

# Institutions and integration (im)maturity: The case of Bosnia and Herzegovina

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## ABSTRACT

In this paper, we analyze the integration maturity of Bosnia and Herzegovina (BiH) on its path towards EU membership and the role of institutions in the process. Integration maturity focuses on five main parameters for readiness to make integration successful: macroeconomic stability, functioning market economy, competitiveness, access to foreign finance and convergence. We combine a discussion of BiH's readiness on these parameters with insights from institutional economics, and show how inefficient institutions are major obstacles to BiH achieving sustained economic growth and attaining the necessary integration maturity. The main reasons for the institutional deficiencies relate to BiH being an ethnically divided country, but just as much it reflects corruption and elite capture of institutions. Only by thoroughly rethinking and reforming its institutional framework will Bosnia and Herzegovina be able to move forward.

## KEYWORDS

Bosnia and Herzegovina, integration maturity, institutions, transition, EU

## JEL CLASSIFICATION

E02, F15, O43

## 1. INTRODUCTION

Bosnia and Herzegovina (BiH) is a transition country with one of the most complicated political systems in Europe. It is also a 'potential candidate' for EU membership, which, when it happens, will, in some sense, mark the end of the transition process. Yet how ready is BiH for the rigours

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of membership? The European Commission, in its 2019 *avis* on BiH's application, highlighted great deficiencies in both the political/institutional and economic realms (European Commission 2019). In doing so, the Commission relied on the Copenhagen Criteria (first formulated in 1993), which measure economic, political and institutional criteria as an assessment for whether a candidate state is ready to begin actual negotiations.

In this article, however, we argue that BiH's failure to build economically efficient institutions stands in its way of deeper integration, in ways that are not fully captured by the Copenhagen criteria. For that reason, we apply a different methodology, *integration maturity*, on BiH, to examine its economic readiness for successful and effective integration. We supplement this analysis with insights from the rich literature on institutional economics, which presents a picture of BiH having significant challenges in building economically efficient institutions – understood here as '[...] the rules of the game in a society or, more formally, [...] the humanly devised constraints that shape human interaction' (North 1990: 3). In all successful transition and accession process, institutions have played a crucial role. In the case of BiH, however, we argue that inefficient institutions hamper the achievement of economic integration maturity.

What is the difference between the established accession (Copenhagen) criteria and integration maturity, one might ask? The Copenhagen criteria and integration maturity overlap in three factors: economic, political and institutional. However, the Copenhagen criteria are too technical and define what has to be done, and not how it should be done. The economic Copenhagen criteria, just like the economic dimension of integration maturity, state that a member state should be a functioning market economy that will be able to cope with competitive pressures of membership. However, the accession criteria provide little clue as to how well a country will be able to function as an EU member state or explain what the consequences of membership will be. Indeed, simply passing formal criteria says little about how fast a country should seek to push the accession process along, or whether rapid accession is to their advantage. Integration maturity, on the other hand, analyzes not merely, if a country is ready to join integration through pre-determined technical checklists, but whether it is properly prepared to benefit from a form of integration that will affect the economic, political, and institutional structures of the country.

Posing such questions is not doubting whether EU membership will be beneficial in the longer term – it unquestionably will for all Western Balkan countries. However, the timelines imagined can be questioned, as integration ultimately imposes both legal obligations and competitive pressures on the acceding state. In the EU's methodology, it is simply assumed that acquis compliance will bring about economic growth and convergence with the EU. Looking at BiH, however, that assumption appears questionable. In fact, as we will argue, BiH will probably benefit from a bit more time on the outside, for the sake of undertaking economic reforms, and for building economically efficient institutional frameworks.

In this paper, we test the following research hypothesis: inefficient institutions hamper the achievement of economic integration maturity.

The paper is organized as follows: After the introductory part, the theoretical framework on the integration maturity and institutional economics is presented in Section 2. Section 3 provides an overview of the political and institutional challenges BiH has faced, followed by methodology and data presentation in Section 4. Section 5 analyzes the integration maturity of BiH through the five main factors. Section 6 concludes the paper and gives recommendations for policy makers and for future research.



## 2. INTEGRATION MATURITY AND INSTITUTIONAL ECONOMICS - THEORETICAL BACKGROUND

The concept of integration maturity was invented by Hungarian economist Tibor Palánkai during the transition process of the Central and Eastern European (CEE) countries. Integration maturity is defined as the capability to exploit the benefits of the given form of integration to the maximum, while the costs and drawbacks can be minimized (Palánkai 2010: 60), and can be analyzed in four main dimensions: economic, political, institutional, and social. In order to become mature for integration, a country must have efficient institutions. While the theory was originally formed for the CEE countries, it can be implemented on BiH and other Western Balkan or post-Soviet transition economies because they share a similar economic history to the CEE countries – both groups are former socialist economies with similar economic system whose goal is EU membership. The CEE countries went through their transition process and joined the EU less than 15 years after the fall of the Berlin Wall (when the process started), the Western Balkan economies, and BiH among them, are nowhere near membership. The novelty of our research is that we analyze the role of institutions in a successful transition process. The original work on integration maturity, which was developed in the 1990s, did not focus on institutional economics as the field was also relatively young at the time.

The work on institutions and their role in economic growth and development was pioneered by Douglass North, who won a Nobel Prize for his work on institutional economics in 1993. North, who was an economic historian, included qualitative indicators such as politics, sociology and history in economic analysis, instead of already-familiar and easily quantifiable labour and capital to understand why some countries succeed and others fail (Yeuh 2018). Institutions provide the incentive structure of an economy; as that structure evolves, it shapes the direction of economic change towards growth, stagnation, or decline (North 1991: 97). History matters (North 1990: vii). It can show us how the USA, a country with developed institutions, has achieved economic growth and development or why sub-Saharan countries, countries with low institutional development have been stagnating. It also explains why the Soviet successor states, where communism lasted over 20 years longer than in CEE, generally have worse property rights institutions and more corruption today (Uberti 2018: 7).

In the transition and accession process, institutions have a crucial role. One of the Copenhagen criteria is that a candidate country must have stable institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities (European Commission 2022a).

We distinguish three types of institutions: political, economic and other institutions. Political institutions determine the constraints on and the incentives of the key actors in the political sphere (Acemoglu et al. 2005) and they have a strong impact over the economic ones (Kryeziu – Coskun 2018). Economic institutions shape the incentives of key economic actors in society and influence investment in physical and human capital; determine economic outcomes; should provide protection of property rights; but they are hard to sustain (Acemoglu et al. 2005: 389). Property rights are the rights of individuals over their own labour and the goods and services they possess (North 1990: 33). Economic institutions can help attract more investment, increase technical innovation, and make economic and business organizations more effective and efficient (Wiggins – Davis 2006), but they depend on the nature of political institutions and the



distribution of political power in society (Acemoglu – Robinson 2010: 1). Other institutions provide enforcement mechanisms such as judiciary and the police (Pejovich 1999).

Economic policies in former socialist countries emphasize the need for governments to create measures to provide impetus for particular types of economic activities (Aralica et al. 2018: 1). These countries have gone through the economic transition, which is a process of institutional change, a process of building new institutions required by a capitalist economy (Redek – Sušjan 2005: 995) because it can be assumed that if institutions fail, the economy will fail as well (Kryeziu – Coskun 2018: 86). Institutions are the fundamental cause of economic growth (Acemoglu et al. 2005: 1) and the main determinants of cross-country difference in per capita GDP are differences in economic institutions (Acemoglu et al. 2005: 25).

The quality of institutions is more important than geography or trade when it comes to explaining the difference in income among countries (Rodrik et al. 2004). Efficient institutions mean establishment of private property, a strong and non-corrupt legal system, efficient markets, and macroeconomic stability with a small and supporting state (Redek – Sušjan 2005:1008). Inefficient economic institutions arise from the desire of political elites to protect their political power and they may therefore oppose changing the economic institutions in ways that would make them more efficient and thus stimulate economic growth (Acemoglu et al. 2005: 432).

Former socialist countries that joined the EU have benefited from strong institutional change and performance compared to transition countries (Aralica et al. 2018). Public authorities must build appropriate institutions to attract more foreign direct investment (FDI) inflows and increase the rate of economic growth (Brahim – Rachdi 2014). Better property rights protection, regulation and lower fiscal burden are some of the factors that contribute to economic performance (Redek – Sušjan 2005). More corrupt countries and countries with larger unofficial economies have heavier regulations of entry for start-up firms (Djankov et al. 2002). Political institutions have a different effect on countries with significant ethnic fractionalization because a regime with fragmented control of power or with power distribution among districts or states acts in opposition to growth (Teles – Pereira 2013: 27).

Institutions should have a positive impact on economic growth. This has been confirmed for the new member states of the European Union (EU), including Croatia, in the period 1996–2012, as a higher level of institutional development is associated with higher levels of per capita GDP (Buterin et al. 2017: 1590). However, in the case of the Western Balkan countries, it has been found that institutions have a negative impact on GDP growth, indicating that the quality of institutions is not sufficient to stimulate economic growth, rather it slows it down (Popovic et al. 2020: 173). The more efficient institutions should lead to a greater degree of integration maturity, higher growth rates, and, eventually, a faster convergence process.

### 3. POLITICAL INSTITUTIONS AND INSTABILITY IN BOSNIA AND HERZEGOVINA

BiH is a textbook example of a weak state with inefficient, extractive institutions. Weak states are those in which policymakers are fully exposed to pressures from domestic interest-groups (Oatley 2019: 144). Extractive institutions allocate power very narrowly to small ruling elite and systematically exclude other segments of society from access to power (Oatley 2019: 213). BiH is a highly decentralized federal state composed of two entities, the Federation of Bosnia and



Herzegovina (FBiH) and Republika Srpska (RS), both enjoying significant autonomy, while the state institutions remain relatively weak. The FBiH further consists of ten cantons, each with full government structures and significant autonomy. Lastly, there is the Brčko District, the status of which was, at the time of the 1995 peace agreement, deliberately left undetermined, to be decided later.

The net result has been a byzantine political system, in which one small country has five presidents, 13 prime ministers, 14 governments and parliaments, 136 ministers, and many hundreds of parliamentarians (Siljak 2018: 4). Add to these 143 municipalities, each with a directly elected mayor and a municipal council, and one quickly senses that BiH is probably the most over-governed country in Europe.

The World Bank's (2022) Political Stability Index shows that BiH has been among the five most unstable countries in Europe (in 2019, the only countries that were less stable were Russia, Turkey, and Ukraine) and the country has not had a positive value of the index since 2004. According to the EIU Democracy index, BiH's system was described as 'worse hybrid regime' in 2019, indicating that elections have substantial irregularities, government pressure on opposition parties is common, corruption is widespread, the rule of law is weak, there is harassment and pressure on journalists and the judiciary is not independent (Economist Intelligence Unit 2020: 53). One index category is 'Functioning of the government', where the country received the third lowest score in Europe (after Russia and Ukraine). This is the country with the highest political risk in Europe (Marsh JLT Specialty 2020). On the other hand, the Bertelsmann Transformation Index (Stiftung, 2022) shows that BiH is a highly defective democracy with limited economic transformation.

Institutions in ethnically divided countries do not usually have a positive effect on economic growth, as the process of making political alliances for the implementation of economic and institutional policies related to economic growth tends to be expensive in these countries (Teles – Pereira 2013). In addition, the large number of political parties in the country leads to political instability because usually they have to form coalition governments. Coalitions may be fragile and prone to internal conflict (Morrison 2006: 166). This has been particularly true in Canton Sarajevo, as in the period 2018–2020 the citizens had to endure three different coalition governments.

The Regional Approach from 1997 was the EU's first policy towards the Western Balkans. The official relations between the Western Balkan countries and the EU started in 1999, when the EU proposed the new Stabilization and Association Process (SAP) for the region (European Parliament 2022). In 2000, the SAP was officially endorsed by the EU and the Western Balkan countries. Three years later, the Process was confirmed as the EU policy for the Western Balkans. BiH signed the Stabilization and Association Agreement (SAA) with the EU in 2008, which entered into full force in 2015. A year later, the country submitted its application for EU membership and it has a visa-free regime with the EU (Delegation of EU to BiH 2020). The country is lagging behind the countries in the region (Endrődi-Kovács – Tankovsky 2022) as it is the only country, together with Kosovo, that is not a candidate for EU membership. It is only a potential candidate. In its 2019 Opinion on BiH's progress towards membership, the Commission was scathing, highlighting governance deficiencies stemming not least from the political system's emphasis on ethnicity (European Commission 2019). In fact, it is hard to imagine BiH progressing far with its EU application, unless it undertakes significant constitutional and institutional reforms soon (Nielsen 2020). The Commission further highlighted problems with legislative implementation and compliance, as well as corrupt practices at all levels.



## 4. METHODOLOGY AND DATA

The focus of the analysis is on the economic aspect of integration maturity, which is subdivided into five main factors: macroeconomic stability, functioning market economy, competitiveness, access to foreign finance, and convergence (Palánkai 2014). However, the importance of the institutional and political dimensions on the economic one cannot be overstated.

Macroeconomic stability and successful integration are mutually dependent on each other, especially in higher stages of integration when the appearance of asymmetric shocks could be harmful for economies. While it is difficult to set a benchmark for what a stable economy is, we can use ideal rates of economic growth, inflation, unemployment, government debt, and budget deficit (Perkins et al. 2013) to describe what the favourable macroeconomic performance of a country is.

Another precondition for successful integration is a functioning market economy, as only that allows a state to fully exploit the possibilities of the EU's Single Market and it should be considered a starting condition for successful integration because only with the proper functioning of market mechanisms can the advantages of internal free trade be exploited (Palánkai 2014). Being in that position, however, is also a matter of institutions. One of the Copenhagen Criteria is that a member state should have a functioning market economy. We use European Bank for Reconstruction and Development (EBRD) transition indicators and Heritage Foundation data to analyze price and trade liberalization, privatization, governance and enterprise restructuring, property rights protection, the rule of law, and judiciary effectiveness.

Competitiveness is the third factors of integration maturity, arising from the economic Copenhagen Criteria's dictum that countries have to have 'the capacity to cope with competition and market forces' (European Commission 2020a). The indicators used for the competitiveness analysis are business environment, KOF index of globalization, labour costs, and foreign direct investment (FDI).

In order to go through the transition process successfully, member states have to have access to finance. However, it is important to see how the funds are invested. We analyze this criterion through the structure of public debt and the country's usage of EU funds. Previous modifications of the methodology (Endródi-Kovacs 2013, 2014) included FDI inflow and the composition of FDI. However, for the purpose of this research, we focus on FDI as a crucial criterion for countries' competitiveness and we limit our analysis to funds obtained from abroad.

The last element of integration maturity is convergence with the bloc one seeks to enter. Convergence is a tendency of poor countries to grow faster than rich countries and at one point in the future they will approach the same steady state (Barro – Sala-i-Martin 1992). Convergence is essentially a function of the previous four factors. If they are present, we will expect to see convergence happening. Countries that are more assimilated can benefit from integration membership, especially in case of asymmetric shocks. While the original work on integration maturity focuses on development and convergence in monetary and fiscal term, we apply the classical approach to convergence analysis and focus on convergence of per capita GDP. We analyze sigma convergence, which measures the dispersion of per capita GDP in the analyzed group of countries, using the minimum to average ratio. If the ratio is increasing, it indicates that a country is catching up, the dispersion is decreasing and the countries converge.

The five criteria are interconnected: without achieving macroeconomic stability, a country cannot be a functioning market economy and cannot trade with other countries. To become a





functioning market economy, the country needs FDI, which it cannot attract if it is not competitive. In order to become competitive, the country needs to build infrastructure and institutions, which requires finance and a transition country must have access to foreign finance. In the end, achieving the first four requirements will lead to higher per capita GDP growth, hence a faster convergence process.

The analyzed period is 2009–2019. We excluded the years 2020 and 2021 from the analysis as the Covid-19 pandemic was an exogenous shock that had a negative impact on the world economy, not just one country. The main limitation of this study is the availability of data, therefore in a few cases the analyzed period is expanded because the average data for that period are the only available. The World Bank, Eurostat, World Economic Outlook, and Heritage Foundation, as well as the Agency for Statistics of BiH, and the Ministry of Finance and Treasury of BiH were the main sources of data for this research.

## 5. EVALUATION OF THE ECONOMIC INTEGRATION MATURITY OF BIH

### 5.1. Macroeconomic stability

BiH has shown a certain degree of macroeconomic stability. The country was affected by the 2008/2009 financial crisis, but it has recovered and its growth rate has been higher than 3% in the period 2015–2019. However, growth has been supported by consumption, driven by an increase in public sector wages or social benefits including pensions. The contribution of investment to growth was only 0.5 pp due to project delays (World Bank 2019).

The country has the most stable currency in the Western Balkan region and the highest score of the monetary freedom index. Konvertibilna marka (convertible mark) is pegged to the euro through the currency board arrangement, which was established in 1997, at the rate of 1 EUR = 1.9558 BAM. The arrangement was the best solution for the country's monetary policy, as it was a fragile country recovering from the 1992–1995 war. Inflation has remained stable in the past 10 years. On average, the prices have risen at the rate of 0.7%, compared to the rate of 1.5% in the EU. The highest inflation rate was 3.7% in 2011. Subsequently, BiH went through a period of deflation in the period 2013–2016, at an average rate of 0.8%. It is interesting to note, that the best-functioning aspect of macroeconomic stability is in a field where the country has adopted a transparent, rigid and externally fixed system of operation, which is therefore largely insulated from political interference. Not that politicians have not tried. Milorad Dodik, a current member of the tripartite Presidency, has tried to abolish the currency board since 2008. Bakir Izetbegović, a two-term member of the Presidency, supported the idea in 2017 (Mušinić 2017).

BiH is a small, open economy, which has a fixed exchange rate with its main trade partner, the EU. Therefore, domestic inflation is largely driven by import prices, which have been low during the last decade (European Commission 2019: 73), with higher prices for transport, housing, alcoholic beverages, and tobacco (World Bank 2019: 24). On February 1, 2018, the country introduced an excise tax on gasoline, which resulted in higher prices for gas and was one of the drivers of inflation (World Bank 2019).

BiH inherited high unemployment rates from the last years of Yugoslavia. The rate was even higher during the 1992–1995 war, which is as expected. After the war ended, the previously public companies did not exist anymore, and there were limited employment alternatives (European Commission 2019). The unemployment rate between 2009 and 2019 was very high,



on average 24.7%, compared to the average rate of 8.9% in the EU. However, people who are registered at the unemployment agencies might work in the informal sector and are only registered for social security coverage, or they are registered for social security coverage, but they are not looking for a job, therefore they should not be included in the labour force.

Unemployment did not decrease simply because employment has increased; BiH, as well as other Western Balkan countries, has faced migration of its citizen to countries of the EU. The number of citizens to whom first residence permits were issued in the EU increased by a factor of 3.4 in the period between 2013 and 2018. In 2018, most residence permits were issued in Germany (30.7%) and Slovenia (29.2%) (European Commission 2021).

BiH did not inherit high general government debt from the previous system and the debt rate, as a percentage of GDP, is still lower than in most EU Member States (the average rate in the EU is 82.9%). The highest debt rate was recorded in 2015, 41.9% and it decreased to 32.8% in 2019. However, the structure of the debt is a matter of concern, as the country takes loans from international financial organizations (IFOs) and does not invest the money in projects for development, but finances the previous debt with a new loan (see section 5.4 below).

A persistent worry for the financial outlook is BiH's vast public sector, which is a consistent drain on the public finances (not to mention a source of corruption and clientelism, more of which later). In a country with a population of less than 3.5 million, 9.1% of workers are employed in public administration, defence, and compulsory social security. The average gross salary in the sector is 1.3 times higher than the average gross salary in BiH. On the annual level, BiH pays around 5% of its GDP for the salaries of people employed in administration. At the same time, 15% people are employed in education, health, and social work activities and both categories earn less than administration (Agency for Statistics BiH 2022a, 2022b).

The country recorded a budget surplus between 2015 and 2019, unlike the countries of the EU, which, on average, had a budget deficit in the entire analyzed period. Revenues rose mainly due to stronger collection of indirect taxes. Expenditures rose mainly as a result of higher spending on public wages, goods and services, and social benefits (World Bank 2020c). That said, for the time being, BiH has achieved a measure of macroeconomic stability. However, the country's economic growth is lower than the growth of most EU Member States and it is not able to recover from crises as fast as other countries in the region or in the EU.

## 5.2. Functioning market economy

The existence of a functioning market economy requires that all prices, as well as trade, should be liberalized and that an enforceable legal system, including property rights, is in place (European Commission 2019: 71). This is also one of the Copenhagen criteria each country has to fulfill before joining the EU.

According to the EBRD transition indicators, most of BiH's progress has been in the area of price liberalization and trade. The country removed all quantitative and administrative import and export restrictions. It is a member of the Central European Free Trade Association (CEFTA), together with Albania, Kosovo, Moldova, Montenegro, North Macedonia, and Serbia. However, the country's main trade partner is the EU. Unfortunately, BiH is not a member of the World Trade Organization (WTO) yet. It was expected that BiH would join the WTO in 2020, but that did not happen. BiH started negotiations for membership in the WTO in 1999 and it should have joined in December 2013. However, the negotiations were blocked between 2013





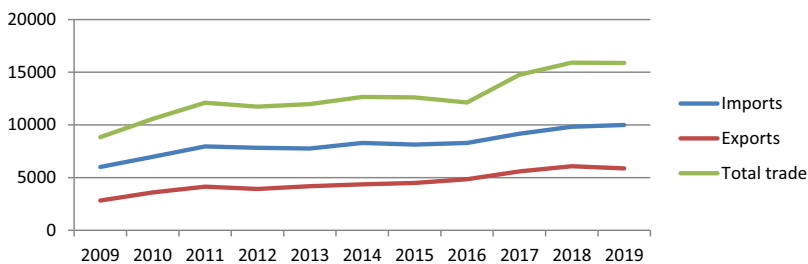
and 2018. The reason was that the Government and Parliament of the Federation of BiH had to change Article 13 of the Law on Internal Trade. The Article stated that stores with the surface of more than 1000 m<sup>2</sup> must contain at least 50% of domestic alimentary products (Government of Federation of BiH 2010, 2016). It took the Federation of BiH four years to delete this one article. By the time the Article was deleted, new problems had arisen. At the moment, the country is negotiating with the Russian Federation on the harmonization of BiH's petroleum-related regulations.

The country's competition policy has slightly improved since 2009. Some competitive pressure is ensured through the country's trade openness. In the period 2009–2019, the economic openness rate in BiH was 89.2%, 36.1 percentage points lower than the EU average. The domestic enforcement of competition policy is limited and falls well behind EU standards (Sanfey – Mijatovic 2017: 6).

The country's main trade partners are EU member states. It imports 61% of goods from and exports 72.3% of goods to the EU (European Commission 2022e). Intra-CEFTA trade is not as pronounced (Siljak 2019). BiH exports 16.6% of its goods to other CEFTA countries and imports 12.4%. While all CEFTA countries have been its export partners, BiH does not trade with Kosovo as much as it did before Kosovo imposed 100% tariffs on goods from BiH and Serbia in November 2018. Other major trade partners are EFTA countries, Turkey, the Russian Federation, and China. Between 2009 and 2019, BiH's trade with the world increased by 80%; imports increased by 80%, while exports increased by 108% (Fig. 1).

The economy of BiH is diverse, as the country does not rely on only one sector. The country mostly imports and exports manufactured goods (almost one-fourth of total trade), machinery and transport equipment (24.4% of export and 20.3% of import) and mineral fuels, lubricants, and related materials (12.4% of export and 6% of import) (European Commission 2022e).

Yet, domestically BiH does not have a single market with harmonized regulations, and has very little transparency in regulatory decision-making. A single market could be achieved through harmonization, not necessarily centralization. The strangest example was the long-running difference in the expiry date of iodized salt between the entities. In the Federation of BiH, the expiry date was three years, while in RS it was two years. That was eventually settled in 2019, and the expiry date is now three years in both entities. More seriously still, in October 2016, the National Assembly of RS made a decision according to which chemical products made in factories in FBiH could not be sold in their market, unless these factories registered with the Ministry of Health of RS (Chamber of Commerce and Industry of RS 2016). The ostensible



**Fig. 1.** BiH's trade with the world

Source: European Commission.



reason for the decision was that the regulations and laws of the Federation of BiH were not harmonized with EU standards. However, at the same time, the companies in question were cleared by EU regulators to export their products to the EU.

While such shenanigans may at first glance seem amusing or bizarre, they underline a more serious problem in BiH's attempts to get on the EU candidate track, namely the absence of any national mechanisms for ensuring legislative compliance with the EU *acquis*, at either entity or cantonal level (European Commission 2019: 6–7), in spite of such mechanisms being a requirement of the 2008 Stabilization and Association Agreement. The difficulties imposed by varying regulatory regimes between the entities, and the lack of regulatory transparency, contribute greatly to making BiH less attractive for investments: it is difficult to explain to a potential investor that when they register a company in one entity, the same rules might not apply in the other.

The least progress has been made in the area of governance and enterprise restructuring. BiH suffers from particular problems with stakeholders and institutions, structure and functioning of the board, and internal control. According to the BTI Transformation Index, BiH has weak governance and it is positioned 106th out of 137 countries. In addition, environmental, health, safety, and social issues need to be integrated into corporate governance practices to align with good international practice (Sanfey et al. 2018: 16). Privatization has lagged behind. According to the Foreign Investment Promotion Agency (FIPA), it is estimated that 60% of small companies and more than 30% of large companies are privately owned or publicly traded. A number of these 'strategic enterprises', which include large enterprises, telecommunications and power utility companies, public utilities, mines, etc, are not still privatized (FIPA 2022b). About 11% of workers are employed in state-owned companies. These companies own about 40% of all fixed assets in the economy. They also distort the labour market because average salaries are 40% higher than in privately owned companies, even though they are less productive. Aggregate debts of these companies are around 26% of BiH's GDP (Cegar – Parodi 2019).

Efficient institutions should provide protections of property rights (Acemoglu et al. 2005) because it is a factor that contributes to better economic performance (Redek – Sušjan 2005). BiH has the lowest Property Rights Index in Europe. In 2014, the value of the Index was only 20 (out of 100). By 2020, it increased to 40.2, but a characteristic of the system is that the court system is inefficient, corruption is present and the judiciary is influenced by other branches of government (Heritage Foundation 2020). In the Western Balkans, the Index ranges between 50.1 in Serbia to 65.1 in North Macedonia. The country also has the lowest Intellectual Property Protection Index in the region (2.88 out of 7 in 2016). The highest score was achieved by North Macedonia, 3.96.

Weaknesses in the rule of law, including the functioning of the judiciary, affect the country's market economy (European Commission 2019: 75). Efficient institutions mean the establishment of a strong and non-corrupt legal system with a small and supporting state with lower fiscal burden (Redek – Sušjan 2005). Corruption, together with the unstable political system, is one of the reasons why BiH does not attract FDI as much as it could because it represents a risk to invest in an unstable country. Based on the Corruption Perceptions Index (CPI) score, BiH is ranked 101<sup>st</sup> out of 180 countries, which indicates that it is a highly corrupt country (Transparency International 2021).

According to the USAID 2019 National Survey of Citizens' Perceptions (USAID, 2020), more than 90% of BiH citizens state that corruption is present in the country; 64% believe that



corruption in public sector employment is extremely prevalent and 59% believe that corruption is extremely prevalent in public procurement. BiH has the second lowest Judiciary Effectiveness Index in the Western Balkan region (after Albania). According to the USAID survey, 53% of people in BiH think that judges and prosecutors cannot be trusted to perform their duties impartially and according to the law; 61% and 60% of people believe that judges and prosecutors take bribes, respectively. People in BiH have least confidence in their national government (23%) in the region. Trust has been declining and citizens of BiH lost most confidence in their national government since 2007 (15 pp) (OECD 2020).

Over the past decade, the country has made some improvement, but it would not be ready to cope with competitive pressures and market forces within the EU. It should be a matter of concern that even in the area where most progress has been achieved, the European Commission still only described BiH as being at ‘an early stage in establishing a functioning market economy’ (European Commission 2019: 78), almost thirty years after the transition process started.

### 5.3. Competitiveness

Competitiveness is defined as “the set of institutions, policies and factors that determine the level of productivity of a country” (Schwab 2019: xiii). According to the EBRD assessment on transition qualities, BiH is the least competitive country in the Western Balkan region. The Global Competitiveness Index shows that the country is ranked 92<sup>nd</sup> out of 140 countries, while the other Western Balkan countries are ranked between 72<sup>nd</sup> (Serbia) and 82<sup>nd</sup> position (North Macedonia). BiH has a diversified and open economy. However, the economy is constrained by the country’s complex constitutional structure, poor business environment, and inadequate infrastructure (Sanfey et al. 2018: 6).

The country has the lowest Business Freedom Index, which represents the overall burden of regulation as well as the efficiency of government in the regulatory process (Heritage Foundation 2020) in Europe. BiH is ranked 183<sup>rd</sup> out of 190 countries in the world in Doing Business topics on starting a new business, which makes it the most unfavourable Western Balkan country to invest in. It takes 81 days to start a new company, and the owner has to go through 13 procedures, and it will cost them the most in the region, 14.9% of income per capita (EUR 685). Even though the country offers low levels of corporate taxation (10%), well-developed industrial zones, and a solid banking sector, considering that in Kosovo an investor can start a new business in 5.5 days and only pay 20 to 50 euros, it is not strange that BiH’s competitiveness is very low because the total cost and number of procedures of starting a business is highly correlated with economic growth (Djankov et al. 2002).

Complying with bureaucratic structures imposes numerous burdens too: for every procedure, a person has to have a notarized copy of a document, which is done by the people employed in administration. This is one of the factors why BiH is inefficient. If there was no need for complicated procedures, foreign investors would be encouraged to start their business in the country and not lose time going from one institution to another. Not to mention often having to repeat the process in both entities. With foreign investment, the real sector would be more developed and people employed in administration could work there and contribute to the country’s GDP. The system itself, therefore, is one of the reasons why the country does not attract foreign investors and is less competitive than its neighbours.



BiH is the worst performing country in public administration in the region. It has the lowest scores, which are well below the Western Balkan average, in the key area for public administration reform: policy making, public service and HRM, accountability, service delivery, public finance management, budget management, public procurement, and external audit. Moreover, in an era of digital government, public administration in BiH remains reassuringly analogue. The only area where BiH has the second lowest score, after North Macedonia, is “Strategic framework for public administration reform” (OECD 2020).

The size of the informal economy in BiH remains significant at 25.5% of GDP (European Commission 2019: 139) because it creates an unfair competitive advantage for companies; it erodes the base for taxation and social security contributions, for labour rights and labour safety. A high level of the informal economy requires the rates for taxes and social security contributions to be unnecessarily high and it also adds a significant burden on registered labour, which negatively affects BiH’s international competitiveness (European Commission 2019). According to Heritage Foundation data, BiH has one of the highest tax burden scores in Europe. The country has a relatively low total tax rate. However, the number of taxes (33) and the time to prepare and pay taxes (411 h each year) make the business environment more complicated and discourage investment.

Another problem holding BiH back, compared to its regional competitors, is that the country has the worst road infrastructure in the region (Sanfey et al. 2018). The country has accumulated more than EUR 5.5 billion for building infrastructure in the period 2006–2019 (Indirect Taxation Authority of BiH 2020). In 2020, the country had only slightly more than 250 km of highways.

In the Central and Eastern European countries (CEEs), improvement in competitiveness was to a great extent due to FDI and globalization, and the main source of competitiveness were the level of productivity, its relatively rapid increase, and the relatively good quality and low cost of their human capital (Palánkai 2010: 12–13). Transition countries rely on foreign investors to bring new capital, which would induce economic growth and catching-up, but also improve existing business procedures, update frequently outdated technology, open new markets, increase the potential for trade, and bring technology and management know-how (Botric 2010: 10). According to the KOF Globalization Index (Gygli et al., 2019), BiH has become more globalized in the past 25 years. In 2017, it was ranked 64<sup>th</sup> in the world. However, it is ranked second-last in the Western Balkans, after Albania (75<sup>th</sup>).

Low labour costs are the advantage for the Western Balkans because over 50% of the manufactured goods in the region are classified as labour and resource-intensive (Sanfey et al. 2018: 25). In 2016, the most recent year with full data available, the average labour cost per hour in BiH was EUR 5.2, only 21.1% of the EU average. The CEE countries’ average was 34.6% of the EU average. The only competitors among the EU countries were Bulgaria and Romania, with EUR 4.5 and EUR 5.3, respectively. In the EU, the lowest labour cost per hour was in Bulgaria and the highest was EUR 41.3 in Denmark (European Commission 2022d).

Although labour productivity increased in BiH, it remains comparatively low. It reached only 51% of the EU average in 2019 (International Labour Organization 2022). The Human Capital Index for BiH is 0.58, the third lowest in the region, indicating that a child born in the country is expected to grow up to be only 58% as productive as they could if they enjoyed complete education and full health (World Bank 2020b).

Even though BiH has many strong points that could attract foreign investors, the country’s FDI to GDP ratio was only 2% in 2019, the lowest in the Western Balkans. The main investors are Austria, Croatia, Serbia, Slovenia, the Netherlands, Russia, Germany, Italy, Switzerland, and



the United Kingdom (FIPA 2022a). BiH offers low levels of corporate taxation, well-developed industrial zones, and a solid banking sector but restricts FDI in some cases because foreign equity ownership of business entities engaged in the production and sale of arms, ammunition, explosives for military use, military equipment, and media cannot exceed 49% of the equity in the given business entity (FIPA 2022c). The country's complicated political system, corruption, and bad infrastructure are further reasons that discourage foreign investment. What is necessary is a little bit of politicians' will to harmonize policies and make procedures less complicated. The state must create a stable political and legal environment that will attract FDI because 'the national political system can be a key determinant of the manner in which enterprise activities are carried on.' (Morrison 2006: 189).

#### 5.4. Access to foreign finance

In order to become a successful member of an economic integration, a country needs resources and investments to improve and maintain the competitiveness of its economy, to develop its infrastructure, to improve the condition of the environment, to build institutions, harmonize legislation and policies, to compensate for losses and to be able to pay obligations to the EU (Palánkai 2010).

BiH has stable general government debt (Table 1), which is below the 60% of GDP level. However, the structure of debt is a matter of concern. The country has been a member of the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD) since 1992. These financial institutions are among the country's main creditors. In June 2020, the share of the World Bank credit in BiH's public debt was 28.7%, followed by the European Investment Bank (EIB) (23.1%), the IMF (10.9%) and EBRD (5.9%). The share of bilateral creditors (foreign governments or banks) was 18.1% (Ministry of Finance and Treasury 2020). Some might ask why these loans are problematic, considering that they are relatively cheap.

**Table 1. Macroeconomic indicators**

		2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Real per capita GDP growth (%)	BiH	-2.5	1.7	2.2	0.7	4.2	2.9	4.7	4.5	4.2	4.6	3.5
	EU	-5.7	1.4	1.7	-0.4	0.3	2.1	3.5	2.5	3.3	2.9	2.2
Inflation rate (%)	BiH	-0.4	2.1	3.7	2.1	-0.1	-0.9	-1.0	-1.6	0.8	1.4	0.6
	EU	1.3	1.9	3.3	2.8	1.3	0.3	-0.04	0.2	1.8	1.9	1.7
Unemployment rate (%)	BiH	24.1	27.3	27.6	28.0	27.5	27.5	27.7	25.4	20.5	20.8	15.7
	EU	9.1	9.8	9.9	10.8	11.4	10.8	10.0	8.4	6.7	5.8	5.0
General government debt (% of GDP)	BiH	25.2	30.2	32.8	36.6	37.7	41.6	41.9	40.5	36.1	34.2	32.8
	EU	-	80.4	81.7	85.0	86.7	86.8	85.0	84.2	81.6	79.6	77.5
Budget deficit/surplus (%)	BiH	-4.3	-2.4	-1.2	-2.0	-2.2	-2.0	0.7	1.2	2.6	2.2	1.9
	EU	-6.0	-6.0	-4.1	-3.7	-3.0	-2.4	-1.9	-1.4	-0.8	-0.4	-0.6

Source: authors, based on data from the World Bank, IMF World Economic Outlook, and European Commission. European Commission, 2022, International Monetary Fund, 2020, World Bank, 2020.



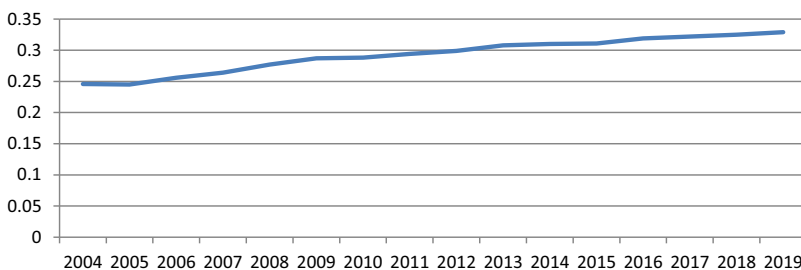
Loans should be used for projects that bring return on investment (Perkins et al. 2013). If BiH used the loans for development projects, they would be acceptable. Unfortunately, BiH takes loans to finance debt and to buy social peace, not least through its vast public sector and its high pension liabilities in a rapidly aging society. Next to the large public administration, as something of a time-bomb, the ratio of employed to retired persons is 1.2:1 (Federal Pension and Disability Insurance Institute, 2020; Institute for Pension and Disability Insurance of RS 2020), which is a burden to the fiscal system and is sometimes financed from the loans.

As a potential candidate country for EU membership, BiH has access to the Instrument for Pre-accession Assistance (IPA), EIB loans, and the Western Balkans Investment Framework (WBIF) grants. Since 1996, the EU has invested more than EUR 3.5 billion in reconstruction, public administration reform, rule of law, sustainable economy, agriculture, and other key areas in BiH (Delegation of the EU to BiH 2020). In the period 2007–2013, the EU funded 324 projects in ten sectors and 352 projects in 26 EU acquis chapters. Over the 2007–2018 period, BiH received EUR 1.5 billion from the EU, of which an estimated EUR 433 million from regional programs. Since 2000, the EIB awarded EUR 2.4 billion in loans to support projects in BiH (European Commission 2019). Bilateral IPA II Indicative funding allocations in the period 2014–2020 in BiH were the second-lowest amount in the Western Balkan region, after Montenegro. The priority sectors for funding in this period were: democracy and governance; rule of law and fundamental rights; competitiveness and innovation; education, employment, and social policies; and transport, with two new sectors; environment, climate action and energy, and agriculture and rural development (European Commission 2022b).

## 5.5. Convergence

Improvements in the aforementioned four areas should ultimately lead to economic convergence, the fifth main measure of integration maturity. Since its foundation more than 60 years ago, the EU has become the modern world's greatest 'convergence machine', propelling poorer, and newer, member states to become high-income economies, and delivering to its citizens some of the highest living standards and lowest levels of income inequality in the world (Ridao-Cano – Bodewig 2018: 18). Throughout its history, the EU has helped its member states and potential member states grow and develop faster.

Figure 2 shows that BiH has been catching up, as the country's per capita GDP increased from 30.6% of the EU average in 2009 to 32.9% in 2019. In 2019, BiH grew at a rate of 3.3%,



**Fig. 2.** BiH's per capita GDP catching-up process with the EU average

Source: authors' calculations based on World Bank data.





while the average EU rate was 2.2%. However, the former socialist countries of the EU grew at the average rate of 3.5%, and BiH's per capita GDP was only 45.6% of their average. Therefore, BiH's convergence process towards the EU should be faster.

One of the reasons why BiH has a lower growth rate is its structure. A transition economy is a category between a developed and a developing country; i.e., the country was industrialized in the past, but it focused on specific sectors and the technology is obsolete (Morrison 2006). Developed countries started growing faster with the industrial revolution and they focused on services after the industrialization process had been completed.

BiH, like the rest of the Western Balkans, has not industrialized completely. In 2017, the country's GDP composition was 64.3% services, 28.9% industry, and 6.8% agriculture (World Factbook 2021). Considering that GDP is the value of everything that is produced in the country during one year, no wonder that BiH cannot grow faster. Consumers do not buy domestic products because they are either of a low quality or they do not exist. If there is no demand, there is no supply and GDP cannot grow. The country's imports are higher than exports because many services are non-traded. Relying on services during a transition process is not sustainable, which has been shown during the Covid-19 pandemic. Therefore, in order to grow faster and converge, the country has to improve technology so that it would not face the Schumpeterian structural crisis – the decline of the old and the rise of the new leading sectors as a consequence of technological revolution, which generated a one-to-two-decade stagnation or slow growth (Berend 2016: 183). The only way it can be achieved is by attracting FDI, which is not possible without making institutions efficient.

## 6. CONCLUSION

What has BiH done wrong? According to the academic literature on institutions, everything! If a country has efficient institutions, then it has protected private property, strong and non-corrupt legal system, efficient markets, small and supporting state, low fiscal burden and macroeconomic stability that help the country attract FDI, which will consequently lead to higher growth rates. Other than macroeconomic stability to some degree, BiH does not have any of the characteristics of efficient institutions. On the other hand, BiH is a highly fractionalized country with weak state institutions; it is one of the least politically stable countries in Europe with one of the least functioning governments, which makes it a country with the highest political risk. The ethnically divided country is not a democracy, but a 'hybrid regime' with a coalition government. These factors represent a burden to the economic and political environment and hamper economic growth. 'Poor institutions are costly – at a minimum, excessive regulations are burdensome and costs to doing business; at the extreme, economies cannot grow if there are unstable political institutions that lead to war or conflict' (Yeuh, 2018: 244). BiH confirms this statement.

There is little doubt that if the country was to become an EU member today, it would flounder. BiH is not catching up with the EU average as fast as it should, as it largely underperforms on all the parameters that make up integration maturity. Therefore, we do not have enough evidence to reject the research hypothesis that inefficient institutions hamper the achievement of economic integration maturity. The analysis can be expanded to the region of the Western Balkans. Furthermore, the econometric analysis can show the effects of different indicators used in the qualitative analysis on the economic convergence process.



Theoretically, BiH should be able to follow the path of the CEE countries and should use them as an example of successful transition, yet it has lagged behind. The argument of this article has been that much of this slowness comes down to inefficient institutions. Improvements in areas such as the business environment require a little bit of political will to make things less complicated and successful. Essentially, BiH must streamline institutions to get the economy moving; not necessarily through centralization, as that, considering recent history, would be politically fraught, and quite likely counterproductive, but harmonization of procedures would go a long way, as would better practices overall.

Yet BiH seems caught in ‘the iron law of oligarchies’, in which self-interested elites exercise both de jure and de facto political power to control both political and economic institutions, and hence economic resources (Acemoglu – Robinson 2010: 22). Ultimately, the responsibility for undertaking the necessary reforms rests squarely with the candidate country, whichever way one looks at it. Is there political or popular will in BiH to change the institutions for the sake of getting the economy moving?

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