
The Commanding Heights of Bosnia

Privatization methods as product of political institutions

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Alen Musaefendic 19905

Tutor: Torbjörn Becker
Examiner: Örjan Sjöberg
Discussants: Jessica Rosencrantz, Hanna Gordon

Privatization of large State-Owned Enterprises (SOEs) is widely accepted as instrumental in Bosnia's effort to escape the persistent economic decline. Notwithstanding the colossal human and monetary resources invested into the process by the International Community the slow progress has turned into a virtual stalemate. The research question is aimed at analyzing this outcome, and it reads: *"How has the political institutional structure affected the privatization process in Bosnia-Herzegovina 1995-2010?"* The importance of the written constitution – and the political institutions heralding from it – is hence assumed from the outset. The problem is addressed through the lens of institutional economics, complemented with insights from public choice theory. The analysis shows that the chosen privatization methods had not primarily been grounded in economic principles, but have to a large extent been designed to conform to geopolitical circumstances shaped by the constitution. The flawed design of the privatization programs can also be traced to the International Financial Institution's standardized approach to privatization, which offers little room for tailoring the privatization process to a country's unique circumstances.

List of Abbreviations

BiH Bosnia and Herzegovina

CEECA Central Eastern Europe and Central Asia

EBRD European Bank for Reconstruction and Development

EC European Commission

EU European Union

FBiH Federation of Bosnia and Herzegovina

FIPA Foreign Investment Promotion Agency

IC International Community

ICG International Crisis Group

IFI International Financial Institution

IMF International Monetary Fund

KM Konvertibilna Marka – Bosnian currency

NGO Non-Government Organization

OHR Office of the High Representative

POS Public Offering of Shares

PRSP Poverty Reduction Strategy Program

RS Republika Srpska

SIDA Swedish International Development Agency

SOE State-Owned Enterprise

SMEs Small- and medium size enterprises

UNDP United Nations Development Program

USAID United States Agency for International Development

Table of Contents

1 INTRODUCTION	3
1.1 PURPOSE.....	4
1.2 METHODOLOGY	5
2 THEORETICAL BACKGROUND	5
2.1 PRIVATIZATION THEORY	6
2.1.1 <i>Theoretical benefits of privatization</i>	6
2.1.2 <i>Methods of privatization</i>	7
2.2 TWO PRIVATIZATION “PHILOSOPHIES”	13
2.3 CRITIQUE OF (MASS) PRIVATIZATION	14
2.4 PUBLIC CHOICE THEORY	15
3 THE CONSTITUTION.....	17
3.1 DIVIDED ECONOMIC SPACE	17
3.2 PROPERTY RIGHTS AND CORRUPTION.....	19
3.3 ETHNIC DIVISION	20
3.4 THE INTERNATIONAL COMMUNITY	21
3.5 LEGAL FRAMEWORK	23
4. THE PRIVATIZATION PROCESS 1995 – 2010	26
5 PRIVATIZATION METHODS IN THE BOSNIAN POLITICAL CONTEXT	33
5.1 DIVIDED ECONOMIC SPACE	33
5.2 MASS PRIVATIZATION AND THE INTERNATIONAL COMMUNITY	37
5.3 PROPERTY RIGHTS	40
5.4 TENDER PRIVATIZATION, RESTRUCTURING AND DEBT	41
6 CONCLUSIONS AND DISCUSSION	44
7 REFERENCE LIST	46
APPENDIX I – THE CONSTITUTION OF BIH.....	52
APPENDIX II – BIH’S LEGISLATIVE AND EXECUTIVE BODIES	57

1 Introduction

The General Framework Agreement for Peace in Bosnia and Herzegovina, signed in Dayton, Ohio in 1995 had marked the end of the civil war 1992-1995. The constitution of the newly founded republic can be found in Annex IV of the agreement.

BiH is still subject to a process of triple transition: 1. from war to peace; 2. from totalitarianism to democracy; 3. from a centrally planned economy to a market-based economy (Donais 2005:4). Central to this process of transition is privatization of state-owned capital.

The economic structure of former Yugoslavia had been heavily dominated by vast industrial conglomerates. In the aftermath of the federation's dissolution it was therefore evident that any move toward economic revitalisation had to involve a comprehensive privatization program. Due to external pressure from international bodies such as the IMF and World Bank – largely supported by domestic public opinion – Bosnia and Herzegovina's plans for immediate and far-reaching privatization were among the most ambitious. The results, however, have been poor. Apart from largely successful privatization of the financial sector, "big privatization" has after a long period of trivial progress transformed into a virtual standstill. Considering the colossal amount of human and monetary resources devoted to the effort by the International Community and local authorities alike, the lack of progress concerning privatization of major SOEs must be considered a failure. This thesis is an attempt to isolate and explain the main causes behind this unwanted development.

Vladimir Lenin was convinced the heavy industry in former Soviet Union, which he referred to as "the Commanding Heights", should always remain publicly owned. Despite the perpetual debate over the merits of privatization, most experts agree that the commanding heights of Bosnia and Herzegovina would best be utilized in private hands. A successfully conducted privatization would be a decisive step toward the establishment of a well-functioning private sector. With profit maximization as the primary goal and hard budget constraints the vast manufacturing industry would have to adapt and modernize in order to survive. The benefits of privatization in a war-torn society go far beyond the financial ones; with higher living standards there will be more to lose by entering into another devastating conflict.

1.1 Purpose

Privatization of major State Owned Enterprises (SOEs) and constitutional reform are two issues of immense importance for the future economic prosperity of BiH. It is not least a necessary step toward economic self-reliance and political autonomy – a prerequisite for a future EU-membership.

The main aim of this thesis has not been to promote or dispute the merits of privatization as such, but rather to map and analyze a very unique case. The importance of the political institutional structure of BiH has already been assumed and established in the research question. Numerous reports and research papers have been written on the two main components of this thesis, namely political institutions and privatization. But they have been conducted separately, and have – to my knowledge – never been contrasted against each other and analyzed as two pieces of the same puzzle.

The institutions deemed as particularly significant for the privatization process are the constitution and the political institutional structure stemming from it. The Dayton Peace Agreement of 1995 has an all-encompassing influence in the way the country is structured and run, both politically and economically. It is a document on which all vital political institutions base their existence.

The research question reads: “How has the political institutional structure affected the privatization process in Bosnia-Herzegovina 1995-2010?”

“The privatization process” refers more specifically to privatization methods. Focus will almost entirely be turned to the privatization of large SOEs.

1.2 Methodology

The problem will be addressed through the lens of institutional economics, as well as public choice theory.

Due to the country's unique circumstances and the international attention resulting there from a large amount of scientific papers, books and newspaper articles have been dedicated to evaluating and explaining the economic development of the post war period. The predominant bulk of the available material is comprised of quantitative evaluations of different sectors of the economy. The sources range from international bodies such as the World Bank, International Monetary Fond, EBRD, the European Commission and the United Nations, domestic and foreign scholars and Non-Governmental Organizations.

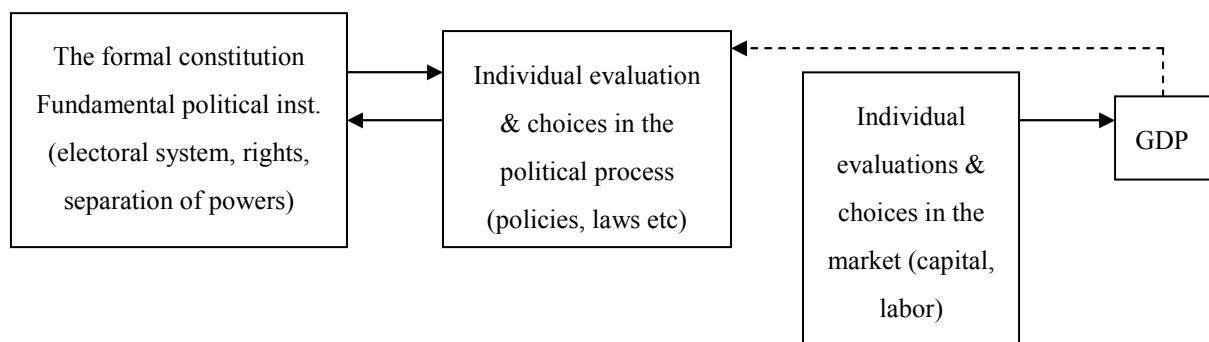
The research question entails a multidisciplinary and flexible approach, which will consist of identifying the most relevant data from the abovementioned sources, quantitative as well as qualitative, and constrasing them in order to gain new insights.

2 Theoretical Background

The basis for the notion that political institutions affect economic outcomes is an incentive-based understanding of human action. With this notion in mind it is logical to conclude that institutions constitute constraints and rights that steer choices in a systematic fashion. If a rule disallows action X, and if there is a credible sanction for breaking that rule, then action X is less likely to occur than in the absence of the rule.

Figure 1 - The Interaction of Political Institutions with the Economy

Source: Kurrild-Klitgaard and Berggren, (2004)



Above is a very simple illustration of how political institutions interact with the economy. A full arrow should be interpreted as “influence”, whereas a broken arrow should be seen as “feedback effect”. Important to note in *Figure 1* is that individual choices and evaluations play an important role in the process. The formal institutions are interpreted by individuals, and once a certain interpretation becomes widely accepted it becomes an “effective institution”. The process starts with the written constitution, which is later interpreted by policy-makers and legislators whose actions are in turn interpreted by players in the market. The business people decide how much capital to acquire, or how much labor to employ based on e.g. minimum wages or taxes. The actions of the market actors finally result in economic growth or decline, i.e. GDP. The GDP can serve as a signal to policy-makers informing them whether or not they are doing a good job. E.g. a severe and continuous GDP decline might force policy-makers to go so far as amending the constitution.

2.1 Privatization theory

2.1.1 Theoretical benefits of privatization

Privatization is undertaken to reach certain objectives. These include: increased efficiency, raised revenue for the state, reduced state interference in the economy and hence increased private participation, encouragement of wider share ownership and development of capital markets. (Mohan 2002:4865)

How does a company reach higher efficiency simply by switching ownership from public to private? Firstly, the enterprise shifts its objective. State-owned enterprises (SOEs) are usually burdened with the task of combining several – sometimes conflicting – objectives. These can be social, such as securing employment and benefits for workers, combined with complying with the political strategy set forth by the ruling political elite. Through privatization, these objectives are replaced by one straightforward goal – profit maximization. Another important efficiency-enhancing effect is hard budget constraints. The enterprise will no longer be able to rely on the government as the lender of last resort. A private owner must hence be superior at limiting any waste of resources. Moreover, monitoring through capital markets and individual owners is considered more efficient than any mechanism the state might employ for the same purpose. Public officials and bureaucrats do not have as strong an incentive to monitor enterprise performance as institutional- and private shareholders. Some economists have

highlighted this “agency problem” as the primary rationalization for privatization. (Majumar and Ahuja 1997:1591)

In an extensive review of available research on privatization Jordahl H. (2008) finds the empirical evidence favouring private over state ownership robust and convincing. SOEs become on average more profitable and efficient after privatization. Other well-documented strengths shown by privatized enterprises are increased investments and sales, and lower leverage (Jordahl 2008:43). However, it is important to emphasize that the study is limited to OECD-countries only. As much of the empirical research shows, the atypical circumstances under which privatization takes place in transition economies render direct comparisons with developed countries misleading.

Apart from the standard objectives for privatization stated above, the Agency for Privatization of the FBiH has specified its expectations on what the privatization program in BiH ought to achieve¹:

- Contribute to regaining lost markets and to integration into the international markets.
- Spread “Western norms and standards” of doing business
- Add new capital to the state and alleviate its debt burden
- Stimulate inflow of foreign investment and hence the revitalization of the economy
- Add to the overall reform program and transition toward a market economy
- Develop sound competition and remove monopolies from various markets
- Inflow of new technology and know how

2.1.2 Methods of privatization

Methods of privatization which have been applied in different countries have varied depending on the circumstances under which the programs had been undertaken. What determines the appropriate method is a mixture of the following aspects: size of the enterprise, its current financial strength and productiveness, product demand, competition landscape, macroeconomic and political environment of the country in which it operates etc. Before a decision concerning the method of privatization can be reached policy-designers must account

• ¹ <http://www.apf.com.ba/model-priv/?cid=1,2,1>

for a range of restrictions and limitations which their particular economic climate inevitably imposes. (Lopez-Calva 1998)

The following four steps need to be completed in order for a successful privatization to commence (Transparency International 2009:10):

1. General strategic planning: Overall political and economic goals for privatization need to be set. The potential influx of fresh capital and new technology into the enterprise needs to be assessed. The risks in terms of political and economic uncertainty and civil unrest should also be accounted for.
2. Enterprise-specific preparation: Financial and organizational restructuring, valuation and possibly determination of a minimum price of the enterprise, listing necessary future investments and guarantees which the future buyer would be obliged to abide.
3. Marketing: Search for a strategic investor or arranging an open tender/auction process. Announcing forthcoming sales via media.
4. Evaluation: Comparing between bidders and selecting a buyer, negotiating and formalizing the deal.

The privatization methods which have been authorized by both entities' privatization laws in BiH are the following:

- voucher/mass privatization
 - o public offering of shares
- tender sales
 - o auctions
 - o direct negotiations
- management and employee buy-outs (MEBOs)
- sale through stock-exchange
- combination of the above

All the aforementioned privatization methods will be elaborated upon in the next section, with the exception of MEBOs. The share of total privatizations conducted through MEBOs has been marginal, and the available data on the ones that did occur is insufficient.

Mass (voucher) privatization

Although a clear-cut definition is not easily discerned, mass-privatization is said to occur when a large fraction of state-owned assets is sold or transferred to a large number of private

citizens. This is usually done through the use of vouchers or certificates, which can be traded for shares in public enterprises. The vouchers are either free or symbolically priced at a low rate. (Lopez-Calva 1998:12)

The main argument for speedy mass-privatization is the risk of the residual state sector becoming entrenched. Empirical research has shown that political influence on the residual state sector tends to grow the longer privatization is postponed, which leads to deterioration of corporate governance, asset-stripping and further indebtedness. (Mickiewicz 2009:25) Cross-country data analysis of the CEECA countries shows that partial reform tends to evolve into political capitalism. (Hellman et al. 2000)

Another advantage of giving ownership to the general public is political acceptability. Theoretically it has also been argued that mass privatization should lead to the development of capital markets (Lopez-Calva 1998), although empirical evidence have yet to offer any validation for this premise.

The major downside of mass-privatization is the lack of new capital, know-how and technology without which the enterprise in question, especially in a transition economy, cannot be transformed into profitability. When ownership of a large enterprise with complex operations is handed over to the general public the resulting ownership structure often becomes dispersed, with owners lacking both capital and competence to govern the enterprise.

A notable drawback of mass-privatization is also the empirically established preferential treatment normally awarded to public managers, unions and the ruling establishment. (Pannier 1996) Apart from draining vital fresh capital from the enterprise, this practice acts as a deterrent against foreign investors who become reluctant to commit resources and expertise in an unpredictable environment.

In BiH, mass-privatization has been mainly conducted through Public Offerings of Shares (POS)². A POS is a sale or redistribution of state capital to citizens via the stock exchange or

² <http://www.apf.com.ba/model-priv/?cid=16,2,1>

some other platform. The theoretical argument behind this method suggests that the outcome of a POS should enhance transparency, development of capital markets and broad ownership. It might also lead to an increase in foreign investment. The approach is, however, technically advanced and costly. The initial offering is usually discounted, which decreases the government's total revenue from the sale. (Lopez-Calva 1998:17)

The Agency for Privatization in Federation of BiH (APF) has conducted three waves of public offerings between the year of 2000 and 2002. *Table 1.1* shows some key statistics and the total outcome of the POS-program.

Table 1.1 The results of Public Offering of Shares in the Federation

	No	Offered capital In KM million	Subscribed claims in KM million	No.of shareholders	One PIF as a major company shareholder	More PIFs as major company shareholders
First POS	537	2.446	4.965	30.400	35	73
Second POS	157	483	1.002	6.130	0	5
Third POS	71	704	1.870	18.700	1	0
Total	765	3.633	7.837	55.230	36	78

Source: www.apf.com

In 1999, each citizen in the Federation was given a certificate of 1900 KM. Some were handed additional certificates as recognition of military service, or as compensation for unpaid pensions. These certificates could be used to buy shares in enterprises via public offerings, or to purchase shares in Private Investment funds (PIFs). The purpose of PIFs had been to concentrate large quantities of certificates in order to facilitate strategic investments and increase shareholder influence. (Balyss 2005:39)

Each public offering consisted of two rounds. The finalization of the third wave in November of 2002 marked the end of the mass privatization scheme in the Federation. 765 enterprises have been wholly or partially privatized using this method.³

³ <http://www.apf.com.ba/model-priv/?cid=16,2,1>

Privatization via the stock-exchange

The capital markets in BiH remain underdeveloped. The amount of capital circulating within the two exchanges is far from enough to satisfy the capital needs of the market in a significant way. The Sarajevo Stock Exchange (SASE) was founded by 8 brokerage firms in 2001, the same year when eight banks and one trading company established the Banja Luka Stock Exchange (BLSE). (Suljkanovic 2007:5) The small size of the Bosnian market, combined with public mistrust toward the privatization process pose a hinderance toward further development.

The eleven PIFs in the Federation have attracted KM 4,5 billion in vouchers, while the corresponding figure for the PIFs in Republika Srpska is KM 1,9 billion. The shares in these investment funds are listed on the two stock-exchanges. Secondary trading in vouchers had been envisioned and encouraged by both the business and political sphere. The goal has generally been to develop strong stock-exchanges through which a substantial portion of state capital would be privatized. In practice, the stock-market has been one of the least utilized privatization methods over the course of the period studied in this thesis. POS via the stock-exchange has, however, resurficed as one of the main methods to be used in the future. (APF 2007) Through POS a certain number of the large (relatively successful) enterprises are planned to be sold to the general public under preferential conditions. Foreign and domestic legal entities would participate on regular terms. Experts continue to regard POS via stock-exchange as the most transparent method of privatization, which would also offer the needed stimulus to the poorly functioning capital markets. (APF 2007:10)

According to APF (2007), the enterprises in which the state holds a *minority* interest, and where a strategic investor with specific commitments is not necessary, make good candidates for stock-exchange privatization. The state typically commands no operational influence in these enterprises. Enterprises operating in the commercial sector (i.e. excluding utilities and/or stratgically sensitive markets) where the state is *majority* shareholder are also deemed suitable for sale via the stock-exchange; provided that their business operations are profitable and self-sustaining.

Tender privatization and direct negotiations

Privatization through sales to strategic investors can either be conducted through direct negotiations with individual investors or an action-like competitive bidding. The advantages of a successfully executed tender procedure are substantial (APF 2007):

- influx of fresh capital
- restructuring and repayment of debt
- restructuring of operations
- new technology and know-how

Enterprises deemed suitable for tender privatization are large, both minority and majority state-owned, which lack capacity to carry on operating without substantial outside help. Notable in this category are the vast conglomerates that prior to privatization must be divided into separate “technical units”. This enables profitable divisions to instantly become eligible for privatization, and the malfunctioning ones to be prepared for either restructuring or liquidation. (APF 2007)

A privately negotiated sale entails a case-by-case review of proposals by the privatization agencies. This approach enables the state to tailor agreements for each company and through thorough research identify the most suitable buyer. Demands on future investments are made and the investor's long-term commitments are ensured. The main disadvantage is the political cost ensuing from back-room deals. An open competitive bidding is to be preferred over a privately negotiated sale in most cases. Political acceptability is higher, and the bidding procedure normally results in a higher sale-price. (Lopez-Calva 1998:13)

Tender privatization is generally plagued by the problem of non-transparency. The specific criteria for the sale are in certain cases not revealed to either prospective buyers or the public. The selection process always carries the risk of being deemed dubious. Suspicion of breach of contractual obligations may tempt rivaling politicians to make allegations of wrong-doing both during and after the tender process, which may go as far as renationalizing of the enterprise. (Earle 2002:10)

2.2 Two privatization “philosophies”

The divergent theories on how privatization in transition economies ought to be conducted can be roughly categorized into two main approaches: the Washington Consensus approach and the Gradualist approach. As both shall be a reoccurring theme throughout this thesis, below is a brief elaboration on the two concepts.

The Washington Consensus

Washington Consensus proponents adhere to the “natural emergence” of the market. The very beginning of the transition period is the perfect time, or “the window of opportunity”, to implement radical reforms swiftly and extensively. The Washington Consensus takes issue with gradual reform based on historical records which show that state power cannot resist interfering and hindering the process, especially at the early stage when the market is vulnerable. Hence the change needs to be complete and irreversible, even when accompanied by temporary instability. The main priority is a complete break with the plan economy. Markets will adapt, and the institutions will grow organically as the market matures. (Roland 2001:34-35)

From the above follows that the Washington consensus approach places little value on the unique circumstance of each country, which is why it is also termed the “clean slate” approach. The fact that most, if not all, countries have a unique history, institutional infrastructure and economic environment is considered close to irrelevant. (Roland 2001:38)

The Gradualist Approach

Firstly, the gradualist approach to privatization – and to transition in general – emphasizes the crucial role of market institutions and laws. The premise that institutions will form “naturally” is rejected. A necessary precondition for a successful, nation-wide privatization scheme is hence to precede it with extensive institution-building. (Hadzic 2002:16)

“Gradualists” recognize the importance of the sequencing of reform. When reforms are conducted in “the right order” a positive domino-effect should lead to easier implementation of future reforms, whereby minimizing the common problem of stalemate. Speed of privatization is not emphasized to the same extent. The risk of asset-stripping and obstruction by incumbents, as maintained by the Washington Consensus, is considered tolerable compared to the adverse effects which ad-hoc privatization in an institutional vacuum can

cause. Transition countries in as low a level of development as BiH are in no condition to handle the massive unemployment, higher prices, and consequent civil unrest inevitably resulting from mass-privatization. The privatization process needs to be accompanied by the emergence of a strong middle class and private entrepreneurs. This way the reforms will gain wider acceptance from the public, and therefore become more stable and long-lasting. (Roland 2001:36)

As market failures are rampant during the early phases of transition gradual implementation of reform is particularly suitable (Carlin and Mayer 1992: 312). It allows for greater reflection and the possibility to reverse measures proven to be inadequate or wrong. This aspect enhances the flexibility of the tool-kit policy makers have at their disposal. The disadvantage is the externalities associated with maximizing politicians who chose reforms based on current public support, rather than the long-term interest of the country (Qian et al 1999:1093).

2.3 Critique of (mass) privatization

The methods of privatization, as well as its benefits, remain a source of dispute within the economics profession to this day. That successful privatization of most commercially viable enterprises is a desirable goal is hardly contested. The way of getting there almost always is.

At the centre of the critique is the notion that neo-classical models of market equilibrium are overly simplistic. Information asymmetries are not sufficiently accounted for. (Mohan 2002:3). When information incompleteness is included into the classical model it becomes clear that market failures are common and substantial. They are no longer limited to natural monopolies and public goods but become an integrated part of every unregulated market. (Florio 2002:364)

Martin and Parker (1997) criticize the imperfections of the market for corporate control. Shareholders are theoretically supposed to punish incompetent and/or corrupt managers by selling shares of the malfunctioned company, depressing the stock price and thereby making the company a potential takeover target. Practitioners in particular would know this notion to be somewhat idealistic: privatization does not make the problem of asymmetric information disappear; dispersed share ownership makes the owners weak and disorganized; a takeover does not guarantee improvement in performance; trading shares involves transaction costs etc.

Martin and Parker (1997) also points to the fact that many enterprises are neither private nor public, but somewhere in between. A wide range of private enterprises and agencies are heavily dependent on government subsidies. These, as well as pure state bureaucracies, are normally not plagued by the agency problem. The notion that public and private companies belong to two separate spheres with entirely different objectives has thus been disputed as well.

Perhaps the most pressing argument against privatization of state enterprises is the inconclusive empirical record of privatized firms, particularly in developing countries. The consensus on the empirical merits of privatization is even more ambiguous than the one concerning the theoretical argument (Mohan 2001: 4866).

2.4 Public choice theory

Public choice theory has brought economics and political science together and introduced self-interest (*homo economicus*) as the guiding principle for all actors involved in the political process: politicians, special interests, bureaucrats and voters alike.

This approach has yielded significant contributions to understanding the abundant suboptimal outcomes in real-life politics and economics (Buchanan 1987:246). Economic theory has for a long time accepted political decisions as exogenously given. Furthermore, the assumption had been that executive and legislative bodies were perfect representatives of the community and their interests (Buchanan 1987:245). The public choice school questions all the aforementioned assumptions. Politicians and bureaucrats are human beings, and as such they respond to the same incentives as private persons (and consequently companies) in the private sector. This means that they too will primarily protect their own interests and privileges, even at the expense of the common good.

The theoretical analysis of public choice originates from the political game with three main groups of “players”: politicians, voters and interest groups. All three groups are primarily interested in realizing their own goals and acquiring benefits; the goal of a politician is to maximise the number of votes and get re-elected. Voters would prefer to maximize their own disposable income. Interest groups *de facto* exist for the purpose of protecting the interests of

their members. Decisions made by politicians are affected by all three, sometimes conflicting, objectives.

Public choice is a central component in modern privatization theory. The crucial assumption that bureaucrats are self-interested actors implies that state enterprises in their control risk being run as tools for their own benefit. Privatization of these enterprises shifts the incentives from narrow self-interest of individuals to that of the company as a whole. (Balyss 2005:15) Furthermore, political institutions are seen not as an exogenous variable of secondary importance, but as a key component of the economic environment of a country.

3 The Constitution⁴

As previously mentioned the constitution of Bosnia and Herzegovina has been crafted in connection to, and as a part of, the General Framework Agreement for Peace in Bosnia and Herzegovina, colloquially known as “the Dayton Accords”, or the “Dayton Agreement”. The basic principle upon which the Constitution rests is that of “ethnic balance”. All central institutions are designed and organized so to uphold this principle.

Due to the pressing and complicated circumstances under which the Dayton Accords had been formulated, the final product became highly complex. Certain sensitive issues were left unsolved, e.g. the status of Brcko District. The overarching objective of the peace agreement was to end the armed conflict between the three major ethnic groups (Bosniaks, Serbs and Croats). Optimizing the long-term economic prosperity of the country had been of secondary importance.

BiH ended up having 13 governments in total – on state, entity and cantonal levels. The Office of the High Representative (OHR) was instituted to oversee the civilian aspects of the agreement. The High Representative (the chair) is also EU Special Representative. OHR holds more executive power than any domestic authority, and is entirely comprised of international politicians and experts. OHR can impose or veto any legislation, as well as remove any public official from office. (Balyss 2005)

3.1 Divided economic space

“Bosnia and Herzegovina shall consist of two Entities, the Federation of Bosnia and Herzegovina and the Republika Srpska”.⁵

BiH has never been divided along ethnic lines at any point in its history. The current division into entities reflects the circumstances prevailing upon the formulation of the Dayton Accords. The Bosniak-Croat Federation of BiH comprises 51 percent of the territory and is populated largely by Bosniaks and Croats. Republika Srpska is mainly populated by Serbs and comprises the remaining 49 percent of the territory. The two entities are divided into smaller

⁴ Most of the facts in this section come from the Constitution itself. See Appendix I.

⁵ The Constitution of Bosnia-Herzegovina, Appendix I, Article I

administrative areas: Republika Srpska into municipalities and FBiH into 10 cantons, which are in turn divided into municipalities. Brcko District in north-eastern BiH officially belongs to both entities but is in practice entirely independent. It is usually referred to as “the third entity”.

The entities enjoy considerable independence vis-à-vis the central state. There are nine explicitly stated areas for which the central government is responsible; foreign policy, trade policy, customs policy, monetary policy, finances of the institutions and international obligations, immigration, international and inter-entity criminal law enforcement, communications infrastructure, regulation of inter-entity transportation and air-traffic control. Areas of responsibility are delegated to different decision-making bodies, e.g. the parliament presides over the budget, the presidency over foreign policy etc.

Other responsibilities which are not explicitly stated in the constitution as belonging to the central state fall under entity jurisdiction. These include fiscal and economic policy. The entities have thus been rewarded privileges normally reserved for sovereign states.

The systems of local government in BiH are greatly divergent. The cantons in the Federation have over time developed different tax systems; resources are allocated differently; and almost every municipality has a unique set of responsibilities. The cantons resemble the entities in their relationship to the state – all tasks not explicitly assigned to the entities belong to the cantons. Hence there are two levels of federalism. The final layer of Bosnian federalism and decentralization involves the responsibilities of local governments, i.e. the municipalities. The constitution grants municipalities self-rule in all matters delegated to them by the cantons or the RS entity. In the FBiH, if the municipality has a majority population that is different from that of the canton as a whole, then public services, education, housing etc constitutionally must be allocated to the municipality to protect the minority within the canton. (Jokay 2000)

This unique decentralization of power has had severe practical implications on the economic development of BiH. In the period of early transition of any country there are vital functions that only a strong central state can fulfil. The government in Sarajevo did not have its own foreign-exchange rate policy, or its own monetary- or balance of payments policy. (Stojanov 2004:19) There was hence no mechanism to steer the economic development of the republic

in a cohesive manner.

The multiplicity of administrative levels, i.e. state, entity, cantonal and municipal, is a continuous source of confusion among public officials, bureaucrats, businessmen and citizens alike. In certain situations it is not clear-cut which administrative level holds jurisdiction. Determining the correct protocol when decisions of different administrative bodies do not coincide is also a challenge. One example of this is the entities' relations with neighbouring countries; Serbia and Croatia specifically. The constitution allows the entities to conduct their own foreign policy in this particular instance. As a result, relations between Republika Srpska and Serbia have in many respects become more integrated than RS and the Federation.

This aspect has contributed to the lack of harmonization in economic and privatization policy between entities, which is in turn reflected by discrepancies in standard of living and economic development between regions as well as municipalities. (OECD 2008)

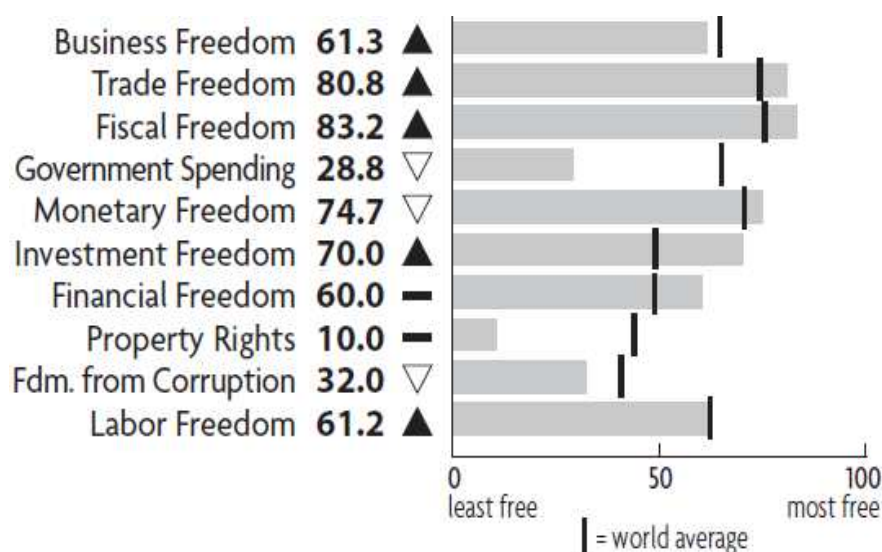
3.2 Property rights and corruption

Adequate property rights protection gives investors the incentive to keep their assets and reinvest, in the assurance that the returns will accrue to them as much as the risks. Insufficient property rights protection incentivizes investors into the opposite direction, meaning divestment and capital flight. (Dyck 2001 in Mickiewicz 2009) The latter also leads to corruption. It creates opportunities for expropriation of benefits by government officials, as well as for state capture by private interests. Previous research shows that empirical indicators of freedom from corruption overlap directly with property rights measures. (Beach and Kane 2007 in Mickiewicz 2009) Mickiewicz (2009) shows in a regression analysis, where property rights protection in a group of CEECA economies have been plotted against a world sample, that BiH scores the lowest of all transition countries.⁶

In the yearly survey conducted by the Heritage Foundation - Index of Economic Freedom - BiH has consistently maintained a very low score. The figure below displays the “ten economic freedoms”, two of which are property rights protection and freedom from corruption. Bosnia's score for 2010 on the property rights index is 10 out of maximum 50. The figure also shows that BiH finds itself close to – or well below – the world average score, not least when it comes to freedom from corruption.

⁶ Mickiewicz (2009), See Figure 2 in the Appendix, p 47

Figure 2. BiH's ten economic freedoms



Source: Heritage Foundation/Wall Street Journal's Index of Economic Freedom 2010

3.3 Ethnic division

“The Presidency of Bosnia and Herzegovina shall consist of three members: one Bosniak and one Croat, each directly elected from the territory of the Federation, and one Serb directly elected from the territory of the Republika Srpska”.⁷

The operational structure of the presidency is perhaps the most illustrative example of the elaborate checks and balances according to which all political institutions at central level are designed. The term limit of the presidency is four years, during which the three members rotate every eight months. The presidency is mandated with conducting foreign policy, executing decisions taken by the parliamentary assembly and representing BiH in international organizations. Complete consensus is required for most decisions taken by the presidency. When consensus cannot be reached it might be sufficient for two members to agree, whereby the third member's entity parliament makes the final decision through a vote.

The electoral system is regulated in the Election Law of Bosnia and Herzegovina, which has been construed to fit the overall institutional framework as dictated by the constitution.⁸

⁷ Appendix I, The Constitution of Bosnia and Hercegovina - Article V

⁸ Election Law of BiH: <http://www.constitutionnet.org/files/BiH%20Election%20Law.pdf>

Representation in BiH is not proportional. For instance, if the Bosniak-dominated party SDA (Stranka demokratske akcije) would hypothetically win the majority of the total vote, it would nonetheless hold one-third of the seats in most central political institutions.

As mentioned previously, Republika Srpska is divided into two administrative levels – entity and municipality – due to its homogenous demographics. This makes the voting process simpler as the need for “protection” of minority ethnic groups is smaller. The demographic make-up of the Federation has constitutionally necessitated the cantonal structure, which does offer more independence to the regions, but also gives rise to paralyzing rigidity.

3.4 The international community

The Framework Agreement for Peace in Bosnia and Herzegovina has been designed by the international community (IC) in its entirety. The constitution grants the IC unprecedented powers over domestic politics. As previously mentioned, the Office of the High Representative (OHR) is the highest executive and legislative body, with the power to veto legislation and remove public officials out of office. These broad powers had not been a part of the original draft of the Dayton Accords. Annex 10 of the peace agreement had been elaborated at the PIC’s (Peace Implementation Council’s)⁹ conference in Bonn in 1997. The reason had been the inability of local authorities and legislative bodies to implement significant reforms. In addition, elected officials had been systematically violating their legal commitments as stipulated by the Dayton Peace Agreement.¹⁰

The initial stage of infrastructure reconstruction had been largely successful. Gradually a vast array of international bodies, NGOs and nations established a presence in, what grew to become, the biggest experiment in nation-building to date. The byzantine net of international players started to reveal its limitations in the post reconstruction phase. Elaborate bureaucracy, overlapping responsibilities, and even competition between different international actors have contributed to hampering economic progress. (OECD 2008)

Steps have however been taken to “streamline” the international community’s efforts and increase effectiveness. A Board of Principles has been established in 2002 under the

⁹ The PIC is a group of 55 countries and international organizations that sponsor and direct the peace implementation process.

¹⁰ <http://www.ohr.int/>

chairmanship of the OHR who acts as the chief coordinator. The permanent members are: OHR, EUFOR, NATO, OSCE, UNHCR, EUPM and the European Commission. The IFIs such as the World Bank and the IMF are frequent participants.¹¹

The World Bank (WB) has led and/or participated in most projects involving economic development and privatization in BiH. Since 1996, the 66 projects financed by the WB in BiH have amounted to a commitment of US\$1.5 billion. In per capita terms, the WB program in BiH has been the largest in the history of the organization.¹² The WB has been a major advocate of Washington Consensus-style privatization, i.e. speedy mass-privatization accompanied by general market liberalization. The WB has, among other efforts, extended credits to the two entity governments to be used for recruitment of privatization experts and consultants. The objective of these credits had been to accelerate large-scale privatization. (World Bank 2002:2)

One of **International Monetary Fund's** (IMF) principal conditions to get engaged with the borrowing nation is the latter's commitment to comprehensive privatization. The organization has been involved in the design of the privatization process in BiH, which it also has been monitoring closely since its inception.¹³ IMF, similarly to the World Bank, has put great emphasis on speedy and all-encompassing privatization.

Other international bodies that have been, and remain, actively involved in political and economic development of the country are: EBRD, USAID, the European Commission, Swedish International Development Cooperation Agency (SIDA), United Nations Development Program (UNDP), numerous NGOs and individual donor countries such as the United Kingdom, the Netherlands, the United States, Germany and Austria, among others.

¹¹ <http://www.ohr.int/>

¹² The official web-page for the WB's activities in BiH www.worldbank.org.ba

¹³ The official web-page for the IMF's activities in BiH, <http://www.imf.org/external/country/bih/index.htm>

3.5 Legal framework

Privatization in former Yugoslavia had begun in late 1980s with the extensive privatization and liberalization effort known as the “Markovic Law”. The methods of privatization used throughout former Yugoslavia were largely based on this doctrine. The purpose of the initiative was to stave off the rampant inflation and make the Yugoslav industry more internationally competitive. The aim of privatizing large enterprises was more specifically to circumvent the problem of management taking full control of large SOEs, which had been the norm during the Yugoslav “self-management” economy. The reform meant that workers received internal shares and thereby gained increased influence vis-à-vis management. (Andréasson 2007)

The first post-war national privatization law – *State Framework Law on Privatization of Enterprises and Banks in BiH* – has been imposed by the High Representative in August 1998.¹⁴ Its objective was to ensure equal treatment for all citizens, access to balance sheets of non-private enterprises across the country, and thorough audit of enterprises which had been illegally privatized during or immediately after the war.

In accordance with the Dayton Peace Agreement, the Framework Law delegates the responsibility to design and implement privatization programs to the entities. Each entity has jurisdiction solely over the state-owned enterprises located within their own respective territories. The OHR’s decision in 2000 regarding the privatization in Brcko District cemented and finalized the fragmentation of the national privatization program into three separate programs. Thus, each entity has its own privatization laws. (TI 2009:16)

The national Framework Law does urge inter-entity cooperation on privatization. This provision has not been enforced in practice. (Balyss 2005:39)

The Federation

The Law on Privatization of Enterprises from 1997 regulates the privatization process in the Federation.¹⁵ In accordance with the Dayton Agreement, the ultimate responsibility for designing and implementing the privatization process has been delegated further down to the

¹⁴ <http://www.fdi.net/documents/WorldBank/databases/plink/factsheets/bosnia.htm>

¹⁵ Law on Privatization of Enterprises, <http://www.apf.com.ba/pravni-okv/?cid=2,1,1>

cantonal level. The rationale for privatization to be organized at the regional level had been to avoid controversies about unfair asset allocation across communities. Gaining public support for large-scale privatization at cantonal level was considered more realistic, as the regions are more ethnically homogenous and politically stable. (Balyss 2005:39).

Each of the 11 cantons has its own privatization agency conforming under a canton-unique legislation. The Federal Privatization Agency (FPA) has been established to coordinate and assist these 11 agencies. The FPA is notably not superior to the cantonal agencies; it is merely obliged to assist the cantons with information and professional advice. FPA gets primary jurisdiction over privatization of enterprises located in more than one canton. (PRSP 2004:59)

The Law on privatization makes a distinction between “small” and “big” privatization. Small enterprises are those valued at below KM 500 000, which employ less than 50 persons. A minimum cash payment requirement was set at 35 percent of the estimated enterprise value. Big privatization encompasses all enterprises with more than 50 employees.

Through various amendments of the Law on privatization the government of FBiH has been granted powers to exempt certain enterprises from the overall privatization program. These enterprises of “strategic” importance could either be privatized using case-specific rules, or be exempted from privatization altogether. The decision of exemption could be made by the government of FBiH if the state-capital of an enterprise is less than 30 percent. In case the state-capital exceeds 30 percent the decision is made by the FBiH parliament at the suggestion of the FBiH government. (TI 2009)

Brcko District

The district of Brcko is governed under a similar framework as RS and the FBiH. The District is granted substantial autonomy, while the international community in form of the OHR maintains the right to veto or impose legislation. The privatization law – The Law on Privatization of Enterprises in Brcko District of BiH – had been voted through the district parliament in 2004. (TI 2009:25)

The law stipulates that the Office for Privatization of Brcko District shall be responsible for the privatization process, and details the methods to be used for certain portions of state capital; e.g. 67 percent of the total enterprise value shall be sold through public tenders or

auctions, whereas up to 33 percent of state capital of any enterprise shall be distributed through vouchers and certificates. Similarly to RS and the FBiH, the enterprises facing privatization are required to produce a privatization plan, conduct any necessary restructuring and finally to provide full information regarding enterprise value, accumulated debt etc. (TI 2009:25)

Republika Srpska

The *Law on Privatisation of State Capital in Enterprises* from 2006 regulates privatization in RS. It has substituted the *Law on Privatisation on State Capital* from 1996. (TI 2009:14) The new law included significant changes. The government of RS had been granted new powers to design and execute specific privatization programs for all strategic enterprises, i.e. enterprises operating in the oil industry, electricity distribution, telecommunications, mining, public media, defence, etc. A significant operational change was also that the Agency for Privatization has been abolished and replaced with the Institutional Development Bank of RS (IRBRS) as the authorised proprietor of state-capital. The initial value of the IRBRS portfolio had been estimated at KM 2,5 billion, of which KM 600 million was to be disbursed within the first three years. (IRBRS 2008:4)

The special authority granted to the government has been exercised on several occasions, most notably regarding the sale of state-capital in the oil industry. *The Law on the conditions of sales of shares in the oil industry of Republika Srpska* from 2007¹⁶ has been successfully and speedily implemented as a result of the new law. Nearly the entire oil industry of RS, in form of Rafinerija Nafta Bosanski Brod, Rafinerija ulja Modrica and Petrol a.d. Banja Luka, has been sold to the Russian oil company Njeftegazinkor. (TI 2009:19)

*The Law on revision of the privatization of state enterprises and banks*¹⁷ was adopted by the RS parliament in 2006. The objective of this legislation was to identify any illegalities, past or present, in the privatization process; to establish the ownership structure of all enterprises; to prevent organized crime from obtaining state capital and to hold public officials accountable. The government of RS is subject to this law, as is the Institutional-Development Bank of RS.

¹⁶ http://www.narodnaskupstinars.net/lat/zakoni/zakon.php?id_zakona=57

¹⁷ http://www.narodnaskupstinars.net/lat/zakoni/zakon.php?id_zakona=134

4. The Privatization Process 1995 – 2010

The process of comprehensive privatization did not gain momentum until the year of 2000, with the privatization of small enterprises. At this point 1400 enterprises were selected to be privatized, among which 300 small companies. Most small-scale and mid-size companies had been privatized by 2002. (Andréasson 2007)

The initial plan had been to implement a rapid and apolitical transfer of public property into private hands. Privatization instead became a protracted battle between ethnic elites, eager to entrench and expand their power through major enterprises. (Donais 2002:2) The initial time-frame for the privatization process had been overly optimistic; e.g. the World Bank states in its *Enterprise and Bank Privatization Adjustment Project* (World Bank 1999) memo that the entire process was expected to be completed within two years! (World Bank 1999:4)

The privatization methods which were designed by the IFIs have been largely based on the Washington Consensus and hence very similar to the previous privatization schemes applied in large parts of Eastern Europe. USAID headed the initiative to design a voucher-based scheme through which state property would become private, and at the same time enable the state to repay the vast debt it owed its citizens. As previously mentioned, even when voucher privatization is successfully executed, no fresh capital is injected into the company and hence no new investments are made. (ICG 2001:23)

The only sector where privatization efforts have brought about a satisfactory outcome is the financial (EBRD 2007:18). All state-owned banks in RS have been privatized and only seven banks remain under government control in the Federation (World Bank 2004:23). This success can be attributed to the high priority which the political leadership in both entities had placed on privatizing the financial sector. Over the period of three years, 2000-2002, most of the banks had been privatized with great efficiency and speed. One notable outcome of the process had been the substantially reduced number of banks; 61 banks in 1999 became 32 by 2006. The reason for this wave of mergers can partly be traced to the new legislation aimed at increasing the minimum capital requirement for banks. (Suljakovic 2007:7)

Federation of BiH

The privatization process in FBiH has progressed very slowly during the entire post-war period. From 1999 to 2003 three Public Offerings of Shares (POS) have been conducted. The total value of privatized state-capital is estimated at KM 3,6 billion. 765 enterprises have been privatized as a result of the three public offerings, and they are now owned by 55 000 shareholders. Apart from the public offerings, 600 enterprises were selected to be privatized through tender offerings in the period of 1999-2006. These comprised 42 000 employees and were valued at KM 1.53 billion. In connection to the tender procedures a total of KM 1,24 billion in new investments have been pledged by strategic investors. (TI 2009:27)

More than a dozen large strategic enterprises operating in aluminum production, construction and telecommunications remain to be privatized, as well as many medium size enterprises. (IMF 2010:19)

Republica Srpska

The Directorate for Privatization in RS was established in 1999. By law, every citizen of RS was entitled to 20 vouchers. Additional vouchers were distributed depending on the length of military service, years of employment etc. The vouchers used in RS did not have a monetary value as they did in the Federation. They could be used to buy shares in enterprises directly or via PIFs. (Balyss 2005:40)

The most significant progress in RS has been made in connection to the IRBRS becoming the authorized proprietor of the entire remaining state capital in 2008. Shortly thereafter 186 enterprises were sold via the Banja Luka stock-exchange, the total value of which had been KM 50,1 million (KM 6,6 million paid in cash, the rest in vouchers). The success of these transactions is seen as a confirmation of the widely established view that stock-market privatization is a method superior to all others, and should be prioritized. The most commonly emphasized upsides of the method are transparency and capital market development. (TI 2009:27) *Table 2* offers a simple review of the largest foreign players currently operating in RS.

Table 2. Foreign strategic investors in RS

FOREIGN			
INVESTOR	COUNTRY	COMPANY	SECTOR
Telekom Srbija	Serbia	Telekom RS	Telecommunications
NaftegazInkor	Russia	Rafinerija nafte Brod	Oil
Altima Special Global Situation Fund	UK	Banjalučka pivara	Food (brewery)
Ukio Bankio Investicine Grupe Kreis	Lithuania	Birač Zvornik	Base metals
Industriehandel AG	Switzerland	Vitaminka	Food (beverages)
Swisslion Takovo	Serbia	Industrija alata Trebinje	Metal processing
Livar	Slovenia	Livnica Banja Luka	Base metals
Balkan Steel	Liechtenstein	UNIS Fabrika cijevi Derventa	Metal processing

Source: IRBRS¹⁸

Tables 3 and 4 show the financial results of the privatization process in RS until April 2008.¹⁹ The data is encouraging if compared to the corresponding numbers in the Federation. The progress can be contributed to the recent changes of legislation and the streamlining of the administrative process, i.e. most importantly the delegation of full responsibility for managing and privatizing all state-capital to a single agency – IBRS.

¹⁸ <http://www.irbrs.net/Default.aspx?lang=eng>

¹⁹ The most recent comprehensive data available at www.irbrs.net are from year 2008.

Table 3. Results of privatization in RS until 2008

	Million KM	%
Total amount of state capital in July of 1998	8 600	
State capital planned to be privatized	8 300	97
Total value of all privatized state capital	5 670	69
State capital remaining to be privatized	26 000	32

Source: IRBRS

Table 4. Privatization income in RS until April 2008

	Vouchers in KM million	Cash in KM million
Strategic enterprises	1,35	1509,32
Enterprises with capital larger than 300,000 KM	169,46	17,4
Enterprises with capital up to 300,000 KM	11,1	1,98
TOTAL	181,91	1528,7

Source: IRBRS

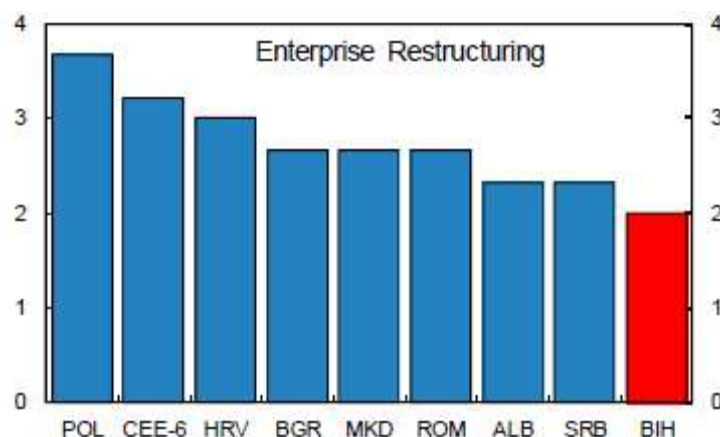
Strategic enterprises

The enterprises which have been labeled “strategic” and hence excluded from the mass-privatization program were either profitable utilities such as telecoms, or cash cows ranging from breweries to hotels. A particularly troublesome category of strategic enterprises consists of former industrial giants whose market has long disappeared, and whose entire work force is de facto unemployed. The political sensitivity of the latter is such that political authorities have been reluctant to take any action regarding their liquidation. The potential social unrest and subsequent electoral defeats act as insurmountable deterrents. The indefinite postponement of liquidation and restructuring procedures poses a great risk of eroding the potential of well-functioning divisions within these conglomerates that still remain. (TI 2009:29)

Many large SOEs remain illiquid. According to IMF’s data from 2005 half of the enterprises are unable to repay their current liabilities from their current assets or current income. (IMF 2005:41) This implies that many SOEs are liquidating fixed assets or using outside financing

to keep up with their current obligations. The other very probable scenario is that they simply accumulate arrears. Figure 3 shows that the level of enterprise restructuring in BiH is inadequate even in a regional context.

Figure 2. Comparison of the level of enterprise restructuring between BiH and CEE-6.



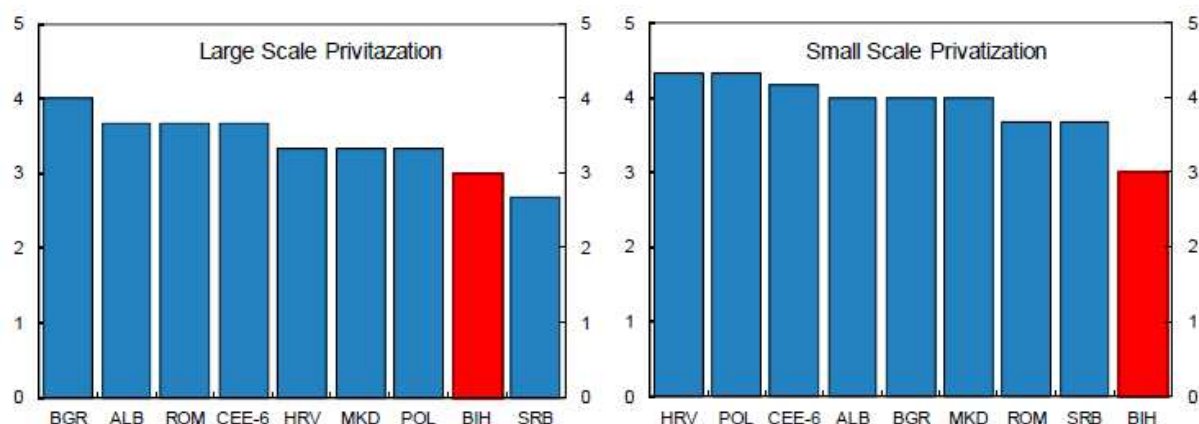
Source: EBRD Transition Report 2009 and IMF estimates of unweighted regional averages. The EBRD maximum score is 4,33. CEE-6 includes Bulgaria, Hungary, Romania, Poland, Slovak Republic and Slovenia.

Tender offers are usually directed at foreign investors, whose interest has been very limited. They are discouraged by vast debts burdening many public enterprises, lack of clear ownership and insufficient protection of – and sometimes discrimination against - foreign investors. (World Bank 2004:23)

General results

Figure 3 shows how Bosnia's privatization results compare in a regional context. The only country with a lower score regarding large scale privatization is Serbia. Out of the seven countries BiH has been the least successful when it comes to small scale privatization.

Figure 3. Regional comparison in the success of large- and small-scale privatization.



Source: EBRD Transition Report 2009 and IMF estimates of unweighted regional averages. CEE-6 includes Bulgaria, Hungary, Romania, Poland, Slovak Republic and Slovenia.

By studying the ownership structure of Bosnian enterprises one can relatively easily discern how well certain objectives of privatization have been reached. The most fundamental goal of transferring ownership from public to private is displayed in *Table 4*:

Table 5. Size of enterprise and ownership

Size of Enterprise	Nr of enterprises	Dominant owner
Top 25 %	25	State 44 %
Bottom	50	Families 28 %
Medium 25 %	26	Families 60 %

Source: Suljkanovic 2007

Ownership of Bosnian enterprises remains heavily concentrated. The table above clarifies the central issue of this thesis: the state remains the dominant owner of 44 percent of the largest enterprises.

The limited comparative research devoted to examining the performance and state of the newly privatized enterprises is ambiguous. Differences in performance between private and state-controlled enterprises are hardly distinguishable. The privatized enterprises have not come much further in their restructuring efforts than the state-controlled ones; e.g. surplus workers are kept in the former as well as in the latter. Productivity and efficiency remain low.

Privatized enterprises are as reluctant to increase transparency and fully disclose their financial situation as are the state-controlled enterprises. (Stojanov 2005:19)

The privatization process in both entities has been continuously plagued by corruption. Political interference has been at its most evident in highly profitable monopoly-like enterprises, whose supervisory boards normally include government officials. Telecommunication firms, power utilities, water companies, tobacco factories and forestry commissions are indispensable sources of cash for the major political parties. (ICG 2001:29) The current stalemate, in the Federation in particular, offers no indication that the envisioned privatization of most – if not all – large SOEs will ever materialize. When a sale does take place, it often becomes subject of revision by the Constitutional Court, which reflects the intrinsic irregularity and ambiguity of the privatization process. (TI 2009:29) No functioning mechanism has been established for overseeing the performance and compliance with the obligations undertaken by the buyer. The lack of oversight has particularly been abused in connection to the war-time privatizations, when vast state properties had been “privatized” under highly inappropriate circumstances. (World Bank 2005:69)

5 Privatization Methods in the Bosnian Political Context

5.1 Divided economic space

The case of Bosnian privatization is unique in several respects, but perhaps the most illustrative is the division of a small market into three separate entities. As previous chapters have shown, this division has been formalized through the Dayton Peace Agreement. It remains to be the essential institutional arrangement which has, in its own right, shaped the Bosnian economy into its current form. As the Dayton Accords had been signed by all three warring parties, and endorsed by the international community, it had been followed rigorously by the IFI's. This has gradually led to a nearly complete partition of economic space, e.g. trade arrangements are signed between entities in a similar way that trade agreements are signed between different countries.

The delegation of economic power to the entities and cantons has led to major flaws in economic planning at the central level (Tzifakis and Tsardanidis 2006:72). The Dayton Accords placed banking and customs regulation under the authority of the central state, but entrusted fiscal policy to the entities and cantons. There was hence no way for the central government to shape countrywide macroeconomic policy. This in turn makes it impossible to formulate a uniform strategy for industrial policy, meaning that the state of BiH had no control over privatization within its borders.

Separate implementation of the privatization program by each entity has been the first big failure. A number of problems arise from having separate privatization schemes within a small market, some of which are: uncoordinated taxes, unforeseen and retroactive taxes, “byzantine” bureaucracy, confusion among perspective investors and numerous other frictions that could have been avoided in a unified economic space. (Stojanov 2002:75) Having three separate privatization programs might not have been as problematic had they been conducted in a swift and coordinated fashion. What separates BiH from most other East-European transition economies is the slowness of the privatization process despite ambitious deadlines. Aided by the IFI's strategy of privatizing first and building institutions later, the legal framework was built around the sluggish progress, resulting in vastly divergent legislation in the different entities – which in turn made coordination in privatization efforts between entities more challenging still.

The fragmentation of territory and consequently the fragmentation of most of the institutional framework has had a substantial impact on strategic enterprises in particular. The enterprises that fared best in privatization have been mid-size, with most of their assets and knowledge-base gathered in one place. (Andréasson 2007:42) The Sarajevo-based transportation company Centrotrans-Eurolines is one example, the furniture manufacturer Standard another. These two companies, although engaged in completely different industries, share several factors in common: both are medium-sized, concentrated in one canton – Sarajevo, and have clear core competencies – transportation and furniture production respectively. This has made it possible to maintain control over assets even during the war, as opposed to loosing entire daughter-companies had the enterprises been dispersed across the Balkans.

The energy conglomerate EnergoInvest is an illustrative example of a less fortunate enterprise. It had been a flagship of former Yugoslavia, engaged in everything from trading, engineering, construction of energy grids etc. Its 55 000 employees had been situated in all parts of former Yugoslavia, as well as abroad. When the state of BiH decided to change the ownership structure from self-management to state-ownership in 1994, difficult issues emerged.

Due to the company's complexity, size and sophistication, it suffered tremendous damage during the war. Considerable assets outside of BiH had been lost. The remaining divisions within the country were divided in two parts: one part belonging to the RS, and the other to the Federation. The production base was largely located in RS, out of which a new company was formed. A vast chunk of EnergoInvest located in the Federation was looted of productive assets and destroyed. In addition, all divisions of the enterprise suffered from "brain-drain", as many highly competent engineers and professionals emigrated (Andréasson 2007:43). The company's main competitive advantage, its knowledge base, was divided and dispersed, which had a detrimental effect on vital knowledge spill-overs between divisions and disciplines.

The case of EnergoInvest is typical in the way it has been affected by the division of Bosnian territory. The more cantons and entities an enterprise occupies, the more politicized the privatization process becomes. Other examples of strategic enterprises which have been subjected to similar dismantling processes are UNIS, Krivaja and BH Telecom etc.

Apart from the general tax rates being excessive in the entire country, the tax administration is discretionary and unpredictable. The lack of harmonization of tax policy between entities poses a major threat to any large or mid-size enterprise with an ambition to operate on a nationwide basis. For instance, a FBiH enterprise with a branch in RS is obliged to pay corporate income tax in RS, without the possibility of receiving a tax credit for this payment in FBiH. The double-taxation law applies only to taxes paid in another country. In any other country this would be considered an unsustainable arrangement: it means that it is cheaper for any enterprise in the FBiH and RS to do business with any other country in the world than doing business with the other entity. (FIC 2007:9)

There are considerable differences in tax rates, tax incentives, and rules for calculating the tax base, which makes tax compliance for nationwide business confusing and complicated. (FIC 2007)

Privatization via the stock-exchange in a divided economic space

The ambitions and expectations by international and local experts for the stock exchanges as the main channel of privatizing vast amounts of state-capital have not come close to materializing, the progress made in RS notwithstanding. The cause can to a large degree be derived from the political institutional structure. Due to the divided economic space, and the government structure supporting it, a small market of less than four million people and many underfinanced enterprises, had established *two* stock exchanges. Expectedly under the current design, the capital markets remain poorly functioning and suffer from a great lack of liquidity. The fragmented regulatory framework hinders the development and deepening of a single market, while it increases the costs of the two stock exchanges and their operations. A regulatory framework on state-level would lead to greater liquidity, more mergers, and make both foreign and domestic investments more attractive.

As previously mentioned, the Privatization Investment Funds in FBiH have accumulated KM 1,9 billion and in RS KM 1,6 billion worth of state capital in certificates/vouchers. The funds are listed on the Sarajevo and Banja Luka stock exchanges, with the goal of spurring secondary trading. Since 2002, the year of closing of the POS program, this vast capital has been passive and of no real significance. The complexity and fragmentation of the regulatory framework has made inter-entity trade in vouchers overly expensive and complicated. That solely political considerations have enabled this structure to develop and remain is apparent,

as *no* economic justification can be conceived. The best-case scenario would be a single stock exchange designed for state-wide allocation of resources. A single stock exchange would decrease costs and increase efficiency through: simplification of procedures under a unitary legal framework, standardization of technological and administrative systems and sharing of costs, and economies of scale in other areas. Since political constraints on such a solution seem insurmountable, the only way to spur trade between entities is to considerably relax the overburdening regulatory restrictions in the financial markets.

One such rule is the restriction on PIFs ownership of any enterprise to 30 percent of total value. The ownership structure of Bosnian enterprises is such that approximately 70 percent of them only have one large blockholder. PIFs are usually the largest shareholder in poorly functioning enterprises which, in most cases, are in reality bankrupt. The state either holds a majority stake in, or is the largest single shareholder of, the most successful (“strategic”) enterprises. The abovementioned legal restriction is valid insofar that it limits non-cash purchase of shares. The problem lies in the restrictions placed on PIFs operational influence. As crucial organizers and participants in the mass-privatization program, the management of PIFs possesses know-how and ability to play an active role in the operations of enterprises, as well as to constitute a counterweight to other dominant blockholders, whether public or private.

Furthermore, enterprises in which the state owns more than 50 percent of the capital are legally restricted from selling the state-capital via the stock exchange, whereas enterprises with less than 50 percent state capital are allowed to do so. The APF itself has been lobbying the government to abolish this rule (APF 2007:11); thus far unsuccessfully, which may be interpreted as a typical clash of outward commitment to privatization by the political elite, and inward private interest in remaining in control of the most successful enterprises.

5.2 Mass privatization and the International Community

The relationship between BiH and the international community, and in turn the IFIs, is globally unique. As the empirical background in previous chapters has shown, the IC is an integrated part of the BiH constitution, rather than an external entity in relation to which BiH can act freely and independently. BiH is in essence a protectorate of the UN and the EU, which per definition sets constraints on BiH's ability to conduct an independent economic policy.

Majumdar and Ahuja (1997:1592) give four main reasons why rapid privatization in developing countries is unlikely to succeed: political constraints, lack of institutional infrastructure, inadequate depth in capital markets, and macroeconomic instability. BiH meets all four criteria. Despite the mass-privatization program officially being proclaimed completed in 2002, the way in which it has been conducted continues to have ramifications on the large enterprises yet to be privatized, almost a decade later.

Privatization under chaotic circumstances tends to take a familiar path. The planners and executors of economic reform policies tend to underestimate the significance of stable domestic institutions, while at the same time overly relying on the markets to regulate themselves. Despite extensive knowledge of past failures of shock-therapy privatization (e.g. in Russia), the same organizations (e.g. IMF and World Bank) propagated once more for the implementation of the same approach. The fact that the rest of the world had already completed substantial privatization programs during the Bosnian civil war was seen as an argument to increase the pace of privatization in BiH, in order not to be "left behind". (World Bank 1996:42)

Tender and direct sales of large enterprises had not been seriously considered an alternative by the IFI's until late 1999. (Causevic 2001:75) Until then the attention had been directed toward mass-privatization of SMEs, with the aim of using the same concept on the largest SOEs as a second stage. Restructuring of enterprises which – before 2000 – employed approximately 60 percent of the officially employed workforce had been neglected for several years. The result of this approach was further deterioration of the poor conditions of large SOEs; production was maintained considerably below full-capacity (60-70 percent in the industry), debt in form of back taxes and wages grew unsustainably; the technology became increasingly obsolete; widespread asset-stripping which began during the war continued

unhindered. By the time large enterprises were to be privatized, the vast majority found themselves in such condition that no investor interest could be expected without massive restructuring. This notwithstanding, voucher privatization had been applied to these enterprises as well. (Stojanov 2004:23)

The IMF and the World Bank operate in accordance to a doctrine largely encompassed by the Washington Consensus. This entails using the same set of assumptions as starting point regardless of the circumstances at hand; with respect to mass-privatization in BiH this means an expectation that a free capital market exists or will develop, and that there will be a demand for equity (vouchers and shares in SOEs) on this market. Finally, this would also entail the existence of efficient company management structures which would ensure that no misconduct occurs in handling these vast volumes of capital.

The assumption that free capital markets, as a first step, would lead to a “natural” development of institutions in order to support that same market, could not have been based on the realities of the Bosnian economy. A functioning capital market presupposes some of the following commonly accepted conditions:

- no entry barriers for new players
- many small players who neither individually nor through agreements are able to affect prices
- transaction costs are low
- bankruptcy legislation is efficient, and the costs of bankruptcy are low
- there is one tax system, and generally no asymmetries in the rules of the game
- information is accessible and the cost of attaining information is low.

It is difficult to find *one* of the “standard” conditions in which the BiH capital markets could be considered adequate. In order to meet some of these conditions a unified economic space must be created, which means that central provisions of the BiH constitution need to change.

What was realistic to expect based on available empirics (Russia, Czech Republic etc) is also what had occurred: a black market for certificates had sprung up, in which they were traded at 2-3 percent of nominal value. People consequently lost confidence in the value of certificates. Investors with political connections could accumulate vast quantities vouchers/certificates for a marginal cost and use them to buy valuable assets or entire enterprises. The first

international tender sale of the “Sarajevo Holiday Inn Hotel” in 2000 is a good example of such misconduct. Contrary to the predictions of IFI’s, there had been no interest from foreign investors to place bids. The only bidder has been a domestic businessman. He had purchased 51 percent of the hotel worth DM 24 million for only DM 15.6 million, out of which DM 5 million had been paid in cash, and the rest in certificates which he had acquired for approximately DM 400 000. This was the starting point of the annulment of 143 tenders of state enterprises. (Prasnikar 2002:42)

The forces which the IFI’s expected to be curbed by privatization are the ones that have hindered it, and subsequently paralyzed it: corruption, shortage of liquidity, social instability, institutional vacuums, the black markets etc. With the black or grey market hovering at 40 percent of GDP – and unemployment doing likewise – for more than a decade must be acknowledged as a failure. The abovementioned forces should have been addressed simultaneously, if not before, any major privatization program was initiated.

The Privatization Investment Funds (PIFs) provide a good illustration of some of the inadequacies in the design of the voucher privatization system. Private shareholdings in Voucher Privatized Enterprises (VPEs) were managed by PIFs for a fee based on the book value of assets. There was hence no incentive for PIFs to promote efficiency and increased productivity as it had no effect on their reimbursement. In addition, the governments’ limitation on PIFs holdings to 30 percent of VPE capital meant that VPEs effectively remained in government control through pension and restitution funds, as well as direct shareholdings. The effect of PIFs, and the privatizations in which they had participated as buyers, has proved negligible - after considerable time and resources had been devoted to the effort.

Reforms designed to build institutions in order to support the emerging market economy were initiated after most of the donor money had already been distributed on various programs. Contributing vast monetary and human resources into the existing institutional structure has in effect strengthened the system which the IC had been hoping to fundamentally change.

The IFI’s have undoubtedly made a number of miscalculations. It is however difficult to discern how much of it was due to ideological considerations, and how much was caused by lack of understanding of local conditions.

5.3 Property rights

The property of Bosnia and Herzegovina has been divided into two parts: the property of Republika Srpska and the property of the Federation.

The difficulties connected to property rights which BiH faces today are partly inherited from the self-management (socialist) era. During Yugoslav self-management employees had “owned” the enterprises in which they worked. The workers’ role as owners had however not been clearly defined, which in practice meant that management had significant discretion in making both operative and strategic decisions. Neither the constitution nor any other political institution has been clear enough regarding a total break from this tradition. Local politicians have taken a soft stance on this issue and allowed some socialist elements in corporate governance to remain.

A review of the abundant research conducted by the IFIs suggests that property rights in BiH are normally viewed as a purely technical matter. This fact might partly explain why very little progress has been made on this particular issue. The political structure of the country is both the cause and the solution to this problem, and needs not only be understood but also reformed in order for any significant improvement to take place.

The IC in Bosnia has failed to focus attention on property rights protection as a vital element of an efficient privatization program. Unanimously the IFIs have urged a swift change of property from public to private, while brushing aside the uncertainty and haziness involving property rights in BiH. The mass-privatization program had been initiated without the responsible authorities having the time or the resources to establish precisely which properties were public, which private, who the buyer is (can the buyer even be considered a private sector-actor?), or if the “privatization” will have any of the desired effects. It is now clear that the state has maintained a key role in the operations of strategic enterprises, and remains the largest owner in BiH. On average, the FBiH still owns 15 percent of the “privatized” enterprises, and RS approximately 30 percent. In addition, the establishment of the Pension and Disability Insurance Funds resulted in the state taking over additional 10 and 5 percent respectively of all assets yet to be privatized. (TI 2007:29)

A deep understanding of the country's socialist history, as well as the complex institutional structure and ethnic divisions of today, are needed in order to clarify the conditions concerning property rights in BiH.

5.4 Tender privatization, restructuring and debt

The result of including heavily indebted enterprises into the mass-privatization program has been a largely symbolic transfer of ownership from the state to Privatization Investment Funds (PIFs) and citizens, with little subsequent restructuring and hence no real effect on operations. The enterprises are now indebted to the state, to their employees, to financial institutions, and to each other. When attention had turned to tender privatization to remedy this problem *no* interest was shown from either foreign or domestic investors to participate. The excessive indebtedness of certain strategic enterprises makes a sale utterly impossible; the debt burden notwithstanding the investor would have to devote substantial resources to the modernization of the production process, as well as to hiring competent workforce. If these loss-making and heavily indebted enterprises are ever to be privatized they need to be thoroughly restructured.

Strides have however been made toward decreasing the commitments of enterprises regarding severance pay, which accelerated the process of decreasing the number of “employees on hold”. One essential milestone had been the Law on Changes and Amendments to the Labor Law of September 2000, which showed immediate results. (Causevic 2001:78) Although this legislation is merely an accounting exercise with no direct impact on operations, it is a necessary step toward physical restructuring and future tender procedures.

A crucial legislation which still requires attention regards the bankruptcy procedures. Until 2003, bankruptcy laws did not exist in BiH (IMF 2005:44). Bankruptcies in BiH remain a rare occurrence. In a functioning market economy insolvent enterprises must be declared bankrupt, whereby the enterprise is restructured and assets are set free. 10 percent of companies in BiH account for 70-80 percent of social security debt (Andréasson 2007). Restructuring the debt of large strategic enterprises is hence an absolute necessity, and a process long overdue. The main goal of debt restructuring must in effect be aimed at relieving the abovementioned strategic enterprises of *all* debt, as they are (in practice) insolvent. Substantial new funds are needed for technological upgrades and overall productivity enhancement; using fresh capital

to repay debt would leave the enterprise in question in even worse condition, taking into account the alternative cost of a squandered opportunity to invest fresh capital into long-term profitability of the enterprise. However, as a decision of this kind would be a political one, the abovementioned reasoning becomes less clear-cut.

Politics of tender privatization

The entity governments have been reluctant to consider financial restructuring of majority state-owned enterprises. As supported by public choice theory as well as empirical evidence, those who benefit the most under the status-quo are those most reluctant to dismantle it. Privatization is essentially a transfer of power from the state onto private investors.

Politicians have to a great extent tended to regard the privatization process as another avenue to appease and gain voters. E.g. the view of permanent employment as a right is deep-rooted in the mentality of Bosnian workers, as a consequence of the country's long socialist past. (Stojanov 2002) It is therefore the norm among the political community to regard downsizing of workforce as politically impossible, even in heavily overstaffed and insolvent enterprises. Politicians, if they act in a self-interested matter as advocated by public choice theory, cannot hence be expected to voluntarily conduct an action which would severely diminish their own influence. The same reasoning applies to workers and bureaucrats.

40 percent of the Bosnian workforce is employed by the public sector. (Causevic 2001:72) From a public choice perspective this vast portion of workers can be viewed as a large and influential interest group, whose main concern is protecting its own privileges, the central component of which is ensuring their job-security. The power of bureaucrats does not only lie in their intimate knowledge of the system, or their incumbent position, but also in their capacity as voters and lobbyists. This aspect partly explains why tenders of the large successful companies, as well as the large and indebted ones, have in some cases been brought to a standstill.

The corporate governance structure which has emerged from the hitherto implemented privatization efforts has imbedded a cronyism which constitutes a severe hindrance to successful tenders. Supervisory boards of state-owned enterprises are often appointed by managers. Board members are normally also members of political parties, and in some cases members of the manager's family. Relevant qualifications as criterion for a board seat is

secondary to loyalty, which results in company boards consisting of individuals with no financial competence or background. (Suljkanovic 2007:4) The board is hence limited in its ability to exercise control over management, as well making major strategic decisions related to privatization.

The abovementioned problem in corporate governance of Bosnian SOEs is crucial in that supervisory boards are the deciding body on matters such as sale of capital and assets, mergers and acquisitions, takeovers etc. It is through the supervisory boards that strategic investors ought to be evaluated and selected. Due to lack of incentive and ability to make radical decisions, status-quo becomes the only feasible *modus operandi* for both the supervisory board and the enterprise.

Another way for the political sphere to retain control over the remaining SOEs is to control the privatization agencies. The agencies in the Federation still have no control over the enterprises whose sale they are mandated to facilitate. Their authority stretches only to overseeing the tender procedure and supplying information and advice. This has enabled the political parties to interfere and keep valuable assets under their control. (IMF 2005:47) No body has official oversight of the enterprises, which is making the agencies' job of preparing large enterprises for privatization nearly impossible. (APF 2008:38)

6 Conclusions and Discussion

The selection of privatization methods is affected by specific objectives of the government, as well as the institutional, political, and market-related constraints which it faces. What this thesis has hopefully shown, is that one cannot be analyzed in isolation from the other.

The written constitution is the key to understanding most developments in Bosnian political and economic life, including privatization. The Dayton Agreement has contributed heavily to the division of the Bosnian market into three separate parts. Most of the legislation concerning economic policy has been shaped around the Dayton Accords, which has cemented the extreme federalism and severely weakened the central state. Instead of one cohesive national privatization program three entity-based programs have emerged, which have in turn been divided into cantonal and municipal programs. Arbitrary division of property between entities, cantons and municipalities ensued. Some of the largest enterprises have been dismantled to conform to the geopolitical circumstances, despite overwhelming economic facts speaking against such a measure. Large and mid-size enterprises with operations in both entities are discriminated through double taxation, incomprehensible legislation, and time-consuming administrative procedures.

This thesis also shows that the privatization methods had not been chosen on grounds of efficiency and suitability, but have to a large extent been based on self-interest and ideological considerations. The outward commitment of local politicians to the privatization process has not been reflected in their actions. What characterizes the privatization process in BiH, even compared to other transition countries, is the slowness of the process and the complete lack of political will to move it forward.

The abovementioned ideological aspect refers primarily to the International Community (IC) in general and the International Financial Institutions (IFIs) in particular. A substantial portion of this paper has been devoted to the miscalculated mass-privatization scheme which was designed by the IFIs. The voucher scheme's importance lies in its vast scale and cost, as well as its continued relevance. Some of the enterprises which it encompassed should have been declared bankrupt before any transfer of ownership had taken place. Today they remain in the ownership of thousands of voucher-holders with little prospect of recovery. The IFIs regional and international comparisons regarding enterprise restructuring, property rights protection,

and large- and small-scale privatization consistently place BiH at the very bottom. The state remains the dominant owner of the largest strategic enterprises. As the IFIs have been instrumental in both the planning and execution of the privatization program the poor results must at least in part be attributed to them. Largely influenced by the Washington Consensus the IFIs continue to apply a standardized approach of comprehensive mass-privatization and rapid market-liberalization, regardless of the unique situation of the transition country in question.

BiH finds itself in a situation with 40 percent unemployment, colossal trade deficits, negative growth, complete dependence on foreign aid, and a persistently over-sized public sector. Privatization of large and mid-size enterprises is a necessary step toward economic recovery. It will however not be possible without changing the institutional framework, starting with the constitution. The central state needs to be empowered; the fragmentation of territory and decision-making needs to be abolished; and a genuine democracy must to be instated.

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APPENDIX I – The constitution of BiH

This appendix only includes selected parts of the constitutions being referred to in this paper.

Article I:

Bosnia and Herzegovina

1. Continuation

The Republic of Bosnia and Herzegovina, the official name of which shall henceforth be "Bosnia and Herzegovina," shall continue its legal existence under international law as a state, with its internal structure modified as provided herein and with its present internationally recognized borders. It shall remain a Member State of the United Nations and may as Bosnia and Herzegovina maintain or apply for membership in organizations within the United Nations system and other international organizations.

2. Democratic Principles

Bosnia and Herzegovina shall be a democratic state, which shall operate under the rule of law and with free and democratic elections.

3. Composition

Bosnia and Herzegovina shall consist of the two Entities, the Federation of Bosnia and Herzegovina and the Republika Srpska (hereinafter "the Entities").

4. Movement of Goods

Services. Capital. and Persons. There shall be freedom of movement throughout Bosnia and Herzegovina. Bosnia and Herzegovina and the Entities shall not impede full freedom of movement of persons, goods, services, and capital throughout Bosnia and Herzegovina. Neither Entity shall establish controls at the boundary between the Entities.

5. Capital

The capital of Bosnia and Herzegovina shall be Sarajevo.

6. Symbols

Bosnia and Herzegovina shall have such symbols as are decided by its Parliamentary Assembly and approved by the Presidency.

7. Citizenship

There shall be a citizenship of Bosnia and Herzegovina, to be regulated by the Parliamentary Assembly, and a citizenship of each Entity, to be regulated by each Entity, provided that:

- a) All citizens of either Entity are thereby citizens of Bosnia and Herzegovina.
- b) No person shall be deprived of Bosnia and Herzegovina or Entity citizenship arbitrarily or so as to leave him or her stateless. No person shall be deprived of Bosnia and Herzegovina or Entity citizenship on any ground such as sex, race, color, language, religion, political or other opinion, national or social origin, association with a national minority, property, birth or other status.
- c) All persons who were citizens of the Republic of Bosnia and Herzegovina immediately prior to the entry into force of this Constitution are citizens of Bosnia and Herzegovina. The citizenship of persons

who were naturalized after April 6, 1992 and before the entry into force of this Constitution will be regulated by the Parliamentary Assembly.

d) Citizens of Bosnia and Herzegovina may hold the citizenship of another state, provided that there is a bilateral agreement, approved by the Parliamentary Assembly in accordance with Article IV(4)(d), between Bosnia and Herzegovina and that state governing this matter. Persons with dual citizenship may vote in Bosnia and Herzegovina and the Entities only if Bosnia and Herzegovina is their country of residence.

e) A citizen of Bosnia and Herzegovina abroad shall enjoy the protection of Bosnia and Herzegovina. Each Entity may issue passports of Bosnia and Herzegovina to its citizens as regulated by the Parliamentary Assembly. Bosnia and Herzegovina may issue passports to citizens not issued a passport by an Entity. There shall be a central register of all passports issued by the Entities and by Bosnia and Herzegovina.

Article III:

Responsibilities of and Relations Between the Institutions of Bosnia and Herzegovina and the Entities

1. Responsibilities of the Institutions of Bosnia and Herzegovina

The following matters are the responsibility of the institutions of Bosnia and Herzegovina:

- a) Foreign policy.
- b) Foreign trade policy.
- c) Customs policy.
- d) Monetary policy as provided in Article VII.
- e) Finances of the institutions and for the international obligations of Bosnia and Herzegovina.
- f) Immigration, refugee, and asylum policy and regulation.
- g) International and inter-Entity criminal law enforcement, including relations with Interpol.
- h) Establishment and operation of common and international communications facilities.
- i) Regulation of inter-Entity transportation.
- j) Air traffic control.

2. Responsibilities of the Entities

a) The Entities shall have the right to establish special parallel relationships with neighboring states consistent with the sovereignty and territorial integrity of Bosnia and Herzegovina.

b) Each Entity shall provide all necessary assistance to the government of Bosnia and Herzegovina in order to enable it to honor the international obligations of Bosnia and Herzegovina, provided that financial obligations incurred by one Entity without the consent of the other prior to the election of the Parliamentary Assembly and Presidency of Bosnia and Herzegovina shall be the responsibility of that Entity, except insofar as the obligation is necessary for continuing the membership of Bosnia and Herzegovina in an international organization.

c) The Entities shall provide a safe and secure environment for all persons in their respective jurisdictions, by maintaining civilian law enforcement agencies operating in accordance with internationally recognized standards and with respect for the internationally recognized human rights and fundamental freedoms referred to in Article II above, and by taking such other measures as appropriate.

d) Each Entity may also enter into agreements with states and international organizations with the consent of the Parliamentary Assembly. The Parliamentary Assembly may provide by law that certain types of agreements do not require such consent.

3. Law and Responsibilities of the Entities and the Institutions

a) All governmental functions and powers not expressly assigned in this Constitution to the institutions of Bosnia and Herzegovina shall be those of the Entities.

b) The Entities and any subdivisions thereof shall comply fully with this Constitution, which supersedes inconsistent provisions of the law of Bosnia and Herzegovina and of the constitutions and law of the Entities, and with the decisions of the institutions of Bosnia and Herzegovina. The general principles of international law shall be an integral part of the law of Bosnia and Herzegovina and the Entities.

4. Coordination

The Presidency may decide to facilitate inter-Entity coordination on matters not within the responsibilities of Bosnia and Herzegovina as provided in this Constitution, unless an Entity objects in any particular case.

5. Additional Responsibilities

a) Bosnia and Herzegovina shall assume responsibility for such other matters as are agreed by the Entities; are provided for in Annexes 5 through 8 to the General Framework Agreement; or are necessary to preserve the sovereignty, territorial integrity, political independence, and international personality of Bosnia and Herzegovina, in accordance with the division of responsibilities between the institutions of Bosnia and Herzegovina. Additional institutions may be established as necessary to carry out such responsibilities.

b) Within six months of the entry into force of this Constitution, the Entities shall begin negotiations with a view to including in the responsibilities of the institutions of Bosnia and Herzegovina other matters, including utilization of energy resources and cooperative economic projects.

Article IV:

Parliamentary Assembly

The Parliamentary Assembly shall have two chambers: the House of Peoples and the House of Representatives.

1. House of Peoples

The House of Peoples shall comprise 15 Delegates, two-thirds from the Federation (including five Croats and five Bosniacs) and one-third from the Republika Srpska (five Serbs).

a) The designated Croat and Bosniac Delegates from the Federation shall be selected, respectively, by the Croat and Bosniac Delegates to the House of Peoples of the Federation.

Delegates from the Republika Srpska shall be selected by the National Assembly of the Republika Srpska.

b) Nine members of the House of Peoples shall comprise a quorum, provided that at least three Bosniac, three Croat, and three Serb Delegates are present.

2. House of Representatives

The House of Representatives shall comprise 42 Members, two-thirds elected from the territory of the Federation, one-third from the territory of the Republika Srpska.

a) Members of the House of Representatives shall be directly elected from their Entity in accordance with an election law to be adopted by the Parliamentary Assembly. The first election, however, shall take place in accordance with Annex 3 to the General Framework Agreement.

b) A majority of all members elected to the House of Representatives shall comprise a quorum.

Article V:

Presidency

The Presidency of Bosnia and Herzegovina shall consist of three Members: one Bosniac and one Croat, each directly elected from the territory of the Federation, and one Serb directly elected from the territory of the Republika Srpska.

1. Election and Term

a) Members of the Presidency shall be directly elected in each Entity (with each voter voting to fill one seat on the Presidency) in accordance with an election law adopted by the Parliamentary Assembly. The first election, however, shall take place in accordance with Annex 3 to the General Framework Agreement. Any vacancy in the Presidency shall be filled from the relevant Entity in accordance with a law to be adopted by the Parliamentary Assembly.

b) The term of the Members of the Presidency elected in the first election shall be two years; the term of Members subsequently elected shall be four years. Members shall be eligible to succeed themselves once and shall thereafter be ineligible for four years.

...

3. Powers

The Presidency shall have responsibility for:

- a) Conducting the foreign policy of Bosnia and Herzegovina.
- b) Appointing ambassadors and other international representatives of Bosnia and Herzegovina, no more than two-thirds of whom may be selected from the territory of the Federation.
- c) Representing Bosnia and Herzegovina in international and European organizations and institutions and seeking membership in such organizations and institutions of which Bosnia and Herzegovina is not a member.
- d) Negotiating, denouncing, and, with the consent of the Parliamentary Assembly, ratifying treaties of Bosnia and Herzegovina.
- e) Executing decisions of the Parliamentary Assembly.
- f) Proposing, upon the recommendation of the Council of Ministers, an annual budget to the Parliamentary Assembly.
- g) Reporting as requested, but not less than annually, to the Parliamentary Assembly on expenditures by the Presidency.
- h) Coordinating as necessary with international and nongovernmental organizations in Bosnia and Herzegovina.
- i) Performing such other functions as may be necessary to carry out its duties, as may be assigned to it by the Parliamentary Assembly, or as may be agreed by the Entities.

APPENDIX II – BiH's Legislative and Executive Bodies

BiH's Legislative and Executive Bodies

