

Economic Reconstruction of Bosnia and Herzegovina: The Lost Decade

NIKOLAOS TZIFAKIS* & CHARALAMBOS TSARDANIDIS**

*Visiting Lecturer, Department of Political Science, University of Crete; **Director, Institute of International Economic Relations, Athens, Greece

ABSTRACT The article discusses the efforts to undertake economic reconstruction in Bosnia following the end of the war. It argues that, despite certain successes such as the rehabilitation of infrastructure and the privatization of the banking sector, overall progress has been below expectations. The study, accordingly, attempts to analyse the reasons behind the reconstruction failure by grouping Bosnia's problems into four different challenges for analytical purposes: the post-Dayton institutional deficiency; overcoming political fragmentation; creating appropriate conditions for economic revival; and graduating from dependency on foreign economic aid. In this respect, it is concluded that the intersection between the economic and political dimensions of post-conflict reconstruction has generated a paradox: while huge amounts of economic assistance have intended to facilitate political reconciliation, the nature of the administrative (political) structure that was established in the post-war period has in turn hindered economic recovery and the creation of a unified economic space. Moreover, political fragmentation and slow progress in economic reconstruction have been in a mutually constitutive relationship in which the existence of the one has contributed to the sustenance of the other.

The international literature has been concerned during the past few years with the differences that exist between post-conflict reconstruction and economic development. Economic development typically involves working within the given political and economic structure to bring about growth. Post-conflict reconstruction, in contrast, involves a drastic change—often a complete change—to the pre-war economic, social and security sectors. The main goal of post-conflict reconstruction is a major shift of the ideology and operations of the political structure. Reconstruction is therefore a problem of “public choice” (Cowen & Coyne, 2003, p. 2). In other words, economic reconstruction should be considered as part of a broader peace-building process not focusing only on how much and in which sectors resources are needed, or on when and for what purposes aid should be delivered, but also on how an integrated strategy could be formulated which takes into account long-term social and political factors as well as the economic needs of the country concerned (Vayrynen, 1997, p. 157; Harme & Sullivan, 2002, p. 89).

Correspondence Address: Nikolaos Tzifakis, 106 Dervenakion Street, 15343 Aghia Paraskevi, Greece.
Email: tzifakis@pol.soc.uoc.gr.

The World Bank's definition of post-conflict reconstruction focuses on the needs for reconstruction and the enabling conditions for a functioning peacetime society, to include the framework of governance and rule of law and "the rebuilding of the socioeconomic framework of society" (World Bank, 1998, p. 14). These post-conflict societies, as the World Bank indicates (1999, p. 1.2), are often characterized by a dominating narrow elite, fragile peace, a lack of confidence between political and economic actors, and weak judicial, financial, fiscal, administrative and regulatory institutions.

One study has identified four pillars of post-conflict reconstruction. These are: first, security or the creation of a safe and secure environment through the establishment of legitimate and stable security institutions; second, justice and reconciliation, which incorporate an impartial and accountable legal system; third, social and economic well-being achieved through the provision of emergency relief, restoration of basic services, laying the foundation for a viable economy and sustainable development; and, finally, governance and participation, by building viable constitutional structures, capacity building in state institutions and public administration and the nurturing of an articulated civil society capable of participating in governance and relieving the state of some of its myriad burdens (Gennip, 2004).

Therefore, there is a broad understanding of post-conflict reconstruction as a multidimensional concept encompassing military, political, economic and social conditions. While the latter are closely interwoven and interrelated—for instance, security is a prerequisite for democracy—it is possible for purely analytical purposes and greater clarity to divide the concept across sectors and speak of political, economic or social reconstruction. The purpose of the present article, accordingly, is to study the process of economic reconstruction in Bosnia and Herzegovina¹ following the conclusion of the Dayton agreement.

The Bosnian war had destroyed a great segment of the country's human resources as well as the results of five decades of material development. The ferocious clashes between the three ethnic communities during the period 1992–95 caused the death of 250 000 people (Bugajski *et al.*, 1996, p. 83). While 1.3 million people were displaced from their homes, over one million people were forced abroad—including most experts and well educated people (e.g. 80% of university teaching staff)—of whom many have not returned (Tihi, 1996, p. 199; International Crisis Group, 1998). The hostilities also destroyed, or seriously damaged, most of the country's infrastructure, including roads, railways, bridges, factories, hospitals and schools, power generators and 30%–60% of its housing stock (Gough, 2002, pp. 177–183; Bugajski, *et al.*, 1996, p. 82). The GDP and GDP per capita had shrunk by 1995 to less than one-fifth of its pre-war levels (See Table 1). The ageing of the population was accentuated by the death and emigration of many young Bosnians and an important fall in birth rate was noted (from 15 per 1000 in 1990 to 12 per 1000 in 1998). Untold psychological trauma remains among those who have experienced the brutality of war. Particularly vulnerable are young people and ex-soldiers. Inadequate health and housing conditions and malnutrition were in turn responsible for a remarkable shortening of life expectancy and an increase in infant mortality (Sacirbey, 1996, p. 349).

The international community has since 1995 set up a massive reconstruction effort in Bosnia, covering everything from rebuilding infrastructure to achieving economic growth, refugee return and prosecution of war criminals. Post-conflict reconstruction additionally entailed transition from wartime to peace and from a planned to a market economy (Ohanyan, 2002, p. 399).

Table 1. Selected economic indicators, 1990–2004

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 (est.)
GDP (US\$ millions)	10 633*	1867	2741	3423	3899	4901	4743	5015	5610	7097	8239
Real GDP growth (%)		32.4	61.9	30.0	15.8	9.6	5.5	4.5	5.5	3.0	5.0
Real GDP as % of 1990 GDP		22	36	47	55	60	64	66	70	72	
GDP per capita (US\$)	2429*	524	728		1054	1316	1254	1320	1466	1852	2150
Unemployment rate (%)					37.4	39.3	39.6	40.3	40.9	42.0	41.0
Current account (% of GDP)			–32			–11.2	–9.8	–16.1	–22.1	–24.5	–23.1
Trade balance (% of GDP)		–21	–36			–67.3	–58.4	–59.0	–59.2	–58.4	–55.4
Foreign direct investment (€millions)					89	85	163	133	280	335	400
External debt as % of GDP		177	132	119	68.1	69.6	67.4	57.7	44.3	36.7	34.0

Note: *Service sector excluded.

Sources: Central Bank of Bosnia and Herzegovina, World Bank, IMF, EU, Bank Austria Creditanstalt and EBRD, Pugh (2005, p. 453).

The Bosnian reconstruction has been broken down by the donor community into two distinct phases, each of them corresponding to a different set of priorities. During the first period, that is between 1996 and 1999, priority reconstruction programmes aimed primarily at rehabilitation of infrastructure and restoration of public services and the establishment of a viable macroeconomic framework. Since 2000 the reconstruction has been aimed at:

- strengthening governance and establishing affordable and equitable social services;
- realizing sound reforms of the fiscal, monetary and tax systems;
- proceeding with the privatization of state-owned enterprises, including banks;
- deregularizing the economy;
- implementing institutional and policy reforms in government administration and the judicial system (World Bank, 2004, p. 5).

The second period was additionally characterized by the EU's adoption of a more pre-eminent role in the Bosnian reconstruction as this process was gradually linked to the imperatives of the Stabilization and Association Process and the country's preparation for European integration (Chandler, 2005).

However, after several years of international involvement, economic recovery has not been achieved, although some important gains were made initially in providing emergency assistance and helping the country to return to normalcy. Very modest progress was made also in creating a unified state. With time, the opportunities for continued progress along these lines have become even more limited, reducing the prospects for sustained growth in Bosnia (Lewarne & Snelbecker, 2004, p. 13). Political and economic power, as Michael Pugh (2002) has pointed out, are closely interwoven, wealth distribution and access to rights and opportunities are extremely uneven, the privatization of economic activity is poorly advanced and social provision is partly dependent on clientelist patronage. The economy is unproductive and there is little incentive to invest. The central institutions are still weak and their operation is frequently undermined by war entrepreneurs and patrimonial elites that have become in many cases interlocutors of international organs and external institutions (Pugh, 2002). Thus, regeneration is prone to regional political obstruction (Gough, 2002, p. 171).

The aim of this article is to explore the main reasons why the reconstruction efforts of post-Dayton Bosnia have produced rather modest results. The argument is developed through the exploration of four different challenges: those of the post-Dayton institutional deficiency; overcoming political fragmentation; creating appropriate conditions for economic revival; and graduating from dependency on foreign economic aid. The study's division into four challenges does not imply in any way that Bosnia's problems of economic reconstruction are simple or isolated from each other. For instance, the difficulties with privatization have been equally attributed to the county's macroeconomic outlook and to its complex institutional framework and the political obstructionism of the local authorities. Therefore the division of the article across four challenges intends to reorganize the discussion analytically in order to contribute to the endeavour of discovering how Bosnia's economic reconstruction can be pushed forward.

The Challenge of the Post-Dayton Institutional Deficiency

The first challenge to Bosnian reconstruction has come from the very institutional framework that the Dayton agreements put in place. Although this framework has been partially revised over the past several years through constitutional amendments and the efforts of the High Representative, the fragmentation of the country's system of government on ethnic lines has been preserved.² The establishment of several centres of power at different levels has additionally impeded the creation of a unified economic space. This cumbersome form of government, while perhaps unavoidable given political tensions, has been largely ineffectual and has been an impediment to economic development at every step for a series of reasons.

First, with the exception of jurisdiction over foreign trade, customs and monetary policy, all other economic powers were internally relegated to the sub-state level of the entities. The fragmentation of economic powers has also led to important deficiencies of economic planning at the central level. A good example here is the absence in Bosnia of an institution or body that would be responsible for targeting and monitoring the consolidated fiscal balance as a result of the country's fiscal decentralization. Considering the fact that the State Ministry of Finance and Treasury accounts in Bosnia for less than 4% of consolidated government spending, it cannot play the role that its counterparts perform in other countries (World Bank, 2004, p. 15). Consequently, although Bosnia maintains one of the world's most complicated fiscal architectures, there is no institution in the country charged with securing an appropriate consolidated fiscal stance.

The dispersion of economic and political powers inside the country was also responsible for the fragmentation of infrastructure services among and within the entities. In Bosnia there are five public companies involved in gas supply, three electricity utility companies, and three electricity regulators. According to the World Bank (2004, p. 28), such a fragmentation of infrastructure services implies increased costs of operation, difficulties of coordination and an obstacle to the attraction of badly needed investments. This is because different infrastructure services have been instruments in the hands of nationalist parties for the collection of revenues and the preservation of institutional fragmentation (Pugh, 2004, p. 57) rather than in the hands of competitors within a deregulated economy for the acquisition of a share of the Bosnian market.

Moreover, the extension of the High Representative's authority in 1997 with the 'Bonn powers' has implied the concentration of absolute executive and legislative authority within his hands (Knaus & Martin, 2003, p. 61). The High Representative has subsequently made sure that the political process functions normally in the country. Yet this has been achieved at the price of Bosnia's transformation into an international protectorate where all major decisions are taken by the international community (Pugh, 2000). As a consequence, Baskin (2003, pp. 165–166) remarks that post-Dayton international operation in Bosnia suffers from a gap between the aspirations of an 'interim administration' and the tools of a mere advisory operation when the 'bad' domestic politicians refuse to take appropriate guidance from the 'wise' international officials.

Further, there is a large discrepancy between the revenues, on the one hand, and the obligations, on the other, of the cantons that were established within the Bosniac–Croat Federation. The cantons were called—mainly through the collection of turnover tax on their territories—to finance their administrations and their social welfare system, including health and education, as well as to contribute to their entity's social spending,

military expenditures and share of the country's external debt (Bojicic-Dželilovic *et al.*, 2004, p. 8).

Besides, another institutional weakness in Bosnia has been the so-called 'privatization' of the state border (Bojicic-Dželilovic *et al.*, 2004, p. 23). The relegation of authority over control of the country's border crossings to the entities and the absence of coordination among the relevant local services generated a window of opportunity for wartime criminal groups involved in smuggling and other illegal trade activities to operate almost without controls. The outcome was the loss of millions of Convertible Marks (KM). As most of the country's imports arrived in the form of contraband, smuggling on the one hand provided consumer goods at a discount but on the other enriched criminal organizations and deprived the government of desperately needed tax revenue (Andreas, 2004). The High Representative imposed the creation of a State Border Service by law in 2000. However, this institution considerably delayed taking control of 100% of Bosnia's borders and has been understaffed and deficient in equipment and training. As a result, it is estimated that the informal or 'grey' economy remains sizeable, accounting for more than a third of the country's GDP (Hadziahmetovic, 2005).

Finally, the size and scope of the government structure has itself been a barrier to the growth of Bosnia's economy. The employment in the public sector of around 40% of Bosnia's workforce, in addition to the extensive international presence on the field, created numerous bureaucratic obstacles to the development of the private sector and drained the budget of scarce resources. Overall, the Dayton-originated 'Byzantine administrative structure' has impeded the creation of a single economic area and has further complicated the economic reconstruction of the country (Ateljevic *et al.*, 2004, p. 247).

The Challenge of Overcoming Political Fragmentation

The complex structure of authority and the requirement for ethnic proportionality in state and entity institutions, coupled with the establishment of several institutional checking mechanisms at both state and entity levels (for instance, the veto right), enabled national elites to obstruct the implementation of economic reforms. Indeed, 'ethnic interests' have dominated much of the country's political and economic agenda. The nationalist parties—which have ruled during most of the post-war period—have maintained their different, and sometimes conflicting, views about how the state and society should be organized. As Götze (2004, p. 679) pointed out, any action in the public space would contradict the expectations and norms of either one or another social actor. The international community attempted through electoral politics to sidestep the nationalists. However, it managed through control of certain sectors of the local economies and the exploitation of the country's constitutional framework "to perpetuate competitive advantages arising out of economic and political 'security dilemmas'" (Manning, 2004, p. 69). One of the consequences was widespread corruption in both of the entities.³ On the one hand, criminal capital accumulated during a criminalized war has been converted to political capital after the war (Anreas, 2004, p. 44) and, on the other, warlords who had developed illegitimate businesses continued after 1995 to maintain strong links with corrupt officials (Omanovic, 2005, p. 3). As Srdan Vučetić emphasizes: the ethnic principle, on which post-Dayton Bosnia rests, has created 'ethnic oligarchies'—communities made up of politicians, business people and gangsters who share the same ethnic background (Vučetić, 2002, p. 74).

The country's political fragmentation was additionally reflected in its uneven regional development. Although regional disparities in development are quite common in transition economies, in Bosnia's case these differences are particularly evident, largely thanks to the absence of a unified economic space. Hence there are three levels in which the enhancement of regional disparities has been observed.

The first level of uneven regional development is that between the entities. Considering the fact that the latter were awarded authority over most domains of the economy, their individual policies have generated different rates of macroeconomic indicators. More importantly, the Bosniac–Croat Federation's larger cooperation with the international community, in contrast to Republika Srpska's constant obstructionism, has had an impact on the extent of reconstruction aid that each entity has received and, subsequently, on the level of its growth and the state of its economy (Gough, 2002, p. 174). In addition, the two entities have maintained little trade with each other, although trade is one of the main sources of income in the whole of Bosnia (Ateljevic *et al.*, 2004, p. 246). The two entities have during the past few years tried to put in place similar institutions and legal systems with the aim of increasing inter-entity transactions (Ohanyan, 2002, p. 399; OHR, 2005, p. 11).⁴ Nevertheless, each of the entities has developed strong trade links with another former Yugoslav state, namely, the Bosniac-Croat Federation with Croatia, and Republika Srpska with Serbia and Montenegro (Broadman *et al.*, 2004, p. 14).

The second level of regional disparity is that between the large cities and the rural areas. While the former witnessed the creation of new business activity in the post-war period, the latter have increasingly been depopulated. This phenomenon—which has in turn triggered the closure of local schools and other sectors of the institutional infrastructure—is strongly associated according to Ateljevic *et al.* (2004, p. 246) with an over-concentration of businesses in a few sectors, such as tourism and retail activities.

The third and last level of uneven regional development is located within the entities. Here the problem is related to each entity's particular geopolitical characteristics. For instance, because of their proximity and close ties with Croatia proper, the Croatian regions of Western Herzegovina have performed better economically than the rest of the Bosniac–Croat entity. Similarly, the eastern part of Republika Srpska is in a worse economic condition than the western part of the entity in part because of its dependence on the weak Serbian market and in part because it has been more politically hard-line, thus receiving even less reconstruction assistance (Gough, 2002, p. 174).

Finally, another aspect of the country's political fragmentation is the absence of the local business community from the reconstruction process. The latter has been confined to merely attempting to participate in reconstruction projects that are put forward by the donor community (Omanovic, 2005, p. 3). The non-influential role of the local business community is the result of two factors. The first is the proliferation in Bosnia of a large number of weak business associations that fail to coordinate their actions for the attainment of common goals (Omanovic, 2005, p. 6). The second is the government's disregard of the local private enterprises' interests. This resulted in part from the Bosnian politicians' overwhelming preoccupation with satisfying the conditions of the international community and in part from the complex structure of the country's government. The dispersion in Bosnia of executive power along several layers of government not only has hindered coordination of state policies, but has also caused confusion among the local business community, which does not know where to direct its demands. The existence of very few channels of communication between the

private and the public sector has further encumbered the effort of local private businesses to bring their problems to the fore.⁵

The Challenge of Creating Appropriate Conditions for Economic Revival

The dynamics of economic reform and therefore of economic reconstruction are dependent on many factors. However, in Bosnia's case three have emerged as the most acute: control of public expenditures, implementation of the privatization process and creation of incentives for attracting foreign direct investment (FDI).

The first problem is related to the critical state of public finances. Although the reform of the public sector has been at the centre of the reform agenda, public expenditures remain bloated and many researchers warn against the danger of a public finance crisis.⁶ Bosnia's public consumption problem has been caused by huge debts, unsustainable deficits, overstretched expenditures and inefficient tax collection.

The country's internal indebtedness increased during wartime and is related to large arrears in payments to budget beneficiaries such as pensioners and the army, as well as to claims of citizens concerning frozen foreign currency deposits and war damages. To these claims, which, according to the IMF, could exceed 200% of GDP (International Monetary Fund, 2004b, p. 25), other payments may yet come to be added. The IMF has expressed concern over the possible implications of a judgement by the Human Rights Chamber ordering the payment of 3.5 million KM to relatives of victims of the Srebrenica ethnic cleansing. Since the court has to adjudge another 1700 cases relating to Srebrenica alone, the repercussions of the aforementioned judgement for the Bosnian public finances could be enormous (International Monetary Fund, 2004b, pp. 27–28). What is more, demands on the public budgets can also emerge from citizens' claims for compensation within the framework of the restitution process.

The country's external debt—which has mostly been inherited from Socialist Yugoslavia and amounted at the end of the war to 177% of the country's GDP (see Table 1)—has represented another dimension of its huge public indebtedness. Bosnia made substantial efforts in the subsequent years to reduce it through the conclusion of rescheduling and concessional agreements with all creditors. Indeed, also taking into account the remarkable growth of the Bosnian economy during 1996–99, the external public debt amounted in 2004 to only 34% of the country's GDP (see Table 1). Yet the government did not show the same eagerness in dealing with its internal debt as it was only two years ago when the Bosnian authorities at last decided to restructure domestic claims with the issuance of bonds. As a result, it is estimated that Bosnia's overall public debt is still very high, being equivalent in 2004 to 59.7% of its GDP (International Monetary Fund, 2004b, p. 29) (see Table 2).

Furthermore, we should note that the privatization process has been stalled. Nevertheless, the operation of many loss-making state-owned enterprises has kept draining resources from the public sector. The shrinkage of these enterprises' output has additionally had an impact on the country's trade balance. It has contributed to the formation of Bosnia's unsustainable trade and current account deficits (see Table 1). Bosnia attempted to boost its exports and mitigate its deficits by the conclusion of asymmetric free trade agreements with the successor states of former Yugoslavia and the acquisition of a preferential trade regime with the EU and countries such as Switzerland, Norway, Japan, the USA, Russia and Canada (Bojicic-Dželilovic *et al.*, 2004, p. 20). However, IMF statistics

Table 2. Public sector debt (as % of GDP)

	2000	2001	2002	2003	2004 (projected)
Public sector debt	58.8	48.2	42.2	34.0	59.7*
<i>Of which foreign-currency denominated</i>	58.8	48.2	42.2	34.0	32.8

Note: *The steep increase in 2004 reflects the issuance of long-term bonds for the settlement of domestic claims on government.

Source: IMF (2004b, p. 48).

demonstrate that, whereas in the past few years output trebled, imports increased more than ten-fold (International Monetary Fund, 2004a, p. 3). As a result, the trade and current account deficits have been steadily growing to an unsustainable extent. To illustrate, in 2004 the trade deficit was equivalent to 55.4% of GDP, while the current account deficit amounted to 23.1% of GDP (see Table 1).

The deterioration of the public (and private) enterprises' performance has without doubt been accelerated by the war's large-scale physical destruction. The secondary sector, which had accounted in the past for half the country's economy, barely reached 20% of its pre-war equivalent (Gough, 2002 p. 171). Yet many industries that restarted production soon found out that they could not sell their products and closed down again. This demonstrated that Bosnian industry suffered not only the ramifications of the war, but also the consequences of its top-down 'authoritarian development' which had rendered it uncompetitive (Knaus & Cox, 2004, p. 63).

The secondary sector's demise prompted a rise in the share of agriculture and services. This structural change represented a 'backward' adjustment, not only because higher shares of agriculture in GDP are typical of earlier stages of development but also because the types of agricultural production and services that grew faster afterwards were those that were less dependent on industry. Considering the severe dimensions of unemployment in Bosnia, working the land was merely for most people a strategy of survival and self-sufficiency and, thus, very little of their production reached the market. Therefore the value of the country's food imports is currently 16 times higher than the value of food exports (OHR, 2005, p. 13).

Besides, the growth of the tertiary sector did not indicate a development trend. It instead reflected the growth to gigantic proportions of the state bureaucracy in compliance with the Dayton Agreement's provision for the establishment of several layers of government (Gough, 2002, pp. 171–172). As a result, Bosnia's public sector has been oversized, overpaid (see the discussion of 'Dutch disease' below) and inefficient, placing a heavy burden on the country's budget. The international community has been warning the Bosnian authorities for some time that the public sector should be downsized with the transfer of services and authorities from the sub-state to the state level. Such a development is essential not only for the sustenance of the economy's growth and the improvement of its competitiveness, but also for the advancement of the country's integration into the Euro-Atlantic structures. However, to the extent that most of the central institutions to which authority should be relinquished are not even in place, the restructuring of the public sector unavoidably entails further institution building—for instance a state-level veterinary inspection service—that will at least temporarily require an increase in public spending (OHR, 2005). Furthermore, the need for the rationalization of the public sector is confronted

by the disinclination of the cantonal and entity authorities to abolish some of the most important powers and jurisdictions that the Dayton Agreement offered them and concede to their relegation to the state level.

Another way of looking at the problem with the public finances is by analysing the composition of the government expenditures. A World Bank study on the country's public expenditures demonstrated with comparative statistics from 2000 that Bosnia directed to defence, security and order, as a percentage of GDP, three times more funds than the average for EU countries (World Bank, 2002, pp. 48–51). The donor community has repeatedly demanded that the Bosnian entities demobilize most of their soldiers and reduce their military budgets. Nevertheless, the policy response of the Bosnian authorities has been at best half-hearted as long as the international financial assistance kept subsidizing Bosnia's budgets. The same World Bank document also showed that Bosnia spent almost twice as much as the EU average on social security, health and education as a percentage of GDP. High social spending in a post-war society is without doubt essential if social funds provide for increased social protection of those citizens with larger needs. However, this is not what has happened in Bosnia's case. First, a great segment of social spending, precisely 3%–4% of GDP, has been in the form of benefits to war veterans (World Bank, 2002, p. 43). To the extent that Bosnia cannot allocate similar funds to people with larger difficulties, for instance disabled people, the war veteran funds are at the least unfair. Second, high spending in health and education has not been reflected in those systems' effectiveness. The fragmentation of health and education alongside cantons and entities renders their services expensive in terms of unit costs and hinders the development of economies of scale. Fragmented health and education systems are additionally inequitable systems because the existence of large differences in revenue among the cantons is projected on their social expenditures (OHR, 2004, p. 14).

Finally, the fiscal picture of the country has been aggravated by its inefficient tax system. Bosnia's fiscal system, like most other governing functions, was based on relegation of authority from state to entity level. The entities developed separate tax regimes and were entangled in competition through the application of different rates. This situation generated a poorly enforced, complicated and disharmonized fiscal system that impeded the conduct of inter-entity trade and obstructed the development of business activity. In 2000 Bosnia initiated a process of reforming its fiscal system that has been *inter alia* based on the reduction of the number of applied taxes, the closing of the rates gap, the establishment of a State Border Service and the introduction of a law on indirect taxation (Bojicic-Dželilovic *et al.*, 2004, pp. 24–25, 32). The consolidation of this process is expected to occur with the introduction of a Value Added Tax (VAT) at the beginning of 2006. To sum up, the bleak picture of Bosnia's public economics has been created by large accumulated arrears, incremental deficits, bloated expenditures and a fragmented and inefficient tax system.

The second crucial problem of Bosnian economic reconstruction has been the poor progress of the privatization process, with the notable exception of the banking sector. Almost a decade has passed since the drafting of the first entity privatization laws and the private sector continues to account for only 50% of the country's economy (World Bank, 2004, p. 23). Not only have many enterprises, including most of the strategic ones, not ended up in private hands, but they have also not been restructured for better performance. Indeed, poor corporate governance is equally evident among many of those enterprises that have already been privatized. According to World Bank statistics of 2001, only

40% of both state and private companies registered profits, while the aggregate profit rate in percentage of sales was -12% (International Monetary Fund, 2004a, p. 13). Delays in privatization, as well as in the reform of taxation, are without doubt challenging the transition from an aid-dependent to an export-oriented economy (Lampe, 2004, p. 115).

The first reason behind the failure of the privatization programme has been its separate implementation by each entity. The elaboration of different legislative procedures hindered the development of a common economic space and a market economy as well as generating confusion among perspective investors (Bojicic-Dželilovic *et al.*, 2004, p. 25).

Moreover, the model of mass privatization that was selected for most of the country's enterprises turned out to be an inappropriate choice. This approach was based on the issuance of certificates in the Bosniac-Croat Federation and vouchers in the Republika Srpska to every citizen over 18 years old (Bojicic-Dželilovic *et al.*, 2004, p. 12).⁷ Mass privatization did not bring enterprises fresh money, expertise or new markets, nor did it contribute in any way to their restructuring.

In addition, the privatization of large and strategic enterprises by putting them out to tender has been marked by failure. Five years after this programme's inauguration most of the targeted enterprises are still public largely because of the absence of political will among the Bosnian authorities to adopt legislation on bankruptcy and to proceed with the restructuring of insolvent enterprises (OHR, 2005, p. 15).

The nationalist agendas of local authorities constitutes another obstacle to the privatization of enterprises. Different ethnic groups frequently and consistently endeavored to sell public enterprises in their regions to people of their own nationality in order to determine each ethnic group's post-privatization employment opportunities (Omanovic, 2005, p. 3).

Finally, the Bosnian authorities' neglect of creating the conditions for the establishment of a business-friendly environment represents the last barrier to the growth of private entrepreneurial activity.

After several lost years, Bosnia has again put the privatization process at the top of its economic agenda during the past couple of years. However, apart from investors' aversion to the Balkans and the difficulty of restructuring and selling insolvent enterprises, Bosnia must also overcome the negative public perceptions of its previous policies, that is to say, its past record on voucher and tender privatization (International Monetary Fund, 2004b, p. 10).

The third problem with the Bosnian economic reconstruction—which is tightly related to the failure of the privatization process—is that the country has seen little FDI during the past decade, in spite of the substantial steps that it has taken to create a positive business climate.⁸ John Bray finds the FDI picture of the country really disappointing. Bosnia has received a mere US\$400 million in FDI between 1994 and 2000. (Bray, 2004, p. 1) Successful investments, such as the purchase of the dairy factory in Bihać by the German company Meggle and the purchase of Kakanj Cement Plant by Heidelberg Zement, were an exception rather than the rule during the 1990s (Omanovic, 2005, p. 4). FDI has significantly increased since then (see Table 1) as privatization has begun to take hold and the banking sector has started to attract foreign investors (World Bank, 2003, p. 65). Nevertheless, foreign investment has always remained far below the constantly declining amounts of foreign aid that the country has received. Here it is worth mentioning the estimates of the IMF that Bosnia needs to attract an additional \$2 billion in FDI by the end of 2007 in order to meet the macroeconomic goals outlined in the mid-term proposal of its Poverty Reduction Strategy Paper (PRSP) (International Monetary Fund, 2004c, p. 52).

To conclude, the overextended public expenditures, inefficient privatizations and low inflow of FDI constitute Bosnia's three interrelated economic problems, which demonstrate some of the current reconstruction process's major deficiencies. These deficiencies are not the result only of post-conflict Bosnia's economic reality but also of its existing institutional and political fragmentation. For example, the coexistence of 14 governments and corresponding legislatures has rendered the country's system of government dysfunctional, unstable and inefficient (Bieber, 2005, p. 4; Tzifakis, 2006). On the other hand, international efforts to reconstruct Bosnia's political system through electoral politics in order to bring to power moderates who would then undertake needed reforms by reshaping the social and economic structure of the country, have failed (Manning, 2004, p. 82).

The Challenge of Graduating from the Dependency on Foreign Economic Aid

Bosnia has been the recipient of over \$5 billion during the past decade. However, international economic assistance has not generated sustainable domestic economic growth (see Table 3). This has best been manifested in the fact that the decline of donor assistance as a result of the completion of the rehabilitation process and the diminution of the need for emergency humanitarian aid has brought about a slow-down in economic growth. The likely additional reduction of international assistance to Bosnia as a result of donor fatigue—the IMF (2004b, p. 46) estimates that in 2008 foreign assistance will be equivalent to one-third of its 2000 levels—justifiably raises questions about the persistence of the growth process. More importantly, the decrease in international aid reveals the emergence in Bosnia of an aid-dependent pattern of development.

The main reason behind Bosnia's aid dependence has been the assumption by the international community of a pre-eminent role in the management of its economy by setting up economic policy and reform agendas and by providing financial and expert support for those policies' implementation. In addition, as Manning (2004, p. 76) has remarked, Bosnia's major donor countries have utilized means such as their bilateral aid and their influence in international financial institutions to affect post-election government formation. Moreover, the IMF and the World Bank have not consulted the Bosnian authorities over the design of their strategies and reconstruction programmes, nor did they involve the latter in aid coordination (World Bank, 2004, pp. 7, 18). The international donors have sought to engage the Bosnian authorities only at the stage of reform implementation through aid conditionality.

The international donors therefore have dominated the policy process across a wide range of areas. This is why many Bosnians have started to admit that their society has become overly dependent on the international community and that domestically generated

Table 3. Size of total external assistance (US\$ millions) vs GDP growth (annual%)

	1996	1997	1998	1999	2000	2001	2002	2003
Total external assistance	848.8	861.9	905.2	1040.3	737.1	639.2	563	539
Annual GDP growth rate	61.9	30.0	15.8	9.6	5.5	4.5	5.5	3.0

Sources: World Bank, OECD, IMF, CBBH.

solutions are crucial to the country's stability and future. However, this dependent pattern of economic reconstruction on foreign aid has produced the following consequences.

First, while the international community was able to set the agenda and influence the enactment of pieces of legislation relevant to reform, it had much less leverage on their actual implementation. Although in most of the cases the local politicians have not openly opposed the transition process, they have subsequently demonstrated no commitment to its advancement (Bojicic-Dželilovic *et al.*, 2004, p. 1). The Bosnian elites quickly felt that they were given a subordinate role in the domain of the economy and adopted a passive attitude towards the reconstruction process.⁹ Their aspiration was reduced to profiting materially and politically from the reconstruction assistance through attempts to influence the donor community about the destination of funds (McMahon, 2004/05, p. 581). As a result, while the Bosnian national leaderships were preoccupied with the advancement of their political agendas, they were feeling that they should not worry about economic issues that were within the hands of the donor community. This is not to say that the Bosnians ignored their country's severe socioeconomic problems. It rather implies that the local leaderships were reluctant to assume political responsibility for the resolution of these problems within the context of frequent occurrence of elections—i.e. every two years—that impeded consensus building and discouraged the expression of support for difficult economic decisions. Likewise, the Bosnian politicians chose to position themselves *ex post facto* towards economic policies of the donor community in line with those policies' effectiveness. When economic measures had a negative impact, the local leadership blamed the international community, while it claimed the credit for policies with beneficial impact (Omanovic, 2005, p. 2). Knaus & Cox offered an additional explanation of the Bosnian politicians' passivity towards the reconstruction of their country by referring to the country's so-called "legacy of authoritarian development". The two analysts' research highlighted the top-down process of Bosnia's industrialization over the past 120 years and concluded that the international community had merely assumed the role previously played by Socialist Yugoslavia's central institutions. To put it simply, Bosnian politicians have in both pre-war and post-war periods looked beyond the borders of their republic for guidance and resources that would contribute to the country's development (Knaus & Cox, 2004, p. 64). Overall, the establishment of a parallel international administrative structure deeply involved in Bosnia's economic reconstruction provided space for the local authorities to remain passive, to advocate populist policies and to act irresponsibly regarding their country's problems (Lewarne & Snelbecker, 2004, p. 69).

Second, developing the social sector, poverty reduction, developing an effective industrial policy and increasing the level of employment have not been among the main priorities of the international financial institutions in Bosnia. The donor community has instead been preoccupied with the implementation of a neoliberal agenda that has been progressively reinforced during the second period of Bosnian reconstruction to promote convergence with EU criteria, integration into the global world economic space and acquisition of membership in the World Trade Organization (WTO) (Pugh, 2005, p. 455). In this respect, external development aid has not attempted to create any linkage between economic and social reconstruction (Papić, 2001b, p. 200). Moreover, as Pugh pointed out (2005, p. 450), the policy adopted by the external agencies of reducing the public sector has been in partnership with, or connived at, by war entrepreneurs and local power brokers in a coincidence of interest.

Third, there has been lack of donor coordination. Different donors have kept their funds under their full control in order to maintain political leverage in the country for the advancement of their agendas. As a result, there has not been one single but several donor structures in Bosnia and this has affected the complementarity of activities and the efficient allocation of available resources. In addition, this situation has permitted the recipients to choose among the donors those that attached fewer conditions and whose assistance could generate greater personal and political gains (Smit, 2000, p. 20).

The establishment of the Stability Pact for South Eastern Europe was alleged to be a product of international experience in Bosnia (Smit, 2000, p. 18); *inter alia* it purported to improve the coordination of economic reconstruction in the entire region. Nevertheless, in Bosnia's case the Stability Pact has had marginal impact. As Žarko Papić (2001a, p. 27) has remarked, this happened because the programmes of economic reconstruction in Bosnia remained dogmatically 'locked' in the conditions they had been in when the Stability Pact did not exist, and they continued to have no link to Stability Pact activities. It was instead the establishment of the Stabilization and Association Process and the EU's decision to assume a primary role in the Bosnian reconstruction that provided for the improvement of donor coordination. The Dayton process has been subordinated to the requirements of European membership (Chandler, 2005, p. 341) and Bosnian reconstruction has accordingly been adjusted to this perspective. Yet one cannot speak of the emergence of a 'one donor' concept that contributed substantially to the success of the Marshall Plan for Western Europe after World War II and entailed the compliance of the recipients with the donor's conditions for eligibility (Smit, 2000, p. 20).

Fourth, a type of 'Dutch disease' emerged in the country. This phenomenon refers to the international community's domination of the country's labour market for the employment of the most skilled workers. The latter are awarded disproportionately high salaries in comparison with the salaries that exist in the remaining sectors of Bosnia's economy (Lewarne & Snelbecker, 2004, p. 29). Knaus and Cox (2004, p. 60) have attributed this practice to donor anxiety to buy loyalty and compliance from employees in both international agencies and newly founded state institutions such as the Brcko district. Hence, the donors' presence on the field unintentionally contributes to the distortion of the labour market and the reduction of the economy's competitiveness. For the private sector is deprived of the most capable workers, while wages throughout the economy increase at higher rates than labour productivity would justify (Lewarne & Snelbecker, 2004, p. 29). One would have expected that high wages would have at least contributed to the abatement of corruption. Nevertheless, the steady downgrading of Bosnia in the *Corruption Perceptions Index* of Transparency International from 70th place in 2003 to the 83rd in 2004 and 88th in 2005 demonstrate that corruption in the country is not only widespread but also flourishing (*Transparency International*, Annual Reports, various dates).

Altogether, the 'Dutch disease' and the passivity of the Bosnian politicians have evolved from temporary side-effects of the international community's pre-eminence in the post-conflict reconstruction into persistent barriers to the advancement of reforms.

Conclusions

This article has sought to demonstrate how little progress in economic reconstruction has been achieved, on the one hand, and that there is a close relationship between the security,

institutional, political and even international deficits and the hardship of the economic development in Bosnia, on the other.

Despite the elaboration of several international reconstruction programmes and the inflow of huge amounts of international assistance, the overall picture is not promising. Results of the study indicate that four basic strains have to be pursued: post-Dayton institutional deficiency, political fragmentation, inappropriate conditions for economic development and graduation from dependency on foreign economic aid. The analysis argues that a paradoxical outcome has been produced which impedes the future of economic reconstruction.

On the one hand, the international community has used economic reforms for political purposes in an effort to build up a reconciliation framework between the two entities of the country (Solioz & Petritsch, 2003, p. 362). This reveals why the Bosnia reconstruction dynamics represent a complex mixture of rehabilitation and efforts to transform the economy and society along with extensive institution building in compliance with the terms of the Dayton peace agreement. As a UNDP Human Development Report clearly emphasizes:

the decentralized administrative structure of BiH was not introduced primarily as a means for the efficient and user-oriented provision of services, as is the case in most other countries, but above all as a means to protect ethnic interests and to create a basis for post-war political stability. The key principles of good governance (effectiveness and efficiency, transparency and accountability, and participation) have thus remained neglected; only now do the high costs of neglecting these critical aspects emerge. (UNDP, 2003, p. 26)

But, on the other hand, the establishment of several centres of power at different levels has additionally caused difficulties for the creation of a unified economic space. In this respect the very structure of the government has not liberated the economy from politics. On the contrary, it has allowed for either recurrent conflict of interests among the entities (for instance, the emergence in the past of tax competition) or, in the best cases, the pursuance of essential reforms at variable speed and in certain respects with modified content (for instance, the privatization process). This explains why the Dayton-originated labyrinth-like administrative structure is responsible for the creation not of a single economic area but of at least two economic areas, further complicating the economic reconstruction of the country.

Moreover, Bosnia's economic recovery seems to have been hampered by its convoluted political system. The persisting attempt of the international community to utilize the waging of elections as a means of bringing to power local interlocutors who would implement its reform agenda has brought about the exact opposite. Frequent electoral processes have dissuaded Bosnian political leaders from endorsing economic measures with short-term negative consequences and have enabled the nationalists repeatedly to affirm their great influence in their ethnic communities and to obstruct the implementation of many necessary economic and social reforms. Therefore, while political fragmentation has impeded the process of economic reconstruction, persistent economic hardship has perpetuated inter-ethnic grievances and political divisions in the country.

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Notes

1. Hereafter Bosnia.
2. According to Sherrill Stroschein, Dayton itself should be perceived as a process, precisely, a set of institutions in a state of flux that are best viewed through a dynamic lens. (Stroschein, 2005, p. 59).
3. Republika Srpska has been less successful in fighting corruption than the Bosniac–Croat Federation. According to a World Bank report, no official has been dismissed, nor has the Bosnian Serb entity brought any major corruption case to court (Broadman *et al.*, 2004, p. 77).
4. Inter-entity trade, according to Stojanov, is very important for Bosnia for at least two reasons. First, for economic reasons, because its expansion can contribute to the growth of the economy and the more effective functioning of the market, and second, politically, because it can stimulate cooperation between citizens of both entities and act as an integrating factor of the Bosnian political area (Stojanov, 2001, p. 47).
5. The High Representative tried to redress the problem by establishing the so-called ‘Bulldozer Committee’ three years ago. This project encompassed the idea of improving the country’s business environment and boosting job creation through the enactment within 150 days of 50 concrete legislative changes. For the record of this committee, see *inter alia* Omanovic (2005, p. 6) and Herzberg (2004).
6. For the financial sector reform see also Tesche (2000).
7. Republika Srpska even distributed vouchers to children (Bojicic-Dželilovic *et al.*, 2004, p. 14).
8. The state-level Law on Foreign Investment—by which the entities were called to adjust their legislative procedures—was adopted in March 1998. This established the policy standards of promoting foreign investment and protecting foreign investors’ rights.
9. Suffice it to recall that local authorities have needed to get the approval of international financial institutions for such measures as increasing pensions or changing tax policy (Omanovic, 2005, p. 2).

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