

# Bosnia and Herzegovina: Two Decades of Peace and Transition

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**Twenty years ago...** The last eighteen months have brought peace and a start to political, economic and social recovery in war-ravaged Bosnia and Herzegovina. With a massive internationally supported construction effort, schools and health clinics have reopened; commercial flights land at the Sarajevo airport; repairs to infrastructure, essential to economic revival, are underway; and commerce has picked up. Growth last year reached 50 percent, and unemployment, though still unsustainably high at 50 percent, has fallen dramatically from its war-time levels. Following the first national elections in September, BiH's State Council of Ministers and the Federation and Republika Srpska (RS) Entity governments were established – important milestones on the road to a more stable political future for the country. (World Bank Country Assistance Strategy FY98-FY99, World Bank 1997)

**Today...** The country has been at peace for the past twenty years, and despite a complex political setup has been able to achieve significant results. Much of infrastructure destroyed in the war has been rebuilt, and institutions have been established to govern the country at all levels of authority. A framework for economic and fiscal management has been established that has brought lasting macroeconomic stability. Multiple reform efforts have improved economic links between the Federation of Bosnia and Herzegovina and Republika Srpska, and some progress has been made in creating a better environment for private sector development and job creation. Much more now needs to be done if Bosnia and Herzegovina is to achieve sustainable prosperity for its citizens and join the ranks of the European Union. ... A consensus is emerging at different levels of society that the time has come for the country to change course and unleash its growth potential. (World Bank Country Partnership Framework FY16-FY20, World Bank 2015a)

**The human and economic cost of the ethnic conflict in Bosnia and Herzegovina (BH) between 1992 and 1995 was enormous.** Conflict in BH emerged soon after the republic became independent during the dissolution of the former Socialist Federal Republic of Yugoslavia (SFRY). It is estimated that more than 100,000 people were killed in BH and 2 million were displaced or became refugees—over half the pre-war population.<sup>1</sup> The economy all but collapsed with a decline in output estimated at 80 percent (World Bank 1996). Employment plummeted and physical infrastructure was decimated, severely impacting social services provision.

**The Dayton Agreement (DA) set the framework for a peace agreement that was signed in Paris in December 1995.**<sup>2</sup> The immediate DA priority was to establish and maintain peace. However, the institutional structure created at that time resulted in significant fragmentation of public institutions and decision-making, which, when added to the political legacy of the war and the transition from the former socialist republic, has affected development progress in the following two decades. The DA maintained the territorial integrity of BH and put in place a decentralized structure, establishing a state or “Institutions of BH” level of government and two entities (the Federation of Bosnia and Herzegovina (FBH) and Republika Srpska (RS)).<sup>3</sup> A Peace Implementation Council (PIC) was established of countries and international agencies supporting the peace process with an Office of the High Representative (OHR) set up as an ad hoc international institution to oversee implementation of the civilian aspects of the peace agreement, with a mandate to facilitate resolution of difficulties arising in pursuit of this goal.

**At the time of the peace agreement, BH had to confront three major economic challenges:** A) Implementing a post-conflict reconstruction program – the most pressing near-term priority; B) Developing new governance structures and

institutions for economic management; C) Managing the transition to a market economy. The scale of these challenges was immense:

*In this new environment, economic reconstruction and recovery have become the focal point for both policy makers and the public: the outcome could cement or shatter the ongoing peace process. The challenge is of immense proportions: history shows that it is always difficult to rebuild after a prolonged war. It is doubly difficult to undertake the task when it involves setting up new governance structures and institutions. Undertaking such a task with a socialist legacy and major unresolved problems in industry, banking and economic management – as in the case of Bosnia and Herzegovina – is truly heroic. (World Bank 1996, p. viii)*

**Two decades later, how much progress has been made?** What have been the drivers of progress and the areas of more or less success? What lessons can be learned for the sustainability of development progress in BH and in other post-conflict countries faced with similar challenges now and in the future?

**Significant progress has been made, although the institutional frameworks established by the DA have had long-reaching economic consequences.** Peace and macro stability have been maintained, although building political cooperation and support for reforms across governments has been challenging. The post-conflict reconstruction – supported by domestic efforts and high levels of international assistance - and immediate recovery in economic activity boosted incomes and contributed to lower rates of poverty. However, growth diminished in the second decade of the recovery as structural weaknesses were exposed following the 2008 global financial crisis. Policies and incentives have been skewed toward the public sector rather than the private

<sup>1</sup>According to the International Criminal Court.

<sup>2</sup>For the Dayton Agreement text see [http://www.ohr.int/?page\\_id=1252](http://www.ohr.int/?page_id=1252).

<sup>3</sup>Brcko District (BD), which the Dayton Agreement did not agree on the allocation of entity control, was established in 1999 following an arbitration process. Its constitutional position is defined in Amendment 1 of the BH Constitution, adopted in 2009.

sector, and toward consumption rather than investment. Similarly, institutional fragmentation has contributed to inefficient public service delivery in many areas. The extensive system of social transfers, such as pensions and veterans benefits, has contributed to social stability, but is expensive and insufficiently targeted to the poor. Unemployment rates have fallen from post-conflict levels but remain high, and activity rates are low, with formal employment discouraged by a weak business environment and high social contribution rates. The social inclusion and cohesion agenda remains unfinished. Reforms have been initiated in social services and, more recently, in labor markets, but deeper reforms are needed to create jobs and improve the quality and equity of social services.

**Recognizing these challenges, a shared understanding is emerging on the imperative to move forward with structural reforms.** With impetus for better implementation than in the past, the Council of Ministers and entity-level governments adopted a medium-term Reform Agenda in July 2015. Its implementation is supported by international partners including the International Monetary Fund (IMF), the European Union (EU) and the World Bank Group (WBG). An application for EU membership was submitted in February 2016, for consideration within the year. Despite this progress,

**The remainder of this overview of a forthcoming World Bank book is structured according to the main challenges faced by post-Dayton BH:** Achieving Reconstruction and Recovery; Building Economic Institutions; Promoting Enterprises and Transitioning to a Market Economy; Investing in People for the New Economy; and Conclusion: Achievements and Challenges.

## ACHIEVING RECONSTRUCTION AND RECOVERY

**At the end of the conflict the economy was devastated, with massive unemployment and low utilization of physical capital.** In addition to the human and physical losses associated with the conflict, production and commercial channels were dislocated as the socialist economy disintegrated and markets had only begun to develop. Prior to the conflict, the economy was quite diversified with a significant industrial sector, accounting for more than half of output and employment, particularly in energy and raw materials, textiles, leather, footwear, machinery and electrical equipment (World Bank 1996). Civilian engineering was strong in the services sector. Following the conflict, many of the main state-owned enterprises (SOEs) lost the role they



political risks remain ever-present and—while the accession process will be an important anchor for reforms—mobilizing internal demand for reforms will be crucial if progress is to be sustained.

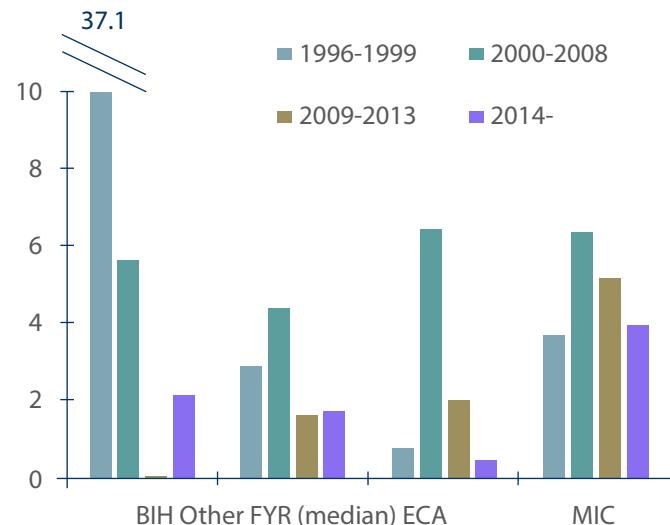
had in the protected market of the Socialist Federal Republic of Yugoslavia (SFRY), trade channels and commercial contacts had been lost and the economy had shrunk dramatically.

**Physical reconstruction in the immediate post-Dayton period was supported by domestic commitments and large-scale official development assistance from external partners.** As key infrastructure services were restored, these efforts were generally viewed as successful, but less progress occurred on institution building and policy reform. Notable variability was also seen in progress by area, entity, canton, and municipality. For example, rehabilitation of community and social sectors was more advanced in urban than in rural areas and in FBIH than RS, where reconstruction started later.

**Growth recovered quickly during the first years of the recovery from 1996-1999.** This growth was from a low base, and stimulated by the significant flows of development assistance and personal worker remittances. In the first few

**Figure 1. After robust growth in the 2000s, the post-2008 downturn was marked in BH**

Real GDP growth, annual average, percent



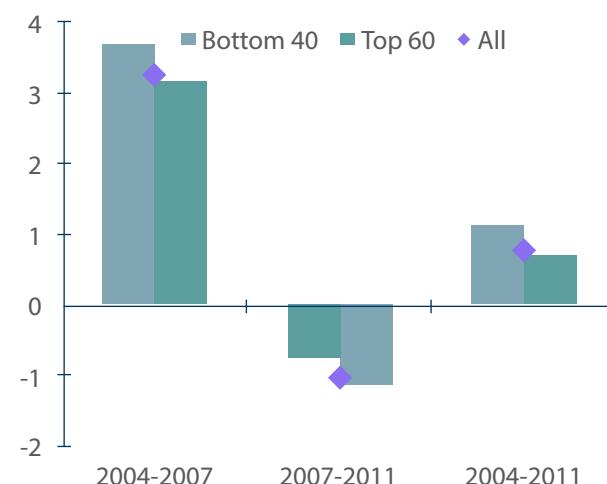
**Note:** FYR is countries of the former Socialist Federal Republic of Yugoslavia; ECA is developing Europe and Central Asia; MIC is middle income countries.

**Source:** World Bank World Development Indicators (WDI).

years, as in many other post-conflict situations, initial resource inflows were highly import-oriented, given the devastation of productive capacity and process of re-establishing domestic economic relationships. As a result, the multiplier effect of this development assistance and remittances appears to have been low.

**The second stage of the recovery, from 2000 to 2008, saw favorable external conditions and domestic developments supporting steady, consumption-driven growth.** In this phase of the recovery the multiplier effect of resource inflows increased as the BH economy recuperated. Strong real export growth was supported by global economic trends and strong investment by a rapid rise in private credit and capital inflows including FDI. Domestic reforms saw

**Figure 2. Growth has been good for the poor**  
Real growth in consumption, 2004-2011, Percent



**Note:** Bottom 40 (top 60) are the bottom 40 (top 60) percentile of households by consumption level.

**Source:** World Bank 2014; Household Budget Survey 2004-11 data.

the establishment of the Indirect Taxation Authority and introduction of the VAT. The first nationwide medium-term development strategy was adopted in 2004 and negotiations with the EU on a Stabilization and Association Agreement opened in 2005. An attempt to reform the constitution in April 2006 was not successful, and the fragile consensus for reform broke down. The steady economic growth of 2000–08 was good for the poor, increasing labor income, which contributed one-third to the rise in incomes of the bottom 40 percent (B40) of households. About 50 percent of income gains due to social assistance transfers (World Bank 2015b).

**Public spending also began to pick up again.** Public spending, which was around 50 percent of GDP from 1996 to 2002, initially fell to around 46 percent of GDP between 2004 and 2006. Spending then rose from 2007 onward, particularly on public sector salaries and pensions. While the rise in spending was enabled by higher revenues after the VAT was introduced, it led to a fiscally unsustainable position within several years (World Bank 2012).

**The third stage of the recovery from 2009 to 2013 was dominated by the global financial crisis and its consequences.** The repercussions of the global financial crisis of 2008 on Europe's banks and the emergence of serious weaknesses in the Euro area had a deep impact on the BH economy and all of South Eastern Europe (SEE) through multiple transmission channels. For example, in 2008 55 percent of BH goods exports were to the EU and the EU was the source of 43 percent of inward FDI stocks in 2009. The EU accounted for an estimated 45 percent of remittances in 2010. Financial linkages are also high with Euro area banks providing almost all the cross-border claims and local claims of foreign affiliate banks to BH, as recorded by the Bank for International Settlements (BIS). As part of the deleveraging of Euro area banks, total "foreign claims" on BH declined by nearly 40 percent from their average 2008 value through 2015 Q3, down from 66 percent of GDP to 51 percent. The global financial and euro crises also exacerbated the difficulties

inherent in accomplishing reforms, such as laying off excess public sector workers at a time in which few private sector jobs were being created to absorb them.

**The impact of this external shock was significant.** The effects of the global financial crises on BH were, arguably, magnified by the BH currency board that constrained the use of monetary policy to alleviate the impact of reduced inflows and made it impossible to facilitate a change in domestic adjustment by devaluing the exchange rate. Public spending did rise post-crisis, cushioning the impact of the downturn through social spending and the maintenance of public sector employment. The economic adjustment - the burden of which was on the private sector - was also hampered by domestic structural weaknesses, particularly in the labor market. With labor income growth adversely impacted by the crisis, pensions and social assistance were left as the main contributors to income growth of the poorest 40 percent of households during the crisis-affected period.

**Most recently, in what appears to be a fourth stage of recovery, growth has picked up, reaching 3 percent in 2015.** Growth rebounded in 2015 following the floods of 2014. However, sustained growth will require addressing the structural weaknesses of the pre-crisis model that have been exposed, as discussed further below, especially the excessive size and inefficiency of the public sector and the bottlenecks to private investment and export performance.

**In terms of the drivers of growth, consumption has been dominant across the past two decades.** Even though the share of consumption in GDP has been declining gradually since 2003, it remains high, at close to 100 percent, and, fueled by remittances and public wages and transfers, supported the high growth rates seen up to the global crisis. Remittances dropped after the crisis, largely offsetting the impact of higher public wages and social transfers and depressing consumption and economic growth. Investment has also not yet recovered from the steep decline caused by

the global crisis. Similarly, between 2004 and 2008 export growth was among the fastest in the region, with the export share rising steadily (although from a relatively low base) but this trend was interrupted when the crisis occurred and the EU economy faltered. Exports have since rebounded somewhat but are still relatively low. On the production side, services now account for two-thirds of GDP and have been a key driver of recent growth. Retail and wholesale trade has played an important role in the post-crisis period but also finance, communications and public administration.

**Following a substantial recovery in relative incomes, the rate of convergence with EU income levels has stagnated since the global financial crisis.** Looking across the four phases of recovery, and with a caveat on the quality of data in the reconstruction period, real GDP per capita (in constant 2010 USD) in BH increased nearly threefold from 1996 to 2015. This was equivalent to an annual average growth rate of 5.8 percent compared with 1.4 percent for the EU in this 20 year period. Leaving out the rapid reconstruction period, BH real GDP per capita grew by average of 3.2 percent per year versus 1.0 percent for the EU from 2000 to 2015. However, with the gap in growth rates narrowing post-2008 the rate of convergence in incomes has slowed. The gross national income per capita of BH, in purchasing power parity terms,



was estimated at just above 10 percent of the EU average in 1996. Relative income levels doubled through the reconstruction period to 1998 and then gradually rose from 22 percent in 2003 to around 28 percent in 2008, the level at which they remain in 2015.

## BUILDING ECONOMIC INSTITUTIONS

**Building effective economic institutions, in some cases from scratch and in other cases on the legacy of former arrangements, was a considerable challenge.** Although the DA prescribed arrangements for the conduct of monetary policy, it left the necessary fiscal structures ambiguous. The DA devolved most government responsibilities and control over revenues to the constituent entities. Within RS and FBH, the constitutional structures support further local self-government and devolution of public service functions and responsibilities to municipalities in RS and to cantons and municipalities/cities in FBH. This structure followed the traditional decentralized structure of the former SFRY.

**While the level of decentralization served a political purpose, the high level of fragmentation within the public sector has contributed to inefficient service delivery in many areas.** The objectives of the Dayton architects were to reach a peace settlement and to reduce the scope for ethnic tensions. In this they succeeded: clearly decentralized governance, if aligned with political or ethnic population structures, is more likely to reduce tensions at the local level than centralized governance. However, because the

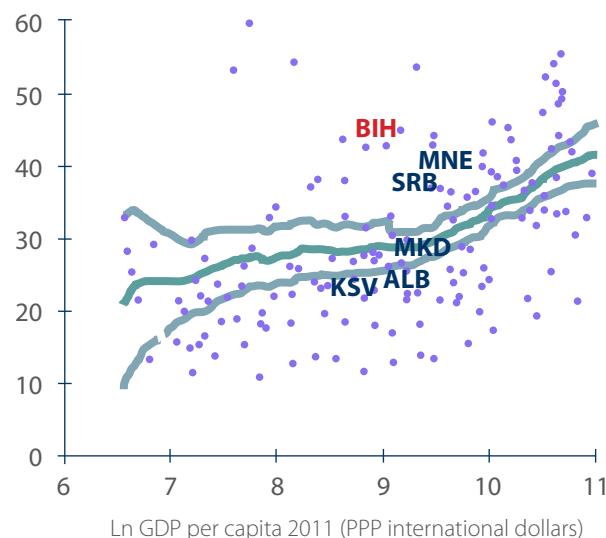
decentralization has contributed to the fragmentation and duplication of public services and decision-making, it may have led to inefficiency when a function assigned to a lower level of government could have benefited from economies of scale. The entity constitutions do not necessarily obligate

such duplications, for example, in FBH, where separate ministries of health were created at the level of cantons, but political considerations dominated.

**Multi-layered administrations have also created a complex legal and regulatory framework for companies.** The multitude of state, entity, cantonal, and municipal administrations – each with the power to regulate business and arbitrate disputes – creates a heavily bureaucratic and non-transparent system. Businesses consider judicial proceedings slow, complex and ineffective. Enforcement of judicial decisions is also viewed as intermittent and unpredictable.

**Figure 3. Revenues to GDP in BH are well above norms by national income level**

Revenues as percent of GDP, Average 2011-2014



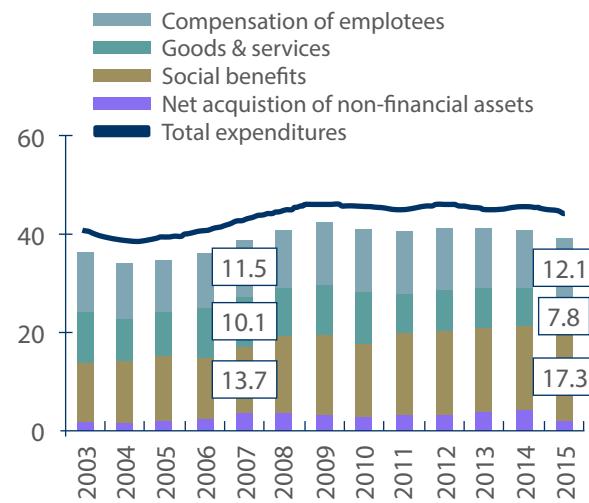
**Note:** The solid line indicates non-parametric nearest neighbor smoothing, with dashed lines showing confidence intervals at  $\pm 2$  standard deviations. Y-axis is truncated at 60 percent.

**Source:** WDI, IMF WEO April 2016.

**The DA arrangements have created challenges in moving forward with reforming the public sector.** Most spending authority and service delivery responsibilities are at the levels of the RS and the FBH and its cantons and, in many cases, this responsibility may not be aligned with the incentives to carry out reforms. This ambiguity is at the heart of many of BH's reform challenges including, for the public sector, (a) accumulation of arrears, (b) lack of resolution in the restructuring of SOEs, (c) uncontrolled spending by extra-budgetary funds such as pension funds, (d) rising public sector wage bill, both in terms of number of employees and relative salaries and (e) the outsize fiscal burden on the private sector.

**Figure 4. High government spending levels are dominated by wages and social benefits**

General government expenditures to GDP, percent



**Source:** CBBH; World Bank calculations.

**The DA assigned one important economic policy function to the State level—keeping prices stable.** While the State also had responsibility for foreign trade and customs policy, administration of customs and taxation was assigned to the entities. In contrast, the DA had an explicit article (VII) making the central bank the sole authority for issuing currency and conducting monetary policy throughout Bosnia and Herzegovina. It specified that for at least the first six years, monetary policy would be outsourced through adoption of a currency board and the central bank governor would be external and, after consultation with the president, appointed by the IMF. The agreement put the management of monetary policy beyond the realm of political discussion, and so far this has worked well.

**A further crucial later development was the Law on Indirect Taxation.** This moved the administration of indirect taxation, given to the entities, to the State level, to be administered by the Indirect Taxation Authority (ITA). Under the DA, the entities had authority over tax policy and over tax and customs administration but in 2003 a state law provided for the establishment of the ITA. Setting up the ITA, and introducing the VAT in 2006, constituted a major reform

was important for supporting development of a single economic space within the country and reducing differential entity policies and administration of indirect taxes.

## PROMOTING ENTERPRISES AND ACCELERATING THE TRANSITION TO A MARKET ECONOMY

**Since 1996, the BH economy—and the enterprises operating therein—had to deal with a dual transition.** The immediate transition was from war to peace. As mentioned, the war destroyed almost all economic activity. Reconstruction and recovery encouraged small-scale service and construction industries, shifting away from agriculture, yet not many export industries flourished. Immediately after the war, both the country and businesses had to adjust their operations to transition from a socialist (self-governed) planned economy to a market-led economy. Early interventions focused on efforts to improve the environment for private investment at the BH and entity levels, such as passage of a liberal BH Foreign Investment Policy Law, introduction of a common currency, and adoption of a



requiring a shift in the constitutional powers for indirect taxation policy from the entity to the state level, establishing the new institution and accounting system, defining the allocation of indirect revenues and harmonizing indirect tax legislation. The move to a single system of indirect taxation

uniform trade and customs policy across the entities (World Bank 2001).

**Following initial progress and growth, the transition to a market economy lost ground.** Privatization and corporate

restructuring ground to a halt, leaving a number of enterprises unable to fully restructure and prosper, while improvement in the business environment and alignment between governance levels slowed, leading to uneven treatment of businesses across BH and creating overlaps and space for rent-seeking. The halt in SOE transformation, restructuring, and sales at times generated political tension. Nevertheless, some critical reforms and adjustments succeeded, leading to an imperfect but somewhat more open environment, in which enterprises operate today.

**Incomplete transition to a market economy has depressed growth of a vibrant private sector.** Productivity grew rapidly during the initial reconstruction phase and then steadily from 2000 to 2008; it has stagnated since. This is in parallel with patterns in other countries in the region, illustrating the deep impact on the region of the global financial crisis and the weakening of Euro area economies. Progress on indicators of economic transition has followed a similar pattern. BH's average score across the EBRD transition indicators, which had trended upwards from 2000 to 2008, has since remained around three, roughly in between the score of 1 where there is little or no change from a rigid centrally planned economy and 4+ for the standards of an industrialized market economy.

**Small scale businesses and large SOEs dominate, creating a “missing middle” of private sector firms.** The complex business environment, coupled with inadequate economic infrastructure and services, has not been conducive to bringing in substantial FDI despite BH's proximity to the EU and its traditional trading linkages with some EU countries. The economy is still based on small-scale service operations and the SOEs, which even today employ large numbers of employees. Except for several in electricity and telecoms, SOEs are largely inefficient and only minimally productive, adding to the general stagnation of manufacturing. Few companies are large enough to be part of international value chains that allow for successful competition in external markets. BH has few enterprises employing 25 or more employees,

which typically are the companies that boost employment. Compared to countries with higher numbers of companies in this group, the BH economy is based primarily on large SOEs and a sizable group of small enterprises that employ no more than 9 employees. Lack of standards and norms deters exports and increases the cost of production in areas where BH could successfully compete externally and grow, such as food production, light metals, textiles, and wood processing.

**BH has a number of advantages it could leverage to rebalance its economic model and re-energize the business sector, if bottlenecks in the business environment are addressed.** Next door to the EU, it is well located to leverage international markets and trade with EU. Current plans for reforming the SOE sector through privatization, restructuring, or bankruptcy are a good starting point for reducing the role of SOEs and opening space for medium-sized private companies to thrive. However, as the 2016 Doing Business report underscores, the BH business environment lags behind regional peers, its labor market remains rigid, and its inadequate infrastructure discourages international and domestic transport and trading networks. High tax rates are a serious deterrent for the private sector and shortages of skills sought by export-oriented and import-competing industries are also substantial. The result is weak investor confidence, both foreign and domestic. Major adjustment to the business environment set out in the Reform Agenda will aim to address many of these prominent impediments to the operation and growth of the private sector and enable access to markets by addressing deficiencies in norms and standards, and facilitating trade between BH entities and



between BH and nearby markets. Efforts are needed to encourage innovative approaches to supporting business, especially engaging the private sector in supporting nascent technologies or businesses. BH businesses also need long-term stability and predictability in the policy environment to attract and foster long-term investment.



## INVESTING IN PEOPLE

**Since 1990, the combined effects of low birth rates and high emigration, particularly by the young, have resulted in a declining and aging population.** BH lost nearly an estimated quarter of its population during the war, mostly due to emigration and displacement. Though some returned after the war, the population decline has continued. The 2013 Census results putting the population of citizens permanently residing in BH at 3.5 million, approximately eight percent less than in the pre-war 1991 Census. The population impact of increased longevity has been offset by a gradual decline in birth rates and significant emigration in the 1990s. Birth rates, which plunged in the 1980s, have stabilized since 2000, but are

still below replacement rates. Net outward migration is also down from the peak levels of the 1990s. These demographic shifts have, and will continue to have, deep impacts on the economic and political landscape.

**Like regional and income-level peers, life expectancy in BH has been improving, but significant health challenges are faced.** Average life expectancy at birth rose from 72 in 1995 to 74 in 2000 and then went up gradually to 76 in 2014, above middle income peers. However, the gap with the EU, where in 1995 life expectancy was about four years higher, was unchanged in 2014, despite a slight dip in the 2000s. Smoking and inadequate diet and exercise are though long-term risks for the health of Bosnians. Bosnians are among

**Table 1. Selected Human Development Indicators**

		BH	Other FYR (median)	ECA	MIC
Life expectancy at birth, total (years)	2000–08	74.9	73.2	69.8	67.9
	2009–14	76.0	74.8	72.0	70.0
Adult literacy rate, population 15+ years, both sexes (%)	2000–08	96.7	83.8	95.7	78.6
	2009–13	98.3	92.2	98.2	83.4
Improved water source (% of population with access)	2000–08	98.2	98.6	92.3	84.2
	2009–14	99.5	99.2	95.3	89.7
Prevalence of overweight, weight for height (% of children under 5)	2000–08	21.0	11.8	8.7	4.8
	2009–13	17.4	15.6	11.3	5.3
Prevalence of stunting, height for age (% of children under 5)	2000–08	12.0	9.8	16.9	33.6
	2009–013	8.9	6.6	12.1	27.4

**Note:** FYR is countries of the former Socialist Federal Republic of Yugoslavia; ECA is developing Europe and Central Asia; MIC is middle income countries.

**Source:** World Bank WDI.

the heaviest smokers in the world; in 2009–13 the average smoking rate was 49.5 percent for males versus 38 percent in middle-income countries. Chronic child malnutrition is also a major health burden. Nearly 10 percent of children experience chronic malnutrition (stunting), a relatively high level among peers in the Western Balkans. Child obesity rates are also surging in all income quintiles but exceed 20 percent for the wealthiest. Undernutrition can have lifelong consequences for a child's cognitive development, while childhood obesity significantly increases risks of non-communicable diseases in adulthood. Both measures of malnutrition disproportionately impact the poor, especially in rural areas.

**Within the aggregate poverty trends, many households or groups are particularly vulnerable to falling into poverty or have more difficulty accessing services or economic opportunities.** Between 2004 and 2007 poverty fell and incomes of the bottom 40 percent of the population grew rapidly. Poverty (measured against a 205 KM daily threshold) fell from 17.7 percent of the population to 14 percent between 2004 and 2007 (World Bank 2015b). The onset of the financial crisis, slowing growth and leading to a rise in unemployment, stopped poverty reduction. At 15 percent of the population in 2011, poverty was slightly higher than the pre-crisis 2007 estimate. Within these aggregate figures, children are more likely to be poor, and child poverty has increased since 2007. People with jobs and better education are also less likely to be poor. In contrast, people with primary education or less are much more likely to be poor; and in 2007–11 their poverty increased. Inequality is also among the highest in the Western Balkans, based on World Bank estimates. With the social inclusion agenda unfinished, many are still marginalized or vulnerable. This is particularly true for groups like the Roma (which are estimated to represent approximately 2.0 percent of the population, World Bank 2015a). Over 40 percent of Roma are estimated to be poor, with one in five adult Roma considered to be illiterate (compared with close to full literacy among the rest of the population) and over half malnourished (World Bank 2015b). Other groups such as the

poor and unemployed also have more difficulty accessing jobs, services, and other state benefits.

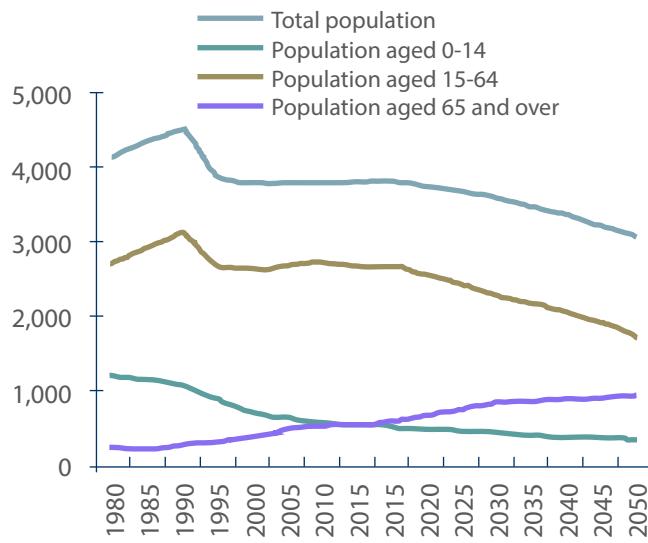
**Rates of unemployment have been structurally high.** In the reconstruction period jobs were created through public sector employment and reconstruction efforts; few new private sector jobs were created. Two decades later only a small percentage of Bosnians have jobs, few have formal jobs, and even fewer have private sector jobs. The 2015 Labor Force Survey figures suggest that the labor force participation rate of those of working age (>15) was 44 percent, and of those in the labor force, 27.7 percent were unemployed. That means only a third of Bosnians over age 15 are employed. High rates of unemployment - with over 80 percent of the unemployed remaining jobless for over a year- and high rates of inactivity are a problem for the economy and society: they contribute to poverty and jeopardize long-term stability. Youth, women, and older workers are particularly affected by inactivity and unemployment. Informality in the labor market is also high.

**Outcomes for many human development indicators have improved but should be better given BH's level of income and high government social spending.** In terms of human development outcomes, people in BH are better off on average than those in many developing and middle-income countries in terms of life expectancy, literacy, and access to water—indicators that have improved slightly in the past two decades. But the level of human development is lower than it should be given the average BH income and government spending on social services.

**Fragmented and inefficient social service delivery is one of the reasons human development indicators are below expectation.** This inefficiency not only undermines human capital development but also heightens the cost of government and adds to the tax burden on workers. Though the extensive system of social transfers, such as pensions and veterans benefits, has contributed to social stability, it is expensive and not well-targeted to the poor. High social

**Figure 5. The BH Demographic Challenge**

Thousands of Population, 1980–2050



**Note:** UN population projections.

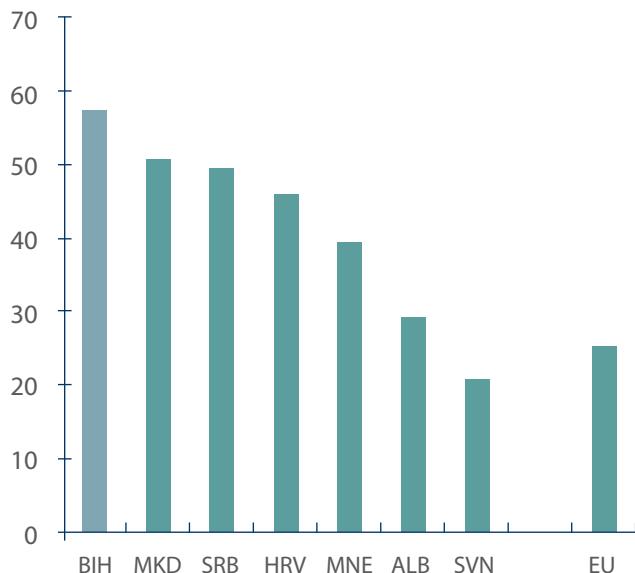
**Source:** UN 2015a.

contributions also discourage formal employment. Social services like health and education inherited positive legacies from the former Yugoslavia, but reforming them has proven to be more difficult than rebuilding them after the war. The broader governance environment has had a significant influence on the cost and effectiveness of services, including politically motivated hiring of managers and staff, fragmented procurement systems, and inadequate monitoring and accountability systems, among other problems.

**With its population declining and aging, BH needs to invest more in its most important resource -- children and youth – and adapt its pension and health systems**

**Figure 6. Youth unemployment is particularly high in BH**

Percent of the Labor Force, 2014



**Note:** Modeled ILO estimates. Unemployment as percent of total labor force aged 15-24. BIH: Bosnia and Herzegovina; MKD: FYR Macedonia; SRB: Serbia; HRV: Croatia; MNE: Montenegro; ALB: Albania; SVN: Slovenia.

**Source:** World Bank WDI.

**to demographic changes.** The low coverage and quality of early childhood development programs have enormous consequences for the future learning, income, and welfare of Bosnia's children and productivity of the economy. What explains this situation? First, because children don't vote or protest on the street, programs that benefit them can be neglected. Second, the social transfer system disproportionately benefits politically influential groups, such as veterans and pensioners, and neglects children, particularly poor children. High spending on pensions, social transfers, and inefficient hospitals is crowding out better long-run investments in human capital, particularly children.

**Reforms to create more jobs, and to encourage labor force participation, are needed.** High and persistent unemployment, particularly among the young, and high inactivity, particularly among women, are major economic and social concerns. Recent labor law reforms are among the steps being taken to address some of these issues. However, the fiscal regime also results in disincentives to work, for example, through high marginal contribution and tax rates, and the design of such social transfers as pensions. Many workers are exceedingly attracted to public employment, and those still working in nonviable SOEs may not be equipped to transition to new employment opportunities. Prospects for the young entering the labor market or for unemployed workers looking for a formal job are also dimmed by poorly adapted education and employment support services, and the scarcity of information about the labor market. The consequence is persistent informality, and the departure of young people from the country.

and increasing use of pooled financing and procurement and (3) enhancing mechanisms for citizen engagement and the accountability of service providers. BH currently lacks all three, but they could be realized in the next five to ten years.

**A prerequisite for better performance, and its monitoring, is establishing policies and data standards at the entity, and preferably the state, level.** Services provision could remain decentralized as long as data are shared more widely and reported. A relatively strong health information system for primary care already exists, but it needs to be better networked, linked to hospitals and institutes of public health, and the data systematically reported. More work is needed to establish basic data standards and infrastructure for education, and performance-based financing for both health and education services could be introduced at the entity and canton level. Establishing a centralized mechanism to make financing more equitable may be more challenging, but could be built up from an already existing basis in the FBH Solidarity



**Reforming service delivery is possible but requires greater attention to performance monitoring, financing systems, and citizen accountability.** As noted, the DA created a fragmented and unwieldy system for organizing services and making policy. But the current constitutional arrangements allow for improving the quality, efficiency, and equity of social services by (1) reinforcing systems for monitoring their quality and efficiency; (2) introducing performance-based financing,

Fund. Finally, more needs to be done to make service delivery more accountable, through performance scorecards and greater involvement of parents in monitoring school quality and patients in monitoring health service quality.

## CONCLUSION: ACHIEVEMENTS AND CHALLENGES

**In the past two decades BH has undergone profound changes and significant progress has been made.** It has gone from conflict to peace; economic collapse to recovery; centralized socialist institutions to markets and decentralized institutions; an economy largely dominated by SOEs and economic planning to a more mixed economy; from disrupted trade linkages to gradual re-integration and recent submission of its EU membership application. The DA established a system of political institutions to govern and economic institutions to stabilize the economy and transition from socialism to markets. These institutional and policy changes catalyzed a significant economic recovery in terms of higher per capita GDP and a narrowing of the gap between per capita GDP in BH and the EU average, although interrupted by the global financial crisis, and progress in the transition, though incomplete, towards a market economy.

**Today reinvigorating growth in an inclusive manner must be the highest priority.<sup>4</sup>** Poverty reduction has stalled and unemployment rates are high, particularly among the young. In 2015, according to the Gallup World Poll, only 8 percent

of respondents in BH thought the economy was going in the right direction, the same number as in 2009, down from 42 percent in 2006. Almost 40 percent of respondents would like to move to another country, reaching 60 percent for those aged 15 to 29. Levels of confidence in government are relatively low (less than 20 percent of respondents) and concern over corruption high.

**A shift to a more sustainable growth model for BH is needed.** The post-crisis experience has focused attention on the economic sustainability of BH's growth model. The strong role of consumption in driving growth in the immediate post-conflict years is understandable given the level of destruction of physical capital and productive capacity during the conflict. However, over a longer period, the domestic economy is small enough that it is unlikely that household- and government-led consumption alone could support enough economic growth to narrow the income gap between BH and the EU.

**More sustainable sources of economic recovery and long-run growth are likely to be exports and investment** (World Bank 2015b). However, both were hit by the recession in the euro area and are discouraged by high marginal tax rates and inefficient government services. Improving competitiveness



<sup>4</sup>For an analysis and prioritization of the challenges faced in reducing prosperity and achieving shared prosperity in BH see the World Bank's 2015 Systematic Country Diagnostics (World Bank, 2015b).

of export-oriented businesses, and supporting the attractiveness of FDI would also help mitigate risks to external sustainability given BH's sizeable current account deficit and external financing needs. In terms of fiscal sustainability, in the baseline outlook of limited fiscal deficits, ongoing reforms and improved growth performance, the debt-to-GDP trajectory appears sustainable. Important progress has also been made on improving debt management. Potentially important fiscal liabilities remain which could have a significant impact on future financing and debt dynamics and on which more analysis is needed. These include public sector arrears and liabilities associated with remaining SOEs. Finally, and crucially, improved job creation, productivity growth and enhanced public service delivery are keys to ensuring the social sustainability of BH's growth going forward.

**Reforms that would support such a rebalancing of growth are well-recognized, but remain challenging within BH's decentralized governance structure.** Decentralized governance increases coordination costs for formulating and implementing reforms and gives different agents potential veto powers. Overlapping authority to control decisions and misalignment of responsibilities and incentives also means that decisions tend to have high transaction costs.

**Political commitment of all governments is a critical building block for reform, but that alone is not enough to make changes happen.** Achieving consensus to move forward on major reforms is clearly difficult given the domestic political environment. The main challenge is to mobilize and harness internal demand for reforms and to hold governments accountable for their implementation. The adoption of the Reform Agenda agreed by the different governments in 2015 highlights how application for EU membership and the EU accession process can support such an internal demand for reform. This process is clearly not without its own challenges, as seen in the recent political debate on adoption of the EU Coordination Mechanism and adaptation of the EU-BH Stabilization and Association Agreement. Furthermore, public

sector reforms in BH are subject to common challenges seen in other countries, including the distribution of winners and losers and financing of transition costs. Local level reforms are less constrained by the need to develop consensus at a national level that comes with major, cross-cutting reforms, and potentially more responsive to demand-driven initiatives. Improved monitoring of service delivery performance and benchmarks can support demand-side accountability for reforms and improved service delivery from the public.

**In order to secure a more prosperous future for the people of BH, the consensus to reinvigorate economic reforms must be maintained and deepened, and the coordination challenges that slow implementation must be alleviated.**

Over the past two decades, the people of BH have had to address not only the economic challenges faced immediately after the conflict, but to navigate the economic impact of external shocks, most notably the global financial crisis and also natural disasters. Significant progress has indeed been made, but with income growth and poverty reduction weakening since the 2008 global financial crisis, the need is clear to move forward with the broad set of measures laid out in the country's Reform Agenda. Growth requires deepening of labor market reforms, improving social protection delivery and reducing the cost of labor; improving competitiveness, entrepreneurship and the investment climate; reducing the size of the public sector while ensuring fiscal sustainability and improving public service delivery; and investing in key transport and energy infrastructure. These are all significant reform areas, each with its own vested interests. In order to fulfill the aspirations of both young and old in Bosnia and Herzegovina, governments will need to work together now to achieve common goals, delivering on a reform agenda that expands economic opportunities, creates high-quality jobs and advances the country's path into the European Union.

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