specify its assumptions on the drop in worker remittances nor does it explain the transmission mechanism of delays in structural reforms on economic growth. The alternative scenario briefly discusses the main effects on the labour market, but does not provide any quantifications. Interestingly, the impact of weaker domestic demand on import growth appears to be quite limited. It also would have been helpful to explain how the size of the export growth shock (of 0.7 pps.) was chosen. Given the multitude of potential negative shocks, which are enumerated in the alternative scenario, the expected total impact on overall GDP growth of 0.8 pps. appears rather optimistic.

Table 1:

Bosnia and Herzegovina - Macroeconomic developments

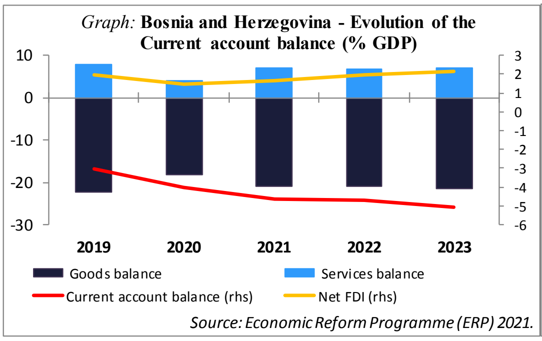
	2019	2020	2021	2022	2023
Real GDP (% change)	2.4	-3.0	2.5	3.1	3.4
Contributions:					
- Final domestic demand	2.9	-3.5	2.4	3.3	3.2
- Change in inventories	0.2	0.1	0.1	0.0	0.1
- External balance of goods and services	-0.7	0.4	0.0	-0.1	0.0
Employment (% change)	-2.3	:	1.7	2.3	2.5
Unemployment rate (%)	15.7	16.3	15.7	15.1	14.2
GDP deflator (% change)	1.9	-0.1	1.1	1.5	1.2
CPI inflation (%)	0.6	-0.8	1.2	1.3	1.4
Current account balance (% of GDP)	-3.0	-4.0	-4.6	-4.7	-5.1
General government balance (% of GDP)	2.2	-4.0	-2.5	-1.4	-0.6
Government gross debt (% of GDP)	31.1	35.2	37.1	36.1	34.9

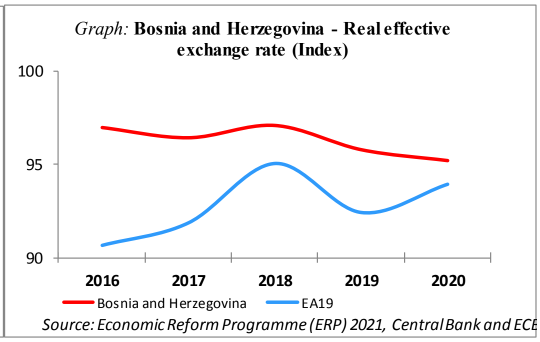
Sources: Economic Reform Programme (ERP) 2021.

Inflation is expected to remain low. In 2020, overall consumer prices were about 1% lower than in 2019, thanks to low prices for imports and weak domestic price pressures. For the programme period, the ERP continues to expect domestic and external price pressures to remain on the low side with annual headline inflation between 1.2% and 1.4%. The country's hard peg to the euro under the currency board arrangement should help to anchor inflation expectations, which then helps to anchor domestic price pressures. Furthermore, expectations of only a subdued domestic recovery are also seen to contain domestic price pressures. However, as the outflow of skilled workers might restart once the economic situation in key destination countries recovers, skills shortages could further deteriorate, creating upward pressure on wages.

The external position is projected to deteriorate slightly. During 2020, the country's current account balance remained largely unchanged as lower export demand for goods and tourism was largely compensated by lower imports, reflecting weaker domestic demand. During the programme period, the current account is expected to deteriorate slightly, resulting from a subdued external demand, in particular in tourism, and a domestic driven recovery, which will increase the current account deficit from 4.0% of GDP in 2020 to 5.1% in 2023. This profile is largely in line with the underlying expected growth profile. As foreign direct investment (FDI) is expected to remain largely stable at some 2% of GDP, a key contribution to the financing of the increasing current account deficits will have to come from foreign loans, in particular from IFIs, given the country's limited access to foreign capital markets. The programme does not specify the sectors of the economy benefitting from foreign investment inflows. The country's stock of foreign exchange reserves has further increased in 2020, partly due to the inflow of foreign assistance, such as the IMF's Rapid Financing Instrument (RFI), amounting to some 2% of GDP. At the same time import spending has declined, leading to a further improvement in the reserve's import coverage. The programme expects a 20% increase in foreign exchange reserves during the programme period, from EUR 7.1 billion in 2020 to EUR 8.6 billion. The programme does not elaborated on the underlying assumptions, but possible explanations could be additional foreign loans, increases in workers' remittances or higher FDI inflows.

Graphs: External competitiveness and the current account





The country's financial sector has weathered the COVID-19 crisis relatively well so far. Despite deteriorating profitability and slow loan growth, the banking sector has so far managed to avoid a marked deterioration in financial soundness indicators. The growth of credit to households and enterprises has slowed sharply during 2020, reflecting lower credit demand in view of deteriorated growth prospects. In particular, corporate loan growth has been very weak. Deposit growth has also decelerated substantially throughout the year, probably reflecting the deteriorating liquidity situation of households and corporations as well as a slowdown in workers remittances. The non-performing loans ratio has continued to decline to 6.1% by end-2020, probably reflecting stricter accounting rules due to the application of the new International Financial Reporting Standard 9 and increased loan write-offs in early 2020. The extended loan moratorium as well government measures to support the real economy might also have had a positive effect on the sector's stability. On the other hand, the uptake of the governments' loan guarantees has been muted in some parts of the country, probably reflecting a low guarantee coverage and cumbersome procedures. Nonetheless, despite the sector's overall stability, there are still pockets of vulnerabilities, in particular in the area of smaller, domestically owned banks. In case that the economic rebound remains muted, a withdrawal of the authorities' support measures could lead to a significant deterioration of the financial sector's soundness indicators. In this context, the absence of a single resolution fund and the limited scope of the Deposit Insurance Agency increase the likelihood that the costs of any substantial bank restructuring might have to be financed using tax payers' money.

Table 2:

Bosnia and Herzegovina - Financial sector indicators

	2016	2017	2018	2019	2020
Total assets of the banking system (EUR million)	13 343	14 440	15 829	17 067	17 262
Foreign ownership of banking system (%)	83.5	84.9	84.8	84.1	83.2*
Credit growth	2.1	5.3	6.6	5.7	1.1
Deposit growth	7.8	10.3	11.3	9.3	5.6
Loan-to-deposit ratio	0.97	0.94	0.90	0.89	0.85
Financial soundness indicators (end of period)					
- non-performing loans	11.8	10.0	8.8	7.4	6.1
- net capital to risk-weighted assets	15.8	15.7	17.5	18.0	19.2
- liquid assets to total assets	27.2	28.4	29.7	29.6	29.1
- return on equity	7.3	10.2	9.6	10.4	6.0
- forex loans to total loans (%)	57.4	55.1	53.3	50.7	48.1

* Q3

Sources: Central Bank, Macrobond, IMF.

3. PUBLIC FINANCE

Due to the COVID-19 crisis, public finances experienced a marked drop in revenues in 2020, while public spending for health and anti-crisis measures rose sharply. In response to the crisis, the authorities adopted revised budgets, lowering revenue estimates but also increasing spending targets by some 10%. Overall, the authorities planned additional spending of about 2½% of GDP for health-related and general support measures, such as providing support to troubled companies and subsidising wages and social security contributions. Furthermore, up to another ½% of GDP has been reserved for providing pandemic-related loan guarantees.

Compared to last year's estimates, the programme expects that in 2020 tax revenues will have been lower by some 1.2% of GDP, mainly as a result of lower indirect and property taxes. At the same time, expenditure is estimated to have been higher by 3.6% of GDP, mainly due to higher public consumption, transfers and subsidies. As a result, the 2020 deficit is estimated to have been 4% of GDP, compared to an expected surplus of 0.2% in last year's programme. This sharp downward revision is of course the result of the significantly weaker economic situation, lower revenues and the strong increase in discretionary COVID-19-related spending. Key measures have been to support enterprises, subsidise social security contributions and wages, accelerate payments of tax refunds, delay deadlines for the payment of taxes and reduce administrative fees and local excise taxes. Furthermore, guarantee funds have been provided for COVID-19-related support. According to estimates, payments to the health sector to fund medical supplies and facilities, hire professionals, and raise their wages were increased substantially, accounting for some KM 200 million or about 0.6% of GDP. Support measures for households and firms accounted for about KM 600 million, or nearly 2% of GDP. Furthermore, the support through guarantee funds amounted to up to 0.5% of GDP. Thus, overall, the direct anti-crisis support is estimated to have amounted to about 2.5% of GDP, plus another 0.5% in the form of loan guarantees. This would imply that about half of the fiscal deterioration is due to additional spending, while the other half is a result of lower revenues due to the COVID-19 crisis. Even when taking into account the high degree of uncertainty surrounding the actual level of support measures, the overall level of support still appears relatively limited when compared to other countries. One important factor limiting the country's capacity to support the economy is the country's limited access to international capital markets, constraining the country to domestic financial markets and to lending by international financial institutions. Furthermore, persistent political disputes, weak administrative capacities and bureaucratic procedures are also constraining the country's ability to swiftly react to such crises. Furthermore, efforts to target the society's most vulnerable population categories of the society appear to have been very limited. Coordination within the country also seems to have been poor.

In the medium term, the country's key fiscal objectives are to reduce the fiscal deficit from 4% in 2020 to -0.6% of GDP by 2023, while at the same time also lowering the tax burden as well as public spending as a share of GDP, by 2 pps. and by 5.3 pps., respectively. The main strategy to achieve this objectives appears to be to assume weak revenue growth and to mainly rely on nominal cuts in investment and subsidies. This will lead to a further reduction in the size of the public sector and will also reduce the deficit down to 0.6% of GDP in 2023. The total fiscal adjustment of 3.4% of GDP during the programme period is slightly frontloaded, with about half of the adjustment (1.4 pps.) planned for 2021, another third (1.2 pps.) for 2022 and the remaining quarter (0.8 pps.) is scheduled for 2023. The adjustment during 2021-2023 largely relies on lowering spending as a percentage of GDP (by 5.4 pps.), while the tax burden is also set to decline further (by 1.3 pps.). Implicit revenue elasticities are relatively low, which might reflect intentions to lower the tax burden on labour and on incomes. However, with this approach, if revenues are higher than planned, those funds risk being used for ad hoc purposes. The programme does not provide sufficient details on intended tax measures, nor does it present complete estimates of the fiscal costs of COVID-19. On the spending side, the already low share of public investment is set to fall further, from 2.9% of GDP in 2019 to 2.0% in 2023. This drop in investment spending might reflect the country's spending strategy, leaving the implementation of investment projects to the availability of external financing, while in the absence of external funds, available resources are primarily used for current spending. In cyclically-adjusted terms, the deficit is estimated to decline from 3.5% of GDP in 2020 to still 1.9% in 2021. According to the programme, the authorities intend to maintain a fiscal stimulus in 2022 and 2023 by targeting cyclically-adjusted deficits of 1.2% of GDP and 1.0%, respectively. There are no explicit links to the reform measures in the structural reform part. Compared to last year's programme, the authorities expect significantly higher deficits throughout the programme period, amounting to some 7% of GDP. Overall, this approach of reducing the deficit in a cautious way appears appropriate given the challenges with COVID-19. However, the composition of the adjustment with a strong reliance on reducing investment spending is not appropriate, as this approach fails to lay the ground for a stronger growth trajectory in the medium term.

Table 3:

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

	2019	2020	2021	2022	2023	Change: 2020-23
Revenues	40.1	38.5	37.2	36.9	36.5	-1.9
- Taxes and social security contributions	36.1	34.8	33.9	33.7	33.5	-1.4
- Other (residual)	4.0	3.6	3.3	3.1	3.1	-0.5
Expenditure	37.9	42.5	39.8	38.3	37.2	-5.3
- Primary expenditure	37.2	41.7	39.0	37.4	36.3	-5.4
of which:						
Gross fixed capital formation	2.9	3.5	2.4	2.2	2.0	-1.5
Consumption	17.2	18.4	17.8	17.1	16.4	-2.0
Transfers & subsidies	15.6	17.6	17.3	16.5	16.1	-1.5
Other (residual)	1.4	2.3	1.4	1.6	1.9	-0.4
- Interest payments	0.7	0.7	0.8	0.9	0.8	0.1
Budget balance	2.2	-4.0	-2.5	-1.4	-0.6	3.4
- Cyclically adjusted	1.4	-3.5	-1.9	-1.2	-1.0	2.5
Primary balance	2.9	-3.3	-1.7	-0.5	0.2	3.5
- Cyclically adjusted	2.1	-2.8	-1.1	-0.3	-0.2	2.6
Gross debt level	31.1	35.2	37.1	36.1	34.9	-0.4

Sources: Economic Reform Programme (ERP) 2021.

Fiscal plans for 2021 envisage a moderate 4% to 2.5% reduction in the deficit, mainly driven by lower investment spending. The programme provides only planned budget data for 2021, which was adopted in September 2020 as the global fiscal framework (GFF). However, the budgets for the entities, accounting for some 95% of fiscal spending, were not included in the document, although they had been adopted on 18 December 2020 for the *Republika Srpska* (RS) and on 11 January for the Federation. According to the September 2020 fiscal plan, the authorities intend to reduce the country's deficit, mainly by cutting expenditure, in particular investment and 'other' non-specified spending items such as inter-governmental transfers. Public consumption and social transfers are set to increase in nominal terms, albeit at rates below nominal GDP growth. Expectations on the revenue side are very cautious for 2021, with a projected increase in total revenues by 0.3% only, compared to nominal GDP growth of 3.6%. Such a low revenue elasticity (of 0.1) is quite unprecedented. The expected output growth in 2021 of 2.5% still will be below the potential (of 2.7%). According to the adopted budgets, the country's fiscal stance in 2021 will most likely be even more cautious in bringing back spending to pre-crisis levels, than envisaged in the global fiscal framework from September, given that the adopted budgets are more optimistic with respect to revenues, and more moderate with respect to spending cuts. For example, the adopted budgets envisage a cut in total nominal spending by some 0.6% compared to 2020, (or 1% of GDP) as reductions in COVID-19-related transfers and subsidies are partly replaced by higher allocations for investment (in the Federation) or higher planned payments for pensions and public sector wages (in the RS).

Debt developments

Public debt rose by 4 pps. of GDP in 2020 and is set to increase by another 2 pps. in 2021, reaching 37% of GDP. After doubling in the wake of the 2008 financial crisis, public debt had declined to some 31% of GDP by 2019, mainly thanks to solid growth in nominal GDP and fiscal surpluses. Difficulties in accessing international financial markets, and the shallowness of the domestic financial market, mean that international financial institutions such as the World Bank, the European Investment Bank and the IMF are still key sources of financing. It is largely thanks to this financing structure that the average implicit interest rate has remained low at some 2¼%. This rate is projected to rise to 2.6% in 2022 before slightly dropping again in 2023. Despite this expected increase, the costs of debt servicing are likely to remain low, at 1% of GDP throughout the programme period. Unless there are significant changes in the international financing conditions, this outlook of slightly increasing financing costs is plausible and consistent with previous programmes. Overall, strengthening growth, inflation and only moderate deficits will help to contain the rise in the debt ratio and will be important factors for the declining ratios in 2022 and 2023.

Box: Debt dynamics

The programme expects a marked debt increase in 2020 and 2021, largely reflecting the costs of the pandemic. The main factor for the increase in 2020 was the primary deficit of 3.3% of GDP. However, the drop in GDP growth contributed nearly another percentage point to the increase in the debt ratio, while interest expenditures added another 0.7 pps. Going forward, the primary deficit is expected to moderate and turn into a small surplus in 2023, while gradually strengthening real GDP growth and inflationary effects are expected to reduce the debt ratio by some 1.5 pps. annually. Furthermore, stock-flow adjustments in 2022-2023 are also projected to help reduce the debt-GDP ratio. Unfortunately, the programme does not provide details on the factors behind the dynamics in the stock-flow adjustment. The historic data presented on public debt is still slightly different from the data provided by the central bank.

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

	2019	2020	2021	2022	2023
Gross debt ratio [1]	**31.1**	**35.2**	**37.1**	**36.1**	**34.9**
Change in the ratio	-1.3	4.2	1.8	-0.9	-1.3
Contributions [2]:					
1. Primary balance	**-2.9**	**3.3**	**1.7**	**0.5**	**-0.2**
2. "Snowball" effect	**-0.6**	**1.7**	**-0.4**	**-0.8**	**-0.8**
Of which:					
Interest expenditure	0.7	0.7	0.8	0.9	0.8
Growth effect	-0.8	0.9	-0.9	-1.1	-1.2
Inflation effect	-0.6	0.0	-0.4	-0.6	-0.4
3. Stock-flow adjustment	**2.2**	**-0.8**	**0.5**	**-0.7**	**-0.3**

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

Source: Economic Reform Programme (ERP) 2021, ECFIN calculations.

Risks to the fiscal scenario are non-negligible. On the revenue side, the programme assumptions are cautious, which might provide a certain buffer against the failure to reach targets on reducing spending. However, this approach of overly cautious revenue projections also risks creating space during the year for ad-hoc, non-targeted and non-priority spending. Furthermore, there are significant risks of contingent liabilities from public loan guarantees, partly because of the COVID-19 pandemic, but also due to guaranteed energy projects. Budgetary allocations for COVID-19 related loan guarantees amounted to about ½% of GDP in 2020. Overall, largely due to a loan guarantee for the construction of a major coal-power plant, contingent liabilities are expected to increase from some 2½% of GDP in 2020 to some 4% of GDP in 2023. Furthermore, there are substantial payment arrears in particular in the health sector, which before the COVID-19 crisis amounted to up to 7% of GDP and which during the pandemic will probably have increased even further. The need to restructure unviable publicly-owned enterprises could also have significant implications for the country's deficits but also its debt ratio. Poor transparency and weak reporting standards significantly reduce the reliability of risk assessments.

Box: Sensitivity analysis

The programme presents a sensitivity analysis of the impact of the alternative, lower-growth scenario on public finances. The alternative scenario analyses the economic effects of export growth being 0.7 pps. lower, which together with other factors would result in average annual GDP growth of about 0.8 pps. lower than in the baseline scenario. According to the sensitivity analysis, the growth of total revenues would be some 0.3-0.6 pps. lower, mainly due to lower VAT revenues. As a result, the deficits would be higher, by about ½ pp. in 2021 and 2022, and by nearly 1 pp. in 2023. Those effects are quite limited, which is not surprising, given the limited direct effects of exports on indirect taxes and the assumed low sensitivity of imports to reduced exports.

The quality of public finances and budget planning remains low. The programme does not contain sufficient plans to improve the spending structure, and lacks a pro-growth orientation. In 2020, COVID-19 related spending led to a shifted towards increased spending for general public services and health, but also direct subsidies and social transfers. In the following years, the programme envisages a certain return to the pre-crisis spending structure. However, in 2023, the share of spending on health and social protection are still significantly elevated, while spending to support the economy is scaled down markedly. Furthermore, there are only marginal nominal increases in spending for education and the environment. Like in the previous ERPs, this approach is not in line with the policy guidance jointly adopted in the last 4 years, urging for a more growth-oriented fiscal policy. For revenues, the programme strongly relies on indirect taxes, which are expected to realise rather low elasticities with respect to nominal GDP growth. Given the regressive nature of indirect taxes and in view of the post-crisis financing needs, the programme fails to discuss measures that could improve the efficiency of tax collection, and in particular improve the contribution from higher income groups. More frequent audits, a better management of large tax payers, the sharing of tax information among entities and the establishment of a central registry of private bank accounts are all important elements that could improve tax compliance. Transparency and governance of the public sector are very limited, leading to major governance issues in particular in the health sector and in publicly owned companies.

The country's fiscal framework continues to be impeded by institutional fragmentation, the low quality of fiscal data and a lack of cooperation among the various stakeholders. Alignment with EU reporting standards and budgetary frameworks is still very limited. So far, only one entity has adopted fiscal rules, and there is no independent fiscal council to monitor countrywide fiscal performance. The effectiveness of the medium-term fiscal framework is also very limited. Finally, the availability and quality of fiscal data suffers from poor reporting standards, a lack of cooperation among the various budget users, and political resistance that impedes alignment with the standards of the European System of National Accounts (ESA). Due to these deficiencies, there could be a significant degree of fiscal underreporting.

4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

The substantial structural weaknesses of Bosnia and Herzegovina's economy are preventing the country from catching up faster and sustained reform measures are needed to significantly improve the living standards of its people. The Commission has conducted an independent analysis of the economy to identify the key structural challenges to boost competitiveness and inclusive growth, drawing from Bosnia and Herzegovina's own ERP, but also using other sources. Several structural weaknesses lead to an underutilisation of the country's economic potential. High structural unemployment is a clear consequence of those weaknesses, rather than merely the result of an educational system that is not functioning properly. It also points to a poor business environment resulting from the country's institutional and economic fragmentation, a weak rule of law and an inadequate and inconsistent legal framework. Furthermore, the economic activities of the public sector have a detrimental weight on the economy due to their inefficient management. The main challenges of boosting competitiveness and long-term and inclusive growth are therefore to (i) increase employment, particularly of young people, women and people in vulnerable situations (ii) improve the business environment through closer cooperation and coordination at all levels of government and (iii) make the public sector more efficient, in particular improving the performance, transparency and accountability of public enterprises.

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

Key structural challenge #1: Increasing employment, particularly of young people, women and people in vulnerable situations

The labour market indicators continued improving until mid 2020, but the activity and employment rates remain very low and differences between entities persist. The activity rate (20-64) increased from 59.0% in 2019 to 61.7% in the second quarter of 2020 while the employment rate increased from 49.7% to 51.9% in the same period. But they continue to be structurally low. The unemployment rate (15-74) was rather stable at 16%. Despite these improvements, national data indicate severe gender gaps in labour market participation and in employment (20-64): 75.2% of men as opposed to 48.1% of women engage in the labour force, 64.7% of men compared to 39.0% of women are employed. The unemployment rate is 17.4 pps. higher for young women (49.0%) than for young men (31.6%). The share of long-term unemployed was very high at 77.3% in 2019 and this is likely to be exacerbated by the COVID-19 crisis. The labour market outcomes differ significantly across entities. In 2019, the activity rate (20-64) and the unemployment rate (15-74) in the *Republika Srpska* entity stood at 67.1% and 12.0% respectively compared to 54.9% and 18.4% in the Federation entity. The female employment rate (20-64) was also higher in the *Republika Srpska* (48.4%) compared to the Federation entity (33.1%). However, as labour market policy falls within the competence of the entities, it is difficult for the administration to come up with a solid and coherent countrywide diagnostic and to agree and implement the necessary reforms.

Due to the COVID-19 crisis, there was a steep decline in working hours and the country has to face a sharp economic contraction that is likely to have a strongly impact on the labour market. GDP plunged 6.3% y-o-y between the third quarter of 2019 and the third quarter of 2020. The previously booming tourism industry which represents more than 1 in 10 jobs, recorded a 70.4% drop in tourist arrivals in the period from January to September 2020 while the overnight stays decreased by 63.5% compared to the same period in 2019. Key research indicators (UNDP 2020) show that the most directly impacted industries have been those related to accommodation, food service, and transport, while the textile industry and fabricated metals sectors experienced a strong disruption in the supply chain. The economy's contraction in these sectors will make it harder, especially for people in vulnerable situations, to access the labour market. The International Labour Organization (ILO) reports that the labour market disruptions caused by the pandemic have affected women more than men and that young people are now more distanced from the labour market. The decline in working hours in the third quarter of 2020 was equivalent to the loss of 170 000 full-time jobs. 245 000 jobs were at risk (ILO and EBRD 2021).

Despite measures to preserve jobs, the number of newly registered unemployed increased, in particular in the Federation entity. The number of registered unemployed increased from 401 846 in December 2019 to 427 593 in August 2020 and shrank again to 413 627 in December 2020, thus above crisis level. According to the Union of Employers of the *Republika Srpska* entity (2020), the crisis had little effect on the number of employees in that entity while 30 000 to 40 000 employees lost their jobs in the Federation entity. One of the possible explanations is the Federation entity's government belated response to the crisis. Among the registered unemployed, 62.7% are people with secondary school attainment (259 171), 28.3% are people with at most primary education (117 182), while 9% are university graduates (37 274)

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

The business structure in Bosnia and Herzegovina is dominated by micro and small enterprises representing a major source of employment. Out of 35 000 enterprises in Bosnia and Herzegovina, 72.8% are micro-enterprises contributing to 40% of GDP while 1.1% are large enterprises (250 and more employees). According to the Centre for Policy and Governance the micro-business sector provides formal and informal employment to more than 400 000 people. Yet they face many challenges - including recruitment difficulties - which means that their potential for development remains largely untapped. This business structure is vulnerable due to the lack of a coordinated extensive public support mechanism.

Employers find it difficult to recruit skilled workers. They underline a poor alignment of the education system with labour market needs. They face skills and qualification mismatches as well as labour shortage. Apprenticeship and opportunities for adult learning are also under-developed. The tax wedge on lower salaries and precarious working conditions remain a disincentive to formal employment.

Significant structural barriers are preventing women and people in vulnerable situations from accessing the labour market.

Vulnerable population, including the Roma population, are at a particularly high risk of long-term unemployment and inactivity regardless of their education level. This has been observed in the country also for young people and women as well.

Gender differences continue to exist in access to employment, quality and pay, highlighting the need to step up efforts to support women's effective integration into the labour market. While Bosnia and Herzegovina complies with international standards, the gender gap in political participation and representation remains a challenge according to the Organization for Security and Co-operation in Europe (OSCE). Women have low participation in the labour market and a wide gender gap exists in employment. Of the total number of registered unemployed, 57% were female in December 2020. Low availability of childcare and elderly care is an additional obstacle to women's participation in the labour market and contributes to low employment levels for women who predominantly assume the role of carer. Given the lack of formal part-time engagement, carers often leave the labour market or work informally (Analitika - Centre for Social Research, 2016). The low enrolment in early childhood education at a mere 15% stands in stark contrast with the EU average of 94.8% (2018)[1]. Despite the rapidly ageing population, the country does not have a system of long-term care (LTC) that would universally cater to the needs of those with a degree of long-term dependency.

Roma women, in particular, are severely disadvantaged and marginalised due to inadequate living conditions, poverty and disadvantageous position in their family which includes early marriage. They also have a difficult access to healthcare compared to other citizens. Much of the data on the employment of Roma are missing. The Roma employment rate is lower than others, and significantly less for Roma women. According to the 2017 Regional Roma Survey, the unemployment rate is 56%. 11% of Roma are employed but they account for 63% in the informal sector. 86% of young Roma (92% for females) are not in employment, education or training. The share of Roma without any employment experience is also significantly higher than that of other categories of the population.

For young people, the prospect of finding a decently paid job becomes hardly credible. Youth unemployment (15-24) remained high at 38.6% in the second quarter of 2020. Depending on the source, approximately 33.8% to 40% of those aged 15-24 are not able to find any sort of work after completing their education. As a consequence, unemployed young people are exposed to multiple risks in the form of social exclusion,

[1] For children aged 4 to compulsory education.

poverty, stigmatisation, and even long-term social isolation. The share of youth not in education, employment or training (NEETs) accounts for 20.7% of the male youth population, and 21.6% of the female youth population. The latter can to some extent be explained by mismatches between the education system and labour market needs and a weak business environment still significantly underdeveloped to generate employment. Employers note that vocational education and training does not provide students with the relevant and up-to-date knowledge and skills (World Bank 2019 report). Facing a lack of job opportunities, poor economic prospects and generally poor working conditions in the private sector, young people, including those well-educated, are migrating abroad. This significantly contributes to a fast ageing of the population in the country.

The brain drain is increasingly becoming a challenge. The latest OECD figures show that, in 2018, 44 700 people left the country for Germany (54%), Slovenia (26%), and Austria (9%). The main reasons young people's desire to leave the country is the inability to find work, partly due to the outdated teaching practices, poverty, political and economic instability. Population ageing, high net emigration flows and low participation of women in the workforce pose challenges for the effective functioning of the social protection and healthcare systems. At the same time, shortages of skilled labour require more and better education and training, which is currently underperforming.

Social dialogue in the country is weak. Consultations in the Economic and Social Council are limited to labour law and do not cover larger economic and social reforms. There are no general collective agreements in either entity. Sectoral collective agreements in the *Republika Srpska* entity are limited to the public sector and some state-owned enterprises. In the Federation entity, sectoral collective agreements are also to be found in some branches of the private sector. In either case, the texts of these agreements are not publicly available on the ministries' websites. The overall effectiveness of social dialogue is low and the labour dispute settlement mechanisms are pending reforms.

Reform measure 17: ("Improving labour market efficiency through effective employment policies and strengthening the role of mediation"). The measure to improve labour market efficiency through effective employment policies and strengthening the role of mediation is appropriate but the means for achieving this are not mentioned for the Federation of Bosnia and Herzegovina. Activities in the *Republika Srpska* entity appear very general.

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

The absence of a common internal market within the country, with partly different legal frameworks and implementation practices, negatively affects the private sector's development. Institutional weaknesses, a weak rule of law, corruption and red tape, lengthy bureaucratic procedures and low quality public administration with the limited capacities are the main elements behind the existing poor business environment. Frequent political stalemates and a lack of cooperation among key stakeholders not assuming their responsibilities lead to overdue reforms being frequenly delayed. The unfavourable business environment, combined with a significant informal sector, results in a high level of structural unemployment, in particular among the young population. The fragmented administrative structure (the poor quality of the institutional set up is reflected in the country's lowest ranking - 114th - in Europe on institutions in the World Economic Forum's Competitiveness Report 2019) puts an added burden on businesses through excessive regulation, taxes and local fees. Starting a business remains cumbersome. According to the Balkan Barometer, corporate leaders from Bosnia and Herzegovina are by far the least confident, as only 28% believe that their economy is a good investment destination, while 38% disagree (RCC, 2020). A more business-friendly environment will facilitate the post-pandemic recovery, attracting more investments and building up economic resilience as well as boosting inclusive growth and competiveness. The implementation of the Common Regional Market will also offer new opportunities.

Due to over-politicisation of the business environment and related socio-economic reforms, including those of a technical nature, the authorities have failed to outline a set of countrywide, comprehensive measures that are consistent and properly sequenced. Countrywide strategies and solutions to support business development are long overdue. This includes the quality infrastructure system, reforming public financial management; using e-signature; reducing para-fiscal fees; reforming insolvency procedures; adopting policies for small and medium sized enterprises (SMEs) and reforming the process for business licenses and permits. In order to ensure countrywide ownership and consistent political support to socio-economic reforms, design and implementation of these reforms will need to be coordinated among all authorities, including the state level.

Such structural weaknesses have been exacerbated by the pandemic as high level of coordination at all levels of government has proved to be challenging in practice. The established crisis management bodies acted in their respective jurisdictions, without a countrywide harmonised approach in place for decisions and actions. The COVID-19 pandemic has made it even more important and urgent to address the structural weaknesses in the business environment. In an attempt to improve the quality of the country's socioeconomic response, the authorities have agreed to establish a Socio-Economic Task Force to provide a countrywide coordination of socio-economic activities. So far, this institution has been not been able to operate properly because of the reluctance of some participants to actively participate in its work. A consistent countrywide approach is largely missing for developing and implementing COVID-19 mitigation measures for SMEs in coordination with the private sector. According to the Balkan Barometer 2020, respondents from Bosnia and Herzegovina are the least satisfied with governmental measures to protect people from the economic consequences of the pandemic.

Measure 9: "Mitigation of the negative consequences caused by the COVID-19 pandemic" is not harmonised across entities. This reflects the fact that a consistent countrywide approach is largely missing and that the country's anti-crisis response has been fragmented until now. Nevertheless, this newly introduced measure elaborates on some aspects of appropriate and timely action for mitigating the effects of the COVID-19 pandemics on SMEs. In the Federation entity, activities involve a short-term relief programme of subsides and guarantees for the economy, while the *Republika Srpska* entity provides for some elements for sustainable recovery through its support for digitalisation, new technologies and social entrepreneurship.

The institutional, legal and regulatory environment continues to be a crucial weakness with adverse effects on the business environment, thus preventing a level playing field among companies. Despite some efforts to simplify legislation and to ensure regulatory impact assessment, the high degree of fragmentation requires companies to comply with different procedures in different parts of the country. Each level of governmental (and within the Federation entity, each of the 10 cantons) has its own business laws, regulations and procedures. Institutional and government barriers remain a significant obstacle to conducting business. The financial and administrative burden on business is characterised by high payroll taxes and an excessive number of administrative procedures at all levels. The very high burden of government regulation is evidenced by the Global Competitiveness Report 2019 where the related ranking is 137th out of 141 countries.

Businesses are subjected to numerous para-fiscal fees and charges due to overlapping administrations and an inefficient delegation of powers to lower levels of government. This facilitates corruption and represents a significant obstacle to businesses and local development. Legislation on developed registers of fees and charges and exchange of information can help eliminate fees deemed harmful for the business environment. End 2020, the *Republika Srpska* entity adopted a set of legislation targeting the reduction of para-fiscal fees. As provided for in the ERP, the adoption of the legal framework for establishing the single register of fees and charges in the Federation entity was adopted in February 2021.

The complex and unpredictable legal and regulatory frameworks foster informality and create room for corruption. The shadow economy accounts for approximately one third of GDP (IMF 2019). It adds to an already significant fiscal burden on formal labour, which in turn impedes formal employment and negatively affects Bosnia and Herzegovina's international competitiveness. Moreover, the large share of the informal sector also likely leads to an underreporting of the economic recession following the COVID-19 crisis, as it largely consists of very small companies in the service sector, which are much more affected by the drop in demand. The reduction of the informal economy by improving inspections was identified as one of the priorities of the socio-economic reforms in 2019-2022.

The legislative framework on preventing and combatting the widespread corruption presents significant gaps due to the non-harmonisation of legislation, strategies and action plans. Transparency International ranks the country 111th out of 180 countries in its newly published annual Corruption Perception Index, making it the worst performer in the Western Balkans alongside North Macedonia. Closer coordination and cooperation involving all levels of government, legal certainty to business through the harmonised legislation across the country and a consistent application of the rule of law are prerequisites for countering corruption more effectively[2].

Weaknesses in the rule of law, including in the functioning of the judiciary, negatively affect the country's market economy and its business environment in particular. The constitutional and legal framework governing the judiciary is incomplete and does not provide sufficient guarantees of independence, accountability and efficiency. Important issues include contract enforcement (in particular settling

[2] According to the RCC Balkan Barometer 2020, Governance, public integrity, and corruption continue to be the most negatively perceived aspect of governance performance with only 2.4% of content business leaders in Bosnia and Herzegovina.

commercial disputes)[3], a substantial backlog in court cases, and problems with establishing property rights. Insufficient cooperation and coordination among the various stakeholders is a major impediment to the rule of law and a proper functioning of the judiciary. This prevents the creation of a countrywide level playing field and has wide-ranging negative effects on the country's business environment.

The lack of a unified countrywide approach to the planning and implementation of SME and industrial policies is an obstacle to the development of entrepreneurship and investments and prevents developing and implementing harmonised countrywide COVID-19 mitigation measures for the small and medium-sized enterprises. Reporting on the principles of the Small Business Act is assigned to the state-level Ministry for Foreign Trade and Economic Relations. However, SME policies exist only at the entity level (OECD, 2019). Progress is lagging in the implementation of the Small Business Act. Bosnia and Herzegovina also lacks a countrywide industrial development strategy. Initial steps have been taken to develop a smart specialisation strategy for Bosnia and Herzegovina, but the strategy remains to be developed and adopted.

The ERP rightly describes that due to the allocation of competences and significant differences in the organisation of the business environment, the reforms are the most complex. Still, the document recognises that the economic recovery will also be based on successful implementation of a number of structural reforms. There is a reference to the need to fight corruption to improve the business environment. The Federation entity's 2020-2021 economic stabilization and recovery program aims to improve the business environment and competitiveness. The ERP hardly makes any reference to the brain drain which is increasingly becoming a challenge[4].

A related and partly rolled over ***reform measure 12 ("Enhancing the business environment")*** is very broadly defined. Without giving sufficient details, the Federation entity aims to improving SME access to financing for and remove administrative barriers. The *Republika Srpska* entity broadly includes further optimisation of administrative procedures for business[5], SME access to financing, a new anti-corruption strategy, fiscal discipline and efficiency of public administration (e.g. register of employees in the public sector). The envisaged improvement and implementation of the legal framework for the free provision of services refers only to the *Republika Srpska* entity[6]. However, the country needs to adopt a country-wide approach, i.e. a single comprehensive law aligned with the Services Directive. In general, some efforts were made to include both entities in designing this measure. However, the absence of a clear approach to consistent reform priorities and the lack of meaningful countrywide result and risk indicators mean that this measure's expected effectiveness can still not be

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[3] It is expected that COVID-19 will increase the number of commercial cases.

[4] Those leaving increased from 28 000 in 2013, to 44 700 in 2018 (WFD, 2020). Some 87% of people are either considering or are already planning to emigrate (Eurostat, 2020).

[5] Portal available on www.pscsrpska.vladars.net

[6] The Common Regional Action Plan aims at adopting a review of the AP 6 to further liberalise trade in services to, inter alia, enable temporary service supply without establishment and authorisation requirement (in line with the Chapter 3 of the EU acquis).

assessed. Some efforts were made to estimate the cost of activities and sources of financing (including World Bank funding to develop the register of employees and streamline administrative procedures for business in the *Republika Srpska* entity). Nevertheless, the way the measure is structured, still reflects the high degree of fragmentation of the business environment and displays a lack of clarity, coherence and focus.

A harmonised approach to the modernisation, simplification and digitalisation of services is missing as the legal framework for a user-oriented administration varies substantially across the country. Consistent with the Digital Agenda for the Western Balkans and the Economic and Investment Plan, a better administrative environment for firms would benefit from the digital transformation of government services for businesses, including e-signature[7], e-registration of businesses, and e-construction permits. Low investment and insufficient competition continue to hinder digital connectivity. As one step towards a comprehensive and effective system of electronic public procurement, this system was enhanced with some additional functionalities. VAT statements and excise duties declarations can now be filed electronically. Given that poor health is a drag on the economy and one of the main reasons for the very low labour market participation rate, both entities have made some progress in establishing electronic patient records to enable healthcare quality agencies to monitor the quality of the services provided (World Bank, 2020). The ERP recognises the importance of e-government and the need to develop e-services.

Simplifying procedures for business registration, licensing and permits countrywide could contribute to a swift recovery from the COVID-19 crisis. The sub-national administration of business registration, licences and permits is complex, partly due to the separate laws and regulations that exist at different levels of government. There is no central registry of business entities and the company registers of the entities and of the Brčko District are not interconnected. Businesses registered in one part of the country are not always automatically and unconditionally recognised in other parts, requiring a costly replication of registration procedures. In areas where the entities have no mutually harmonized legislation (e.g. food supplements and cosmetics), SMEs are asked to formally register in both entities to be able to place their products on the market. The Global Competitiveness Report (2019 edition) gives a particularly low ranking for the time it takes to start a business (137th out of 140). Also the Balkan Barometer surveys (RCC 2020) indicate that Bosnia and Herzegovina is the region's leading critic in terms of obtaining a business license and records lowest scores across nearly all categories surveyed, scoring especially poorly on procedures, requirements, and paperwork. Reforms are continuing for business registration, though in the Federation entity, a set of laws to simplify the registration process of business entities is still pending adoption. The *Republika Srpska* entity recently launched and Brčko District advanced preparations for the electronic registration of business entities. The ERP refers to the need to reform the business registration system. However, the issue is only clearly mentioned in the context of the reform measure on e-government and with a reference to one entity only.

[7] New draft legislation aims at transposing the eIDAS regulation and is intended to simplify the services to citizens and the business community in BiH as well as to facilitate the transfer of electronic documents in public administration.

E-authentication is critical for building trust in e-commerce and in government e-signature services. The adoption of a new law on electronic identification and trust services for electronic transactions with a single supervisory body for the whole country in line with the EU *acquis* is still pending. A first qualified trust service Provider for issuing qualified electronic certificates is in place. Preparations are ongoing for other bodies[8] to get this status as well. However, countrywide harmonisation of e-signature and the related coordination, cooperation and data exchange between different administrations is still needed. A lack of interoperability and harmonisation of the e-signature system throughout the country limits the capacity to provide electronic services. Implementation of customs policy legislation (including the electronic transit procedure (NCTS), the authorised economic operators (AEO) scheme and electronic customs declaration for import and export customs procedures) is dependent on the foreseen accreditation of the Indirect Taxation Authority being accredited, as planned, as a qualified trust service provider and subsequently issuing the e-signature. Progress in this area will make it easier for the country to prepare for regional recognition of trust services, including e-signature, as well as recognition of the AEO scheme within the region, both provided for in the Common Regional Market Action Plan. Although the reform measure on 'establishing an electronic signature system' has been discontinued, the ERP (measure 13) has identified the need to adopt the (long delayed) law on electronic identification and trusted services for e-transactions.

Key challenge #3: Increasing the efficiency of the public sector, in particular by improving the performance, transparency and accountability of public enterprises

Bosnia and Herzegovina's public sector is oversized and inefficient, putting a significant burden on taxpayers and adversely affecting the business environment. State influence on the economy is significant, and countrywide public spending remains at a relatively high level, while the quality of the services provided is low[9], in particular in the transport and energy sectors as well as in healthcare and education. Efforts to rebalance the country's current public sector-led growth model and move to a more private sector-led model are not sufficient, given that, according to official statistics, public spending accounts for more than 40% of GDP. Bearing in mind the large tax contributions, the public sector provides little in exchange in terms of availability and quality of the country's public services (World Bank, 2019). Ineffective service delivery, poor human resource management and accountability have major implications on efficiency, quality and access to public services. A functional legislative framework for registries of public sector employees has not been established. Public procurement plays an important role for the private economy, but procedures are complex, prone to corruption and still contain a preference for domestic suppliers, which is incompatible with the *EU acquis* and a breach of the Stabilisation and Association Agreement (SAA). Payment arrears of the public sector are substantial, creating a considerable burden for private companies, but also a high degree of uncertainty for other public services because

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

[9] According to the Balkan Barometer (RCC, 2020) and in terms of business satisfaction with public services, Bosnia and Herzegovina is the only economy among WB6 where dissatisfied managers outnumbers happy managers (32% vs. 28%).

of unpaid contributions to health and pension funds. Some levels of government, namely the state level and the Brčko District, have already adopted individual public finance management strategies 2021-2025. This is a step forward towards the adoption of a comprehensive, countrywide public finance management strategy. Nevertheless, at this stage, there is no direction for countrywide reform on public finance management with performance based monitoring[10].

Oversized, non-transparent and inefficient state owned enterprises (SOE) continue to have an important footprint in the economy. In spite of progress in the Federation entity, existing registers of public companies are outdated, not comprehensive and not publicly available. Regular reporting on the performance of SOEs is absent. Legislation defines public enterprises as companies that are either public corporations or companies that would normally be part of the general government (IMF, 2020). According to estimates (IMF 2019), there are over 550 (majority public) SOEs employing around 80 000 persons, thus accounting for around 11% of total employment (about a quarter of public sector employment). They control assets worth an equivalent of 100% of GDP. Among all SOEs, entity-owned SOEs (including the electricity companies of the entities, coal mines in the Federation entity, the *Republika Srpska* entity forest company, highway companies, railways) have the largest operations and account for most of the employment of the SOEs. Despite lower productivity[11], the average salaries of SOE employees are 40% higher than in private companies.

SOEs are undermining competition, negatively affecting the country's macroeconomic performance, fiscal sustainability, labour market outcomes and overall competitiveness. The SOE sector is characterised by weaknesses in transparency, accountability and performance. Productivity is low in many large SOEs, and many of them are not profitable. SOEs and public enterprises dominate key sectors of the economy, including energy and telecommunications utilities (World Bank, 2018). Many SOEs are statutory corporations that are subject to preferential treatment and deviating from ordinary corporate norms (OECD, 2018). Subsidies give SOEs a competitive advantage over the private sector, and in so doing negatively affect the efficiency of resource allocation and the country's fiscal performance. For instance, coal-fired electricity generation takes place in five thermal power plants, of which four are majority state-owned (ECS, 2019). Moreover, government assistance in all its direct and indirect forms represent also an important disincentive in terms of efficiency and performance of SOEs as it weakens budget constraints. As for the interaction of SOEs with the private sector, the poor quality and fairly high cost provision of inputs to private enterprises negatively impact the private sector's competitiveness. SOE's lobbying governments may prevent private actors from entering markets. Liabilities to suppliers (4% of GDP according to the IMF) have negative repercussions on the private sector. Fiscal sustainability is undermined by arrears on tax and social security contribution (amounting to 4% of GDP).

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[10] Countries with strong public finance management systems were also able to respond more quickly and more effectively to the COVID-19 crisis (as reported in the first Global Public Expenditure and Financial Accountability Report).

[11] Average revenue per worker (measuring productivity) is considered to be around 8% lower than in the private sector.

SOEs are a significant burden on the country's public finances. To a large extent, the country's SOEs are in poor financial shape and close to half of them experience shortfalls in liquidity and require both explicit and implicit budgetary support. Monitoring and managing fiscal risks in ministries of finance is not sufficient. Liquidity problems often result in tax and social security contribution not being paid on time, thus rendering the financial situation of the entity's pension and health funds more difficult. About three quarters of the largest (20) SOEs face considerable financial risks. The cost of supporting public companies and guarantees, which often translate into substantial contingent liabilities, is a heavy burden on public finances and thus the country's taxpayers. Apart from direct subsidies and loan guarantees, government support is granted indirectly through tax and social security contribution arrears. Potential investors are required to assume these debts and maintain the existing workforce. These large payment arrears in SOEs impede the transparency of public sector accounting but are also a burden to private companies in the form of unpaid payment obligations. Some of the SOEs requiring subsidies are no longer operating, but still maintain workers. SOEs' total debts (including approximately 4% of GDP in tax and social contribution arrears) are around 26% of GDP (IMF, 2019). While the precise numbers have not yet been determined, total public sector debt is likely to be approximately 55-60% of GDP.

The COVID-19 pandemic represents a significant additional burden on the public health system, characterised by high spending inefficiencies. The COVID-19 outbreak is severely straining health and public health systems, while measures to contain its spread are resulting in an economic slowdown and threaten the economic security of many of the country's citizens, particularly those with low-incomes. Given the ongoing uncertainty over the next phase(s) of the pandemic, high levels of confidence and trust in the country's health systems are critical if the country is to manage this public health crisis effectively. Bosnia and Herzegovina allocates close to 10% of GDP to the healthcare sector, but the quality of healthcare and the population's satisfaction with it are low. The main reasons for this are fragmentation and the lack of synergies between entities (and cantons), deficient financial control of hospitals and healthcare centres, and the limited accountability of the authorities and hospital management for results (World Bank, 2020). Reforms to strengthen the healthcare sector and achieve a better managed, good quality and accessible public healthcare for all citizens including people in vulnerable situations of the society are at an early stage. Over time, this also includes addressing the substantial payment arrears in the sector. Some public enterprises are significantly behind their payments to health funds, and their employees do not have access to the health services they are entitled to (IMF, 2020). The ERP includes a measure aimed at healthcare reform, but activities are limited to the *Republika Srpska* entity (based on a 2019 action plan to ensure the health system's sustainability) which aims to increase the fiscal discipline of healthcare institutions and its Health Insurance Fund. A particular focus is on halting the increase of arrears and finding a model for their clearance. It is regrettable that the ERP does not present healthcare reform as a countrywide reform measure.

Centralised SOE oversight units (coordinating government efforts to monitor performance in view of strengthening the sustainability of the SOE sector) will need to be established to separate oversight from policy and regulatory functions of the line ministries. The joint socio-economic Program 2019-2022 includes plans to create such units responsible for financial performance monitoring. In addition, responsibilities for monitoring and assessing fiscal implications of SOEs will need to be assigned to ministries of finance. The coverage of SOEs is limited in terms of financial auditing by the Supreme Audit Institutions (SAI), and the implementation of SAI recommendations is low (IMF, 2020).

Whereas legislation partially provides for open and transparent selection procedures, appointments to SOE boards are highly politicised in practice. There are major gaps in terms of legal framework and implementation. Insufficient capacity and the independence of supervisory boards remain an important concern (IMF, 2020). SOE performance and board decision making are insufficiently separated from the political cycle. Vested interests are largely responsible for the slow privatisation process and attempts to sell shares in public companies earmarked for sale have been largely unsuccessful.

There are no ownership policy documents outlining the rationale for government ownership of SOEs. SOE registries and datasets are either not updated or display significant shortcomings. While entity governments have determined 'strategic companies', the rationale for public ownership is not based on clearly defined policy objectives. Privatisation (and as appropriate a solid restructuring process as part of this process) may be considered when there is no policy rationale for continued public ownership. Solid registries of SOEs are a precondition for a proper categorisation in terms of policy relevance and economic viability.

The privatisation process is still not complete and restructuring efforts have made little progress. Due diligence procedures for two local telecommunication companies in the Federation entity have been completed, but follow-up remains unclear. Privatisation of utilities is ongoing in the *Republika Srpska* entity and has taken place in some cantons. The *Republika Srpska* entity is also continuing to restructure its railways. Institutionalization of a central restructuring facility as a central source of standards, analytics, technical assistance, and public financing for SOE restructuring and resolution may be considered, to ensure that the process of company level reform and restructuring - which can also accelerate the green and digital transformation - is transparent, systematic, and predictable.

The ERP does not provide a thorough analysis of this key challenge nor any country wide measure to address it. The existing references are limited to the need to restructure some public companies in the transport and energy sector. A few activities along these lines were included in the energy and transport market reform measures. One measure, focusing on healthcare reform in the *Republika Srpska* entity, also includes defining models to settle arrears. Finally, this entity also refers to reducing the share of public expenditure in public administration by establishing a register of employees[12] and increasing efficiency. The *Republika Srpska* entity recognises that the inefficiency of the public sector is reflected primarily in the inefficiency of public companies. The Federation entity has committed to implementing austerity measures in the public sector by restricting growth in the number of employees and the growth of wage expenditures and wage contributions. The Federation entity's economic stabilization and recovery

[12] As indicated as one activity under measure 12 ('enhancing the business environment').

program for 2020-2021 envisages reform of SOEs as one key objective[13]. The government of *Republika Srpska* entity set up a Working Group for Public Enterprise Reform in September 2020 to prepare an action plan for the reform of public enterprises in the *Republika Srpska* entity. The ERP could have referred to relevant activities planned in the adopted socio-economic reform package. These include creating publicly available and harmonised registers of public companies, establishing central oversight units in both entities, enhancing supervisory, management and appointment procedures and analysing restructuring models for the two telecom companies.

The COVID-19 pandemic could be an opportunity for a more fundamental reform of the SOE sector which has a potential to increase GDP by an annual 3% (IMF, 2019). Significant fiscal shocks and the need for a more responsible fiscal policy in the aftermath of the crisis have the potential to trigger reforms that lead to important efficiency gains in this sector. Opposition to reform can be reduced through careful selection of entrypoints and sequencing (World Bank, 2020). The inclusion of the SOE sector reform in the 2019-2022 socio-economic reform package ('de-politicisation, increased sustainability and efficiency of state owned enterprises'), adopted by entity and state-level governments signals a political willingness to engage in the SOE sector reform and reap the potential benefits.

[13] Moreover, the government of the Federation entity Government endorsed the 2021–2027 development strategy (awaiting endorsement by Parliament), which stresses the importance of an efficient, transparent and accountable public sector.

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

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

Bosnia and Herzegovina performs weaker relative to the EU-27 average in most of the principles of the European Pillar of Social Rights, according to available indicators of the Social Scoreboard[14]. The employment rate remains very low, particularly for women and young people. A high 77.3% of unemployed people were long-term unemployed in 2019. The job creation is localised and the low mobility of workers limits the allocation of labour resources to emerging needs. The gender employment gap (people aged 20-64), still at 23.6 pps. in 2019, was twice as high as the gap in the EU-27 (11.7 pps.) and has only showed a slight decrease of 0.8 pps. since 2016. This gap is exacerbated by the low availability of elderly care and early childhood education and care.

Education continues to be of low quality, and the country suffers from a continuing skills mismatch. There has been little change in levels of educational attainment in recent years. This indicates slow structural change in both the labour market and the education system. It is positive that the share of early school leavers is very low at 3.8% in 2019, much below the EU-27 average (10.2%). However, there is a large share of low-skilled people in the population. Upskilling strategies to increase the skill levels of the workforce are not sufficiently developed to accompany a gradual move of the economy towards a structure that requires a more skilled workforce.

BiH		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Better than EU average, improving
	Gender employment gap	Worse than EU, deteriorating
	Income quintile ratio (S80/S20)	N/A
	At risk of poverty or social exclusion (in %)	Worse than EU average (proxy), trend N/A
	Youth NEET (% of total population aged 15-24)	Worse than EU average, improving
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU average, improving
	Unemployment rate (% of population aged 15-74)	Worse than EU average, improving
	GDHI per capita growth	N/A
Social protection and inclusion	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU average (proxy), trend N/A
	Children aged less than 3 years in formal childcare	Worse than EU average, trend N/A
	Self-reported unmet need for medical care	N/A
	Individuals' level of digital skills	Worse than EU average, trend N/A

Social transfers have a limited impact on reducing poverty. Means-tested social assistance does not cover basic living needs. Other non-contributory social benefits insufficiently target low income and vulnerable segments of the population. It is estimated that the reduction of the at-risk-of-poverty rate by social transfers is 9.16%, significantly lower than the EU-27 average (32.38% in 2019). Participation in early childhood education and care is significantly lower than in the EU and elsewhere in the region. It stands at only around 5% for children under 3. Most children enrolled in early childhood education and care come from urban families where both parents are employed, while children from rural areas or whose parents are unemployed almost rarely attend.

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

[14] The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The indicators are also compared for the Western Balkans and Turkey, with one small adjustment in the age bracket for the unemployment rate (reducing the upper age limit to 64 instead of 74) for Albania and Kosovo* due to data availability. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2019 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). Data from 2017-2019 are used and can be found in Annex A.

5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2020

Overall: Partial implementation (41.2 %)[15]

2020 policy guidance	Summary assessment
PG 1: Take the necessary fiscal measures to alleviate the economic shock of the COVID-19 crisis, in particular protecting the most vulnerable groups. In order to support the recovery, improve analytical, planning and coordination capacities to strengthen country-wide macroeconomic policy formulation and its implementation. Improve the provision of timely, exhaustive and country-wide statistics and its transmission to Eurostat and the ECB, in particular on national accounts, the labour market and government finance, in line with Eurostat recommendations.	There was **limited implementation** of PG 1: 1) **Partial implementation**: In order to alleviate the economic shock of the COVID-19 crisis, the authorities increased support to the health sector, delayed deadlines for tax payments, subsidised wages and social security contributions and provided financial support to enterprises. Those measures amount to up to 2½% of GDP. Furthermore, loan guarantees have been provided, amounting to another ½% of GDP. However, efforts to protect in particular people in vulnerable situation have remained very limited. 2) **Limited implementation**: The data provision in the macroeconomic part of the ERP has improved. However, coordination and cooperation among the various stakeholders have remained insufficient. 3) **Limited implementation**: Quarterly Labour Force surveys are now produced. Also, the Central Bank has continued to work on the General Government data base. However, very little progress has been achieved with national account statistics and government finance statistics.
PG 2: To accelerate the economic recovery, increase growth-enhancing public investment as a share of GDP, based on a comprehensive investment strategy. Improve the targeting of social transfers by increasing the share of means-tested benefits in total social spending.	There was **limited implementation** of PG 2: 1) **Limited implementation:** Some, largely foreign financed investment in infrastructure took place. However, those investments were not necessarily part of a medium-term, growth-enhancing investment strategy. 2) **Limited implementation:** In one part of the country, a comprehensive mapping of all social benefits has started, with a view to establish the base for a better targeting of social transfers.
PG 3: Closely monitor financial stability challenges arising as a result of the coronavirus pandemic and take appropriate action if needed, while addressing the remaining obstacles to NPL resolution and ensuring the proper coordination of supervisory activities.	There was **substantial implementation o**f PG 3: 1) **Partial implementation**: Banking supervisory agencies have worked closely together to coordinate the implementation of support measures for the financial sector such as debt moratoria. But there is no centralised macro-prudential framework. In addition, the remaining obstacles for an effective NPL resolution framework have

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

	not been addressed, such as facilitating out-of-court restructurings and amending the tax treatment of NPL sales to specialised companies.
Strengthen the bank resolution framework by adopting the law on deposit insurance.	2) **Full implementation:** The Law on Deposit Insurance was adopted. At the same time, the bank resolution framework is still not fully operational and needs to be strengthened further, for instance by widening the coverage of the Deposit Insurance Agency and increasing its funding.
Safeguard the integrity of the currency board arrangement and the independence of the central bank, while enhancing its analytical capacity by establishing macroeconomic projections.	3) **Substantial implementation**: The full convertibility of the domestic currency was ensured. The CBBH conducted inflation expectations and bank lending surveys. A macroeconometric model was developed and the CBBH carried out macroeconomic projections. However, the circumstances of the appointment of three Board members in 2020 might raise questions about central bank independence.
PG 4: With a view to mitigating the economic consequences of the COVID-19 pandemic and stimulating economic recovery, establish an effective, coordinated and transparent mechanism to support the businesses affected by the crisis, in particular small and medium-sized enterprises and the self-employed.	1) There was **limited implementation** of PG 4: **Limited implementation**: In May 2020, a task force was established to coordinate the activities of all levels of the government in Bosnia and Herzegovina concerning socio-economic measures in response to the COVID-19 crisis and to facilitate mobilisation of funding for all levels of government through domestic funds and foreign financial assistance. However, the task force has rarely met and does not appear to be operational. Although substantial resources were allocated to mitigate the economic consequences of COVID-19, a consistent countrywide approach (coordinated with the private sector) is largely missing and the country's anti-crisis response has been fragmented, insufficient and slow so far. Delays in implementation occurred, particularly with the provision of loan guarantees which are characterised by cumbersome procedures. Also, the Economic Stabilization Fund in the Federation entity, aimed at supporting businesses, was established with significant delay.
Extend social protection coverage and provide incentives for businesses and employees in the informal economy sector to register and to facilitate their transfer to the formal economy.	2) **Limited implementation**: Embarking on a more strategic approach to reduce informal employment has not progressed. Active labour market measures addressed to a limited extent the issue of employees in informal economy and their transfer to formal economy by implementing employment and incentive programmes for employers. COVID-19 mitigating measures include subsidising company's social security contributions and provision of minimum wages to workers in affected sectors. Some steps were taken to map social benefits in order to better target them. To improve fiscal harmonisation in the country, the Federation entity has committed to adopting legislation to reduce the tax burden, but has still not done so.

With a view to a swift recovery after the COVID-19 crisis, simplify business registration, licensing and permit procedures country-wide.	3) **Partial implementation**: Efforts were made to facilitate online business registration, but such efforts need to continue and be streamlined. Closer cooperation among different levels of government, allowing in the end for mutual recognition of business registration, is required. All business registries are now accessible online. An integrated electronic system for the registration of business entities and entrepreneurs is successfully launched in the *Republika Srpska* entity. The system simplifies the process and shortens the time required for registration. E-registration is in the testing phase in Brčko District. Moreover, an e-construction permitting system is being piloted in the *Republika Srpska* entity in some cities. The Federation entity is lagging, as the legislative framework for online registration is still not fully in place (awaiting adoption by the Parliament). Once the legislation is fully adopted, the procurement process for the system's implementation can be triggered and the system can be operational in the Federation entity by the end of 2021.
PG 5: Ensure adequate and sustainable funding to strengthen the health care sector with an aim to improve access to quality public health care for all citizens.	There was **limited implementation** of PG 5: 1) **Limited implementation:** The authorities increased health system capacities and re-oriented health providers towards COVID-19 designated facilities. However, the fragmentation of the healthcare system has made coordination that much more difficult. Reform of the health system is one of the priority reforms in terms of ensuring adequate and sustainable financing and efficient service provision to healthcare users.
Identify scope for and implement centralised procurement of pharmaceuticals and medical equipment, especially for high-cost and high-volume medications.	2) **Limited implementation**: Apart from COVID-19 related procurement (where the Ministry of Civil Affairs took a coordinating role, e.g. regarding the COVAX mechanism and the EU advance purchase agreement), there was no centralised procurement of pharmaceuticals or medical equipment. BIH jointed the European Union Joint Procurement Agreement for medical countermeasures (JPA) in April 2020 and is a full member since end February 2021.
Adopt and implement a credible and relevant countrywide Public Finance Management strategic framework with a performance based monitoring and reporting system.	3) **Partial implementation**: No countrywide strategic framework for public financial management with a performance based monitoring system has been adopted. With the technical assistance of the IMF's Fiscal Affairs Department, public finance management reform strategies for 2021-2025 have been developed at all levels (a precondition for preparing the country-wide strategy) and adopted at some levels of government, and a countrywide strategy is expected to be drafted in the coming period. Improving public financial management at all levels is also necessary to support fiscal consolidation measures and ongoing structural reforms.
PG 6: Take measures to preserve employment including through short-time work schemes, and strengthen without delay the capacity and	There was **partial implementation** of PG 6: 1) **Partial implementation:** The measures and their implementation were addressed by a series of measures at all levels especially those tackling the mitigation of the

human resources of employment offices to ensure registered jobseekers more active support including an increased provision of active labour market policies, especially training, upskilling and reskilling.	consequences of the COVID-19 pandemic. However, these seemed to be insufficient. The measures to strengthen the capacity and human resources of employment offices were partially addressed in both entities (under the World Bank loan), but not in the Brcko District. However, these seemed to be insufficient especially due to the unexpected COVID-19 pandemic, highlighting the un preparedness of the labour market institutions for work under such extraordinary circumstances, and the measures, at times, seemed to be inadequately implemented.
Complete in the whole country the discharge of public employment services from administrative duties related to health insurance for registered unemployed.	2) **Partial implementation:** The measures have only been adopted in Nov 2019 and implemented in 2020 in *Republika Srpska*, but discharge of these services still has to be completed in the Federation entity.
Ensure increased coverage of unemployment and needs-based social benefits and in the medium term, map non-contributory social benefits in the whole country and rebalance the social assistance system from status-based to needs-based benefits while increasing their adequacy and coverage.	**3) Limited implementation:** There was no implementation to increase coverage of unemployment benefits. Some measures to address the PG subpart are underway such as comprehensive mapping of all social benefits in the *Republika Srpska* entity, but the measures still have to be implemented in the Federation entity. BiH should continue activities to develop an efficient, sustainable and fair system of social protection and protection of families with children that will guarantee the basic and equal rights of people in vulnerable situations.

6. ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE 2021-2023 ERP

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

Informal economy

The widespread informal economy poses another burden on business in Bosnia and Herzegovina, as the size of the informal economy has remained significant and underminined fair competition. The level of the informal economy appears to be around 30% of GDP and rather persistent over the last years (EFENDIC, PASOVIC, 2018) and the share of informal employment in total employment stands at 30.5% (ILO, based on LFS 2019). The resulting narrow tax base requires rates for taxes and social security contributions to be higher than would otherwise be necessary. This also adds to a significant fiscal burden on labour, which in turn impedes formal employment and negatively affects Bosnia and Herzegovina's international competitiveness. Informal employment is estimated to account for nearly one third of total employment. Apart from low tax morality due to the presence of corruption, inadequate tax policy and a fairly high income inequality in society, the different types of institutional failings appear to be an important factor fostering the informal economy and undeclared work. Policy recommendations to address the informal economy, also broadly relevant for Bosnia and Herzegovina, require a comprehensive package of reforms, including reducing regulatory and administrative burdens, promoting transparency and improving government effectiveness, as well as improving tax compliance, automating procedures, and promoting electronic payments (IMF, 2019). While recognising the informal economy as an obstacle to competitiveness, the ERP diagnostic is weak and limited. The measure to reduce the informal economy has been discontinued without explanation. Nevertheless, the *Republika Srpska* entity mentions (in the context of the on business environment measure) improving the work of inspection bodies and introduction of a revision of the current system of fiscal cash registers as a way to reduce the grey economy. The Federation entity is committed to preventing tax base erosion and profit shifting. The ERP explains that the Federation entity has committed to continuing to implement a tax reform by introducing a cumulative social contribution rate of 32.5% and increase the non-taxable part of income to EUR 409. The aim is to reduce the tax burden that is higher in the Federation entity than in the *Republika Srpska* entity and thereby to contribute to fiscal harmonization in the country. Under **measure 12 ("Enhancing the business environment")**, reference is made to new 'fiscalization systems' to reduce tax evasion.

Research, development and innovation

Bosnia and Herzegovina still has limited capacity for technological absorption and for research, development and innovation. The legislative framework regulating science and research development remains fragmented and still needs to be improved throughout the country. There is still no action plan to implement the 2017-2022 revised strategy for scientific development. The institutional set-up for innovation policy is highly decentralised and limited innovation impedes productivity of the private sector. The entity level deals with research and development (R&D) and innovation policy, and coordination is poor. However, a recent decision on appointing the Science Council aims to address this issue. Key obstacles include low investment in R&D; a very low number of researchers per head of population; very few innovation-related policies or strategies and very limited cooperation between academia and the private sector. The Global Competitiveness Report ranks Bosnia's innovation capability (including research and development) 117th out of 141 countries. The country's estimated total allocations for research remain low at 0.3% of GDP. The revised strategy for scientific development sets the goal of having 0.8% of GDP investment in research and development by 2022, which would still be far from the EU´s 2020 average of 2%. The country's research capacities remain very limited, while the trend of a brain drain continues, most notably in the health, medical, and IT sectors, with no systematic measures having been introduced so far to address the issue. Following the COVID-19 outbreak, academia and industry began some activities to alleviate the impact of the pandemic, such as producing medical and personal protective equipmentand sharing expert knowledge and information. However, there needs to be more systemic collaboration and interaction between 'triple helix' actors - academia, industry and governments. According to the 2019 Balkan Barometer, the technological innovation and capabilities score is among the lowest in the region (RCC, 2020). The ERP recognises that the system of managing research, science and innovation is ineffective and identifies the need to strengthen innovation, develop institutional capacities and increase the financing of science, technology and innovation. However, in terms of concrete activities, the ERP only explains that legislation on and the establishment of a Science and Innovation Fund in the *Republika Srpska* entity has been postponed due to the pandemic.

Digital economy

The country is still at a very low level of digitalisation[16], performing well below the average of the economies of south east Europe (SEE) when it comes to using and accessing information communication technologies. The Global Competitiveness Report (2019 edition) ranks Bosnia and Herzegovina 80th out of 140 countries for adopting ICT. The information and communication sector accounts for 4.9% of gross value added (2019). While the country ranks worst in terms of perception of digital services provided by the public administration for businesses, reports indicate that the quality of the digital services provided by public administrations has slightly improved (RCC, 2020). Also, the percentage of individuals having basic or above basic digital skills is relatively low (24% in 2019) reflecting deficits in the education system where only 8.4% of the secondary pupils have access to a computer at school while just 6.8% of secondary pupils have school-based access to the internet (ETF, 2019). Legislation to liberalise the telecommunications and electronic media sector is not yet in place. The opening up of mobile virtual network operator (MVNO) licences in mid-2021 might offer opportunities to increase competition in the market. For this to happen, authorities should ensure fairly and transparently priced access to the networks of incumbent

[16] 1.6 out of 5 according to the OECD Competitiveness Outlook (2018).

operators by new operators applying for MVNO licences. Bosnia and Herzegovina remains the only country in the region that does not have a broadband strategy, even though it introduced the 4G network in 2019. Still, according to the Balkan Barometer, businesses from Bosnia and Herzegovina seem to be among the most digitalised in WB6 (RCC, 2020). There are 67 internet providers and 3 080 859 internet users (87.25% penetration rate), with a penetration rate of 20.05% for broadband internet. The regulatory environment for e-commerce is underdeveloped[17]. No financial support tools have been developed to accelerate the adoption of ICT and digital services. The availability of a government digital service to complete administrative procedures is among the lowest in the region (RCC, 2019). The use of e-filing for taxes is low. The fragmentation of responsibilities among different levels of authorities has a direct impact on e-government services. Creating a single portal and expanding digital services will allow enterprises to complete processes online (OECD, 2019). This would make it possible to reduce the cost and number of required procedures, while diminishing the opportunities for corruption. The country is continuing to focus on adopting (i) a law on electronic identity and trust services for electronic transactions with a single supervisory body for the whole country; (ii) adopting a broadband access strategy; (iii) a strategy to develop the information society; and (iv) a law on electronic communications and electronic media. The 2021–2027 development strategy of the Federation entity (awaiting endorsement by the Parliament) honours the importance of innovation and digitalisation. The ERP recognises that an efficient and transparent provision of e-services to citizens and businesses (an area where the *Republika Srpska* entity has a particular focus) enables a better business environment. In general, the document does not provide for a thorough analysis of this sector and is limited to general statements, including the need to improve the ICT sector by aligning the regulatory framework with EU standards.

Measure 13: "Improving the communication and information society along with the alignment of the regulatory framework with EU standards"

This rolled over measure is in line with the digital agenda, has the potential to support to some extent the Economic and Investment Plan (flagship 8-digital infrastructure) and the Digital Agenda and is very relevant for economic growth and increased productivity. Activities planned under this measure refer mostly to the adoption of legislation and strategies, including the adoption of the broadband internet access strategy and the Law on electronic communications and electronic media. These activities are consistent with the findings and recommendations issued by the European Commission and have the potential to support the Regional Digital Area as envisaged in the Common Regional Market Action Plan. However, no progress in adopting or implementing legislation is noted so far. The adoption of a new Law on electronic communications and electronic media as well as the Law on electronic identity and trust services for electronic transactions with a single supervisory body for the whole country will also reinforce the regulatory framework on e-commerce. The lack of further progress in implementing this measure is compounded by no indications of budgetary appropriations and vague indications of key performance indicators.

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[17] The Federation entity is still working on an e-commerce law.

Economic integration reforms

Technical barriers to trade are still substantial and both detrimental to trade as well as to a common internal market within the country. The legal basis and administrative structure for technical regulations, standards, conformity assessment, accreditation, metrology and market surveillance are in place, but they are not aligned with the EU *acquis* and remain uneven and fragmented. There is still no countrywide strategy for putting in place the quality infrastructure. The inadequate and uncoordinated level of harmonisation of the legislative and institutional framework with the EU *acquis* on free movement of goods can result in enterprises having difficulties in exporting to the EU single market and in being forced to perform double registrations if placing their products in both entities. The country will need to abolish double registration of companies and any additional registration requirements in the two entities and, where such requirements exists.

The ERP recognises that the lack of a properly developed system of quality infrastructure and the lack of a related strategy stand in the way of a common internal market within the country. *Reform measure 10 (Enhancing the quality infrastructure system according to the EU model/developing a legal and planning framework)* aims to adress this issue. This rolled over and long delayed measure on harmonising quality infrastructure is highly relevant in increasing the country's competitiveness and long-term growth potential. If implemented, the measure would help to create a common internal market within the country and to facilitate trade. The measure is in line with the country's commitments under the Stabilisation and Association Agreement (Article 75). However, the measure also includes implementation of activities related to the implementation of the *Republika Srpska* entity's own quality infrastructure strategy, which is not a countrywide approach. Cross-cutting coordination between the relevant institutions at different levels of government - indispensable for a meaningful implementation of this measure - has not yet been ensured. Apart from establishing a working group for a strategy in November 2020, no progress was made in implementing this measure. Without proper timelines, key result indicators (which are provided only for one entity), more concrete activities, costing or impact on competitiveness, it is difficult to assess to what extent this measure reflects a realistic commitment. The ERP fails to discuss the implications of the *Republika Srpska* entity's own quality infrastructure strategy adopted in October 2019. An Agreement on Conformity Assessment and Acceptance of Industrial Products (ACAA) with the EU - as mentioned as part of the analysis related to this measure - requires Bosnia and Herzegovina as a whole to have a fully EU compliant quality infrastructure. The same applies to a fully operational Common Regional Market to function in line with EU rules. Unless activities are implemented in the country as a whole, Bosnia and Herzegovina will not be in a position to accelerate EU market integration ahead of accession and fulfil its role within the Common Regional Market.

The Common Regional Market adopted at the Sofia Summit in November 2020 is an important driver of growth and transformation, bringing the region closer to the EU. The action plan is based on EU rules and standards. Deeper economic integration will accelerate compliance with the EU *acquis:* the Common Regional Market is a stepping-stone to integrate the region more closely with the EU Single Market already before accession. Regional cooperation has so far delivered concrete results, including the regional roaming agreement, an agreement on trade facilitation, a regional investment reform agenda, a decision on authorised economic operators, a decision to liberalise trade in services and an agreement to facilitate trade in fruit and vegetables. The country needs to make continued efforts to implement Additional Protocol 5 on Trade Facilitation and Additional Protocol 6 on Trade in Services of the Central European Free Trade Agreement (CEFTA); playing a constructive role in ensuring finalisation of the negotiations of the CEFTA Additional Protocol 7 on Dispute Settlement in 2021. In addition, other aspects of the Common Regional Market action plan should be implemented without delay, such as the free movement of people with IDs, the regional development of e-commerce or the mutual recognition of professional qualifications. This would help to unleash the regional potential of trade in services. It is important that regional initiatives include all Western Balkan partners and are in line with EU rules, building on existing commitments. A full-fledged common internal market across Bosnia and Herzegovina is a basis for regional integration. There is a need to foster mutual recognition of (i) certificates, (ii) testing facilities, (iii) risk management systems and (iv) pre-arrival processing of documents. There is also a need to make progress in implementing the customs policy law, which includes introducing the concept of authorised economic operators. Trade integration with the EU increased markedly, but trade with neighbouring non-EU countries was also up**.** Exports to the EU-27 accounted for 73% of total exports in 2019. Imports from the EU accounted for 62% of total imports. Exports to CEFTA countries rose slightly during 2019, by about 0.5 pps. to 16.6% of total exports, as increases in exports to some of those countries, such as Serbia, largely compensated for the sharp drop in exports to Kosovo resulting from the hike in tariffs. In terms of the effects of the pandemic, in the first 10 months of 2020[18], exports to the countries of the European Union were 11.1% less than during the first 10 months of 2019, while imports were 16.4% lower. Exports to CEFTA countries were 13.4% less than in the same period last year, while imports were 11.7% less. Bosnia and Herzegovina is not yet a member of the World Trade Organisation (WTO), although membership negotiations have been at a very advanced stage already for some time. The ERP fails to provide a proper analysis of this sector.

As the two measures mentioned under this section of the ERP are only referring to the *Republika Srpska* entity, they can not be considered as measures fostering economic integration. **Measure 14 "Improving e-government"** is in principle consistent with the digital agenda, the Declaration on e-Government endorsed in Belgrade in 2019 and has the potential to support to some extent the Economic Investment Plan (flagship 8-digital infrastructure). It focuses on efforts of the *Republika Srpska* entity to progress towards implementation of its e-government development strategy for 2019-2022. Without a countrywide discussion of the measure, it can also hardly contribute to a regional digital area envisaged under the Common Regional Market Action Plan. Measure 15 on real estatate brokerage also covers only one entity (real estate activities account for 5.7% of gross value added in 2019).

Energy

A fragmented, inconsistent, uneven legislative and regulatory framework prevents the country from moving forward and meeting its international obligations. The country remains in a serious and persistent breach of its obligations in a number of fields,

[18] BiH Agency for Statistics

particularly natural gas and electricity. The lack of political agreement in natural gas sector is jeopardising security of supply, with effects on the country's economy and the lives of its citizens. The necessary steps to ensure the adoption of the crucial State Electricity and Gas Law in line with Energy Community requirements on the state level are still missing. The lack of a legislative framework significantly impedes the country's effective integration in the regional energy markets. Energy intensity of GDP[19] in Bosnia and Herzegovina is about four times higher than in the EU and the country is the most carbon intensive economy in the region. In 2017, coal accounted for 61% of primary energy generation. Important coal subsidies[20] per unit of final electricity consumption exceeded the incentives paid to renewable energy producers and are effectively subsidising pollution (World Bank, 2020). Despite the ongoing infringement case initiated by the Energy Community Secretariat, preparations for implementing the Block 7 Tuzla thermal power plant investment project reached its final stage, prolonging dependence on coal[21]. Several new or expanded lignite-fired power plants are planned or under construction. Nevertheless, plans of the governments to promote the recovery are an opportunity to accelerate the transition to a low-carbon economy and cleaner energy production, in view of long term consistency with the Green Agenda for the Western Balkans. To support a comprehensive energy sector reform, the recently launched initiative for coal regions in transition in the Western Balkans and Ukraine (managed by the European Commission and five collaborating international partners) aims to assist to move away from coal to towards a carbon neutral economy, while ensuring that this transition is just.

The renewable energy and energy efficiency sectors have the potential to contribute to de-carbonisation and alleviate the economic impact of greenhouse gas (GHG) pricing and may over time reduce electricity prices. The country will need to adopt state- and entity-level legislation on renewable energy and energy efficiency in line with the obligations stemming from the Energy Community Treaty. As for *renewable energy*, though moderately advanced in implementation, the country's 2020 target of 40% has not been met[22]. The regulatory framework continues to be cumbersome for issuing authorisations and licensing. Market-based support schemes are still missing and revised renewable energy laws will need to be adopted, in line with the principle of a cost effective support framework. However, there are plans to adopt a new support package based on auctions, including amendments to the relevant entities' legislation. There is no appropriate system for guarantees of origin and for the use of minimum levels of energy for RES in new buildings in place. On *energy efficiency*, the entity legislation is not fully compliant with the Energy Community acquis[23], and the existing laws are not properly implemented. Each entity has established an Energy Efficiency and Environmental Fund. Work on a new national energy efficiency action plan has, for the most part, been completed and the adoption of the plan is awaiting political endorsement. Work on the

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[19] Kilograms of oil equivalent (KGOE) per thousand Euro

[20] Coal subsidies per unit of final electricity consumption exceeded the incentives paid to renewable energy producers (ECS, 2021).

[21] Coal mining provides an estimated 13 000 direct jobs across 14 operating mines, but mine productivity is low (World Bank, 2020).

[22] The country achieved a 37.6% share of renewable energy sources (RES) in gross final consumption.

[23] Energy Efficiency Directive and the new Framework Energy Labelling Regulation.

National Energy and Climate Plan is already at relatively advanced stage, but entity and state level plans need to be streamlined. It is important that investments in energy infrastructure, including thermal and hydro power plants, be made in compliance with Bosnia and Herzegovina's obligations under the Stabilisation and Association Agreement and the Energy Community Treaty. The ERP partly recognises some of these challenges, particularly the requirement to align the legislative framework for gas and electricity with the third energy package, as well as improving energy efficiency[24] and RES. The economic recovery from the COVID-19 pandemic should be used as an opportunity to accelerate the transition to a low-carbon economy. A green recovery approach will allow Bosnia and Herzegovina to make full use of the Economic and Investment Plan for the Western Balkans (European Commission, 2020) and its three energy flagships on renewable energy, transition from coal and a renovation wave (energy efficiency).

Measure 1: "Energy and gas market development"

This rolled over measure rightly recognizes the importance of adopting of the state level legislation on electricity and gas in line with the Third Package which would allow for development of the energy and gas market. This is consistent with Bosnia and Herzegovina's commitments under the Energy Community Treaty and the connectivity agenda, both of which aim at gradually integrating Bosnia and Herzegovina into European energy markets. It is also a priority of the country's framework energy strategy. The measure is relevant to the development and functioning of an internal energy market, unbundling the transmission system operator and the distribution system operators of the entities as well as setting up organised markets, i.e. power exchange or market coupling. However, bearing in mind in particular the continued politically motivated delays, the measure is inconsistent and uneven. It fails to state that the existing *Republika Srpska* entity Law on Gas will have to be amended and harmonised with the state level law. The planned activities suffer from the sector still being hampered by political interference and from the failure to allocate necessary resources. The activities are not presented per year but grouped for the years 2021-2023, so it is difficult to assess the ambition and credibility, especially considering the limited progress in the implementation of activities in 2020. The measure does not provide clear and consolidated information for the country as a whole in terms of economic indicators, implications and effectiveness for achieving greater competitiveness.

Measure 2: "Improving energy efficiency and the use of renewable energy source"

This largely rolled over measure tackles some priorities to improve reforms in energy efficiency and the use of renewables. Activities such as the adoption of a national energy and climate plan (including an Action Plan for RES)[25], a national (or: integrated) Energy Efficiency Action Plan, plans for a market-based renewables support scheme and a building renovation strategy are consistent with the ambitious goals of the Green Agenda for the Western Balkan region[26] as well as the Economic and Investment Plan[27]. Even

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[24] The Federation entity 2021 – 2027 Development Strategy of the Federation BiH (awaiting endorsement by the Parliament) honours the importance of resource-efficient and sustainable growth.
[25] An important priority of the Green Agenda for the Western Balkans
[26] The declaration on the Green Agenda was endorsed by the country
[27] Flagship number 5 – transition from coal

though work for some activities planned for 2021 already started in 2020, there is still high risk of delays in adoption and implementation of laws/plans. The information given in the ERP is very fragmented and not consolidated, making it difficult to issue a sound assessment on the measure's effectiveness on competitiveness and overall growth, More comprehensive and coordinated action between all levels of the government is required in order to achieve measurable progress. A proper budget allocation to implement the different plans will be crucial for the measure's success.

Measure 6: "Establishment of economic instruments in the field of environment and energy efficiency" is not sufficiently elaborated for any adequate assessment and only concerns the Federation entity. The priorities identified (including adoption of new Law on the Environmental Protection and Energy Efficiency Fund in the Federation of Bosnia and Herzegovina) are therefore likely to be insufficient in meeting the country's needs.

Transport

Transport infrastructure in Bosnia and Herzegovina is insufficiently developed[28] and structural adjustment is slow, impeding the country's growth potential and competitiveness. The country's transport strategy needs an update to reflect economic developments. According to the Balkan Barometer (RCC 2020), in terms of availability, quality, and affordability of transportation infrastructure, respondents from the business community are among the most dissatisfied in the region. The necessary investment is delayed by the absence of a single or harmonised legal and regulatory framework, insufficient administrative capacities, poor implementation and coordination, inadequte cooperation between government levels and delays in securing agreed external financing. The highway network is limited (198 km in 2018), rail network utilisation is well below the EU average and the density of the railway network is low (20 lines in operations per thousand km^2), making it more difficult for companies to export, and increasing their costs and transport time. The legislative framework on concessions and public-private partnerships remains highly fragmented or is absent in parts of the country. There has been no progress in implementing measures to reform the country's connectivity, which would be a significant driver of economic growth (at a much lower cost). The transport sector is dominated by poorly managed and often inefficient SOEs which exercise monopolies in roads, railways and airports. The entity railway companies are listed as very high risk. The railway company of the *Republika Srpska* entity is undergoing operational and financial restructuring with support from a World Bank programme. The risk score for the railway company of the Federation entity suggests that financial and operational restructuring may also be warranted to reduce financial risks for the Federation entity (IMF, 2019). Bosnia and Herzegovina has to gradually open its railway market, which is hampered by unsafe, outdated and unreliable railway infrastructures on at least half of the core railway network and practically on most railway sections outside this network. Two railway companies of the entities need to complete the process of separating infrastructure management from transport services to ensure their full independence. Competitiveness is affected by overemployment in the main rail transport

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

operators. The economic cost of road crashes[29] and the environmental costs of transport activity are very high (OECD, 2018). To some extent, the ERP recognises the main challenges and refers to, among other issues, to underinvestment in railway and road infrastructure and the need to restructure public railway companies.

Measure 3: "Development and improvement of transport infrastructure"

This largely rolled over measure lacks a strategic vision and a structured approach to sector reforms, presenting activities in a fragmented and sometimes repetitive way and sometimes referring to micro-interventions. Various relevant issues related to a more countrywide approach have still not been addressed, such as the need to establish a national system for the continuous collection of road crash data, improved cooperation and coordination between government levels and the related need to overcome delays in securing agreed external financing. In general, activities are presented in an asymmetric manner. For instance, activities related to the financial and operational restructuring of public railway companies (the *Republika Srpska* entity aims to restructure 'Željeznice RS' until the end of 2021) and the need to complete the process of separating infrastructure management from railway undertaking functions are incomplete and incoherent. Equally, investment programmes to address infrastructure deficiencies only indicate activities for one entity without clear costing. Moreover, there are some concerns about the technical maturity of these investments and the indicated timetable. The ERP recognises that considerable financial investment is needed to improve the railway infrastructure, but the activities make no references to revitalising the railway network in line with the Green Agenda for the Western Balkans and promoting a greener and more sustainable transport network. Overall, the measure is not sufficient to have a significant impact on the economy as a whole.

Agriculture

Bosnia and Herzegovina faces many obstacles to increasing agricultural productivity and opportunities for its agriculture. These obstacles include low overall investment and administrative capacities, land fragmentation, low productivity, and outdated facilities for manufacturing and processing. Forests are underexploited: following a ruling by the Constitutional Court annulling the Federation entity's Law on Forestry, the forestry sector in the Federation entity is not duly regulated. Other reasons include low forest roads density and land mines. Small farms and plot fragmentation dominate in Bosnia and Herzegovina. Due to the structure of farms, there is little specialised agricultural production. Agriculture, forestry and fisheries continue to play a significant role in economic growth, job creation and social stability. These sectors account for 6.6% of gross value added (2019) and 18% of employment (2019), although an estimated 60% of Bosnia and Herzegovina's population live in rural areas (UNDP), which is very high compared to the OECD average of 20%. As the last agricultural census was conducted in 1960, the absence of up-to-date data on agriculture is a

[29] The country has managed to reduce road fatalities by 18% over the period 2010-2019, well below the European Commission's goal of reducing fatalities by 50%, as outlined in its 2011-2020 policy orientation on road safety.

stumbling block to policy making in this sector. The largest share of support for agriculture and rural development (88.7% in 2017) is through direct production support measures. Support measures are not harmonised and in the absence of proper monitoring and evaluation mechanisms, they are not effective enough to increase the sector's productivity and competitiveness. The EU is Bosnia and Herzegovina's key trading partner for agricultural goods. On general food safety, food safety rules and specific rules for feed, Bosnia and Herzegovina increased its export of a number of commodities to the EU by complying with some EU rules and requirements (e.g. industrial eggs as well as poultry meat and poultry meat products). Before it can export other categories of meat, the country first needs to carry out complex preparatory activities to comply with the EU SPS standarsds and import rules. The country has adopted a strategic plan for rural development for 2018–2021 which has the potential to create more synergies between food safety policy, veterinary policy, phytosanitary policy, agricultural policy and rural development policy; this is necessary for the country's overall sustainable economic growth. The ERP recognises the challenge that a lack of harmonised policies and standards in the country poses for this sector, resulting in highly decentralised and fragmented agricultural production, limited economies of scale and therefore limited growth in the sector. The document also rightly stresses that the approach currently applied in the country prevents an internal agreement to comply with the requirements for IPARD assistance and more generally refers to the lack of funding and investment.

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

The measure has mostly been rolled over. It is largely relevant for the sector's economic performance, growth and export potential as well as job creation and retention. Last year's recommendations better structuring and more harmonisation, consistency and prioritisation of the envisaged activities across the sector have not been followed. On the contrary, the measure appears even more fragmented than in the previous ERP and there are no clear references to the sector's overall priorities, many of which are important for further integration with the EU. Therefore, it remains unclear whether and how to consolidate and harmonise priorities across the sector. The measure is characterised by a high degree of fragmentation and does not demonstrate synergies among entities. The *Republika Srpska* entity includes an activity for the 'protection of domestic production'. In that context, it is of vital importance to our bilateral relationship that Bosnia and Herzegovina respects its international commitments under the SAA. The current strategy for the sector expires in 2021 and there is no reference to a strategy beyond 2021. There is also no reference to COVID-19 mitigating measures or to considerable EU assistance to recovery and resilience of agriculture and rural areas. Among other aspects, the measure includes setting up administrative structures for the common agricultural policy, which include a paying agency, elements of an integrated administration and control system, a land parcel identification system and a farm accountancy data network. There is some reference (in one entity) to starting the alignment of direct payments with EU rules. However, and as largely recognised by the ERP, the measure appears too ambitious and lacks a structured approach to reforms, given the still prevailing issues related to this sector's coordination, the already accumulated long delays, the high number of activities planned and the sometimes unharmonised presentation of activities (e.g. in terms of a new forestry information system or a water information system). There is insufficient information on timelines and budgeting.

Industry

The industrial sector still suffers from the absence of a common internal market within the country. Industry accounted for 23.1% of gross value added and 23.8% of employment in 2019. The sector was the main contributor to the country´s exports over that period. In 2019, the share of value added of mmanufacturing accounts for 15.2%. Bosnia and Herzegovina does not have a unified approach to enterprise and industrial policy, as this is an exclusive competence of the entities, the Brčko District and the cantons in the Federation entity. There is no state-level body promoting consistency between industrial strategies and other policies affecting industrial competitiveness. The fragmented institutional framework is not conducive to business creation, investment, entrepreneurship, innovation and the promotion of SMEs. The ERP fails to provide a specific diagnosis of this sector. Addressing the issues of key challenge #2 is critical and the implementation of the ERP measures on business environment, energy, transport and innovation are crucial for industrial development. Industrial policy will be key in achieving the Green Agenda for the Western Balkans. Integration with the EU internal market means integrating with its industrial ecosystems as they transform in the spirit of the European Green Deal. This implies not only the need for a green modernisation in enterprises, but also investments in the co-operative linkages in the industrial eco-systems such as innovation, inward foreign direct investment, export prerequisites and skills development. The ERP recognises the importance of the manufacturing sector.

Measure 5 "Support to the manufacturing industry" aims to support a medium-term recovery of the manufacturing companies in the *Republika Srpska* entity from the effects of the COVID-19 pandemic. The measure is relevant and appropriate in light of the proposed sectors most heavily affected by the economic downturn. It is also comprehensive and sufficiently ambitious to provide for a gradual transition of the support from a short-term supply of working capital towards increased investments and product development for building the resilience of companies' in the medium term. Nevertheless, the expected effectiveness and significance for growth and jobs retention are limited due to the absence of countrywide efforts to define a long-term recovery plan.

A circular economy, addressing in particular waste, recycling, sustainable production and an efficient use of resources is one of the five broad areas covered by the Green Deal. A circular economy promotes innovative and more efficient ways of producing and consuming. Considerable efforts and investments are needed to build properly functioning waste management centres and recycling facilities, so that the country can use the existing resources currently ending up in landfills (over 90% landfilling rate in the region) or being burned up in incinerators.

Measure 6: "Improving integral waste management and the system of circular economy" is a rolled over measure to establish a legal framework and infrastructure that can support transition to a circular economy and enable adequate management of specific types of wastes. This requires identifying and categorising different types of waste to enable recycling and reuse in support of the circular economy. The measure is in principle relevant, appropriate and consistent with the Green Agenda. Environmental standards are low and often neglected, impeding the health (and thus productivity) of the country's labour force and constitute another factor supporting the brain drain. However, while the analysis and description of the measure mentions only the *Republika Srpska* entity, activities also appear to be carried out in the Federation entity (without elaborating on its rationale in the analysis and description of the measure). In addition, for a number of activities it is not sufficiently clear to which entity they refer to (e.g. drafting new Law on Waste Management). There are also inconsistencies in terms of sources of funding. Without a consistent, countrywide strategy for waste management (the ERP appears to make no reference to the environmental protection strategy which could provide for this), the measure does not cater for the much needed gradual transition to a circular economy in a country-wide harmonised manner. Moreover, given the limited progress in implementing activities in 2020, the proposed activities are overly ambitious.

Services

The service sector, including public administration, health and education, is the largest in terms of employment and value generation, accounting for nearly two thirds of the gross value added (65.3% in 2019). During 2019, most new jobs were created in services and most of the active labour force was employed in this sector (50.3% in 2019). Bosnia and Herzegovina usually achieves a surplus in the service balance, as well as substantial net inflows from tourism. Services exports represent a significant part of the country's international trade. Nevertheless, the country could gain from a liberalisation of the services sector and by addressing the complex regulatory environment for the provision of services even among entities. Tourism has a significant growth potential with high growth in visitor rates. The direct contribution of tourism to employment amounted to 3%, and the total contribution of tourism to employment amounted to10.6% (OECD, 2018). However, the outbreak of the COVID-19 pandemic particularly affected the tourism sector: Only 498 000 visits were recorded in 2020 in the country, a 69.7% decline compared to 2019. Travel restrictions resulted in foreign tourists only comprising 39% of the total and having almost 80% fewer overnight stays than in 2019[30]. The ERP fails to provide a specific countrywide diagnostic of this sector.

Measure 8 "Improving the legal framework governing tourism and reducing the impact of theCOVID-19 pandemic on tourism" is a continuation of the 2020 ERP introduced support for an improved legal framework in the Federation entity. Now there is a focus on the mitigating effects of the COVID-19 pandemics on the tourism sector. While individual actions to adopt legislation and strategic documents in both entities are appropriate for a rolling out of the reform process in this sector, the measure has not been re-designed to provide for properly sequenced and countrywide consistent priorities. Under these circumstances, the measure's effectiveness would be limited to providing short- term relief for tourism operators and would not have an impact on a long-term recovery. Bearing in mind the need to mitigate the effects of the COVID-19 pandemic, the development of (mutually consistent with the countries in the region) tourism emergency plans and crisis management strategies should start already in 2021. The measure would in general have benefitted had it taken more into account additional tourism related priorities mentioned in the Common Regional Market Action Plan (item 8.8) and addressed also the lack of a qualified workforce.

Education and skills

Education continues to be of low quality, and the country suffers from a continuing skills mismatch. While part of the problem is poor links between education and the economy, the PISA 2018 finding demonstrate there are clear quality challenges in

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[30] Source: European Delegation in Bosnia and Herzegovina

education in core areas like literacy and numeracy, possibly emanating in primary education and followed through to secondary education, where pupils following vocational education continue to be disenfranchised. The risk is that if systemic quality improvements are not established across all BiH education systems, the economy will be continue to be disadvantaged while employment potential will be undermined. More coordination is needed among the relevant decision makers in the field of education, such as the Conference of Ministries of Education and the Rector's conference. The establishment of the Intersectorial Commission for Qualifications Framework or the correct coordination between Accreditation Agencies at both entity and federal levels is crucial to finalise the accreditation of higher education institutions and study programmes in the country, as well as the development of an action plan to implement the outcome-based common core curriculum prepared by the BiH Agency for Pre-school, Primary and Secondary Education.

Measure 16 "Improving the link between education and the labour market" aims to improving the harmonization of education with the requirements of the labour market in order to provide economy with educated and professional people and increase the number of employed persons. Improving the education system at all levels is key given the low level of achievement in the PISA survey. The ERP rightfully highlights concerns over enrolment policy which will need to be addressed across all education systems.

Employment and the labour market

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

Social protection and inclusion

Bosnia and Herzegovina's fragmented healthcare systems lacked a coordinated and anticipatory approach to COVID-19. However, both entities adopted almost identical epidemiological measures to tackle the pandemic. The systems were unprepared for the number of infected people in autumn surge. The Federation of Bosnia and Herzegovina has a decentralised system of child and family benefits in which implementation of the rights stipulated by the Federation entity general law on social protection is devolved to its cantons. As a result, each canton, depending on its financial possibilities and political priorities, determines which benefit to finance, and at what level. This has strengthened exclusionary policy practices and led to discrimination against children and women (Dobrotić and Obradović, 2020). The government of the *Republika Srpska* entity Government passed the Decree-Law on Changes to the Health Insurance Law, stipulating that financing of COVID-19 treatments will be financed from the entity budget for people without health insurance. In the Federation entity, the Law on alleviation of the negative economic consequences caused by COVID-19 stipulates that during the state of disaster caused by the COVID-19 and for 1 month after, all those residing in the Federation entity are granted universal health insurance coverage – which, in fact, lasted only until the end of June. For the remaining period, this issue was dealt with by the cantons. The country's healthcare system was struggling even before COVID-19, with considerable inequalities in the provision of healthcare between cantons and entities, in terms of coverage of population groups, availability of essential medicines and commodities, out-of-pocket patient spending and health institution debt arrears (World Bank 2020).

Reform measure 18 "Improving the social protection system" aims to develop an efficient, sustainable and fair system of social protection of families with children and to ensure regular payment of social benefits. The activities are mainly focused on adapting the legislative framework. It is therefore unlikely that the effects will be visible in the short or medium term.

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

Area/Sector	2016	2017	2018	2019	EU-27 Average (2019 or most recent year)
Energy					
Energy imports dependency (%)	31.5%	34.0%	24.3%	N/A	60.62%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	448.81	434.20	463.40	N/A	112.92
Share of renewable energy sources (RES) in final energy consumption (%)	25.36%	23.24%	35.97%	37.58%	19.73%
Transport					
Railway Network Density (meters of line per km^2 of land area)	19.9 [w]	19.9 [w]	19.9 [w]	19.9 [w]	49.0 (2018)
Motorization rate (Passenger cars per 1000 inhabitants)	225.2 [w]	251.6 [w]	262.4 [w]	268.8 [w]	519 (2018)
Agriculture					
Share of gross value added (Agriculture, Forestry and Fishing)	7.5%	6.6%	6.9%	6.6%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	N/A	16.2% [w]	15.7% [w]	N/A	4.3%
Utilised agricultural area (% of total land area)	34.7% [w]	34.4% [w]	34.7% [w]	35.3% [w]	40.0% (2017, EU-28)
Industry					
Share of gross value added (except construction)	22.6%	23.3%	23.9%	23.1%	19.7%
Contribution to employment (% of total employment)	22.0% [w]	22.7% [w]	23.5% [w]	N/A	18.1%
Services					
Share of gross value added	65.2%	65.3%	64.4%	65.3%	73.0%
Contribution to employment (% of total employment)	50.8% [w]	51.6% [w]	52.1% [w]	N/A	70.8%

Digital Economy					
Percentage of broadband penetration of households who have internet access at home	61.5% [w]	66.0% [w]	69.0%	72.0%	86% (2018)
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	N/A	64.9% [w]	70.1% [w]	69.9% [w]	85% (2018)
Trade					
Export of goods and services (as % of GDP)	36.3%	40.9%	42.5%	40.5%	49.4%
Import of goods and services (as % of GDP)	53.0%	57.1%	57.3%	55.2%	45.7%
Trade balance (as % of GDP)	-22.5%	-22.7%	-22.0%	-22.7%	N/A
Business Environment					
Rank in WB Doing Business (Source: World Bank)	79	81	86	90	N/A
Rank in Global Competitiveness Index (Source: World Economic Forum)	111	103	91	92	N/A
Estimated share of informal economy in GDP (as % of GDP) (Source: IMF)	Up to 34.4%	N/A	N/A	N/A	N/A
Research, Development and Innovation					
R&D intensity of GDP (R&D expenditure as % of GDP)	0.24%	0.20%	N/A	N/A	2,2%
R&D expenditure – EUR per inhabitant	N/A	N/A	N/A	N/A	EUR 688.6

Education and Skills					
Early leavers from education and training (% of population aged 18-24)	4.9% w	5.1% w	5.4% w	3.8% w	10.2%
Youth NEET (% of population aged 15-24)	26.4% w	24.3% w	21.6% w	21.0% w	10.1%
Formal child care - children aged less than 3 years (% of total)	N/A	N/A	N/A	N/A	35.3%
Individuals' level of digital skills (% of individuals aged 16-74 who have basic or above basic overall digital skills by sex)	N/A	N/A	N/A	24%	56%
Employment					
Employment Rate (% of population aged 20-64)	44.2% w	46.6% w	47.7% w	49.7% w	73.1%
Unemployment rate (% of labour force aged 15-74)	25.5% w	20.7% w	18.5% w	15.9% w	6.7%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	24.4 pps. w	23.0 pps. w	23.7 pps. w	23.6 pps. w	11.7 pps.
Social Protection System					
% of population at risk of poverty or social exclusion	N/A	N/A	N/A	N/A	20.9%
Impact of social transfers (Other than pensions) on poverty reduction	N/A	N/A	N/A	N/A	32.38%
Self-reported unmet need for medical care (of people over 16)	N/A	N/A	N/A	N/A	1.7%
Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	N/A	N/A	N/A	N/A	4.99

w: *data supplied by and under the responsibility of the national statistical authority and published on an "as is" basis and without any assurance as regards their quality and adherence to EU statistical methodology'*

Sources of data in Annex A: EUROSTAT and Agency for Statistics of Bosnia and Herzegovina, unless otherwise indicated.

ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM THE 2019-2021 ERP

Reporting on the implementation of the structural reform measures of the 2020-2022 ERP did not follow the guidance note: this reporting is inadequate, inconsistent and incomplete, as for instance, there is no information about the *Republika Srpska* entity. In the absence of contribution from state level ministries, it also focuses mostly on non-countrywide measures and only partially reflects the current state of play. When available for one entity, the reporting on the stage of implementation appears often incorrect. There is no reporting at state level. Overall, progress in implementing structural reforms has not advanced much.

ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Council of Ministers adopted the ERP 2021-2023 on 3 February and submitted it to the Commission on 5 February. Preparation and coordination of the ERP was impeded by the consequences of the COVID-19 pandemic. The quality of the programme points to continued significant weaknesses in administrative coordination and policy formulation. The document still falls short of being comprehensive and internally consistent and lacks an overall strategic vision. The readability of the document remains to be further improved. Insufficient time has been left to finalise the ERP as some contributions were submitted very late. Bosnia and Herzegovina needs to strengthen its coordination capacity on economic policy and to ensure consistent political support, high visibility and coherence of the ERP.

Inter-ministerial coordination

The preparation of the ERP was centrally coordinated by the Directorate for Economic Planning (DEP). No single countrywide programme was presented and measures consist often of various pieces of legislation to be adopted at entity level.

Stakeholder consultation

As last contributions from entities to the DEP were only received a few days prior to the adoption of the ERP, no public consultations were held.

Macroeconomic framework

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

Fiscal framework

The programme continues to lack a consistent, complete and sufficiently detailed presentation of the country's fiscal policy both for 2020 and also of budgetary plans for 2021. The presentation of fiscal impact of COVID-19 is incomplete. This strongly impedes the analysis of countrywide fiscal developments. Public investment projections in the fiscal part are not consistent with the macroeconomic framework. The requested links to structural reforms are still largely missing. The rationale and underlying measures of the chosen policy approach are not sufficiently elaborated upon. The programme provides hardly any quantitative analysis of budgetary measures. The compilation and presentation of fiscal data is not yet in line with ESA 2010.

Structural reforms

Sections 5, 6 and 7 do not follow the programme requirements, which reflects the absence of proper coordination on country-wide challenges and reform priorities. In many cases, policy goals are vaguely formulated and are not supported by implementable measures and activities. Key result indicators are not always present and potential risks frequently indicate frequently political obstacles. Reporting on the implementation of the policy guidance is insufficient. In spite of technical assistance[31] on fiscal implication of reform measures, tables 10a, 10b and 11 do not follow the guidance note, as they are inadequate, inconsistent and incomplete, providing information about one entity only. Significantly more efforts are required to improve the ERP process, which means more senior policy makers also need to participate in its formulation. The identification of key obstacles continues to often lack clarity and consistency with the reform measures and activities.

[31] Provided by the Centre of Excellence in Finance in Ljubljana.

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