

Bosnia-Herzegovina

Status Index (Democracy: 6.80 / Market economy: 6.43) 6.61		Management Index 4.71	
HDI	0.786	Population	3.7 mn
GDP per capita (\$, PPP)	5.967	Population growth¹	0.2 %
Unemployment rate	N/A	Women in Parliament	12.3 %
UN Education Index	0.86	Poverty²	N/A
		Gini Index	26.2 (2001)
Source: UNDP: Human Development Report 2005. Figures for 2003 unless otherwise indicated. ¹ Annual growth between 1975 and 2003.			

A. Executive summary

Bosnia-Herzegovina has made great advances in the transformation process since the end of the 1992-1995 war. Much of the infrastructure has been rebuilt, half of all refugees and displaced persons have returned to their pre-war homes. Political and ethnic violence is scarce and does not threaten to destabilize the country. Bosnia-Herzegovina has held regular democratic elections since 1996 and governments at the state level and the two entities, the Croat-Croat dominated Federation (FBiH) and the Serb Republic (RS) have changed. Originally weak and ineffective in the years immediately following the war, the state government has become functional, even though it remains weaker than that of other comparable countries.

Despite these successes, Bosnia's transformation is slow and continues to be riddled with difficulties. In 2004, GDP still amounted to only 60% of the pre-war level and unemployment stood at 40%. When the informal sector is factored in, the unemployment rate is lower, yet nonetheless high. Foreign direct investments have been increasing in recent years and reached \$660 million in 2004. However, confidence in the economy remains low, as evidenced by the fact that by mid-2003 only approximately 30% of the Federation of Bosnia and Herzegovina (FBiH) and 7% of the Republika Srpska (RS)'s large strategic companies have been sold. Similarly at the political level, most reform initiatives, such as the establishment of a joint command for the entity-based armed forces and a State Investigation and Protection Agency to investigate serious crimes were internationally driven, rather than priorities of local political elites. Consequently, the implementation of many reforms has been lagging due to the lack of domestic political support. The importance of external actors in the transformation process is closely linked to the dominance of the nationalist parties, which won the last elections in 2002 and dominate state and entity governments. Formally, these parties support reform. However, their narrow ethno-nationalist agenda conflicts

with a true drive to advance transformation. Moderate parties of the opposition have been weak and similarly divided between Serbs, Croats and Bosnians.

Overall, transformation in Bosnia is mixed. Although the country has stabilized substantially since 1995 and accelerated economic reforms in the past four years, it remains divided and dependent on external support for the transformation process.

B. History and characteristics of transformation

Bosnia began the process of transformation with its first free elections in 1990 as one of the republics of Yugoslavia. Although one of the poorest Yugoslav republics, Bosnia saw rapid economic development since 1945, including the creation of a strong industrial base. National identity became increasingly politicized only toward the late Yugoslav period and was a consequence of nationalist mobilization in neighboring Serbia under the rule of Slobodan Milosevic. Bosnia's population, 43.5% Muslim, 31.2% Serb and 17.4% Croat at the last census in 1991, largely supported political parties along ethnic lines in the first elections. The initial coalition of the nationalist parties broke up at the beginning of the Yugoslav wars in Croatia and diametrically opposed views on the future of Bosnia emerged. Muslims and Croats mostly supported independence, while most Serbs favored remaining in Yugoslavia. The war that followed the international recognition of Bosnia's independence in April 1992 lasted until late 1995. Devastating the country and leaving between 100,000 and 200,000 dead, the war resulted in deep ethnic divisions that continue to shape the country today. The Serb Democratic Party (SDS) sought to take control of a large part of Bosnia and join Serbia with the support of the Yugoslav National Army and the Serbian government. The campaign included mass murder and expulsion of the non-Serb population. Later, a war between the Croat Democratic Union (HDZ)-controlled statelet of Herceg-Bosnia and the government dominated by the Muslim Party of Democratic Action (SDA) was fought over the Croat attempt to secede from Bosnia. The Dayton Peace Accords, which ended the war, confirmed an independent Bosnian state, but granted far-reaching autonomy to the RS, one of the two entities covering 49% of the state territory. The FBiH is the other entity, covering the remainder of the territory with the exception of the small separate district of Brcko, which had remained contested between the two entities. The FBiH is in turn decentralized to ten regions, five of which are Bosnian and three Croat-dominated, while the remaining two have a largely mixed population. The central government has been weak and most powers have been exercised by the entities, including the armed forces. A feature of postwar Bosnia has been the strong international presence. Peacekeepers, first under NATO command (IFOR, later SFOR) and since 2004 under the European Union command (EUFOR) have been supervising the peace. The civilian presence has had a tremendous impact on the transformation of the country. In particular, the Office of the High Representative (OHR), the international civilian oversight office, has been able to

dismiss officials, pass laws and make decisions since being granted the so-called Bonn Powers in 1997 by the Peace Implementation Council, which brings together the key countries and organizations involved in the peace process.

Political life is fragmented into entities and ethnicity. The same nationalist parties that came to power in the first multiparty elections in 1990 and held power during the war continue to dominate the political system, even if their support has waned in the postwar decade.

C. Assessment

1. Democracy

1.1. Stateness

Serb and Croat nationalists, who sought to secede from the country, have contested Bosnia-Herzegovina as a state. In recent years, support for violent secession waned and there were no major organized groups who sought the break-up of the country by force. The state's monopoly on the use of force was strengthened with the establishment of a joint state level command over the armed forces of the two entities in 2004. Due to the presence of international peacekeepers (SFOR, and EUFOR since November 2004), the state does not maintain a full monopoly on the use of force. However, the number of international peacekeepers has been declining in recent years (7,000 in 2004) and they do not challenge the sovereignty of the state. The following events document the fact that the state's monopoly on the use of force is not yet fully consolidated: the fall of the government of the RS, and a temporary walkout of Serb politicians from the state government over plans of the OHR to establish a unified police structure in December 2004.

Violence against returning refugees has declined in recent years. Nevertheless, refugees returning to areas where their respective community does not dominate often face administrative hurdles and other forms of discrimination, in addition to sporadic attacks. Formal rights of non-dominant communities have been secured in a series of amendments to the entity constitutions in 2002 and subsequent legislation. However, these rights are rarely implemented. This is reflected in a relatively low number of returnees to the areas in which their ethnic group does not represent the majority of population (only 20% of the total number of returns). In addition, only 1 million of the more than 2.2 million internally displaced people (IDPs) and refugees have returned to their pre-war homes, with some 460,000 living in Bosnia-Herzegovina, Serbia and Montenegro, and Croatia as refugees or IDPs.

The Law for Protection of the Rights of National Minorities was adopted in 2003, however its implementation still has not commenced. According to the Helsinki Committee for Human Rights in Bosnia-Herzegovina, the economic and social rights of the members of minority groups are more frequently violated than those of constituent peoples. Procedural obstacles made it impossible for national minorities to elect their representatives for local assemblies in 2004 local elections, subsequently this group remains deprived of opportunities to influence political developments.

The state is defined as secular and religious dogmas have no noteworthy influence over law or policy making. Yet, the overlap of religious and ethnic identity has resulted in the use of religious symbols for nationalist purposes in Bosnia-Herzegovina.

The formal dominance of religious institutions has decreased in recent years, for example, the emphasis of the Serbian Orthodox Church in the RS, including in the constitution, has promoted the exclusion of Croats and Bosnians in the past. Constitutional amendments and changes to legislation eliminated this form of discrimination in 2002.

Informally, however, religious institutions continue to significantly influence Bosnian politics. Religious leaders' extensive involvement in politics was exposed during the pre-election campaign for general elections in 2002 and municipal elections in 2004. In both cases, the Helsinki Committee for Human Rights in Bosnia-Herzegovina reported on the significant influence of religious leaders on election outcomes, exercised by directing the electorate toward three national parties – the SDS, SDA and HDZ.

The interference of religion in politics produces a two-fold effect: (1) the ethnic religious elites have grown into influential interest groups in BiH's political discourse, often impacting policy outcomes, and (2) the fragmentation of the political agenda along ethnic nationalist lines, and subsequently the process of ethnic homogenization is being perpetuated.

The state infrastructure extends over the entire territory of the country and has been expanding in recent years. Still, these two entities and the district of Brcko remain highly autonomous, an overlap of competencies persists, and the state capacity to ensure the even application of legislation and other decisions are uneven.

1.2. Political participation

Free and fair elections have been held repeatedly in Bosnia-Herzegovina. In 2002, the Bosnian electoral commission, rather than the Organization for Security and

Cooperation in Europe (OSCE), organized general elections for the first time autonomously without major problems. Elections for municipal councils, mayors and the district of Brcko were held without significant incidents in October 2004. For the first time mayors were directly elected in the country, as was a unified city council in previously divided Mostar. Some incidents of fraud, nevertheless, have occurred. As the OSCE notes, the electoral system is very complex and often not understood by voters.

The government has the power to govern in principle, but its ability to govern is constrained by the continued intervention of the OHR, the fragmentation of public authority in the entities and regions, as well as the extensive veto rights at state and entity level. The OHR can veto legislation and decree laws, decisions and otherwise interfere in governance. The OHR has made less use of these powers in 2004 than in previous years, but did dismiss more than 60 officials, including ministers and the president of parliament of the RS in 2004 over the lack of cooperation with the International War Crimes Tribunal for former Yugoslavia. In March 2005, the OHR announced that it would revisit past dismissals and consider some mechanism allowing for appeal.

The most extensive formal veto rights are granted to all three nations at the state level and in the FBiH, and since 2002 in the RS. The extensive and essentially unlimited veto rights granted to all constituent people (Bosnians, Croats, Serbs) have often impeded the effectiveness of government.

The freedoms of association and assembly are constitutionally guaranteed and unrestricted and new entity and state laws, passed in 2001 and 2002, ensure the unrestricted operation of NGOs in both entities. However, problems remain in the entities' tax laws. Many have yet to be harmonized and offer associations limited exemptions.

However, procedural problems arise with the implementation of the legislation. The BiH Ministry of Justice, in charge of administering the Law on Associations and Foundations of BiH, introduced a complicated and lengthy procedure, causing difficulties with the registration process. As a result, many NGOs have yet not succeeded in registering at the state level, which preserves registration at entity and regional levels.

The freedoms of opinion and the press are not restricted. Print and electronic media remain territorially and ethnically divided. As the Council of Europe noted in a monitoring report in 2005, Bosnia-Herzegovina still lacks a public broadcasting law in line with European standards. While a reformed state broadcaster began operating in August 2004, necessary legal reforms were rejected by parliament in October 2004. Electronic media are regulated by the

independent Regulatory Agency for Communication. However, the Council of Europe and other independent observers have voiced their concern over the independence of the agency and possible attempts by the government to increase its influence over these institutions.

Pressures and attacks on the mass media by the representatives of the political and religious leaders point to informal government attempts to establish control over media reporting.

1.3. Rule of law

The separation of powers is formally unrestrained at the state level. The unclear separation of competencies between municipalities and regions, regions and the FBiH and entities and the state have rendered the decision-making structure less transparent and negatively affected the separation of powers. The ability of the OHR to act as unchecked executive, legislature and judiciary without legal recourse to its decisions, even if the decisions are taken in the best interest of the country, constitutes a serious impairment of the separation of powers. This has been criticized by a 2004 resolution of the Council of Europe Parliamentary Assembly.

Nationalist parties' informal influence over the different layers of government has often eroded the separation of powers. While the parties no longer have a monopolistic hold on power as in the early postwar years, the three nationalist parties continue to exercise disproportional informal influence over most layers of government.

The judiciary operates relatively independently. However, in the past, the judiciary has been controlled by political parties, tainted by ethnic bias, weak professional standards and corruption. Since 2000, major reforms have substantially improved the independence and quality of the judiciary. The Independent Judicial Commission completed its work in 2004, restructuring the court system and reducing the number of judges. The High Judicial and Prosecutorial Councils (HJPCs), established in 2002 at the entity and state levels and merged into a single body with competence for all levels of government in 2004, are responsible for the appointment and dismissal of judges and have strengthened the independence of the judiciary. Funding arrangements for the judiciary constitute one remaining structural obstacle to its full independence. The ministries of justice at different levels of government set courts' budgets. Given the general budgetary constraints in the BiH, such an arrangement is likely to perpetuate corruption and political influence by nationalist parties on courts' decisions. The delegation of the European Commission to BiH is currently in the process of proposing changes to funding arrangements of the judiciary, whereby

the HJPC would take over the budgeting function from the executive. Corrupt officeholders have been prosecuted, but trials have targeted only political opponents and been tainted frequently by political biases. Laws on conflict of interest (2002), elections (2001) and other key areas (for instance, procurement) provide adequate legal means to prosecute corruption. The legal framework was further improved through OHR's recent imposition of changes to the immunity laws which restrict the scope of immunity provisions, limit the number of officials covered by immunity, and ensure that these provisions apply only in respect to actions carried out strictly in the scope of official duties.

However, the courts have been often passive in pursuing such cases. The Office of the Prosecutor of Bosnia-Herzegovina has a special department staffed by national and international prosecutors who are investigating and prosecuting cases of organized crime, economic crime and corruption. So far, the international prosecutor has brought most charges against corrupt officeholders forward. A recent indictment against the BiH presidential member, Dragan Covic, and the President of the BiH Constitutional Court, Mato Tadic, is a case in point.

Similarly, a number of high profile cases of corruption and abuse of funds in state or entity run companies and state institutions have been revealed by international auditors in 2003 and 2004, resulting in a series of dismissals (by the Office of High Representative) and resignations of management of these companies, including the entity telecommunication companies.

Civil rights of returning refugees continue to be violated by local and entity authorities in the form of open or discreet discrimination. Nevertheless, great progress has been made since 1996, in particular with regard to the restitution of property. By August 2004, the property law allowing for the return of refugees and internally displaced persons to their pre-war homes was implemented for 93% of affected persons.

However, a further breakdown and analysis of these figures reveals somewhat gloomier situation. The number of returnees, who have returned to the areas where their ethnic group constitutes a numerical minority, is only 20% of the total number of returnees. The authorities in the areas where there are minority returnees often show favoritism toward the majority returnees when it comes to property rights and allocating financial resources.

Although Bosnia-Herzegovina has a comprehensive system for the protection of human rights, often the institutions have been overwhelmed with the number of pending cases, resulting in serious delays in the administration of justice. The BiH Constitutional Court alone has a backlog of 6,000 cases as of late 2004, inherited from the Human Rights Chamber, which closed at the end of 2003. A human rights commission, operating as a division within the constitutional court, is

tasked with resolving these cases and its mandate was recently extended. The system of government also discriminates against citizens who either do not belong to one of the three constituent people or refuse to identify with them, as political representation is often coupled to declarations of ethnicity.

1.4 Stability of democratic institutions

Democratic institutions fundamentally perform their functions, but there are severe frictions between institutions, in particular between the entities and the state level. Furthermore, at the state level itself, the strong ethnic interests, enshrined through veto rights, negatively affect institutional stability. The en masse resignation of Serb members of the state government in late 2004 paralyzed the state government and highlighted the potential for destabilization, especially considering the lack of consensus over the organization of the state among the representatives of the three largest communities.

As a largely imposed institutional arrangement, the postwar Bosnian state has suffered continuously from a lack of legitimacy. A significant part of the Serb population does not recognize the Bosnian state or rejects any strengthening of the state, preferring independence for the RS or joining Serbia. Parts of the Croat population in western Herzegovina likewise reject the state and support secession to join Croatia. Most Bosnians finally reject the RS as having been created through war crimes and support a considerably strengthened central state. The absence of a consensus on the strength of the state and the extent of decentralization have, at the time of this writing, prevented any genuine reform of the postwar constitutional framework.

Some smaller radical parties and movements among all three communities reject democratic pluralism and its institutions, but a more serious challenge arises from nationalist parties that support democratic institutions but reject (implicitly or explicitly) the equality of the communities in the territory that they dominate.

1.5. Political and social integration

Representation in parliament following the 2002 general election is relatively fragmented with eight parties, an effective number. This fragmentation is, however, not an indication of instability, as the large number of parties in parliament is the result of a complex electoral system favoring small parties and the fragmentation of the party system along ethnic lines. In fact, the Bosnian party system has been relatively stable due to the large degree of support the dominant nationalist parties enjoy among the three communities. In the elections for the state presidency in 2002, the three nationalist parties gained between 35.5% and

61.5% of the votes from their respective electorate. Little cross-ethnic voting takes place and most fluctuation takes place within the three dominant communities. The main lines of differentiation are ethnicity, expressing itself in different options for the organization of the state, and territorial basis (all Serb parties are based in the RS). The other axis of differentiation allows for distinction between moderate and nationalist parties. Moderate parties within each community belong to the liberal and social democratic party spectrum, whereas the nationalist parties are more conservative in orientation. Programmatic considerations, however, are often subordinated to personalities and national issues, also among moderate parties.

Generally, there is very little aggregation and articulation of societal interests through the political party system in Bosnia-Herzegovina. Instead, a top-down manipulation of societal interests by the political elite prevails. This is especially true for nationalist parties.

The network of interest groups is weak and largely divided along ethnic lines. The strongest interest groups are based on religious institutions and veterans' organizations and thus coincide with ethnic divisions. Neither business interests nor trade unions are effective, the former due to the weakness of the private sector and the latter due to ethnic divisions and the large informal sector.

Consent to democracy is high, and political protests do not call the constitutional framework into question. Trust in democratic institutions, however, is low. A 2002 survey indicates that in both entities, religious institutions and the army are more trusted than parliament or government, the latter being trusted by between 18% and 31% of the population, depending on the entity.

Self-organization in civil society encounters political, cultural, socioeconomic barriers and is thus unevenly distributed, spontaneous and temporary. According to 2003 statistics, there are 1,500 to 2,000 NGOs, but only 300 are deemed active. A 2002 survey indicated that most NGOs are active in the fields of education, children and youth, women, and health. According to a 2004 survey, between 61% and 70% of the population have positive impressions of different forms of civil society organizations. While 61% of respondents in this survey indicated their willingness to volunteer, most NGOs suffer from the lack of volunteers and domestic resources.

2. Market economy

2.1. Level of socioeconomic development

With a per capita gross national income of \$1540 in 2003 (World Bank), Bosnia-Herzegovina belongs to the lower-middle income countries of the world and is the

poorest successor state of the former Yugoslavia, largely a consequence of the 1992-1995 war. The United Nations Development Program (UNDP) Human Development Report (2003) estimates some 72% of all adults fall below the poverty line in terms of the minimum quality of one of the following fields: education (27%), health care (16%), work (22%) and housing (11%). In 2002, unemployment stood at 41.1%. Nevertheless, low wages, rather than unemployment, is one of the primary causes of poverty. Poverty varies regionally and coincides with ethnicity, with poverty being the most widespread in Serbian populated regions and least in Croat dominated regions. The most excluded community in Bosnia-Herzegovina is the Roma, whereas refugees and returnees also suffer from disproportionately fewer opportunities for socioeconomic development.

2.2. Organization of the market and competition

In 2004, market competition still operated under a weak institutional framework. The scope of the informal and the state sector has been substantial. The World Bank estimates the informal sector to account for 20% to 40% of the GDP (2002), resulting in significant distortions of the market. Obstacles for a common market between both entities, such as different tax regimes, have further distorted market competition. Most of these have, however, been removed in recent years. Most of the relevant laws on investment and the creation of market competition have been passed, but implementation is lacking. The excise and sales tax policy is now determined at the state level and is uniform for the entire country. A value added tax will be introduced on 1 January 2006, and will be administered by a statewide indirect tax authority, replacing sales taxes and creating a more transparent business environment.

The OHR Bulldozer Initiative, launched in 2002, has brought together businesspeople, public administrations and the OHR to identify administrative obstacles to business development. In 2004 in terms of the cost and the time required for starting new businesses, Bosnia-Herzegovina ranks considerably worse than the average of the 130 countries surveyed by the World Bank.

In 2003, the creation of monopolies was made a criminal offence. A state level competition council was established in 2004, more than two years after the passing of the relevant legislation, but has been slow in becoming active. The overall legislative framework is complex. Separate laws exist at the entity and state level; the latter passed last in 2001, but they are substantively compatible. The slow implementation of legislation and the persistence of de-facto hurdles between entities have reduced the effectiveness of the legislative framework in preventing the establishment of monopolies. As a result, state companies or monopolies dominate the strategic business sectors. These entity-owned companies are dominant in the telecommunications, energy and water sectors.

Foreign trade is liberalized in principle, although tariffs are still applied. Free trade agreements with Serbia and Montenegro, Croatia, Turkey, Macedonia, Albania, Bulgaria, Romania and Moldova are in force. The free trade agreement with Slovenia was abolished on May 1, 2004 due to its accession to the EU. In 2004, Bosnia-Herzegovina, however, temporarily postponed the reduction on tariffs on agricultural goods from Croatia and Serbia and Montenegro due to pressure from domestic producers. Tariffs range from 0% to 15%. However, Bosnia-Herzegovina is not able to take full advantage of the existing free trade agreements due to technical barriers to trade, which are hampering BiH exporters and limiting access of BiH companies to foreign markets.

The institutional foundations are laid through an independent central bank for a solid banking system oriented toward international standards, with functional banking supervision, minimum capital requirements, and market discipline. The banking sector has been privatized and banks with insufficient capital and links to organized crime, emerging during or after the war, have been closed. Bank supervision was strengthened in 2003; more stringent capital requirements for banks have been introduced. Under the IMF's Standby Arrangement (SBA), the governments have committed to further strengthen the banking supervision by introducing immunity for banking supervisors from individual prosecution for improper conduct of their work. More than half of all banks are foreign owned. According to the European Bank for Reconstruction and Development (EBRD), Bosnia-Herzegovina has the highest density of banks in southeastern Europe and is second to Croatia in terms of assets as shares of the GDP.

Payment transfers were transferred from the state Payment Bureau to commercial banks in 2001. Stock markets exist today in Banja Luka and Sarajevo and lending by banks to business and individuals increased in recent years, but interest rates remain high and banks have often shied away from lending to business due to high risks.

2.3. Currency and price stability

Run by an international official, the Central Bank enjoys constitutionally guaranteed independence from the government. The convertible mark (konvertibilna marka, KM) is linked in a currency board to the euro, thus eliminating the risk of high inflation. In 2003, the government signaled its commitment to continue the currency board well before the commitment to the currency board deriving from the peace agreement ran out. Inflation is very low, secured by the currency board and sustained by a balanced fiscal stance. In 2003 and 2004 inflation was below 1%.

There is a consistent policy for stability, induced by international organizations in Bosnia-Herzegovina and the country's commitments under the IMF SBA. The macroeconomic performance under the SBA, in respect to the fiscal balance, inflation and reserves, has been satisfactory. Overall, the consolidated fiscal balance has improved by over 7% of the GDP since 2001, and the consolidated budget deficit amounted to only 0.3% of the GDP in 2004. Bosnia-Herzegovina has been regularly servicing its external debt, which in 2003 amounted to \$2.88 billion.

However, given that the international community and the Central Bank induce most of the stability, it is uncertain whether the culture of stability would persist if left to discretionary policies administered by BiH policy makers. Furthermore, the current account deficit is worrying at 16% of the GDP in 2004.

2.4. Private property

Property rights and the regulation of the acquisition of property are well-defined in principle. A key component of the peace plan has been the return of private property to the pre-war owners, reversing illegal confiscations made during the war. As of this writing, this process has been largely completed. By September 2004, nearly 90% of cases involving socially owned houses and 95% regarding private property were resolved. The legal basis for private property was created through entity level laws in 1998 and OHR-imposed changes to other relevant laws and procedures. Today, there is no challenge to private property, despite the long record of illegal confiscation in both entities. Much of the implementation of the private property legislation was internationally supervised and at times even directly carried out.

At the time of this writing, the collateral legislation was just being approved.

Furthermore, the financial claims by BiH citizens on the Bosnian authorities amount to approximately KM 9 billion. Most relevant in this respect are the claims based on old foreign currency savings and claims based on war damages (equipment, materials, produce and goods and services handed over to the military for its operation). In December 2004 a strategy on settling the internal debt has been agreed by all levels of government, envisaging that the claims will be settled through the emission of long-term bonds and cash payments.

Private companies can act freely in principle, but encounter economic barriers to development. State companies or monopolies dominate strategic business sectors. These entity-owned companies are dominant in telecommunications and energy sectors. Privatization was delayed in the late 1990s by political elites for fear of losing control of key resources. Large-scale privatization is going ahead painfully

slowly and only under strong pressure from international community. The negotiations on the corporate governance loan with the World Bank, conditioned by corporate restructuring, have dragged on for quite some time now. The bankruptcy system is in its infancy.

Much of the privatization in Bosnia-Herzegovina was voucher based. This mass privatization has been problematic for both its lack of capital infusion and abuse arising from individuals buying up undervalued shares. The degree of privatization varies according to the size of the companies. According to IMF data, by the middle of 2003, some 77% of the state capital in the FBiH and 47% in the RS have been privatized. However, these mostly include smaller companies. Few of the larger companies with 50 or more employees or more than KM 500,000 capital have been privatized, although by the middle of 2003 in both entities more than 50% of these had also been privatized. Strategic companies, some 100 companies in both entities, have been much slower to privatize. These are due to be privatized through tenders, but often tenders had to be re-run or postponed due to the lack of interest from investors, especially from outside Bosnia. By the middle of 2003, only 30% in the FBiH and around 7% of these companies in the RS had been privatized. The privatization of banks is regulated separately from other companies. Here all banks have been put in the process of privatization, merged, closed or put in receivership.

2.5. Welfare regime

Social networks do not cover all risks for all strata of the population. One-fifth of the population is considered poor. Poverty is particularly widespread among households characterized by low paying jobs, unemployment, lack of education and forced migration during the Yugoslav wars. Roma are particularly disadvantaged.

Social assistance, pension, unemployment and health insurance schemes compensate for gross social differences, but these schemes are limited in scope and quality. Bosnia, for example, spends proportionally less on social welfare than any other country in southeastern Europe. Due to high unemployment and the large informal sector, pensioners outnumber insured persons in the RS, and in the FBiH the number of insured contributors is only slightly larger than the number of pensioners. As a result, pensions are low and many pensioners can be considered poor. A particular challenge in Bosnia-Herzegovina is the payment of veterans and persons with disabilities resulting from the war. Some 180,000 disabled veterans and their families are receiving some form of benefit in both entities.

While efforts have been undertaken to promote the participation of women in public life, women continue to be underrepresented, particularly in rural regions of Bosnia.

2.6. Economic performance

After the war, the BiH's GDP had dropped to 20% of its pre-war level. The recovery despite massive foreign assistance has been slow. By 2004, it was still only at 60% of the pre-war level. Unemployment has been high, around 40% in both entities, even increasingly slightly in recent years. Foreign aid has dropped since 1998. Recently however, it has been compensated by increased investments. After little foreign direct investment due to the postwar uncertainty, foreign direct investment has increased substantially in recent years. It nearly tripled from \$260 million in 2001 to \$660 million in 2003, amounting to 5.4% of the GDP.

2.7. Sustainability

Ecologically compatible growth receives only sporadic consideration, and no major legislation has been passed since the end of the war to protect the environment. Environmental protection is exclusively an entity competence, but since 1998, the Environmental Steering Committee for Bosnia-Herzegovina has been co-coordinating the entity policies.

Due to the challenge of postwar reconstruction and in the absence of major investments, the environment remains subordinated to any growth efforts. In 2004, plans to build a series of hydroelectric dams in the RS were revived, although environmentalist groups noted the threat to the Tara national park in the border region of Montenegro and Bosnia-Herzegovina.

There is a dense network of institutions for education, training, and research and development in Bosnia-Herzegovina, but lack of reform, funding and the consequence of war, and ethnic divisions have seriously affected the quality of the educational system. Until recent OSCE-initiated reforms, schools and curricula remained separated at the entity and regional level; and they have often perpetuated antagonism and are low quality. Since 2000, reforms have sought to eliminate stereotyping from textbooks and curricula and united ethnically divided schools. The university sector remains ethnically divided and strongly politicized in some parts of Bosnia-Herzegovina. In addition, the university system has suffered from war and postwar brain drain and the absence of substantial and consistent reforms in line with the Bologna Process.

3. Management

3.1. Level of difficulty

The structural constraints on governance are considerable. While much of the infrastructure damaged in the war has been rebuilt, not much new infrastructure could be added due to the reconstruction process. Bosnia-Herzegovina has neither a significant highway network nor a railway system recovered from the war. The mountainous topography coupled with a legacy of underdevelopment does not facilitate governance. The human consequences of the war provide for the most significant constraints, both in terms of the man-made inter-ethnic and inter-entity boundaries, as well as with regard to the following factors: a large refugee population within Bosnia-Herzegovina and in neighboring countries, the brain drain resulting from the war, and a lack of economic and social prospects in postwar Bosnia-Herzegovina. The population in 2004 was estimated to number around 3.8 million, or some 13% less than the 4.37 million registered in the 1991 census.

Traditions of civil society can be considered moderate, as most civic organizations during the communist period, even if nominally independent, were not self-organized. An emerging civil society in the 1980s was largely destroyed in the war and through nationalist political parties' semi-authoritarian control of the state and government. Postwar funding favored civil society mostly based on service delivery rather than through the formulation of the population's genuine needs.

Bosnian society and its political elite are deeply divided along ethnic lines. These lines were territorialized during the war, resulting in a strong geographic concentration of ethnic groups. Due to the predominance of ethnic issues in politics, multiethnic parties have not been able to build a significant electorate across the ethnic divide. Ethnically motivated incidents are rare, usually connected to refugees returning to areas where they now constitute a functional minority. The last major interethnic incident involved riots in Banja Luka over the beginning of the reconstruction of the city's main mosque in 2001.

According to the regular UNDP early warning surveys, around a quarter of the population fears that in the case of a withdrawal of international peacekeepers the war would resume. There is, however, little chance for large-scale violence due to the substantial reduction of arms, as well as changed regional context, where support from Serbia or Croatia for any armed secessionist project is not expected.

Profile of the Political System

Regime type:	<i>Democracy</i>	Constraints to executive authority:	3
System of government:	<i>Parliamentary</i>	Electoral system disproportionality:	4.1
		Latest parliamentary election:	05.10.2002
		Effective number of parties:	7.9
1. Presidency:	<i>Dragan Covic; Sulejman Tihic; Borislav Paravac</i>		
Prime minister:	<i>Adnan Terzic</i>	Parties in government:	5
Type of government:	<i>oversized coalition</i>		
		Number of ministries:	9
		Number of ministers:	9
<p>Source: BTI team, based upon information by country analysts, situation in July 2005. Constraints to executive authority (1-6 max.) measures the institutional constraints posed by a federal or decentralized state, a second parliamentary chamber, referenda, constitutional and judicial review and the rigidity of the constitution. Electoral disproportionality (Gallagher index) reflects the extent to which electoral rules are majoritarian (high values) or proportional: $\sqrt{1/2 \sum (v_i - p_i)^2}$; v_i is the share of votes gained by party i; p_i is the share of parliamentary mandates controlled by party i. Effective number of parties denotes the number of parties represented in the legislature, taking into consideration their relative weight (Laakso/Taagepera index) = $1 / (\sum p_i^2)$; p_i is the share of parliamentary mandates controlled by party i. Number of ministries/ ministers denotes the situation on 1 January 2005.</p>			

3.2. Steering capability

Due to the considerable powers of the entities, Bosnia-Herzegovina has in fact three governments, one for each entity and the state government. The parties in power at the state level are in power at the entity level, resulting in considerable overlap in terms of political orientation. While all three governments formally seek to integrate Bosnia-Herzegovina into the EU and reform the system of government and economy, the parties making up the government remain deeply entrenched in ethnically based politics and frequently postpone reforms for short-term political benefits. International pressure and heavy-handed intervention has been largely responsible for most reform initiatives and legislation. As nationalist parties in government hold deep differences over the desirable nature of the state, the degree of central and entity competencies and the war, consensus building in government has often been impossible, resulting in significant delays. Due to the ethnic electorates of the parties, they do not compete with each other but with the opposition parties, and all three nationalist parties possess strong authoritarian and paternalistic instincts toward their respective constituency.

The state and entity governments formally seek to achieve reforms, but often rely on international intervention for their imposition and frequently fail to implement them. The narrow ethnic agenda of the governing parties furthermore distorts the focus on reforms. In particular, in the RS, the parties' goal to maintain a maximum degree of autonomy of the entity stands in conflict with the self-professed goal of reform. Reform of the police, based on proposals to establish a state-wide police with a regional centers cutting across entities, has been met with

particular resistance, promoting the temporary resignation of Serb members of the state government and the RS government in December 2004.

Nationalist parties' adoption of reform rhetoric is widely perceived as insincere and domestically driven reform efforts remain much in doubt.

While they have a strong majority in government, the contradictory interests of the nationalist parties did not translate this majority into effective decision-making. Many political observers agree on the need for constitutional reform to streamline the complex institutional structure of the country, but a consensus among the three national parties is unlikely and debate on constitutional reform has stalled. Reforms at the state level, such as the introduction of a state command over the armed forces of the entities and the establishment of the State Investigation and Protection Agency (SIPA), and of the judiciary have been all instigated by international actors, most prominently the OHR. At the same time, the governments have also been more willing to cooperate with international reform initiatives, mostly to alleviate external pressure, but they have delayed implementation.

The political leadership responds to mistakes and failed policies with changes, but its policy frequently remains stuck in the same routines. The continued intervention of international organizations furthermore reduces the learning process among domestic political elites, as the OHR often overrides flawed decisions and laws. However, there has been the suggestion to reduce the competencies of the OHR in 2005.

3.3. Resource efficiency

Bosnia-Herzegovina is plagued by structural inefficiencies at all levels. The system of regions and entities is extremely complex, costly and has had a detrimental impact on decision-making. Thus, the city of Mostar alone (formally united by OHR decision in early 2004 following the recommendations of an independent commission) had 550 employees at the municipal level previous to unification (six in Mostar) and 124 at the city level, resulting in a 1:189 ratio of population to civil servants and accumulating a cost of KM 288 (approximately €147) per capita for 2003. While Mostar might be an extreme case, the duplication of different layers of government has made the state extremely costly. As the World Bank and the EU note, public spending amounts to 56% of the GDP, considerably higher than other transition countries. In recent years, the government deficit has been drastically reduced. In 2003, the consolidated government deficit stood at 3.4% of the GDP, down from 9.4% (before grants) in 2002.

Reforms in recent years have seen the passing of Civil Service laws and the creation of state and entity civil service agencies, which are charged with the professionalization of public administration. The agencies review past appointments and carry out recruitment for new positions. Beyond streamlining existing structures, there has been little willingness on the part of government to contemplate simplifying the institutional structure of the state.

The introduction of the single account on January 1, 2005 created a new funding arrangement for state institutions and eliminated the state's dependence on entity transfers for its operations. Audit offices at state and at entity levels were established in 1999 and 2000 and since then have become increasingly important in uncovering abuse of state funds by government officials. In addition, special auditors appointed by the OHR have investigated allegations of abuse of resources and corruption, particularly in state run enterprises, such as telecommunications companies.

Governments in Bosnia-Herzegovina require the inclusion of Croats, Bosnians and Serbs. Representatives from each community have the legally enshrined veto right to block decisions in parliament and in government (other than decisions which are forwarded to parliament for voting), requiring consensus on all government decisions. The government has been dominated by the three strong nationalist parties, in addition to smaller, more moderate partners, such as the Bosnian Party for Bosnia-Herzegovina (SBiH) and the Serb Party for Democratic Progress (PDP). Instability did not result from the number of coalition partners, but from different state organization and reform priorities. Because the parties appeal to different ethnic constituencies, there is little competition between them. A slim majority and small parties, often competing over the same electorate, however, marred the 2001-2002 coalition of the moderate Alliance for Change.

Members of the current government have often made contradictory political statements thus reducing the appearance of a unified government. In fact, the nature of governance in the country has made most governments in postwar Bosnia-Herzegovina miniature parliaments, rather than coalitions based on shared political priorities and interests.

The legislative framework to curb corruption has been put in place in recent years, including the election law, laws on public procurement and conflict of interest, and freedom of information. The government passed an action plan to combat corruption in 2002, largely the result of external pressure. Transparency International has noted, however, that by 2004 the government had implemented

only 40% of its anti-corruption plan and that the government had missed many of its own deadlines. Nevertheless, the overall legal framework is now in place and its implementation has improved in recent years.

3.4. Consensus-building

There is a formal commitment among the political leadership of Bosnia-Herzegovina to democracy and a market economy, but concepts of state vary greatly and there is doubt about the degree of this commitment. All nationalist parties have been used to quasi-authoritarian control over areas under their dominance (to varying degrees), but have accepted democracy as a political goal. Authoritarian patterns of behavior, however, remain and political opponents are often characterized as traitors and detrimental to national interests. The close linkages between political leadership and economic interest groups, often going back to the war, have further challenged the full-fledged commitment to a market economy. Moderate political parties, currently largely in opposition, lack clear programs in terms of building a market economy and are often caught in the logic of ethnicity-based politics. The SDS, HDZ and SDA give strong emphases to group identity in their political platforms and subordinate democracy to national interests.

Considering that the system of government in Bosnia-Herzegovina at the state and entity level is built on the principle of all communities being able to veto any decision, vetoing reform is deeply ingrained in the country's postwar politics. The key veto players are the RS parties, which have been suspicious of most reform efforts for undermining their entity's autonomy. International pressure, in particular by the OHR, has reduced their ability to veto the reform process. One could see the December 2004 failed attempt to block the state level government through the resignation of all Serb members of government (following the OHR dismissal of police officers) as evidence for the ineffectiveness of veto players. At the same time, the veto players, which also include extremist wings of HDZ and SDA, have stopped formally vetoing reforms. Instead, they have delayed or stopped implementation, a strategy that has been considerably more successful. Thus, many reform initiatives, including the reunification of Mostar in 2004, have not translated into reality.

The political leadership largely derives its legitimacy from existing divisions in Bosnia-Herzegovina and the absence of a cross-community consensus on reform. For example, the RS government forced its SDA members to resign after the OHR dismissed 60 officials of the RS for not cooperating with the International War Crimes Tribunal for the former Yugoslavia (ICTY) in July 2004. At the same time, the party maintained its coalition with the SDA at the state level. Largely, party compromises are not dictated by an interest to reduce divisions, rather their aims are to avoid penalties from international organizations.

These tense relations are not limited to competing parties representing different communities. Within each community, interaction between the governing and the main opposition parties are often tense and confrontational. Thus, cooperation among the Social Democratic Party in the FBiH, the nationalist parties or the

Alliance of Independent Social Democrats in the RS with the SDS is unimaginable. These divisions are partly programmatic and partly based on the conflict-ridden political climate during the past decade that reinforced these divisions.

The Bosnian political leadership does nothing to promote social capital and is indifferent with respect to the role of civic engagement and solidarity. While the nationalist parties do support narrow, ethnic civic engagement (in churches and so on), cross-ethnic engagement is not encouraged and the political leadership has often been suspicious toward civil society organizations. The political leadership is not engaged in broad societal dialogue and there is little tradition of public discussion of reform initiatives.

Solidarity is mostly based on regional, local and kinship ties, while ethnic ties matter more at the level of political leadership than at the societal level.

The political leadership frequently ignores civil society actors and formulates its policy autonomously. Much of civil society has been critical toward the nationalist parties, thus not making them natural partners in the policy process. In contrast, international policy and lawmakers such as the OHR have in the past often included NGOs in the deliberation process and acted in consultation with civil society.

There have been improvements in the relationship between government and civil society, however, in recent years. The Poverty Reduction Strategy Program of the government involved NGOs in the drafting process, if not into the formulation of the strategy, which demonstrates the willingness of the governments for issue-oriented cooperation with civil society.

The legacy of the war continues to impact political processes in Bosnia-Herzegovina today. Reconciliation has not made significant advances in recent years. A draft law on establishing a Truth and Reconciliation Commission has been in parliamentary procedure since 2001 with little signs of being passed.

Following strong pressure by the OHR, the RS established a commission, which acknowledged the mass murder of RS forces in Srebrenica. Both the president and the government endorsed these findings, but these steps have largely been seen as being the consequence of external pressure, as the RS has not arrested one indicted war criminal and cooperation with the ICTY has been minimal.

The lack of consensus within Bosnia-Herzegovina expresses itself in the different positions of the members of the presidential administration since 1996 over the Bosnian case against Serbia and Montenegro for genocide during the war at the International Court of Justice. The Serb member supports dropping the case, while

the Bosnian members want it to be pursued.

3.5. International cooperation

As Bosnia-Herzegovina has been a de facto protectorate over the past decade, cooperation with international donors has been intensive and has taken many forms. Aid and technical assistance have covered every aspect, ranging from reconstruction and refugee return to public administration and reform of the security sector.

According to IMF data, foreign assistance has been declining steadily from 19.6% in 1998 to 6.9% in 2002 as a share of the GDP. The total amount halved from \$884 million in 1998 to \$388 million in 2002. Altogether, Bosnia-Herzegovina received around \$5 billion between 1996 and 2002 in aid, most of which went to the FBiH (81.9%). This imbalance has been the consequence of the RS being excluded from receiving aid in the first postwar years due to its lack of cooperation with international organizations in issues such as war crimes.

The BiH government has been largely a reliable partner to international organizations, donors, individual countries and NGOs due to the strong international presence and pressure on the country. The strong reliance of the country on external assistance in financial and other respects had a stabilizing effect on its foreign relations. The independence of the central bank proved key for a strong and stable currency policy. Agreements with the London (1997) and Paris Clubs (1998) were less an indicator for the stability and confidence in the country, but rather a necessity for postwar reconstruction and stabilization. Risk derives less from government policy, but rather from political instability. The fragile nature of the state and its strong reliance on external assistance has been the key reason for limited foreign direct investments, further discouraged by different tax systems in the entities.

Cooperation with the ICTY has been a key obstacle in relations between Bosnia-Herzegovina (in particular the RS) and international organizations and bi-lateral partners. Membership in Partnership for Peace was delayed in 2004 as a result and sanctions by the OHR and the United States against the RS were imposed in 2004. The structure of the state has furthermore made international cooperation difficult and less reliable. The process of concluding a Stabilization and Association Agreement with the European Union has been delayed not least due to the complicated structure of the state.

The political leadership of Bosnia-Herzegovina cooperates with neighboring Croatia and Serbia and Montenegro, as well as in regional forums of cooperation, such as the Stability Pact and the South East European Cooperation Process (SEECP), which it chaired from 2003 to 2004. Free trade agreements have been

signed with neighboring states and other southeast European countries. The country joined the Council of Europe in 2002 and has applied to join the NATO's Partnership for Peace (PfP). Membership in PfP, however, was rejected twice in 2004 over RS's lack of cooperation with the ICTY. Tensions remain with both neighboring states over a number of issues. Disputes with Croatia include the Bosnian access to the Croatian port of Ploce and past support of the HDZ and the Croatian authorities to Croatian secessionism. Relations with Serbia remain shaped by the legacy of the war and the Serbia's lack of cooperation with the ICTY. In addition, Bosnia-Herzegovina has a lawsuit against Serbia and Montenegro for genocide pending at the international court of justice. Relations have also been burdened by repeated statements from Serbian politicians, including the current Prime Minister Kostunica and late Prime Minister Djindjic, supporting either the unification of the RS with Serbia or an exchange of the RS for the independence of Kosovo.

4. Trend of development

4.1. Democratic development

Over the past four years, stateness, political participation and the rule of law have improved in some segments. State institutions have become more effective and gained key competencies. Reform of the public administration, including armed forces and police, has made significant progress. The state structure, however, remains complex and often dysfunctional, reducing its capacity for democratic and transparent governance. Due to the changed regional context, support for secession in Bosnia-Herzegovina declined and the formally exclusive control of nationalist parties began eroding, although as of this writing it remains strong. Furthermore, some internationally managed institutions and competencies, such as the organizations of elections, have reverted to Bosnian control.

The divergent views on the nature of the state held by the political leadership and the fact that the most sought after indicted war criminals, Radovan Karadzic and Ratko Mladic, remain at large has constrained the pace of reforms.

The level of consolidation of democracy has not changed substantially. Non-nationalist parties remain weak and divided whereas the nationalist parties mostly pay lip service to reform but delay implementation. The divisions along ethnic lines remain pertinent. Although the administrative capacity of institutions has improved in recent years, the functionality of key institutions continues to rest on

international intervention. Unlike four years ago, most intervention has shifted from outright imposition to strong international coaching of the law making process.

4.2. Market economy development

The country's level of development has improved slightly from 2000 to 2005, mostly resulting from the continued postwar reconstruction, rather than from a notable increase in economic activity. Unemployment remains high and has not seen any remarkable decrease over the past years. While net wages increased from KM 374 in 2000 to KM 495 in 2004, so did the cost of living rise.

The institutional framework of a market economy has improved in numerous areas. The privatization process continued throughout the period, payment bureaus were closed and the tax laws reformed.

Overall, economic development has improved both quantitatively and qualitatively, reflected by subsequent, strong growth of the GDP, a continuous and substantial decline of inflation, increasing inflows of foreign direct investment and a significant reduction of the country's foreign debt.

Table: Development of macroeconomic fundamentals (2000-2004)

		2000	2001	2002	2003	2004 proj.
Growth of GDP in %		5.5	4.5	5.5	3.5	
Export growth in %		7	5	20	35	
Import growth in %		-1	6	16	23	
Inflation in % (CPI)		5	3.2	0.3	0.1	0.9
Investment in % of GDP		25	21	21		
Tax Revenue in % of GDP				23.36	23.55	
Unemployment in %	FBiH	38.8	39.8	41.7		
	RS	39.2	41	39.6		
Budget deficit in % of GDP		-10.0	-5.8	-2.5	0.3	
Current account balance in billion \$		-0.621	-0.811	-1.036	-1.244	-1.319

Source: IMF, World Bank, Central Bank of BiH, Agency for Statistics of BiH. Inflation: consumer price index, average of period

D. Strategic perspective

The key strategic challenge for Bosnia is the ability to reform its system of government to function effectively both independent of direct international intervention and in perspective of EU membership. 2005 will see a further reduction of international organizations managing the Bosnian transformation process, including the transformation of the OHR into the office of the European Union Special Representative in BiH, although the transfer of competences to the EUSR, an office the HR has been holding formally since 2002, is not going to be

completed in 2005 and the ability of the High Representative to dismiss officials and impose laws will continue into 2006. The reforms of recent years have been carried out within the framework of the Dayton Peace Agreement and remained constrained by the constitutional set-up of the state. Constitutional reform and other initiatives to simplify decision-making structures have come to naught because of mutually exclusive views by the key political actors. In the mid-term, a moderate reform will be necessary to reduce the complexity of the state in its decision-making structures.

The process of the erosion of the entities is likely to continue in the coming years. The entities have not only lost powers to the state level, such as in the field of defense and likely also with regard to police in 2005, the legislation between the entities has become increasingly harmonized so that the degree of institutional and legal difference has become less remarkable. The residual symbolic dominance by different communities in different entities, however, remains a potent expression of inequality in Bosnia.

The number of refugee returns has been reduced to a trickle due to the completion of the property return process. Thus, in 2004, only approximately 20,000 refugees and internally displaced persons (IDPs) returned to their homes, nearly a third of the 2003 54,000 returnees and less than 20% of the 107,909 returnees in 2002. Still, around half of the refugees and IDP have not returned, raising the issue of where the return process has basically come to an end and around half of all refugees will not return to their homes. The formal completion of the return process would pave the way for a new population census and would confirm the new demographic realities in both entities. This would reflect itself in the public administration recruitment procedures and representation in parliament for the three constituent nations and minorities, both of which are in part determined by the last census, today based on the 1991 census.

Key to the successful continuation of Bosnia's transformation will be the emergence of a political leadership that will autonomously advance the agenda of reform and thus secure the implementation of decisions presently often neglected due to the unwilling compliance of much of the current leadership. Second, only a significant economic up-turn will stabilize Bosnia. With unemployment stagnating at high levels and a large informal sector of the economy, political stability remains at risk. Improving the business environment has been the focus of international organizations, including the creation of a function internal market and a harmonized economic framework for investments. Third, the issue of interethnic communication needs to be tackled. Initiatives such as the reform and integration of the educational system have reduced stereotypes, but there is still a long way to go to normalize interethnic relations in the country.