

5. INVIGORATING THE LABOR MARKET

A. INTRODUCTION

5.1 **Labor mobility and redeployment have been low in BH by regional standards, especially in the formal sector** (World Bank, 2002b). This sector, particularly the budgetary, state and socially-owned sectors, still maintains some of the features that characterized the labor market during socialism. Lack of labor mobility, a compressed wage structure, low labor force participation and wage determination mechanisms that allow strong wage growth with little regard to changes in productivity, were all characteristics of the pre-transition labor market in BH. Given the relative weight of the formal labor market, many of its features characterize the labor market as a whole.

5.2 **These features can be traced to the *pre-transition* behavior of the labor market in BH.** Hoping to obtain severance pay or feeling unable to cope with changes, workers in the formal sector usually get attached to their old enterprises. Job preservation is also facilitated by managers that see their influence over employees as a way to preserve their own managerial positions. Acting with little regard to profits, SOE managers often show little interest in meeting the labor restructuring needs of their enterprises. Wage, tax, and utilities arrears, coupled with subsidies, have concentrated among large public sector enterprises, softening their budget constraints, and perpetuating the existence of such schemes. However, these mechanisms are progressively diminishing in importance as the sector of protected enterprises is shrinking. Not surprisingly, the sector's share in total employment is decreasing accordingly.

5.3 **Enterprises in the informal sector seem to operate differently, particularly in the way they recruit, pay and retain personnel.** These enterprises are generally smaller in size, recruit mainly younger workers, and on average pay slightly lower but more timely wages. During 2001-02, this sector increased its overall employment and its share in total employment. The sector's lead in net and gross employment creation results from much higher accession and separation rates than in the formal sector. In other words, the chances of finding and losing a job are much greater in the informal sector. The informal sector is also less associated with political use of employment, receives lower subsidies and has a stronger profit seeking orientation. It is also outside collective labor agreements.

5.4 **The labor market in BH shows a noticeable duality between the functioning and performance of its formal and informal elements.** Its average performance reflects the combination of a poorly functioning and relatively rigid formal labor market dominated by large and state-owned companies, and a very flexible informal labor market based primarily on small and medium enterprises. Not surprisingly, BH has one of the largest informal sectors in Europe. This is not a sustainable situation, either from a labor market perspective or from a fiscal point of

view. Informal sector companies have limits on their ability to develop and grow. They also face obstacles to export and are more difficult to integrate into the European production chains. In addition, workers in the informal sector pay no social security contributions and do not accrue pension and healthcare rights.

5.5 **This study finds a labor market which is also dual in several other dimensions.** Particularly important is the duality between a relatively flexible labor market in the private sector and a rigid labor market in the budgetary, state and socially-owned sectors. There is also a striking duality in the way men and women approach the labor market, as well as between poorly-educated and well-educated workers and between younger and older workers.

5.6 **The objectives of this chapter are to analyze the recent performance of BH's labor market and to identify policy measures to improve its functioning as a means of supporting growth in output and employment.** The assessment of labor market policies and performance is challenging, especially in an economy undergoing profound structural change. This is because labor market outcomes can be influenced by a broad range of macroeconomic and structural policies, external and behavioral factors at the branch or even firm level. In addition, since the benefits of labor market reforms (revamped labor laws were introduced in both Entities in 2001) are likely to materialize only over the long term, and since BH introduced most such measures relatively recently, their impact is not yet fully discernible.

5.7 This chapter starts with a historical overview of the labor market in BH and the transformation the economy had undergone in the last two decades. The evolution of wages, employment and productivity is analyzed using time series data from the formal sector. In the early 2000s, nominal wages grew at a pace unmatched by the growth of productivity. The resulting increase in unit labor cost adversely impacted the competitiveness of BH firms. The recent release of two previously unavailable household surveys allows for a more comprehensive analysis, including of the informal sector and employment dynamics. The chapter reviews the institutional setup and its relevance for wage determination, minimum wages and presents an empirical analysis of earnings. A special section is devoted to skill development in BH, covering education, training and active labor market programs. The last section of the chapter summarizes the evidence and the policy recommendations relevant to the labor market in BH.

B. THE LEGACY OF A PARTICULAR TRANSITION

5.8 BH was born out of the disintegration of Yugoslavia. The Yugoslav self-management system was based on 'social' ownership of enterprises, effectively that of managers and employees. The incentives embedded in the system resulted in persistent wage pressures and poor allocation of resources. **Inefficiencies at the micro level were covered by financial arrangements that permitted non-viable enterprises to survive.** Enterprises owned banks and were consequently able to influence their lending decisions, softening their budget constraints and "socializing" losses, thereby artificially extending the lives of otherwise non-viable firms. Enterprise losses were financed through bank loans that were ultimately monetized by the central bank. The prevalence of soft budget constraints turned inflation into a chronic problem. In fact, inflation in BH averaged near 70 percent annually in the twenty years preceding independence.

5.9 **Despite its flawed incentive structure, the Yugoslav system was far more market-oriented than those of the Central and Eastern European countries (CEECs) and the former Soviet Union,** and did not rely on central planning. In the so-called ‘self-management’ system, enterprises were free to make most of their own decisions regarding pricing, external trade and investment. Banks were owned by enterprises and managed in a decentralized manner. The system allowed greater competition than in the CEECs and generally avoided the shortages of consumer goods that often characterized those economies.

5.10 **While generally more flexible, the self-management system did not spare the Yugoslav republics from several of the distortions that saddled factor markets in socialist economies elsewhere.** In particular, the labor market in BH during socialism was characterized by large employment in the social sector (especially industry) and little geographic mobility of the labor force. High government and worker involvement in wage determination resulted in a fairly compressed wage structure. However, there were also differences with the more centralized forms of socialism. The labor market in the self-management system was relatively more flexible. Unemployment existed in BH well before the beginning of transition⁶⁵ although it was repressed by political pressures exerted on enterprises to hire beyond needs, resulting in considerable overemployment. Systemic pressures to induce labor force participation were far more moderate than in the more centralized socialist economies. Consequently, activity rates in the SFRY were lower compared with the more centralized socialist economies in Europe.⁶⁶

5.11 The historical perspective is particularly important in the case of BH as **many of these labor market features remain entrenched and can be related to slow reform in many areas.** In fact, activity rates for women remain low nowadays, government and worker intervention in wage determination high and the resulting wage distribution compressed. The public sector continues to be an important employer. Although industrial employment has fallen significantly, labor hoarding continues to be an issue, particularly in protected, state-owned industries, while labor mobility remains low in the formal sector.

The Formal Labor Market Throughout Transition: Structure of Formal Employment

5.12 An evaluation of the BH labor market would ideally be based on an analysis of extended trends in labor force participation, employment and unemployment. However, the lack of survey-based labor market data before 2001 constrains the coverage of longer periods primarily to the formal sector. The picture of the post-war period which emerges is one of limited labor mobility, important recovery of wages and a timid pickup of employment at a pace far below real GDP growth.

5.13 As demonstrated in Chapter 1, BH has seen significant economic growth since the end of the war. **The drop in economic activity was much sharper than in other transition economies⁶⁷ and so was the rebound.** Postwar employment in the formal sector in BH was

⁶⁵ Unlike other socialist countries, the former SFRY recognized the existence of unemployment in the 1950s. Unemployment remained low until the 1970s, however.

⁶⁶ Activity rates in BH were among the lowest in SFRY and consequently, among the lowest among the socialist countries.

⁶⁷ At one point during the war, recorded GDP fell to just 17 percent of its 1989 level.

drastically reduced, with formal employment only 59 percent of the comparable 1991 level in 1997 (the reduction was pronounced in both entities; Table 5:1), and some 65 percent in 2003.

Table 5:1 Formal Employment By Sector of Activity, 1991 and 1997-2003 (in thousands)

	1991	1997	1998	1999	2000	2001	2002	2003
A. Bosnia and Herzegovina								
Total ^{1/}	976	575	639	628	641	627	637	634
Agriculture ^{1/}	36	n.a.	n.a.	21	21	21	21	20
Manufacturing ^{1/}	498	n.a.	n.a.	256	255	247	239	235
Services ^{1/}	441	n.a.	n.a.	351	365	359	372	369
B. Federation								
Total	638	373	395	408	410	407	394	387
Agriculture	21	n.a.	10	10	10	11	11	10
Manufacturing	325	n.a.	161	161	161	156	151	146
Services	292	n.a.	224	237	241	241	232	231
C. Republika Srpska								
Total	338	202	244	221	228	220	238	237
Agriculture	15	n.a.	n.a.	11	10	10	10	10
Manufacturing	173	n.a.	n.a.	96	94	92	88	89
Services	149	n.a.	n.a.	114	123	118	140	138

Notes: 1/ Totals for 2001 and 2002 include employment in the Brcko district that are excluded in the sectoral breakdown. The sectoral breakdown, as a result, does not add up to the total.

5.14 Formal employment has also undergone some important changes in structure. Above all, the postwar formal workforce has become significantly older on average. The share of less educated workers in employment fell substantially. In comparison to the prewar years, employment has shifted away from manufacturing, where it fell in both absolute terms and relative to the total. From 1991 to 2003, the share of manufacturing employment fell by 12 percentage points, a similar decline to that in Bulgaria and Romania, but steeper than the reduction in Croatia, FYR Macedonia and SAM (WIIW, 2000). With agriculture stagnating, employment in services commensurately increased. In comparison to the FBH, in 2003 the RS had a higher share of workers employed in manufacturing (7 percentage points more), and in agriculture (2.5 percentage points more).

The Formal Labor Market Throughout Transition: The Growth of Wages

5.15 The economic recovery was also accompanied by significant general wage inflation in both Entities. Table 5:2 shows the evolution of aggregate nominal net wages during 1998-2003 period. Net wages grew from KM 296 a month in 1998 to KM 486 in 2003, a cumulative increase of more than 64 percent. Even after controlling for consumer price inflation, which averaged around 2.2 percent per annum over the same period, real wage increases remain significant. This wage inflation spiral appears to be led by relatively high paying firms and the government sector, with systemic spillovers to the rest of the economy.

Table 5:2 Average Wages and Employment

Year	FBH			RS			BH		
	Net monthly wages (KM)	Wage growth (%)	Employment Growth (%)	Net monthly wages (KM)	Wage growth (%)	Employment Growth (%)	Net monthly wages (KM)	Wage growth (%)	Employment Growth (%)
1998	329			170			296		
1999	374	13.7	0.8	216	27.1	-9.6	343	15.9	-3.1
2000	414	10.7	0.3	277	28.2	3.2	374	9.0	1.5
2001	444	7.2	-1.4	309	11.6	-3.4	443	18.4	-2.3
2002	484	9.0	-3.8	347	12.3	6.7	446	0.7	1.9
2003	530	9.5	-0.7	385	11.0	0.0	486	9.0	-0.6

5.16 **Rapid wage growth has positioned BH on the high side of the distribution of average wages across the countries in the region.** As shown in Table 5:3, wages in BH are second only to wages in Croatia and above average wages in Serbia. Interestingly, the relative position of average wages in BH in 2003 replicates closely the one before transition; the exception being the relative position of BH wages vis-à-vis Serbia.⁶⁸ However, the structure of GNI per capita has changed dramatically, with the relative position of BH deteriorating markedly. That is, wages in the formal sector in BH recovered their relative position vis-à-vis the other countries, outpacing the recovery of economic activity.

**Table 5:3 Net and Gross Wages, 2003
(In euro per month)**

	FYR					FBH	RS	BH
	Bulgaria	Romania	Macedonia	Croatia	Serbia			
Net Wages	115	130	194	521	176	268	194	247
Gross Wages	145	179	327	743	255	394	294	367

Source: National statistical offices and central banks.

C. A MORE COMPREHENSIVE LOOK AT THE LABOR MARKET

5.17 The data reported above show developments in the formal part of the labor market. With the release of the 2002 survey Living in Bosnia and Herzegovina (LiBH), labor market data covering more than one year are now available for the first time.⁶⁹ This enables more insights into two previously not well analyzed aspects of the functioning of the labor market: the informal sector and employment dynamics (Table 5:5). This section examines the characteristics of the labor market in BH, including skills and age composition using micro level data. It also

⁶⁸ Wages in Serbia before transition were on average higher than in BH.

⁶⁹ This allows analysis of two cross sections of the Living Standards Measures Survey (LSMS), conducted in 2001 and 2002. The LSMS is a household level survey, with several components including a detailed labor market module. In 2001, the sample covered 9,445 individuals, of which 7,313 were selected and surveyed again in 2002. Individuals living in RS account for 55 percent of the sample, while women account for almost 52 percent. The two waves form a panel data allow for a unique opportunity to address key questions regarding labor market outcomes in BH in general, and employment and wage determination in particular.

investigates the employment and wage structure across different sectors, including changes in this structure between 2001 and 2002. The surveys reveal some interesting developments in the labor market that may challenge to a certain extent the prevalent understanding of BH labor market in areas such as labor force participation and overall labor market flexibility.

5.18 In other words, **relatively high wages by regional standards are not backed by a proportionately higher labor productivity**. Using GNI per capita as a proxy for labor productivity, wage differentials between BH and other SEE countries are larger than productivity differentials (Table 5:4). Put differently, productivity adjusted wages are high in BH compared with other transition countries. For example, manufacturing wages in Croatia are about 125 higher than in BH; however, productivity in Croatia almost four times greater than in BH. This implies that despite higher wages, unit labor costs are lower in Croatia than in BH. Similarly, while manufacturing wages in Bulgaria and Romania are about half those in BH, labor productivity in these countries is higher.

Table 5:4 Gross Wages in Manufacturing ^{1/}

	Monthly gross wages <hr/> (US\$)	GNI per capita	Gross wages/ GNI per capita (percent)
BH	219	1,230	18
Bulgaria	109	1,520	7
Croatia	494	4,620	11
Czech Republic	341	5,250	6
Estonia	281	3,580	8
Greece	1432	11,960	12
Hungary	312	4,710	7
Ireland	1804	22,660	8
Latvia	225	2,920	8
Lithuania	247	2,930	8
Poland	457	4,190	11
Portugal	679	11,120	6
Romania	112	1,670	7
Slovak Republic	255	3,700	7
Slovenia	793	10,050	8
Spain	1461	15,080	10

Source: Wages: Yearbook of Labor Statistics 2001, ILO; Gross National Income: World Bank Atlas, 2002; Exchange rate: World Development Indicators, The World Bank, 2002.

5.19 **The high unit labor costs in BH reflect both a large tax wedge and high net wages, primarily the latter.** The tax wedge in BH is broadly similar for the two entities. But while the tax wedges have recently been declining, average net wages have increased. In fact, the strong real wage growth in BH over the past six years has significantly contributed to the current high unit labor costs.⁷⁰ Factors

which may have contributed to these developments include the strong bargaining position of workers with ‘protected’ jobs, and the functioning of the wage negotiation process (Collective Agreements) in the formal sector. The latter seem to have an impact on both the aggregate and inter-sectoral evolution of wages. There is evidence of spillover effects, where wages continue to move together in the labor market through mechanical adjustments mandated by the Branch Collective Agreement. To understand the factors behind this wage evolution, we analyze workers’ mobility in the next section and the wage mechanisms and institutions in the subsequent section of this chapter.

⁷⁰ Wages in the FBH, nevertheless, are significantly higher than in the RS.

**Table 5:5 Sample Description, LSMS, BH 2001
(in percent)**

Entity		Gender	
Federation	44.69	Male	48.2
RS	55.31	Female	51.8
Age		Education	
15—18		Unfinished	
	7.63	Elementary	15.12
19—24	11.44	Elementary	29.43
25—34	15.94	Vocational	31.04
35—44	17.78	High School	17.66
45—54	17.29	College (2Y)	3.32
55—64	13.71	College (4Y+)	3.37
65 +	16.21		

Source: LSMS 2001.

Notes: The estimated frequency distributions are all weighted.

Employment, Unemployment, and Labor Force Participation in 2002

5.20 Based on the 2002 LSMS survey, the following emerge as the salient features about aggregate labor market stocks and participation rates in BH:

- **Employment rates are very low**, below 43 percent of the working age population, with lower rates for the FBH—about 39 percent—than for the RS—about 49 percent.
- **The share of employment in the informal sector is an extremely high 37 percent.** This share is 32 percent in the FBH and an even higher 41 percent in the RS.
- **The proportion of women in informal employment is practically the same as their share in total employment.**
- **At 21.4 percent in 2002, the unemployment rate is one of the highest in the region.** It is similar in both the FBH and the RS, but it is higher in both Entities for women than for men.
- **The level of youth unemployment is alarming**, reaching 56 percent for 18 years old or younger and close to 44 percent for the 19-24 years old.
- **Female labor force participation is low at about 39 percent of the working age population, one of the lowest in the region.** Generally, participation rates are significantly higher in the RS than in the FBH, including for the female workforce. Therefore, while the participation rates in the RS are in line with regional averages, BH's low overall participation rates reflect low rates in the FBH, particularly for women.

5.21 The age and education distributions reveal a relatively young and well-educated population. About 20 percent of the working population are less than 24 years old and almost 50 percent have a high school degree or vocational training. Vocational training is the most common among individual educational attainments.

Employment and Unemployment Structure

5.22 **The public sector continues to provide a large portion of employment in BH** (Table 5:6).⁷¹ However, its share declined from almost 49 percent in 2001 to 42 percent in 2002. The private sector's employment share increased in 2002, but to a still very low 36 percent. As mentioned earlier, the informal sector employed a significant close to 40 percent of all workers in both years of the sample. More than 50 percent of the employed are in the agriculture, manufacturing or construction sectors.

5.23 Table 5.7 breaks down the employment rate and unemployment rate by age and education groups in both 2001 and 2002. The unemployment rate shows consistent patterns with the employment rate, with the average increase in the unemployment rate from 2001 to 2002 spread across different age and education groups. **Unemployment is the highest for the young and the poorly educated. It decreases significantly with age and educational attainment.** The unemployment rate for the young is very high, 56 percent and 46 percent for those between 15-18 years or age and 19-24 years of age, respectively. These rates are substantially higher than the overall unemployment rate of 21 percent in 2002.

5.24 **Similarly, the employment rate rises with age until 55 years, before dropping very rapidly.** The employment rate also varies across different education groups. It is very low for the uneducated: 20 percent in 2001 and 25 percent in 2002 for individuals with no elementary education. It increases with educational attainment with significant differences for university graduates. The increase in the aggregate employment rate between 2001 and 2002 is most pronounced for older and less educated individuals, while the young appear not to have benefited from this increase in employment.

Table 5:6 Employment Distribution in BH, 2001 and 2002

	Employment Share (in %)			
	2001	2002	2001	2002
Public	48.83	42.17	Agriculture and Fishing	19.43 20.86
Private	33.43	36.18	Mining	2.97 3.17
Others	17.74	21.65	Manufacturing	20.05 19.16
			Utility	2.5 2.52
Informal Sector	37.22	39.74	Construction	11.34 10.26
Formal Sector	62.78	60.26	Trade	9.18 9.45
			Hotels and Restaurants	4.27 4.06
			Storage and Communication	6.08 5.89
			FIRE	1.6 1.74
			Others	7.97 9.94
			Public Administration	7.16 5.5
			Education	4.13 4.08
			Health	3.31 3.37

Note: Total employment in this tables includes workers in and out working age (15-64).

⁷¹ The definition of Public Sector in this section encompasses the Consolidated General Government as well as publicly owned enterprises.

Table 5:7 Employment and Unemployment Rate, by Age and Education, BH 2001 and 2002 (in percent)

	Unemployment Rate		Employment Rate	
	2001	2002	2001	2002
Age				
15—18	53	56	5	6
19—24	36	46	29	27
25—34	19	28	48	48
35—44	11	15	58	60
45—54	10	11	54	57
55—64	6	8	22	27
Education				
Unfinished Elementary	14	13	20	25
Elementary	20	28	26	29
Vocational	18	23	50	51
High School	15	21	44	45
College 2Y	8	8	58	58
University 4Y	2	5	75	76

Labor Dynamics, 2001-2002

5.25 The panel structure of the LSMS 2001 and the LiBH 2002 also allows further investigation of some dynamic aspects of employment in BH. In this section, we describe some basic statistics on job changes. We then analyze labor market flexibility from a micro perspective; that is, that related to labor market stock and flow analyses of employment, unemployment and non-participation, as well as job creation and job destruction.

5.26 The evolution of the labor market between the two panel waves⁷² is relatively positive. **Despite a severe jump in the unemployment rate by about 5 percentage points, which understandably attracted considerable attention, employment evolved in a positive fashion** over the two years. Extrapolating the survey results, an estimated 50,000 jobs were created on a net basis, resulting in a 5 percent growth in employment. There was a significant increase in private sector employment (particularly in small and medium enterprises) and a moderate one in the public sector. There have also been significant changes in the sectoral composition of employment and in the weight of public sector employment. All these changes are in line with the expected changes during transition.

5.27 **Positively, and in contrast to previously held beliefs, labor market participation in BH has also proven to be very responsive to changes in available employment.** An increase of close to 12 percent in the number of active persons in just one year shows that individuals are

⁷² The 2001 LSMS involved 5,400 households. The LiBH Wave 2 sample is made up of over 3,000 households drawn from the LSMS, using a corrected sample that enhanced the representative nature of the data. For the purpose of analyzing the dynamics of the labor market in BH during 2001-02 we use a panel of only those households interviewed in both waves in order to avoid variations introduced by the rotation of part of the sample.

willing to participate even at the available wage rates if and when job opportunities become available. On the negative side, employment growth was driven by the informal sector. Formalizing at least part of this job creation without hurting overall employment remains a key challenge in the years to come.

Table 5:8 Main Labor Market Indicators

	2001	2002
Unemployment rate	16.2	21.4
Employment rate	40.7	42.7
Participation rate	48.5	54.3

Growing Informality and Falling Public Sector Employment⁷³

5.28 **An estimated 242,000 gross jobs were created from 2001 to 2002.** This is defined as the number of working age persons that were either unemployed or inactive in 2001 and that were employed at the time of the following wave. In other words, an important 23 percent of those employed in 2002 were inactive or unemployed in the previous period. This indicator (which omits labor-to-labor mobility) shows a non-negligible employment creation. In the opposite direction, the level of job destruction was also important, albeit to a lesser degree. Some 193,000 people within working age that reported to be employed in 2001 were either unemployed or inactive by 2002.

5.29 Does this new evidence contradict the characterization of the labor market in previous studies as rigid and with little capability of introducing the necessary changes required by transition? As earlier studies were based on data collected from pension institutes, they could only analyze the dynamics of the formal labor market. The second wave of the household survey provides for the first time a view of the dynamics of the whole labor market. The resulting far more dynamic picture of BH labor markets by no means contradicts previous studies.

5.30 **In fact, the view of a rather static formal labor market remains valid in light of the limited mobility encountered in the formal sector. It is in the informal sector where the majority of job creation and destruction occurs.** The formal sector in BH shows severe symptoms of sclerosis, including low labor shedding and job creation. Only one-eighth of the net employment gain during the period of analysis was in the formal sector. While formal sector employment increased by a non negligible 2.8 percent, employment in the informal sector grew by 9.3 percent. A similar picture emerges for labor shedding, even though job destruction in the formal sector was unusually high during this period as a result of an important contraction in public sector employment.

5.31 **Of those previously unemployed or inactive individuals that became employed between 2001 and 2002, some 71 percent found jobs in the informal sector.** It was also in the informal sector where the majority of the job losses occurred. However, the incidence of the

⁷³ In this section, the definition of public sector includes both the consolidated general government and public enterprises.

informal sector in job destruction was somewhat smaller. In fact, some 67 percent of those who lost or left a job between the two surveys had a job in the informal sector at the time of the 2001 survey. Nevertheless, within the context of an overall expansion in jobs, the informal sector created more than 87 percent of all net jobs gained in 2001-02.

5.32 The estimated share of informality in total employment has increased from roughly 35 percent to 37 percent in just one year; a phenomenon with important consequences for the quality of employment as well as for fiscal performance. Interestingly, the share of youth in informal employment has decreased, that of older workers has increased and that of prime-age workers has remained relatively constant.

Enterprise Size and Labor Mobility

5.33 Labor mobility is highly concentrated among small and medium enterprises. While enterprises with fewer than 51 employees accounted for half of total employment in 2001, they created more than four-fifths of the new jobs and destroyed almost three-quarters of the old jobs. The cohort of SMEs was the only one with net job creation during 2001-02. The remaining cohorts generated a net contraction of employment while their share in total labor creation and destruction was below their share in total employment at the beginning of the period. This difference is connected to the ownership structure of enterprises, the creation and performance of *de novo* enterprises and the status of the privatization process in BH. In fact, even though privatization has been underway for several years, BH has managed to transfer ownership primarily in small- and, to a lesser extent, medium-sized firms, with the state still holding majority ownership stakes in the remaining companies.

Table5:9 Composition of employment (2001) and of employment creation and destruction (2001-2002)
(by enterprise size)

	Employment 2001	Empl. Creation 2001-02	Empl. Destruction 2001-02
1--50	50.4	81.4	73.7
51--200	25.6	13.0	13.6
201 +	24.0	5.6	12.7
	100	100	100

5.34 Alternative evidence arising from the BEEPS2, covering the 1999-2002 period, also shows that net job creation was entirely concentrated among the newly created firms while employment contracted among state-owned and privatized firms during this period. Complementary analysis of a sample of enterprises in BH shows that the overall job flow rate in firms with more than 100 employees was negative during 1997-1999, with 4.2 jobs created on average and 5.3 jobs were lost (World Bank, 2002b).

Labor Force Participation and Unemployment

5.35 Low labor force participation, compared with other countries in the region, is a key problem characterizing BH's labor markets. While male labor force participation is on the

low side, female participation has been extremely low, and among the lowest in the entire Europe.⁷⁴ However, according to the latest data coming from Labor Force Surveys, the increase in employment seems to have triggered a rush towards participation, which has surprisingly reached all age groups, even the elderly.

5.36 The recent increase in participation has surpassed the increase in employment, however, resulting in a significant increase in the unemployment rate. Consequently, in just one year and in the context of an employment expansion, the unemployment rate jumped from **16 to 21** percent. Every single age group has seen its ratio of employment to working age increase, along with participation and unemployment.

D. AN ALTERNATIVE LOOK AT LABOR MARKET FLEXIBILITY

Institutional Framework

5.37 So far we have analyzed the flexibility of the labor market from a micro perspective. It is also important to explore labor market flexibility from a macro perspective with a focus on the flexibility underpinning labor market institutions and wage determination mechanisms. This involves the analysis of labor laws, labor taxation, minimum wage, unemployment benefits, and active measures. Improving the macro flexibility of labor markets is one of the key preconditions for addressing key weaknesses of BH's labor market. A labor market with strict rules to protect job security tends to have more stable jobs but also more long-term unemployment, greater non-participation and larger informal employment. Employers may be reluctant to hire workers if they face constraints in dismissing them for business reasons. Together, restrictive hiring and firing regulations increase the protection of incumbent employees but reduce access to formal employment. Excessive informal activity is evidence that the formal labor market is not functioning properly. Formalization of informal employment would help improve both the fiscal position of social security funds and prospects for those currently employed in the informal sector.

5.38 BH's significant recent progress in reforming rigid labor market legislation needs to be preserved and deepened. A new Law on Labor, adopted in December 2001, provided more flexibility both in the firing and hiring of workers. These changes are the basis for the efficient reallocation of labor to increase labor productivity.

The Institutional Setup for Wage Determination in the Formal Sector

5.39 In Yugoslavia, wages were determined under the self management system. The government set the firm's wage bill, with the objective to minimize differences across firms. Within the firm, individual wages were set by workers. This resulted in a very compressed wage distribution, both across and within firms. In 1988, the Yugoslav Law on Enterprise formally ended the self management system by transferring wage decision making from the workers to the employer (equity owner).

⁷⁴ Labor force participation in BH was one of the lowest among all Yugoslav republics during the SFRY period.

5.40 **Today, BH's labor market is governed by very elaborate institutional arrangements, with variation across entities, sectors, and cantons.** The institutional framework that regulates the determination of salaries and payments is defined by the Entity labor codes. According to these codes, the government, trade unions, and employers' associations negotiate and sign a general collective agreement (GCA) whose outcome is obligatory for employers represented in the bargaining process. However, the ministry of labor could extend the coverage of the collective bargaining agreement to employers which did not participate in the conclusion of the collective agreement. Collective agreements and the rule book regulate the minimum wage and the terms and methods of its harmonization. Labor codes also set a range of entitlements including severance pay, termination notice periods, annual leaves, overtime pay, and work experience premium.

5.41 **In the FBH, until very recently, only state-owned enterprises participated in bargaining.** For private enterprises, collective bargaining agreements have been non-binding since the 2000 legislation. The public administration also has separate collective bargaining agreements for the Federal government and the different cantons. Trade unions in both entities have significant bargaining power that extends to the pre-war era. This power was reflected in the process and outcomes of the current GCAs which predate the approval of the labor codes in both entities. With the government and the Chambers of Commerce (representing mostly the management of SOEs) heavily concerned about social outcomes at the time the GCA is concluded, little heed was paid to the interest of the owners. However, this has started to change and as the private sector continues to expand, newly formed employers' associations are expected to play a more significant role in future negotiations.

5.42 On the basis of the GCAs and the labor codes, Branch Collective Agreements (BCAs) grouping related activities in production are negotiated among governments, trade unions and employer association representatives. The BCAs follow the GCA, but may specify more generous conditions. More importantly, they determine a base wage and coefficients for the complexity of the specific task. Workers are classified into nine categories based on the level of education, training and personal qualifications. The base wage, the complexity coefficients and the experience premium are used in the calculation of paid wages. Rule books of operations at the firm level tailor sectoral arrangements to enterprises' particularities.

5.43 In each Entity, governments, trade unions and employers' associations are engaged, within the framework of the recently established Social and Economic Councils, in ongoing discussions on reforming the wage determination system, including indexation formula and the minimum wage (see below).

Impact on Wage Formation

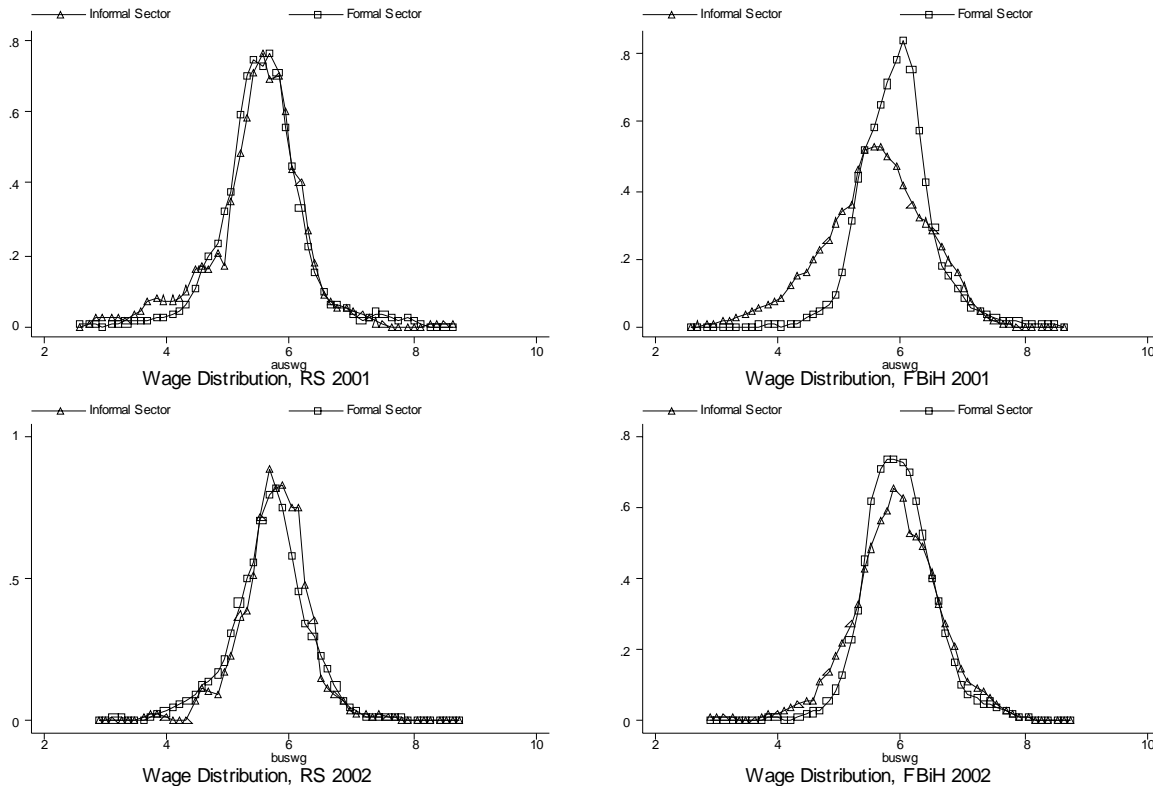
5.44 **Using individual level data, we try to answer a set of important questions regarding wage determination.** To what extent does the institutional setup introduce rigidity in the labor market? Is the wage distribution overly compressed? What is the effect of minimum wages on the overall wage distribution? Do wages reflect market forces and individual characteristics?

5.45 **We start by investigating wage inequality and how it changed between 2001 and 2002, distinguishing between the formal and informal sectors.** These differences could shed additional light on the effect of wage setting institutions in the labor market in BH. Figure 5.1

displays the kernel estimates of the log wage distributions in the formal and informal sectors in BH, in 2001 and 2002. In 2001, the differences between formal and informal sector wages are shown in the higher density in the left tail of the informal sector wage distribution, and the higher mean for the formal sector wage distribution. In 2002, these differences almost disappeared and the overall wage distribution appears to have become more compressed.

5.46 Most the differences between formal and informal sector, as well as the changes between 2001 and 2002, are attributed to wage changes in the FBH. In 2001, wages in the formal sector in the FBH were considerably more compressed than wages in the informal sector. In 2002, these differences narrowed significantly. Figure 5.2 shows the differences in (log) wage distributions between the formal and informal sectors in 2001 and 2002 for the FBH and the RS separately. In the RS, the two wage distributions in 2001 and 2002 are very close. On the other hand, formal and informal wages in the FBH are distributed very differently. In 2001, the gap between the left tails of the two distributions is very large, the mode for the informal sector distribution is considerably lower, and the right tails of the two distributions are virtually identical. These features of the distributions appear to reveal the binding effect of the minimum wage in the FBH.

Figure 5:1 Wage Distribution, Formal and Informal Sector, by Entity, 2001--2002



The Role of the Minimum Wage

5.47 **One possible explanation for the differences across sectors and across entities is the effect of the minimum wage.** The minimum wage in the FBH is set by the 2000 GCA at 55 percent of the net average wage in the economy, adjusted regularly based on published data from the statistical office. In the RS, the minimum wage in 2000 was 68KM for workers in budget financed enterprises, and 80KM for workers in other enterprises. In 2001, the ratio of the minimum wage to average wage is estimated around 49 percent in the FBH and 26 percent in the RS. In both entities, the BCA may specify a base wage that exceeds the minimum wage.

5.48 The minimum wage is not expected to affect wage setting in the informal sector. However, in the formal sector, a binding minimum wage is expected to constrain wages from falling below a certain level. One would expect a mass in the wage distribution around the minimum wage as many employers are bound to pay the minimum wage. Spillover effects and mechanical escalation clauses could also influence wages for workers earning above the minimum wage. A non-binding minimum wage should not have such implications.

5.49 To test the effect of the minimum wage on the wage distribution, we need to compare the actual wage distribution to the one that could describe wages in the absence of a minimum wage. The informal sector is often thought of as a good candidate for such a counterfactual wage distribution.⁷⁵

5.50 The differences between the two sectors in the two entities, shown in Figure 5.2, **support the argument that the minimum wage influences the level of wages in the FBH, with substantial spillover effects.** The graph for the RS shows a very small gap between the two distributions.

5.51 The effect of the minimum wage on wage distribution can be further studied by looking at international evidence. Compared with other transition economies, the level of the minimum wage as a proportion of the average wage is the highest in the FBH. Together, Figures 5.2 and 5.3 suggest a significant effect of the minimum wage on the wage distribution, particularly in the FBH.

Empirical Analysis of Wage Determination

5.52 **An empirical investigation of wages reveals significant differences across the entities, gender, educational groups and sectors.**⁷⁶ They also suggest an important institutional influence on wage setting.

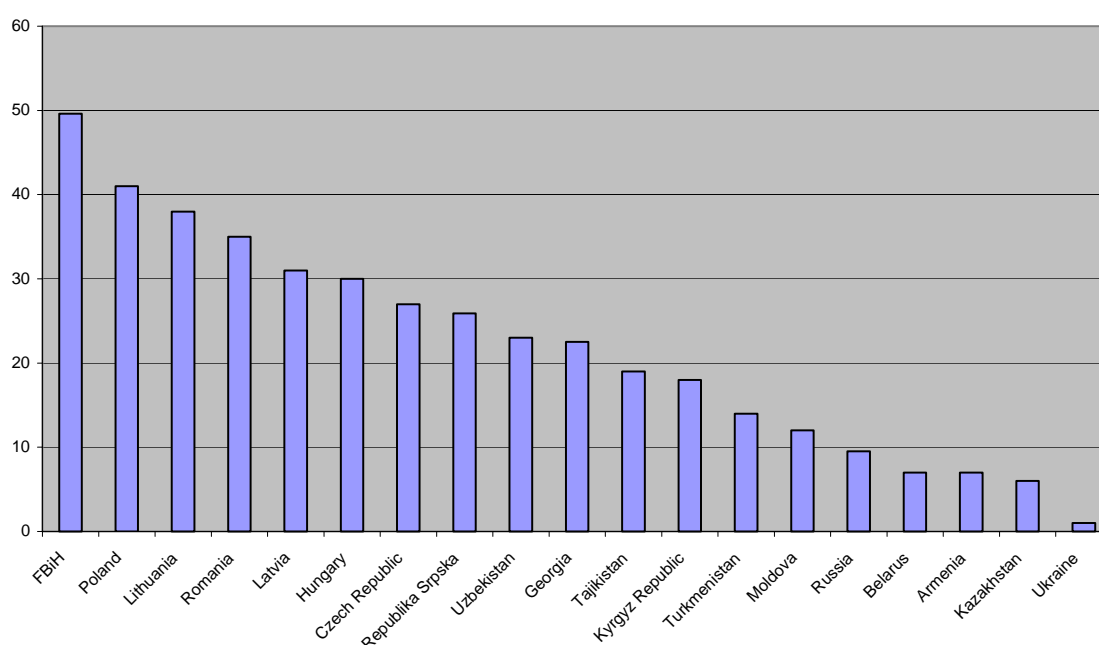
⁷⁵ In fact, the minimum wage could influence wages in the informal sector through its effect on workers' reservation wage. This means that the minimum wage should be thought of as a lower bound for wages.

⁷⁶ In the earning model retained here, net monthly wages are the dependent variable. The explanatory variables include individual characteristics, like gender, age, educational attainment, as well as firm characteristics like firm size, sector of employment, industry of occupation. The model also include Entity and job tenure indicators. The model is estimated separately for the two survey years. Regression results are reproduced in Appendix 5.3

5.53 As shown in Appendix Table 5.1, average wages in the RS are significantly below average wages in the FBH. Holding everything else constant, workers in the RS earned about 39 percent less than their counterparts in the FBH in 2001. While this gap has narrowed slightly in 2002, it remains large and significant.

5.54 **A gender gap also seems to persist**, with women estimated to have earned around 21 percent less in 2001 and 16 percent less in 2002 than their male counterparts. This gap is statistically significant and is also in line with that in other countries in the region. However, combined with the low participation rate (uncharacteristic for the region) and low employment rate, this pay gap highlights the important disadvantages faced by women in BH.

Figure 5:2 Minimum wage as share of the average wage, Transition Countries



5.55 **The estimated age earning profile reveals systematic differences between the formal and informal sectors.** In the informal sector, the estimates suggest a weakly inverted U shape profile, reaching a maximum for workers between 25 and 34 years old in 2001, and an almost flat profile in 2002. In the formal sector, the results show a positive and increasing age effect. Wages are estimated to be more than 18 percent (13 percent) higher for workers 55-64 years old compared to the wages of workers 25-34 years old in 2001 (in 2002).

5.56 **Returns to education are estimated to be large and significant.** In 2001, compared to workers with elementary education, workers with vocational training earned 10 percent more; those with high school diploma 23 percent more; graduates of two-year colleges 37 percent more and university graduates 72 percent more. All these differences were statistically significant, and increased even further in 2002. In contrast to the steep profile for the returns to education, the effect of firm tenure on wages seems to be negligible and statistically insignificant. Taken together with the age-earning and education-earning profile, the small effect of tenure may indicate that firm-specific skills are valued less than general skills.

5.57 Workers in state-owned enterprises (SOEs) are estimated to have earned between 25 and 19 percent less than workers in the public administration, health and education in 2001 and 2002, respectively. Workers in the private sector are estimated to have earned 18 and 9 percent more than government workers in 2001 and 2002, respectively. All these differences are statistically significant. The compression of wages across these sectors between 2001 and 2002 is also consistent with the overall wage compression shown in the distributions in the previous section.

5.58 **The estimated model also shows significant differences across different firm structures. Wages in small size firms are between 35 and 20 percent lower than wages in large firms.** The size effect on wages is common in many other countries. Given the sizable informal sector in BH, however, it is hard to disentangle the effect of size from the effect of formality.

Wage Arrears

5.59 **Wage arrears are widespread among firms in both Entities.** Faced with high labor costs and/or deteriorating revenues, a number of firms either delay or reduce wage payments. The top panel of Table 5.11 shows the shares of workers in both entities that were accumulating arrears in 2001 and 2002. In the RS, about 42 percent of workers have not received their pay for at least 2 months, down to one-third in 2002. While arrears are less common in the FBH, the share of workers accumulating arrears continues to be large and significant. The lower panel in **Table 5.11 shows that about a quarter of workers in both entities are receiving a different remuneration than their contracted pay.**

E. EDUCATION AND TRAINING

5.60 **Education and training opportunities for BH's youth have not changed significantly since the Yugoslav era, and in the case of adult training, opportunities have substantially decreased.** The focus of the country's politicians since the end of the war has been more on issues of political control of education institutions, than on thinking about what sort of skills, competencies and aptitudes the country's youth and workforce will need in Europe in the 21st century.

5.61 The overall level of educational attainment in the workforce is high and the age distribution is biased towards younger people. Moreover, according to the BEEPS, enterprises report that the education and skills of workers is not currently seen as a significant barrier to operations and growth, though this might change as the economy shifts). However, the formal labor market is rigid and has become relatively inaccessible to young people and those with low skills; and unemployment among youth remains very high. Finally, as would be expected, individuals' wages rise as their educational attainment increases. Moreover, while employers value general skills more than specific ones, approximately half of those in the labor market have secondary vocational training as their highest educational qualification. This calls for a profound change in educational strategies, especially for the upper-secondary system.

Table 5:10 Wage Regression Results, BH LSMS 2001 and 2002

	2001		2002	
	Coefficient	T-Statistic	Coefficient	T-Statistic
Constant	5.969	77.160	5.974	68.530
RS	-0.397	-14.020	-0.388	-13.300
Informal Sector				
Age				
15—18	-0.081	-0.420	0.053	0.250
19—24	0.138	1.770	0.022	0.250
35—44	-0.168	-2.240	0.086	1.090
45—54	0.038	0.410	0.000	0.000
55—64	-0.354	-2.130	-0.088	-0.530
Formal Sector				
Age				
15—18	0.071	0.220	0.362	0.810
19—24	-0.028	-0.360	-0.071	-0.940
35—44	0.069	1.510	0.021	0.450
45—54	0.163	3.210	0.062	1.200
55—64	0.184	2.450	0.138	1.970
Female	-0.219	-7.250	-0.165	-5.270
Tenure				
1	-0.117	-2.130	-0.039	-0.630
2	0.032	0.570	0.134	1.580
3	-0.012	-0.220	-0.020	-0.400
4	0.063	1.150	-0.067	-1.350
5	-0.050	-0.900	-0.134	-2.570
6	-0.159	-2.740	-0.218	-4.040
Education				
Unfinished elementary	0.089	1.170	0.164	2.110
Vocational	0.101	2.560	0.154	3.880
High School	0.235	5.230	0.368	8.020
College 2Y	0.377	5.560	0.531	7.510
University 4Y	0.719	11.350	0.898	13.690
Sector				
SOEs	-0.256	-6.070	-0.192	-4.340
Private	0.185	3.310	0.099	1.910
Others	-0.715	-4.360	0.086	0.470
Informal	0.067	0.910	-0.034	-0.470
Firm Size				
1—10	-0.357	-6.040	-0.228	-3.270
11—100	-0.078	-1.660	-0.037	-0.610
101—500	-0.215	-4.500	-0.194	-3.130
Adjusted R-Squares		0.31		0.29

Note: LSMS 2001 and 2002. Dependent variable is the net monthly wage in log form. The excluded group are men, 25 to 34 years old, with elementary education, working in the public formal sector in a large 500+ firm size. Sample weights were used in all regressions.

Table 5:11 Distribution of workers receiving arrears or not usual wages, By Entity for 2001 and 2002 (percent)

	2001	2002
Share of workers receiving arrears		
RS	42	33
FBH	19	16
Share of workers receiving actual pay different from contracted pay		
RS	24.1	25.6
FBH	25.6	27.2

Note: Arrears are defined as a delay in salary payment of 2 months or more

A New Perspective on Skills

5.62 What sort of skills, competencies and aptitudes are required to support economic growth? This question should be examined in the context of BH's transition from a largely protected economy dominated by large, socially-owned industrial enterprises, to an economy that must compete in a broader European and world markets and must depend on the development of the service sector and the growth of small companies. In the global economy, BH will not be able to compete on the basis of its comparatively low-wage workforce. Private enterprises of all sizes will be looking to fill knowledge-intensive, value added, and higher-earning jobs in part to pursue exports and to attract foreign direct investment. Evidence from other countries (de Ferranti et al. 2003) has shown that investment decisions, both foreign and local, depend on investors' perceptions of whether or not the local workforce has the skills, knowledge and attitudes to utilize and exploit the new investments.

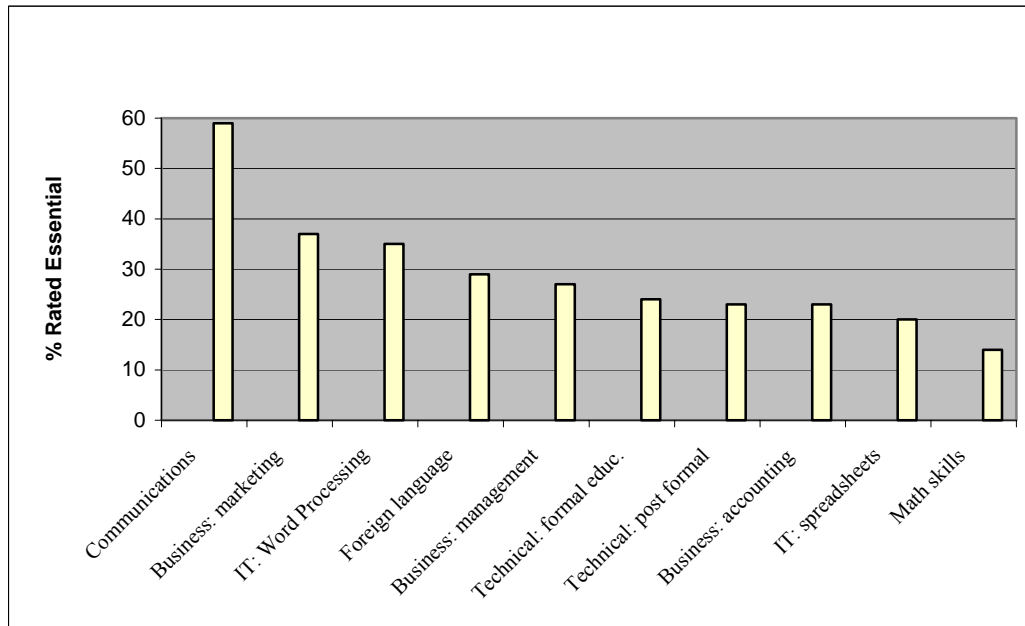
5.63 A recent study (Birks Sinclair IBHI, 2003) sheds some light on the changing demand for skills in BH. When 102 employers were asked to rank the importance of various skills, only about half reported that technical skills gained from formal education were essential or very useful, while over 70 percent identified as essential or very useful skills gained from specialized training outside the education system. Even more revealing are the skills that employers found essential (Figure 5:3): good communication skills (identified by 59 percent of employers as essential), business methods (marketing) (37 percent), word processing skills (35 percent), and foreign languages (29 percent). At the same time, only just over 20 percent found technical skills essential (whether gained in the formal system or the private sector).

5.64 The same study found a worrying gap between what employers are looking for and the perceptions of teachers and secondary education graduates. When asked to identify the most important skill that employers are looking for, about half of the 152 teachers and over 1,000 recent secondary graduates surveyed chose technical skills gained of a subject in the formal education system. There was little recognition among teachers or students of the importance employers give to communication skills and to foreign languages.

Implications for Secondary Education

5.65 Other evidence also suggests serious problems with the orientation of BH's education system. For example, the study also found that the private rate of return to all forms of three-year secondary vocational schooling in BH was zero, compared with a 4 per cent return to secondary general education. These relative returns are a function of the higher costs of vocational education and the fact that vocational graduates have a higher tendency to be unemployed or employed in low wage jobs (which are not always in the occupational field in which they were trained). Many EU and transition countries are rapidly moving away from a manpower planning model in which the public sector attempts to predict what specific jobs and occupational skills will be in demand in the future and then fine tune the secondary education curriculum to produce workers who are fully trained for those jobs. This is both because their economies are moving too quickly for the formal system to catch up and, in any case, because individuals need broader skills to adapt as their jobs change not simply specific skills for their first jobs. In contrast, fully 80 percent of secondary students in BH continue to be enrolled in technical or vocational programs and one-third of all secondary students are enrolled in vocational programs of three years or less, none of which offer access to tertiary education and only a very few of which will lead to eventual employment in that occupation. Moreover, many young people do not receive their first choice of occupational program or choose a program mainly because a nearby school happens to offer it.

Figure 5:3 Importance of Skills as Ranked by Employers



Source: (Birks Sinclair IBHI, 2003)

5.66 **In addition to offering only limited employment prospects, vocational education is also expensive.** Evidence from the Sarajevo and Tuzla cantons shows that vocational programs in BH are up to one third more expensive per student than general education programs (Catic 2003, Levacic 2003). Given all this evidence, it is not surprising that there has been declining

parental and student demand for vocational programs and increasing demand for four-year secondary programs (Table 5:13), in keeping with trends in OECD countries (OECD 2001).

5.67 **The nature of vocational education in BH is gradually changing in a progressive direction.** With EU funding, the curriculum in several programs is being broadened to include a wider range of more generic work-related skills and increased general education components. This clearly should be encouraged. However, significant shifts away from vocational education (especially three-year courses), which this report advocates, will require a careful information campaign by government to explain the rationale. At present teachers, parents and students were not overly dissatisfied with current three-year vocational programs compared to general programs, except to note that they are under funded (World Bank 2003a).

Table 5:12 Implied Private IRRs by Type of Education for BH, 2002

Secondary	IRR %	Higher Education	IRR %
Gymnasium	4	General Programs	0
Secondary technical	3	Education	0
Secondary Vocational	0	Arts and Humanities	16
University	8	Social Sciences, Economics,	9
		Law	
		Science	17
		Technical Industry	9
		Construction	
		Agriculture	6
		Health	0

Source: Birks Sinclair IBHI 2003

Notes: (1) All secondary school IRRs have been derived from the comparison with no schooling because there was no significant impact of primary education.

(2) The IRR for secondary vocational education and for some higher education programs is zero reflecting no significant impact for these programs.

The IRR for university has been derived from a comparison with gymnasium since these schools supply the most university entrants.

The IRR for all higher education degrees has been derived from a comparison with gymnasium since these schools supply the most university entrants.

IRRs for higher education have been derived assuming that all courses last 6 years on average.

Implications for tertiary education⁷⁷

5.68 **As in most countries, tertiary education in BH remains a good investment for the individual.** Rates of return average about 8 percent, with generally higher rates of return for the sciences and humanities and lower rates of return for agricultural sciences and other technical subjects (Birks Sinclair IBHI, 2003). University graduates are less likely than those with lower levels of attainment to be unemployed and much more likely to be employed in the formal sector, particularly the public sector, which makes up a large share of formal sector employment (World Bank 2003b). Interestingly, however, those with a university degree are also more likely

⁷⁷ This Report uses the term 'tertiary' rather than 'higher' education in line with current international practice (OECD 1998), to cover all types of post-secondary education including but not limited to universities.

to be discouraged workers, i.e., without work but not actively searching for employment. This may be because these graduates can wait for what they perceive to be the right job, since they can expect higher wages and in any case they usually come from more affluent families who can support them while they wait for work.

Table 5:13 Trends in Enrollment of Different Kinds of Secondary Schools

School Year	Gymnasium	%	Technical Schools	%	Vocational School	%	Total
FBH							
2000/01	26118	23.24	42545	37.85	40781	36.28	112399
2001/02	27139	23.70	44211	38.60	40567	35.42	114523
2002/03	27496	23.78	45478	39.33	38992	33.72	115632
RS							
2001/2002	9,242	18.0	24,424	47.7	17,581	34.3	51,247
2002/2003	9,419	18.1	25,965	50.0	16,564	31.9	51,948

Source: Federation and RS Statistical Institute

5.69 **Like the secondary level in BH, the tertiary education system seems to be failing to provide a steady supply of graduates with appropriate skills in a dynamic labor market.** Although the evidence is more anecdotal in nature than with secondary (more research is clearly needed), students, university leaders, some professors and many local stakeholders report that tertiary programs suffer from outdated curricula, teaching methodology, reading lists and mono-disciplinary programs that are highly theoretical and unrelated to labor-market reality. However, few university professors identified the relationship between the labor market and the curriculum as an important issue and most were focused only on the need for more funding, higher salaries and better working conditions (World Bank 2003b).

5.70 **The reasons for the disconnect between demand for more relevant programs and the perpetuation of traditional teaching and learning at BH's universities lie in the fragmented nature of the tertiary education system, without effective management or accountability.** The autonomous-faculty system leads to costly duplication in teaching (with each faculty organizing its own courses in subjects outside its specialization), administration and services. The responsibility for tertiary education lies with cantonal governments in the FBH, which because of small revenue bases cannot provide significant investments in quality improvements and engage in ethnically-based political interference. Moreover, students, many of whom study free of charge, are allowed to churn for years in the system. For example, of all students who began their university studies in the FBH in 1997/98, less than 3 percent graduated on time (the EU average is roughly 50 percent). At the University of Sarajevo, the overwhelming levels of repetition mean that the costs per graduate in 2002 were near 13 times the annual costs per student (Catic 2003). These flaws are widely recognized throughout the education system and there is broad consensus on the need to shift responsibility for tertiary education to the level of the Entity in the FBH or the State. However, political maneuvering has so far prevented adoption of a modern tertiary education legal framework.

Implications for Adult Training

5.71 **The inadequacies of BH's formal education system are compounded by weaknesses in the supply of quality adult education and training opportunities.** As a result, those exiting the formal system with inflexible skills and a weak aptitude for continued learning have great difficulty overcoming these shortcomings. The proceeds of an earmarked unemployment benefits payroll tax are devoted largely to passive programs, such as those providing unemployment benefits, rather than active employment facilitation measures, such as job-based and private sector training, job search assistance and counseling. When training does occur, monitoring and evaluation for quality assurance and the tracking of participants does not take place. Job search assistance, one of the most cost-effective active labor market interventions, is underdeveloped in BH.

5.72 Although training by enterprises was the principal source of adult training in the former Yugoslavia, very little job training by enterprises takes place in BH today. For example, as suggested by a recent survey of 95 adults found that only about a quarter undertook some form of adult training within three years of leaving secondary school in 2000 (Birks Sinclair IBHI, 2003). This is despite a well meaning but non-enforced law that obliges enterprises with more than 50 employees to provide training for workers with work experience over 6-12 months. For the limited amount of enterprise-based training that does take place, there is no adequate institutional structure for recognizing certificates, diplomas or transcripts. To the extent training is regulated, it is done on the basis of setting physical input standards (size of classroom, number of qualified trainers, etc.) rather than by attempting to measure what trainees are learning. This is a weakness shared by the formal education system.

5.73 **Training offered by private training providers and NGOs is almost exclusively limited to computer training and foreign languages, and even for these there is no system for degree or diploma recognition.** NGOs are prohibited by law from charging for training courses, limiting their ability to expand their services.

The relationship between poverty and education in BH

5.74 **There is a strong relationship between poor educational opportunity and poverty in BH (World Bank 2003b).** BH's 93 percent net primary enrollment rate is the same for those from poor and non-poor households, but it is low by EU standards, including the EU's 10 newest members who have net enrollment rates very close to 100 percent. Although the primary enrollment rate was not found to vary significantly across gender or urban and rural areas, it is thought that non-enrollment in primary education is heavily concentrated among refugees, the disabled and the Roma. BH's pre-school enrollment rate of only 4.3 percent is strikingly below European standards for all income levels and very few children from poor families have access to this head start in education. As access to pre-school and kindergarten programs inevitably rises in the coming years, one of the most pro-poor policies the government could embrace, given international experience, would be to provide funding for pre-school and kindergarten programs targeted to the poor and the disadvantaged.

5.75 Of equal concern, only 73 percent of the 15 to 18 year age group is enrolled in secondary school, reflecting some incidence of dropouts and the disproportionate share (40 percent) of

students in three-year vocational programs. Most European countries have net secondary enrollment rates of 85-95 percent. Among the population in BH falling below the poverty line, the share of secondary enrollment falls to only 57 percent. To make matters worse for poor children, those that are enrolled in secondary schools have a much greater tendency to be enrolled in vocational programs, a development that reduce labor market flexibility and usually leads to unemployment or low earnings.

5.76 Three-year secondary programs do not provide access to tertiary education, compounding the problems faced by the poor in gaining access to higher education. Whereas the net enrollment rate for the non-poor in the tertiary age group (age 19-23) is 27 percent, it is only 9 percent for youth from households below the poverty line. Because public higher education institutions in BH offer free admission only to the best performing students (who tend to come from higher income households) and higher education students tend to benefit from a number of non-education subsidies such as housing, board and transport, public funding for higher education in BH is highly skewed to benefit households that need public subsidies the least. The top 20 percent of households in BH in terms of overall consumption benefited from 41 percent of all public spending on higher education, while the bottom 20 percent benefited from just 6 percent of higher education spending (World Bank 2003b).

5.77 BH is in danger of seeing declines over time in the educational attainment of the poor as private contributions rise and if public spending is not re-oriented to support those disadvantaged students. However, even if the country manages to keep the poor in school, it is only improvements in the quality and relevance of their education that will help break the vicious circle of poverty and make a positive contribution to overall economic growth in BH.

F. THE ROLE OF EMPLOYMENT SERVICES IN BOSNIA AND HERZEGOVINA

5.78 Low job reallocation in the formal sector and existing mismatches between labor supply and demand underscore the importance of the efficient use of employment services and passive and active labor market policies. However, despite significant resources allocated to these initiatives, in particular in the FBH, and a wide network of offices spanning the country, employment services have proved largely irrelevant in facilitating job flows in the formal sector, especially in the face of a large and absorptive informal sector.

Institutional Arrangements

5.79 The legal frameworks governing the activities of the Employment Institutes (EI) were substantially overhauled in both Entities in 2000, but continue to face a large reform agenda in the area of active labor programs. Employment services are dispensed at both Entity and sub-Entity levels. In the RS, there is a single EI, with 6 regional branch offices and 55 municipal offices. The FBH employment service network comprises the Entity-level Federal Employment Institute and ten cantonal Employment Services with 79 municipal offices.⁷⁸ Of the resources collected in the FBH, 70 percent are administered by the cantons and 30 percent by the

⁷⁸ The formation of the Federal Institute structure eliminated previously separate and ethnically-based employment services in FBH.

Entity.⁷⁹ Recent reforms have introduced an Employment Agency at the State level which is tasked with compiling country-wide employment statistics and representing BH in international and bilateral labor affairs.

Programs

5.80 Apart from registering the unemployed, the Employment Services in BH are tasked with administering unemployment insurance and active labor market programs for the unemployed. Financing unemployment benefits is the priority in both Entities and active programs are funded from the excess resources not taken up by benefits.

5.81 **Unemployment benefit coverage in BH is low by regional standards. With cash benefits available only to unemployed who have made unemployment contribution payments (and whose employer has made payments) and rampant contribution evasion, cash benefits accounted for only 16 percent of total EI expenditure in the FBH and 23 percent in the RS in 2003.** Consequently, significant resources remain for the financing of active labor programs, in particular in the FBH. Due to important differences in contribution rates for the unemployment insurance (2.5 percent in the FBH and 1 percent in the RS),⁸⁰ the financial positions of the two EIs are nevertheless very different.

5.82 **The current mix of active labor programs in both Entities is very limited, with an emphasis on programs such as subsidized wages or credits to firms.** However, international evidence suggests that these two are among the least cost effective programs (Betcherman, et. al. 2004). At the same time, simpler and more cost effective programs such as job counseling and basic job brokerage functions have been non-existent or seriously neglected. In particular, funds for active programs have been directed to favored state firms with negligible monitoring or accountability for use of funds. A recent audit and business process review of the Entity EIs identified poor business processes and lax financial management in both Entities, in addition to a serious lack of monitoring of internal operations and evaluation of EI programs.

5.83 The resulting lack of accountability for resource use, exacerbated until recently by lack of appropriate regulations, has been a serious concern, particularly in the FBH. As the FBH spends significant public resources on credit programs (around 0.5 percent of Entity GDP in 2003 out of a total expenditure of 1 percent of GDP, with an additional 0.4 percent of GDP in unallocated reserves), this is an unsatisfactory outcome, and one that Entity Governments recognize in the MTDS must improve given the high levels of registered unemployment and significant corporate restructuring challenges ahead. Some of these issues are being addressed; in fact, the RS has recently stopped its credit programs, while the FBH EI is in the process of winding them down.

⁷⁹ Entity funds are available for redistribution to the cantons on a needs basis through a solidarity mechanism.

⁸⁰ Excess financing in the FBH EI have triggered recent reform discussions about a possible reduction in the unemployment insurance contribution rate.

**Table 5:14 Expenditures of the Entity Employment Institutes, 2003
(percent)**

	RS	FBH
Administration and capital investments	33	15
Assistance to the unemployed	26	30
- Unemployment benefits	23	16
- Health insurance contributions	1	12
- Pension insurance contributions	1	2
Labor market programs	41	54
Reserves		
Total	100	100
Total Expenditures (percent of Entity GDP)	0.3	1

Source: Entity Employment Institutes, labor market programs in the FBH include credit programs worth KM 39m.

5.84 In the municipal employment offices, simple registration activities are crowding out other activities such as job referral and counseling. Since the employment services in both Entities also finance health and pension insurance contributions for the registered unemployed, receiving these benefits is often the only incentive to register. This also applies to a significant number of people employed in the informal sector or engaged in agriculture who register as unemployed for that reason (which accounts for the significant gap between figures for registered unemployment and ILO-consistent estimates based on the LSMS).

5.85 **The inadequacy of EI activities is confirmed by surveys of the unemployed** which indicate low faith in public employment services to provide them with a useful service when looking for work.⁸¹ Moreover, surveyed job-seekers rely on informal networks in their communities to find employment, mostly of an informal nature, rather than to go to the municipal employment office for help. This is compounded by perceived better employment opportunities in the informal than the formal sector, according to anecdotal evidence. The flip side of this unsatisfactory job referral performance is that, on the labor demand side, the employment services are equally unattractive to employers seeking further hires.⁸² Employers see advertising and personal contacts as more useful ways to recruit. Failure to keep integrated Entity-wide (or let alone country-wide) records of unemployed by set of skills means that the employment services have little to offer employers in their strategic search.

G. CONCLUSIONS AND POLICY RECOMMENDATIONS

What Did We Learn?

5.86 BH has seen significant growth over the last several years, fueled by aid flows supporting reconstruction after the end of the war. In the labor market, **this growth was reflected in the**

⁸¹ See Birks Sinclair (2002) for survey results of the unemployed from both Entities.

⁸² Ibid.

early 2000s by increased number of entrants, and increase in employment opportunities. It was also reflected in overall high wage inflation in both the RS and the FBH.

5.87 **The labor market in BH is characterized by a dual structure, with a dynamic informal sector covering small- and medium-sized enterprises and the self-employed, and a formal sector still dominated by public workers and large enterprises.** Employment creation during the early 2000s was primarily in the informal sector, while the formal sector continues to struggle with significantly high labor cost and debt overhang.

5.88 **The BH labor market is characterized by a very low participation rate, a low employment rate, a high unemployment rate and a large informal sector.** Between 2001 and 2002 the labor market was not able to absorb all the new entrants into the labor force. As a result, the unemployment rate increased to an even higher 21 percent by 2002. The unemployment rates for young men and women were around 3 times the national average, while the employment rate for older workers is significantly below the national average.

5.89 **Concerns about equity in the wage determination, possibly due to cultural and historic reasons, are clearly reflected in a compressed wage distribution and (accrued) wage inflation driven by automatic indexation mechanisms.** As a result, these mechanisms introduce distortions and keep formal employment artificially low. Informal employment is stimulated, by contrast, underpinned by incentives to underreport and underinvest. While the number of “waitlisted” people decreased significantly in the early 2000s, wage arrears and other distortions continue to hamper corporate restructuring, including privatization.

5.90 **Preliminary evidence at the industry level points towards a wage inflation spiral led by relatively high paying firms,** but systematically spread over other sectors in the economy. Wage rigidity in general, and the minimum wage in particular, could become more binding as growth slows down, and the economy goes through severe restructuring and adverse demand shocks.

5.91 At the micro level, data between 2001 and 2002 suggest **a lack of flexibility in the labor market hinders resource allocation and employment creation. Women and youth appear to have suffered the most** in the labor market, with a particularly low female participation rate and a significantly high youth unemployment rate. Older workers seem to have also been differentially affected by relatively high wages leading to a very low employment rate.

5.92 **Returns to education are very large and are reflected in high earnings and favorable employment outcomes.** While the age earning profile is rather flat in the informal sector, it is steep in the formal sector. Wages in the SOEs are lower than those paid to employees in the public administration, health and education.

Policy Implications and Recommendations

Reducing rigidities in the formal sector

5.93 As shown in Table 5.14, a large fraction of workers were accumulating arrears in both Entities during 2001 and 2002. More than one-quarter of workers are paid below their usual pay

levels. In turn, accumulated wage arrears and pendent severance payments have created a debt overhang problem that is hindering privatization. Rigidities in the formal sector are anchored in the behavior of managers that act with disregard for profits and show a strong orientation towards protecting existing jobs. Accelerated privatization would help break this vicious circle.

Minimum Wage

5.94 The evidence in this report indicates a high relative minimum wage in BH compared to other transition economies, and a binding minimum wage reflected in a rigid wage structure and compressed wage distribution in the formal sector covered by collective bargaining agreements. To reduce the unwanted effect of the minimum wage on the wage distribution, it will be essential to untie the minimum wage from the average wage in the FBH. De-linking the minimum wage from the average wage would contribute to arrest wage inflation and reduce wage compression in the formal sector.

Youth Employment and the Minimum Wage

5.95 An estimated 53 percent (56 percent) and 36 percent (46 percent) of teenagers and young adults were unemployed in 2001 (in 2002). The corresponding employment rates are very low. Because young workers tend to be hired in low-paying jobs, minimum wage policies are very relevant to their employment outcomes. In fact, the binding minimum wage shown in the previous section might be having an adverse differential effect on youth employment outcomes in BH, and could explain the high unemployment rates for youth in 2001 and 2002. To facilitate the entry of younger workers into the formal sector, new entrants to the labor market and young workers need not to be covered by the collective bargaining agreements and their wages should be allowed to drop below the minimum wage set by these collective bargaining agreements.

Collective Bargaining

5.96 In order for the collective agreements to reflect the interests of all concerned parties, it will be important to empower the private sector in the BCA negotiations and to reduce the scope of coverage of the BCAs to only firms represented in the bargaining process.

5.97 Recognizing the different nature of the state as employer, the wage setting process for the public administration should be removed from the collective agreements that determine the salaries of other formal sector workers. The public sector should move away from BCAs into a statutory setting of wages for workers in the public administration. In parallel, the Government should improve its control over the enterprises it owns. Income policies could be introduced –on a limited time basis- to arrest wage inflation in a selected group of firms, particularly among the group of large enterprises.

5.98 Allowances currently represent a disproportionate share of total earnings for employees in the formal sector. Allowances should be progressively integrated into the base wage.

Old Workers

5.99 In contrast to younger workers, the regression results above show that wages for older workers in the formal sector are very high. Unlike most estimates of the earning profile in other

countries, the estimated wage age profile for the formal sector in BH does not have an inverted U shape. The 0.6 percent experience premium mandated by the labor code in both entities could provide an explanation. However, the low employment rate for older workers (22 and 27 percent in 2001 and 2002, respectively), might be a consequence of considerably more expensive older workers for employers.

Informality

5.100 The compression in the wage distribution and the rigidities highlighted above underlie the relatively high share of informality in the labor market. While the informal sector seem to be highly dynamic and responsible for the creation of most new jobs between 2001 and 2002, the implications in terms of fiscal repercussions and social protection for workers are alarming, making any potential employment recovery unsustainable.

5.101 Policy discussions should focus on reducing the sources of rigidities as a means to support a gradual shift of employment to the formal sector. Labor market institutions, particularly payroll taxes, contribute to the co-existence of a dual labor market in BH. A large tax wedge, particularly in the FBH, produces clear disincentives for SMEs to formalize their operations. Improving the efficiency of the social security institutions and reducing payroll contributions when their finances so allow it, will help reduce incentives for informality.

Education

5.102 In a global economy, BH will not be able to compete on the basis of its comparatively low-wage workforce. Private enterprises of all sizes will be looking to fill knowledge-intensive, value added, and higher-earning jobs in part to pursue exports and to attract direct foreign direct investment. Evidence from other countries (de Ferranti et al. 2003) has shown that investment decisions, both foreign and local, depend on investors' perceptions of whether or not the local workforce has the skills, knowledge and attitudes to utilize and exploit the new investments. The effects on the poor are disproportional. BH is in danger of seeing declines over time in the educational attainment of the poor as private contributions rise and if public spending is not re-oriented to support those disadvantaged students. However, even if the country manages to keep the poor in school, only improvements in the quality and relevance of their education will help break the vicious circle of poverty and make a positive contribution to overall economic growth in BH.

5.103 As access to pre-school and kindergarten programs inevitably rises in the coming years, one of the most pro-poor policies the government could take, given international experience, would be to target funding for pre-school and kindergarten programs on poor areas and disadvantaged groups. While there is broad consensus on the need to shift responsibility for tertiary education to the level of the Entity in the FBH or the State, political maneuvering has so far prevented adoption of a modern tertiary education legal framework.

Employment Services

5.104 The inability of Employment Institutes to facilitate labor reallocation through active labor programs, in particular through job referral and counseling, calls for urgent further reforms,

given the large pool of unemployed and likely additional demands as enterprise restructuring gathers pace. Some progress is already being made. Both Entities are developing more effective policies on ALPs which are consistent with fiscal realities and administrative capacity of the employment services. A framework for revised programs has been developed with Entity and cantonal employment services, and is being used as a basis for further program development. This reform is informed by recent experience which showed that job referral and counseling as well as focused on the job-training can have a significant positive impact on job reallocation in BH.

5.105 To put this agenda into practice, the employment services and in particular the municipal offices as main service providers are in need of **capacity building** to improve their job referral and job search assistance capacities. In addition, the **financing of health and pension insurance** for the unemployed is in need of reorganization, in order to re-orient the employment offices' central task from registering people to active programs and to remove the adverse incentive to register as unemployed simply to have access to health coverage. Finally, excess financing in the FBH EI makes it possible to explore a **reduction in the pay-roll unemployment insurance contribution rate** from the current 2.5 percent closer to the 1 percent in the RS.