



Are institutions supportive of economic development and EU integration process - The case of transition economies and BiH?

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Assessments of BH institutions!

The strategic goal of Bosnia and Herzegovina (BiH) is full membership of the European Union and it seems that an overall consensus about this "European future" has been agreed in the country. Bosnia and Herzegovina is currently going through the Stabilisation and Association phase, a process that should further support its steps towards the full EU membership. Unfortunately, BiH's position in the whole process of European integration cannot currently be marked as satisfactory, at least for two reasons. If we compare the position and speed of improvement of BiH with other countries from the region, it seems that BH lags behind in the EU integration process. Similarly, the economic development of this country cannot be marked as satisfactory. The official unemployment rate is above 40%; GDP is still only around 70% of the pre-war level GDP; the trade deficit is around 50% of GDP, which makes this country import-dependent while at the same time around 50% of domestic companies do not produce at their capacity. The costs of starting and closing business put this country almost at the world bottom according World Bank doing business reports (2004-2007). There are many reasons for this position of BiH. Without underestimating other determinants, we consider that a particularly important aspect of achieving successful integration and economic development in the future is the establishment of an efficient institutional framework. This may be especially the case for BiH having in mind the "unique" institutional framework in this country and its potential consequences for economic performance and European processes.

Empirical research and contemporary economic theory generally suggest that a nation's institu-

tional framework is an important factor determining economic performance as well as success in the processes of economic integration. Institutions are important because they determine economic performance by imposing "rules of the game" and by reducing the transaction costs associated with economic decision-making in the economy.

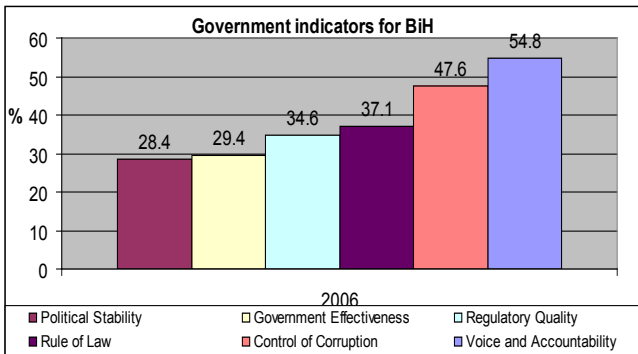
When the process of transition began many institutions collapsed. The development of institutions that support market and private enterprises in the later phase has influenced the overall economic performance of TCs. Consequently, it was "extremely demanding" for transition economies to establish capitalist institutions overnight on the "ruins of socialist institutions" that could not be used as a building block for the new capitalist system. What was happening in the practice was that by building a capitalist system those countries were also building a new institutional framework (Redek and Susjan, 2005).

There are a few empirical studies that analyse the link between institutions and economic performance in transition economies¹. It is worth to mention that only research by Eicher and Schreiber (2007) includes BiH in its sample, but it does not provide any explanation for this country. Hence, the quality of the institutional framework and its impact on economic development and integration process is especially interesting for BiH. Unfortunately, BiH lags behind other countries from the region, even behind the average of all transition economies. Some visual presentation of BH position compare to other transition economies regarding some institutional indices and institutional fields is provided on the following graphs.

¹ For example: Brunetti et al. (1997); Assane and Grummy (2003); Chousa et al. (2005); Redek and Susjan (2005).

Summary

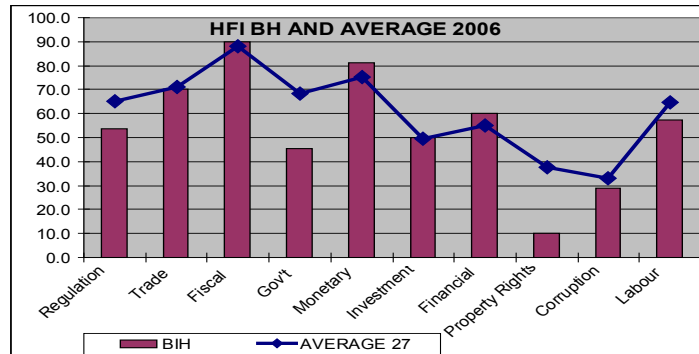
Institutions - that may be defined as rules, organizations and enforcement characteristics (WB, 2002) - are an important determinant of economic performances in transition economies. Moreover, the efficiency of state institutions was an important determinant of those economies early accession to full EU membership. *Consequently, institutions need to be treated as important factor that influences economic performance and the speed of the European integration processes in transition economies.* Almost the highest correlation between institutions and economic performance in transition economies is obtained for Bosnia and Herzegovina. *Accordingly, institutions in BiH may be "highly" important in supporting better economic performance of this country.* Unfortunately, the efficiency of BiH state institutions is far below transition average. *In such situation it is necessary to improve efficiency of state institutions in order to improve economic performance of this country.* Our empirical analysis suggests that, on average, by *improving efficiency of institutions for 10% in transition economies, GDP per capita may raise almost \$400; or analysing in terms of growth, 1% increase in quality of institutions leads towards 1% higher GDP per capita growth.* Moreover, with the current macroeconomic performance and efficiency of domestic institutions, *BiH has around 1% of probability to become member of EU, having in mind results of other economies that have already become EU countries.* Our results also suggest that if BiH, for example, wants to improve its position in the EU integration process to the level of the current EU candidate till 2015 (i.e. Croatia), *than quality of BiH institutions need to rise around 5% per year.* Currently, it is below 2%.



Graph 1:
Governance indicators, BiH, 2006

If we look **Governance indicators (GI) for BiH in 2006**, for example, we can see that political stability has the lowest value indicating the high likelihood of BH government in being destabilized. Moreover, the Government efficiency takes the "second" low place indicating the low quality of public services, quality of policy formulation, and implementation. Thirdly, Regulatory policy is also marked very low suggesting the "inability" of government to formulate and implement sound policies and regulations that support private sector development. Apart from the problem of political instability, government efficiency and enforcement of institutions by government, the rule of law is another "crucial" determinant of the institutional framework marked at low level. In a word, almost all government indicators are very low; hence the efficiency of BiH governments overall is marked low.

Similar message comes from the Graph 2 as well. Looking the **HFI - the Heritage foundation index** - subcomponents that can be used as proxy for quality of certain institutional

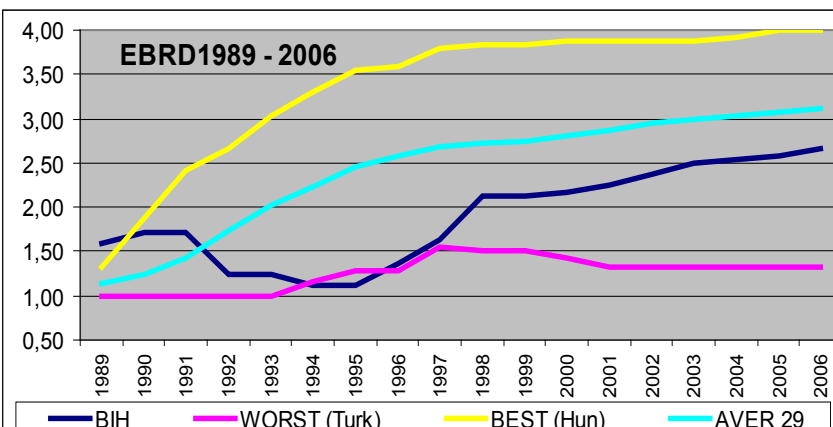


Graph 2:
HFI, BiH and transition average, 2006

areas in BiH in 2006, we may see that BiH is below transition average in almost all ten institutional aspects. Those are mainly the field of regulation; government; and property rights; all components of particular importance for an efficient institutional framework. Property rights institutions are especially marked low, while the same conclusion may be for regulation and government. Only monetary, fiscal, and financial institutions in BiH are on the average level of other transition economies.

Finally, using institutional components of **EBRD transition index 1989-2006** we may see on Graph 3 again how BiH lags behind average transition economies, as well as that the speed of improvement is not at satisfactory level; the BiH average of this index is around 50% of the benchmark level that means a fully established market economy; the level assumed for the EU integration as well.

Graph 3:
EBRD institutional index 1989-2006



As we could see, the quality of institutions in BiH is far below EU transition and EU-candidate countries, even below the average of all transition economies. Summary findings from our analysis of "institutions relevant for economic growth" in BiH (Rodrik, 1999) are provided in the following table.

Note: Institutions (in BiH) are not only political issue!

The current institutional structure in BH is very complex; it is costly, creates many overlapping authorities and even after more than one decade after initial establishment suffers from lack of harmonisation. Consequently, entrepre-



INSTITUTIONS	ASSESSMENT	COMMENTS
Institutions for macroeconomic stabilisation	Efficiency at "satisfactory" level	UNDP survey indicates that efficiency of those institutions is not problematic for business sector. Official data go in line with survey results: economic environment without high inflation; low budget deficits; rapid increase in collection of taxes last years.
Property rights institutions	Efficiency marked as very low	HFI and GI suggest that property rights are far below transition level. Also, UNDP survey indicates that judiciary system, which is relevant for property rights protection, is the least efficient in BiH,
Regulatory institutions	Efficiency marked as extremely low	GI imply that institutions responsible for regulation in BiH are far below satisfactory level. UNDP survey indicates lack of efficiency of different level of governments, especially central government
Institutions for conflict management	Efficiency marked as very low	UNDP survey indicates that judiciary system is the least efficient in BiH
Institutions for social insurance	Efficiency marked as quite low	UNDP survey suggest that institutions for social insurance are not that problematic for business sector but still they are not marked as efficient
Informal institutions	Marked as highly present	Results from UNDP survey suggest that informal institutions are highly used in everyday business activities and as efficiency of formal institutions decreased they were used even more

neurs face higher transaction costs in terms of the time and money they must spend inside the current institutional arrangements of BH. Apparently, it is not surprising that according to some surveys (ex. Early Warning System BH, UNDP; April, 2007) the biggest obstacles to economic development that entrepreneurs identify are institutionally rooted, like: unfair competition; grey economy; corruption; and low efficiency of the judiciary. The complexity of BH's institutional framework and "lack" of efficiency has been recently recognized as a political problem, but the economic consequences of such a structure and consequences on its EU integration success need to be seriously taken into account. In our research we have established two empirical econometric models in which those issues are treated and quantified; conclusions are summarized below.

Institutions in BiH need to be treated as important factor that influences economic performance and the speed of the European integration processes, not only as "political issue"

What to conclude?

- **We should know gains:** according obtained empirical results in a simple econometric model, an increase of institutional efficiency in transition economies of 10% may improve the level of GDP per capita by almost \$400 on average; hence, it is

increase of standard of living. Similarly, 1% increase in institutional quality leads towards 1% higher economic growth. *By improving the quality and efficiency of domestic institutions in BiH it is possible to stimulate higher economic growth and standard of living.*

- **About BiH:** our analysis suggests that most efficient institutions in BiH are institutions for macroeconomic stabilisation - Central bank and fiscal authorities. The least efficient institutions in BiH are property rights institutions; regulatory institutions; and institutions for conflict management. *Accordingly, BiH needs to improve the efficiency of non-market institutions in order to improve its economic performance and the speed of the EU integration process. Namely, it will be important to improve the efficiency of Central government BiH, Judiciary system, Agency for privatisation, and Employment services.*
- **Institutions - BiH - EU:** the results from the panel Logit model indicates that with the current macroeconomic performance and efficiency of domestic institutions, BiH has around 1% of probability to become member of the EU, having in mind results of other economies that have already become EU countries. *Taking into account possible economic development of BiH till 2015, BiH may "count" on EU membership if improves*



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was born on 04th January 1978. He graduated at the Faculty of Economics in Sarajevo with outstanding results and was awarded as one of the best students of human sciences in BH. He completed his Master thesis at the Faculty of Economics in Sarajevo in 2004. His scientific-research work is based in fields of Macroeconomics, European economy, and Institutional Economics. He finished number of specializations at European universities, published 19 papers in domestic and foreign publications, and had presentations at 7 international conferences. Currently, he is doing PhD dissertation from the field of Institutional Economics at the Staffordshire University in the UK. He works as the senior teaching assistant at the School of Economics and Business in Sarajevo.

the efficiency of its institutions roughly 5% per year. If institutional efficiency remains quite the same (last three years institutional index raised 1.9% on average), EU integration may last decades.

- **Institutions and money:** the costs of state institutions in BiH are high for business sector as consequence of direct costs (in terms of direct paying for taxes, etc.) and indirect costs (costs because of lack of enforcement of some institutions, etc.). *It is necessary to improve enforcement of state institutions by decreasing time-wasting procedures, mainly regarding contract enforcement, obtaining different business licenses, acquiring information, and solving business disputes. Appropriate remedies may be undertaken in a short-period of time and it is necessary to develop strategy to improve the enforcement efficiency of existing institutions.*
- **Friendships, etc.:** "Informal institutions" (i.e. unwritten rules) in BiH are used to a large extent by business sector. Extensive reliance of business sector on informal institutions may increase overall costs of business and harms the competitiveness of domestic companies. *By providing more efficient state institutions, transaction costs for business sector will be lower; informal institutions will be less used in business operations, and finally, the competitiveness of domestic companies, may increase. By increasing institutional efficiency in BiH it is possible to increase the competitiveness of domestic companies and that of the BiH economy overall.*

Main sources

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