Corruption in Bosnia and Herzegovina

Causes, Consequences and Cures

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Master thesis in Economics
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2010
Abstract

The state of Bosnia and Herzegovina (BiH), a developing country that once was a part of the communist Yugoslavia, is struggling to move from wartime to peacetime, to shift from a centrally controlled economy to a free market economy, and to stir from a socialist style government to a democracy. All of these processes lend themselves to great corruption. The aim with this paper, thus, is to provide a frame of reference that can be used when writing and implementing policies against corruption in BiH. This paper tries to identify the sectors in BiH that are most affected by corruption and to discuss possible causes of corruption in the country. The paper also discusses possible effects that corruption in BiH has on the country’s economic growth, how corruption can be fought in the country and how a successful reduction in corruption affects BiH’s economic growth.

This work finds several flaws and weaknesses in the society of BiH. BiH faces today weak policies, weak institutions and weak penalty systems. There are strong regulations and no institutional controls. The economy is weak and leads to poverty. This paper argues that it is through these weaknesses in the society that corruption in BiH has arisen, and has consequently affected all major sectors and institutions in the country; it can be seen in the political parties, the Police and other Enforcement Structures, the Judiciary, public utilities, the Health System and the Education System. Corruption has furthermore slowed down the privatization process and is used by employers during recruitment processes to exploit citizens in need of a job.

This paper also finds that corruption in BiH brings with it its own distortions as it undermines social capital by creating mistrust between various actors in the country, hinders both domestic and foreign investment, increases poverty and encourages growth of the black market. All of these distortions lead to a slowdown in the economic growth.

Furthermore, this paper asserts that BiH needs help from the European Union, the Office of high Representative and possibly other international actors in the fight against corruption. They must help BiH to implement strategies that will give the leading politicians incentives to fight corruption. The paper stresses the lack of politicians’ will to fight corruption in BiH today as the biggest and most central problem in the fight against corruption. The anti-corruption program in this paper therefore emphasizes the importance of anti-corruption measures that first and foremost deal with this problem. Only when this issue is resolved can BiH move to anti-corruption strategies on national level. The anti-corruption strategies on national level themselves should contain effective government anti-corruption strategies. They should also promote anti-corruption education and secure free access to information.

Finally, this work identifies probable positive effects on BiH’s economic growth if corruption is successfully fought; the country will experience higher domestic and foreign investment, the mistrust will decrease and result in higher social capital, and both poverty and the black-market activity will be reduced.
Abbreviations and acronyms

BiH: Bosnia and Herzegovina
BiH HoR: BiH House of Representatives
CCI: Center for Civic Initiatives
EUSR: EU Special Representative
FBiH: The Federation of Bosnia and Herzegovina
HDZ: The Croatian Democratic Union
HR: High Representative
JASP: Judicial System Assessment Program
KM: Konvertibilna Marka, KM 1 ≈ € 0.5
NGO: Non-govermental organizations
OHR: Office of High Representative
PDP: Party of Democratic Progress
RS: Republika Srpska
SAA: Stabilization and Association Agreement
SBiH: Party for BiH
SDA: The Bosniak Party of Democratic Action
SNSD: Serb Union of Independent Social Democrats
TI: Transparency International
UNDP: United Nations Development Programme
UNMIBH: UN mission in Bosnia and Herzegovina
Figures and tables

Figure 2.1: Wage level and corruption ..................................................................................... 18
Figure 3.1: GDP Growth 2001-14 ............................................................................................ 28
Figure 3.2: Import and Export .................................................................................................. 29
Figure 6.1: Prisoners’ dilemma ............................................................................................... 44
Figure 6.2: The phase diagram ................................................................................................ 47
Figure 7.1: The phase diagram and the scenario 1-development ............................................. 49
Figure 7.2: The phase diagram and the scenario 2-development ............................................. 51
Figure 7.3: The corruption-output relationship ......................................................................... 52
Figure 9.1: The phase diagram and the scenario 1-alternative development ......................... 62
Figure 9.1: The phase diagram and the scenario 2-alternative development ......................... 64

Table 3.1: Key macroeconomic indicators 2007-10 ............................................................... 28
Contents

Preface ....................................................................................................................................... 8

1. Introduction ............................................................................................................................ 9
  1.1 The problematization of corruption ...................................................................................... 9
  1.2 Problem formulation .......................................................................................................... 10
  1.3 Aim ..................................................................................................................................... 10
  1.4 Method ................................................................................................................................ 11
    1.4.1 Methodology ........................................................................................................... 11
    1.4.2 The empirical research ............................................................................................ 12
    1.4.3 Method criticism ..................................................................................................... 12
  1.5 Disposition ......................................................................................................................... 13

Part ONE

2. Previous research .................................................................................................................. 15
  2.1 Causes of corruption ........................................................................................................... 15
    2.1.1 Political factors ........................................................................................................ 15
    2.1.2 Economical factors .................................................................................................. 17
  2.2 Economic consequences of corruption ............................................................................... 19
    2.2.1 Size and composition of government expenditure .................................................. 19
    2.2.2 Domestic investment ............................................................................................... 20
    2.2.3 Corruption and the underground economy .............................................................. 21
    2.2.4 Urban bias, poverty and other consequences .......................................................... 21

3. Facts about BiH ....................................................................................................................... 23
  3.1 The history of BiH ............................................................................................................... 23
  3.2 The political situation today ............................................................................................... 25
  3.3 The economical development ............................................................................................. 27

4. The corruption in BiH ......................................................................................................... 30
  4.1 Politicians, governing and institutions ............................................................................... 30
    4.1.1 Corruption in political parties .................................................................................. 31
4.1.2 Corruption in the Police and other Enforcement Structures .............................. 31
4.1.3 Corruption in the Judiciary ................................................................................ 32
4.1.4 Corruption in public utilities .......................................................................... 32
4.1.5 Corruption in the privatization process ......................................................... 33

4.2 Corruption in the Public Sector Service Delivery ................................................. 33
4.2.1 Corruption in the Health System .................................................................... 33
4.2.2 Corruption in the Education System ................................................................. 34

4.3 Employment, salaries and the standard of living ............................................... 35

5. Causes of corruption in BiH .................................................................................. 37
5.1 Root Causes ........................................................................................................... 37
5.2 Causes due to the political atmosphere ............................................................... 38
5.3 Causes due to economical issues ......................................................................... 39

Part TWO

6. Corruption and transparency in a growth model ................................................. 42
6.1 Structure of the model ......................................................................................... 42
6.1.1 Assumptions and the economy ...................................................................... 42
6.1.2 The political process ....................................................................................... 43
6.2 The dynamic optimization problem .................................................................... 45

7. Effects of corruption on economic growth in BiH .............................................. 48
7.1 The development path ......................................................................................... 48
7.1.1 Scenario 1 ........................................................................................................ 48
7.1.2 Scenario 2 ........................................................................................................ 51
7.1.3 The corruption-growth relationship ............................................................... 52
7.2 Channels through which corruption affects growth ......................................... 53

8. The anti-corruption program ............................................................................... 55
8.1 Altering the will of the politicians ...................................................................... 55
8.2 Country strategies and policies ......................................................................... 57
8.2.1 Government anti-corruption strategies ......................................................... 57
8.2.2 Access to information .................................................................................... 59
8.2.3 Anti-corruption education .............................................................................. 60
9. The anti-corruption program and the development path ............... 62
  9.1 Scenario 1-alternative development .................................................. 62
  9.2 Scenario 2-alternative development .................................................. 64

10. Conclusions ......................................................................................... 65

References ................................................................................................. 67

Appendix .................................................................................................... 70
Besides being citizens of Sweden, we are both also citizens of Bosnia and Herzegovina. We travel to Bosnia and Herzegovina one to three times a year due to the great part of our families and friends that still lives there. During our travels we have seen ruthless corruption and we have several times also been targets of its dishonest actions. We apprehend corruption in Bosnia and Herzegovina as an increasing phenomenon at the same time as we see more and more human beings struggle for their survival. We sincerely hope that this work will contribute to a reduction of corruption in the society of Bosnia and Herzegovina and thus lead to better life for many citizens.

We would like to thank Paul Nystedt for his supervision, our opponent Katarina Händel and all of you who have contributed to this work by giving constructive criticism and other valuable suggestions. We would especially like to thank all of our interviewees, you know who you are.

Linkoping, February 2010

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1. Introduction

Causes and consequences of corruption, together with anti-corruption measures, have attracted much attention in recent years by both academics and policymakers. The corruption, however, is not a new phenomenon. Kautilya, the prime minister of an Indian king, wrote two thousand years ago a book called “Arthashastra” where he discussed corruption. Dante placed bribes in the deepest parts of Hell seven centuries ago, which reflects the medieval dislike for corruption. Shakespeare gave corruption important roles in some of his plays. It is not obvious why corruption has received so much attention in recent years, but there are some circumstances that may have contributed to this. The political hypocrisy that made the decision makers in some industrial countries during the Cold War ignore the political corruption that existed has been stopped as the Cold War ended. Globalization has led to frequent contacts between individuals from less corrupt countries and individuals from more corrupt countries, which may have resulted in an increased international attention to corruption. The recent increase in the number of countries with democratic governments and free media could also have created an environment where people can discuss corruption. Nongovernmental institutions such as Transparency International have recently played more important roles as they continue to publicize the problems of corruption and try to create anti-corruption movements. There have also been empirical studies of corruption, which have contributed to a greater awareness of this problem.1

1.1 The problems of corruption

The criminal law contains at least four different approaches to wrongfully obtain control over the property or personal interests of others. One is when the thief removes property when owners and custodians are not looking, i.e. by theft. A second method involves the obtainment of property or obedience by use or threat of unauthorized personal force. A third class of victimization involves the use of fraud or falsity to induce victims to part with things of value because they believe the facts that the offender has misrepresented. The forth method to wrongfully obtain control over the property or personal interest of others is through the use of social or institutional power.2 If powers, granted to persons for restricted purpose, are used for unauthorized personal gains, illegal exchanges take place: a government official charged with selecting the most qualified firm for an investment project selects the firm that offers him most money in a personal bribe; an university professor with the power to assign passing grades in exams on merit basis instead trades the passing grades or higher grades for cash or personal favours from students or their families; the prime minister grants public licenses that are not supposed to be given away to friends and family members rather than auctioning them off. In all of these cases, the offender has power for limited purposes and uses it in forbidden and unauthorized ways. This falls in line with Transparency International’s definition of corruption as the abuse of entrusted power for private gain. Transparency International further distinguish between “according to the rule” corruption and “against the rule” corruption. The

1 Tanzi (1998)
2 Zimring and Johnson (2005)
former implies payments where a bribe is paid to receive treatment for something that the bribe receiver is required to do by the law. The latter is a bribe paid to receive services that the bribe receiver is unauthorized to provide.  

While corrupt behaviour is no more or less dishonest than crimes involving force or stealth, the social structure of corruption and its distribution in a society differ from those of other crimes such as fraud, personal force or stealth. While other crimes are typically acts of persons who lack social or economic power, corruption is by definition an act of persons who have economic power to bribe others or the power to provide a favour for a bribe. Furthermore, all of the immediate parties involved in corrupt exchange often gain from the unauthorized use of power, and a self-defined victim is lacking. This also separates corruption from other crimes such as burglary or robbery. It is this dynamic and often hidden social structure of corruption that makes corruption dangerous and devastating for developing economies and economies in transition as their social and institutional structure seem to be well suited for corruption. Dangerous and devastating in the sense that corruption and other aspects of poor governance and weak institutions cause substantial and adverse effects on economic development.

1.2 Problem formulation
The state of Bosnia and Herzegovina (BiH), a developing country that was a part of the communist Yugoslavia, is struggling to move from wartime to peacetime, to shift from a centrally controlled economy to a free market economy, and to stir from a socialist style government to a democracy. All of these processes lend themselves to great corruption. The Transparency International places BiH on a shared 99th place in an index that covers 180 countries. The 99th place is shared with countries Tonga, Zambia, Madagascar, Senegal, Jamaica and Dominican Republic. This shows a negative development of corruption in BiH as the country was ranked in 82nd place in 2004. This continues to be a big issue in BiH today. Thus, earlier attempts to reduce corruption in BiH seem to have resulted in failures.

1.3 Aim
The aim with this paper is to provide a frame of reference that can be used when writing and implementing policies against corruption in BiH. We provide a discussion around these following main questions:

1. How is the situation regarding the corruption in BiH?
2. What are the causes of corruption in BiH?
3. How does corruption slow down the economic growth of BiH?
4. How can corruption in BiH be fought?
5. How will a successful reduction in corruption affect the growth of BiH?

3 Transparency International – Frequently asked questions about corruption
4 Zimring and Johnson (2005)
5 Mauro (2002)
6 Transparency International – Corruption Perception Index
1.4 Method

1.4.1 Methodology

The main questions that constitute the aim of this paper require different methodological approaches. The first main question must be tackled through some sort of empirical study of BiH’s society today. Thus, an empirical research was conducted in July 2009. This research, which was accomplished by interviews, together with empirical research in BiH made by the bodies Office of High Representative (OHR), Bosnian office of United Nations Development Programme (UNDP), UN mission to Bosnia and Herzegovina (UNMBiH), The Bosnian Institute, CHR Michelsen Institute, Transparency International and The Citizen’s Forum will be used to provide a discussion about the spread of the corruption in BiH. The research made by these bodies is used to enhance the information-framework. Our ambition is also to use, when possible, the information and experience that we have gained in our travels to BiH in order to provide a clearer illustration of the situation in BiH.

The second main question is clearly linked to the first and requires, thus, a similar methodological approach. More correctly, it is a continuation of the first question, and can only be tackled when the spread of corruption is somewhat mapped out. By studying the sectors that are affected by corruption and at the same time study the history of BiH, the political situation in BiH today and the economical development of BiH, we can provide a discussion regarding the causes of corruption in BiH. Earlier research of corruption by Dreher, Kotsogiannis and McCorriston (2004), Abed and Davoodi (2000), Tanzi (1998), Becker (1968), and Mueller (2003) will be used as a framework to this second question.

The third main question requires a more theoretical approach since a theoretical growth model must be used to analyze the economic development. We use the model of Ellis and Fender (2006), which introduces endogenous corruption into a variant of Ramey growth model. The motivation for using this model is that it provides a manageable framework for analyzing both the steady state and adjustment paths of a dynamic economy in which the relationship between corruption, the level of output, and the growth rate depend on the level of fiscal transparency. The model does also a good job in explaining the results found in the empirical literature, something that is important to us since it raises the credibility of our work. In order to put a more empirical hallmark on the discussion of this third question, we will also discuss the channels through which corruption may affect the growth in BiH. This will to some extent also be based on the empirical research conducted in July 2009, and will use earlier empirical research on effects of corruption on growth conducted by Tanzi and Davoodi (1997), Mueller (2003), Tanzi (1998), and Wei (1998) as a framework.

The fourth main question regarding the fight against corruption is certainly the most difficult to answer. We believe, however, that if the most important causes of corruption are identified, measures that eliminate the weaknesses that serve as basis for the causes can be conducted. Our aim is thus to bring forth an anti-corruption plan that discusses different measures along with their designing and implementation.
For the last main question, we will return to the model of Ellis and Fender to show alternative developments paths for BiH, based on a reduction in corruption.

1.4.2 The empirical research
Corruption is a sensitive topic in BiH, and thus, the interview questions\(^7\) were written in a way that allows the interview subjects to decide how much they want to say or not say. We had to go as far as to write questions that can be answered simply by yes or no. We hoped however, as we asked questions in this careful way, that the interviewees would feel comfortable to elaborate their answers. Our motivation was to have, as much as possible, a geographical differentiation for the interview. Thus, we conducted the interviews in the large city of Sarajevo, the middle-size city of Gorazde and the small city of Ustikolina. When choosing candidates for the interview, a differentiation was again necessary. The aim was to interview individuals with different life-situations such as different professions and different ages, which do not have any incentives to lie. The empirical research, therefore, consists of interviews with students, workers in firms, self-employed persons, municipal workers and unemployed persons, and ended with a total sum of 20 interviews; 13 employed, 4 students and 3 unemployed. Asking questions about corruption in BiH is very sensitive and sometimes dangerous, and requires cautious methods. When looking for interview subjects, ironically a wide network of contacts is needed. When potential interviewees are found, some sort of background research about the individual must be done before a decision is made. In the background research we wanted to find out, when possible, about the individual’s profession, family, status, age and education. This background research is a guarantee for us where the aim is to investigate if it is safe to talk to the individual and if the individual has any incentives to lie. If the candidate fits our criteria for being interviewed, someone needs, in turn, to guarantee for the interview subject that it is all right for him or her to do the interview with us. The interview subjects needed to be sure that we would not write any names. This complicates the research a lot; not only does it require more time and effort, but it also decreases the scale and magnitude of the empirical research. The documentation of the interviews was made by writing exactly what the interview subjects said.

1.4.3 Method criticism
Since the process of finding candidates for interviews turned out to be complex, this could result in a bias in the selection of interviewees. There were individuals that were desirable and eligible for the research because of their higher positions and social statuses, but who could not, for various reasons, be interviewed. Furthermore, a problem that arises when making interviews is the fact that the interviewees may not be telling the truth. This is something that has been avoided as much as possible in the candidate-selection process through the background research, where only candidates that we believe are reliable have been chosen. A consequence is, however, that the number of interviews has decreased drastically.

\(^7\) See appendix for the questionnaire
1.5 Disposition
Since our aim consists of questions that we tackle with different methods, we divide this paper into two parts. In the first part we will discuss the two first questions because similar methodology is used. This part will also present previous research and a background of BiH. In the second part we discuss the remaining three questions, together as we provide a presentation of the model of Ellis and Fender.
- Part ONE -

Corruption is neither easy to measure, nor is it easy to identify the factors that cause it. The main purpose of this first part of the paper is to tackle with these problems. Chapter 2 presents previous research on the corruption phenomenon. Chapter 3 deals with the background of Bosnia and Herzegovina where the history, the political situation today and the economical development are presented. In chapter 4 we qualitatively describe the spread of corruption in Bosnia and Herzegovina where the empirical research, made by us and other bodies, will be presented. Chapter 5 provides a discussion on possible causes of corruption in Bosnia and Herzegovina.
2. Previous research

In this chapter we summarize the empirical research concerning the corruption. We present the major determinants of corruption that have been found studying various countries using various techniques. We also present the effects of corruption on the economical growth and development that researches have been able to account for. Corruption is a complex phenomenon and the causality of its causes and its effects on the growth often goes in both directions. The research presented here, however, studies the causality in one direction; which weaknesses in the society seem to trigger corrupt behaviour, and what effects corruption seem to have on economic growth.

2.1 Causes of corruption

When presenting the determinants of corruption, it falls natural to divide the causes of corruption into two categories, political factors and economical factors.

2.1.1 Political factors

Corruption is believed to be related to the scarcity of the political system. It is furthermore believed that democracy, by promoting political competition and consequently increasing transparency and liability, can reduce corruption. The political factors include among others a given country’s democratic environment, the efficiency of its institutions, the efficiency of the judicial system, and the origin of its legal system.\(^8\)

**Underlying weaknesses in public policies and institutions**

Corruption is mostly a symptom of weaknesses in economic structures and institutions. This is considered to be the origin of much of what is distinguished to be corruption in the public sector. When these weaknesses are defined, they seem to provide a stronger link to economic performance than do measures of real or observed corruption.\(^9\)

Even though corruption is not an exclusively economic phenomenon, economists concentrate on corruption as a public economic policy issue, because corruption weakens the state’s capacity to fulfil its designated purpose in the economy. In this sense it is not difficult to see that economic policy distortions and weak state institutions create an environment that is favourable to corruption. If for example the separation line between the state and the market is not clear enough and is not suitably regulated, it may be difficult to distinct between what is public and what is private and may lead to a corrupt behaviour. Regulations that are permeative, hidden and applied in a capricious manner allow economic agents to find ways to secure favourable interpretations. Restrictions on trade and exchange also tend to cause unofficial, often corrupted, channels for market-induced transactions. This implies that statements linking corruption to economic performance are essentially statements about the

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\(^8\) Dreher, Kotsogiannis and McCorriston (2004)

\(^9\) Abed and Davoodi (2000)
link between structural distortions and economic performance. Corruption is mostly an appearance of these distortions.\(^{10}\)

**Regulations and authorizations**
The role of the state is frequently carried out through various rules and regulations, especially in the developing countries. To engage in various activities, such as opening a shop, investing or buying a house, licenses, permits and authorizations of different kinds are required. These regulations and authorizations give the officials who authorize the various activities a power similar to that of a monopolist. The officials can refuse the authorizations or simply wait a couple of months before deciding. This implies that they can use their public power to derive bribes from those in need of the authorizations or permits.\(^{11}\)

Because of the regulations, frequent contacts between citizens and bureaucrats are required. Thus, the acquirements of the authorizations and permits are also very time-consuming. Surveys from various countries, in particular from the developing and transition economies, indicate that managers of enterprises, especially from small enterprises, spend a large proportion of time dealing with the bureaucrats. Payment of bribes can reduce this amount of time that is taken away from managing the enterprises.\(^{12}\)

**Quality of the bureaucracy**
There is a great difference in the quality of the bureaucracy among countries. In some states, public sector jobs give a lot of prestige and status, in others not. The quality depends on many factors. Tradition and the effect it has on pride that individuals have in working for the government are important factors that may explain why some bureaucracies are less liable to corruption, and are, thereby, more efficient.\(^{13}\) The result of Rauch and Evans (2000) suggests that the more are recruitment and promotion merit-based, the less is the extent of corruption.\(^{14}\)

**Penalty systems**
Becker’s (1968) analysis of crime prevention implies that, given the probability of getting caught, the penalty plays an important role in determining the extension of criminal or illegal acts.\(^{15}\) By increasing the penalties on those getting caught, the corruption could, at least in theory, be reduced. Thus, the existing penalty structure in various countries is an important factor in determining the extent of corruption.\(^{16}\)

In reality, relatively few people are punished for acts of corruption. The penalties that are effectively imposed do not seem to reflect the penalties specified in the laws and regulations. The slow administrative procedures followed before a public employee is punished, and the need to provide incontestable evidence, are main reasons for this. Also, the judges who will impose the penalties may themselves be bought by the accused or corrupt in some other way.

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\(^{10}\) Abed and Davoodi (2000)  
\(^{11}\) Tanzi (1998)  
\(^{12}\) Ibid  
\(^{13}\) Ibid  
\(^{14}\) Rauch and Evans (2000)  
\(^{15}\) Becker (1968)  
\(^{16}\) Tanzi (1998)
In return, they themselves may put obstacles to the proceedings. These factors limit the role that penalty system has on corruption.\textsuperscript{17}

**Institutional controls**
Becker’s (1998) other important ingredient in his analysis is the probability that those who commit crimes would be caught.\textsuperscript{18} This is a matter of institutional controls, which are to a large extent a reflection of the attitude of the political body toward this problem. The controls that exist inside institutions are in general the most effective ones. Clear rules on the ethical behaviour and good auditing offices together with honest and effective supervisors should be able to discourage or discover corrupt activities. These characteristics, however, differ from country to country and are almost non-existent in some.\textsuperscript{19}

**Transparency of rules, laws and processes**
The lack of transparency in rules, laws and processes in countries creates a fertile ground for corruption. The documents specifying the rules are not publicly available at the same time as the rules often are confusing. Laws are often written in such a way that only skilled lawyers can read them. Furthermore, at times, it is difficult to understand the processes and procedures on policy matter and other decisions that were followed before a decision was reached.\textsuperscript{20}

Strong legal establishments and efficient legal systems with well-specified restrictions protect property rights and hence provide a stable framework for economic activity. When the legal system fails to provide for the enforcement of contracts, there is a negative effect on operation of the free market and, in turn, reduces the incentives for agents to participate in productive activities.\textsuperscript{21}

**The size of the public sector**
Several studies have been made concerning the corruption and the size of the public sector. Tanzi (1998) observes that the important role of the public sector in the economy gives public officials some degree of freedom in the allocation of goods and services provided and, therefore, increases the probability that corruption will occur. This phenomenon is strengthened if the wages public officials receive are relatively low.\textsuperscript{22} Furthermore, Goel and Nelson (1998) have found, when using convictions for public abuse of office as an index of corruption, that corruption at the state level in the US increases with the size of state governments.\textsuperscript{23}

**2.1.2 Economical factors**
The economic determinants of corruption across countries are based on several factors; the degree of openness,\textsuperscript{24} spending decisions and the level of public sector wages.\textsuperscript{25}

\textsuperscript{17} Tanzi (1998)
\textsuperscript{18} Becker (1968)
\textsuperscript{19} Tanzi (1998)
\textsuperscript{20} Ibid
\textsuperscript{21} Dreher, Kotsogiannis and McCorriston (2004)
\textsuperscript{22} Ibid
\textsuperscript{23} Mueller (2003)
\textsuperscript{24} Dreher, Kotsogiannis and McCorriston (2004)
\textsuperscript{25} Tanzi (1998)
The degree of openness
Less open countries have restricted trade and capital flow controls, which leads to rent seeking behaviour and enhances the incentives to engage in corrupt activities. Several studies have shown that increased competition decreases corruption and that more open economies are less corrupt.\textsuperscript{26} Studies presented by Wei and Wu (2001) shows evidence on countries with capital controls having higher corruption and hence receiving less foreign investment. They are also more prone to financial crises.\textsuperscript{27} Neeman et. Al. (2003) have shown that the effect of corruption on economic growth depends on the openness of the economy.\textsuperscript{28}

Level of public sector wages
It has been speculated that the wages paid to civil servants are important in determining the degree of corruption. Lindbeck (1998) argues that the low level of corruption in Sweden during the 20\textsuperscript{th} century is due to the fact that at the shift from 19\textsuperscript{th} to 20\textsuperscript{th} century, high-level administrators earned 12-15 times the salary of an average industrial worker.\textsuperscript{29} Corruption due to greed and corruption due to need may in this sense be separated. The CC’ curve in the graph below is the trade-off between corruption and wage level. Higher wage level leads to lower corruption.

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{figure2_1.png}
\caption{Wage level and corruption\textsuperscript{30}}
\end{figure}

Assume that the wage level R is required by a family of a public employ for a decent living. In this sense OA is corruption due to greed and corruption beyond OA is due to need. The figure also connotes that there will always be public officials who are corrupt, regardless of the wage level.\textsuperscript{31} Rijckegehem and Weder (1997) have tested the relationship between wage level and corruption by using cross-sectional data. Their result supports the common intuition by finding a statistically significant relationship between corruption and wage levels, similar to the C curve in the figure.\textsuperscript{32}

\textsuperscript{26} Dreher, Kotsogiannis and McCorriston (2004)
\textsuperscript{27} Wei and Wu (2001)
\textsuperscript{28} Neeman et Al (2003)
\textsuperscript{29} Lindbeck (1998)
\textsuperscript{30} Tanzi (1998)
\textsuperscript{31} Ibid
\textsuperscript{32} Rijckegehem and Weder (1997)
Spending decisions
Public expenditure can be affected by corruption. Some high level public officials have great discretion over decisions regarding public investment projects, which bring forth the possibility for corruption to heavily distort, both in size and composition, this type of public spending. These kinds of projects have even been carried out just to give some individuals or some political group the chance to get “commissions” from those who are opt for executing the projects. This has resulted in projects which would not have been justified on objective criteria of investment selection such as cost-benefit analysis, and has eventuated in a reduction of the productivity for the expenditure. Furthermore is the governmental expenditure on goods and services, another area affected by corruption.\textsuperscript{33}

Creation of extra-budgetary accounts is also a used tool in many countries. While some of the extra-budgetary accounts have legitimate specific purposes such as pension funds and road funds, many are set up to reduce the political and administrative controls. It is common in many countries to channel money received from foreign aid towards special accounts that are less transparent and less controlled than the money channelled through the budget. Some of this money may then be used for illegitimate or personal purposes.\textsuperscript{34}

2.2 Economic consequences of corruption
Empirical studies claim that corruption has effects on the economic growth and development. We sum up the results of some of the studies here.

2.2.1 Size and composition of government expenditure
There is nothing monotonous or custom about the investment budget and its composition. Even though government spending in the short run has limited discretion because it reflects explicit or implicit entitlements or previous commitments, capital spending to politicians, and especially to specific politicians, is highly discretionary. High political figures such as the members of parliament or ministers must make some of the basic decisions. These decisions affect the size of the total public investment budget, the composition of that budget, selection of projects and their location, and the size of each project. This implies that within these decisions, some high-level individuals will have substantial control or influence. This is especially true when the institutional controls are weak, i.e. the controlling institutions are not well developed.\textsuperscript{35}

The size of public investment projects has a tendency of being large and it is often domestic or foreign private enterprises that execute them. This connotes that there is a need to choose the enterprises that will be in charge of the projects. Profits for private enterprises for getting a contract to execute a project, particularly a large one, can be huge. As a result, the managers of these enterprises may be willing to pay a “commission” to the government officials that will help them get the contract. Even for a small commission with a few percentage points on a project that costs millions of dollars can be a large sum of money. When commissions are

\textsuperscript{33} Tanzi (1998)
\textsuperscript{34} Ibid
\textsuperscript{35} Tanzi and Davoodi (1997)
based on project costs, the public officials who extract the payments for helping the enterprises win the contracts will have a great interest in increasing the size or scope of the projects in order to get larger commissions.\textsuperscript{36}

The enterprise that pays the commission may, in return, be able to recover its cost from the payment of the bribe in several ways. They may for example lower the quality of the work done and on the materials used and, thus, deliver an inferior product. They may also recover the costs of the commission by overpricing.\textsuperscript{37}

There are several phases in the process of approval of an investment project. In a civil construction project for example, decisions have to be made regarding the specification and design of the project, issue of tender, tender security, tender negotiations, and tender approval and contracting process. This makes it possible for strategically-placed high-level officials to affect the process in ways that lead to the selection of a particular enterprise.\textsuperscript{38} The legislature body and its members, along with the citizens they represent, are forced into a principal/agent relationship with respect to the bureaucrats making this choice. Due to the lack of information, the legislature will often not be in a position to determine whether the bureaucrats’ choice of a bidder-enterprise offers the best combination of quality and price available. The legislature will also not be able to determine whether the bureaucrats have chosen a bidder-enterprise due to the characteristics of its bid, or by the size of the bribe that accompanied it.\textsuperscript{39}

This all results in the country having higher costs for the specified project than would have been the case in the absence of corruption, bigger and more multifaceted projects than would have been necessary, and projects with inferior quality that do not perform up to the standard.\textsuperscript{40}

The rate of return of projects as calculated by cost-benefit analysis stops to be the criterion for project selection as high-level officials influence the approval of investment projects. This leads to less productive capital spending that contributes less to the growth. In these situations, the enterprises that execute the projects care mostly about the profits they make and the politicians that authorize the projects and choose the enterprises care mostly about the bribes. Thus, the whole decision-making process associated with the investment budget is distorted by corruption.\textsuperscript{41}

\textbf{2.2.2 Domestic investment}

Small enterprises are forced by public officials to make payments in order to make things happen, or even to keep bad things from happening. These payments must in many cases be made if the enterprises are to remain in business. Due to these payments, the cost of doing business for small activities may rise as much as 20\% of total operating cost. This kind of

\begin{itemize}
  \item \textsuperscript{36} Ibid
  \item \textsuperscript{37} Tanzi and Davoodi (1997)
  \item \textsuperscript{38} Ibid
  \item \textsuperscript{39} Mueller (2003)
  \item \textsuperscript{40} Tanzi and Davoodi (1997)
  \item \textsuperscript{41} Ibid
\end{itemize}
corruption that acts as a cost-increasing mechanism for small enterprises, and especially for new, emerging enterprises, is coercive. They are more or less forced by bureaucrats and by tax inspectors to make substantial payments. The local governments’ officials impose partly legal and partly illegal pecuniary costs, which must be paid if licenses or authorizations are to be obtained. In many countries, especially, yet again, in developing countries and, ever more, in economies in transition, the small enterprises are the main engine for growth. Obstacles to establishment and growth of these enterprises can be very damaging.42

2.2.3 Corruption and the underground economy

As corruption constitutes illegal activity by those in government, transactions in the underground economy represents illegal activities by the citizens. Corruption, as already mentioned, raises the costs of doing business and therefore tends to drive legitimate economic activity underground. Individuals that are engaged in the underground activity, both buyers and sellers, try to hide the activity from the government. This is done in order to avoid having to get any licenses that are needed for doing business, to avoid regulation, and to avoid taxpaying.43

When the economy is driven underground, the economic efficiency can be affected in several ways. Underground participation brings with it its own distortions. For example, buyers may need to travel greater distances in order to make a purchase, implying that they may need to devote more time to the transactions. The quality of the goods the buyer receives may also not be of the same quality as is if the goods had been purchased from legitimate business. When safety and environmental regulations are avoided, social welfare is reduced through greater risk consumers or employers obtain when going underground. The government on the other hand loses tax and license revenues and may be forced to impose higher tax rates or to introduce additional taxes to cover its expenditures. The government may also make erroneous judgements about economic policies based on the figures for the legitimate economy. This occurs as the underground economy is difficult to measure.44

2.2.4 Urban bias, poverty and other consequences

Corruption makes poverty even worse and persistent. This occurs in cities as well as in rural areas because poor people have less means and political power to bribe officials. Rose-Ackerman (1998) presented several channels through which poor people are negatively affected by corruption. The level of social services will be lower for the poor. Investments concerning the infrastructure will be biased against projects that are favourable for the poor. There may also be higher taxes for the poor. The poor will have a disadvantage when selling their agricultural produce. It is harder for the poor to escape poverty using small-scale enterprises.45 Gupta, Davoodi, and Alonso-Terme (1998) have shown that high and rising corruption increases inequality and poverty through several channels; the economic growth is lowered, the tax system is biased to favour the rich and well-connected, the government policies are biased towards favouring inequality in asset ownership, the social spending is

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42 Tanzi (1998)
44 Ibid
45 Rose-Ackerman (1998)
lowered, the access to education by the poor is reduced, and the risk of investment by the poor is increased.\textsuperscript{46}

\textsuperscript{46} Gupta, Davoodi, and Alonso-Terme (1998)
We dedicate this chapter to present necessary information about Bosnia and Herzegovina. We explain the history of BiH, describe the political situation today and report on economic development in recent years.

3.1 The history of Bosnia and Herzegovina

The area that is now called Bosnia and Herzegovina was in ancient times called Illyricum. It was conquered by the Romans in 2nd and 1st centuries B.C. and folded under the province of Dalmatia. The area was overrun by the Goths in 4th and 5th centuries A.D, and remained occupied until the 6th century, when it was claimed by the Byzantine Empire. During the 7th century the region was settled by the Slavs.47 In the 9th century, two neighbour kingdoms were established; Serbia in the southeast and Croatia in the west. Local nobles under the authority of the Kings of Hungary governed Bosnia during the 11th and 12th century. Around the year 1200, Bosnia won its independence from Hungary and remained an independent Christian state for approximately 260 years. The Ottoman Empire expanded into the Balkans where the Turks defeated the Serbs at the famous battle of Kosovo in 1389. In 1463 they conquered Bosnia. In the century that followed, many Bosnians adopted the triumphant faith of the Islamic conquerors. The Muslim preachers taught a broad-minded form of Islam that allowed Bosnians to adapt their old traditions to the new faith. The Ottoman sultans beautified the towns and cities in Bosnia with splendid Mosques. They also established religious endowments that supported schools, Islamic seminaries, libraries, orphanages and almshouses. Many Muslim Bosnians followed the ranks of the Ottoman ruling elite and became soldiers, statesmen, Islamic jurists and scholars. A distinctive Bosnian Muslim culture was created, with its own architecture, literature, social customs and folklore. There were, however, also Bosnians who did not choose Islam. The Ottomans allowed them full freedom to worship, live and trade as they wished, but imposed higher tax-rates on the non-Muslim. Bosnia retained a distinct identity as the Eyalet of Bosna, a key province of the Islamic Ottoman Empire, for more than 400 years.48

In the 19th century, the borders of the Ottoman began to shrink. Serbia and Montenegro, with the aid of their fellow Slavs, the Russians, fought successfully against the Ottoman Empire in 1876. Following the end of the Russo-Turkish war (1877-1878), the great powers of Europe met in Berlin to decide what to do with the Ottoman Empire. In an effort by Europe to ensure that Russia did not dominate the Balkans, Austria-Hungary was given a mandate to govern Bosnia and Herzegovina. The borders of the Ottoman Empire, however, should remain intact. On October 7, 1908, the Austro-Hungarian Empire finally annexed Bosnia and Herzegovina. As Serbia had claims on Bosnia and Herzegovina, this resulted in a worsening of the relation between the two countries. The hospitality reached a climax when the Austrian archduke,

47 Infoplease – Bosnia and herzegovina
48 Riedlmayer – A brief history of Bosnia-Herzegovina
Franz Ferdinand, was assassinated in Sarajevo on June 28, 1914, by a Serb nationalist youth. This precipitated the start of the First World War (1914-1918). On October 26, 1918, BiH was annexed to Serbia as part of the newly formed Kingdom of Serbs, Croats and Slovenes. In 1929, the name was changed to Yugoslavia.\textsuperscript{49} No special provision was made for people who did not considered themselves to be Serbs or Croats. During the interwar years Bosnia’s Muslim Slavs were forced to register themselves as either one or the other.\textsuperscript{50}

In 1941, the Germany invaded Yugoslavia where BiH was made part of Nazi-controlled Croatia. When the Second World War ended, BiH was reunited into a single state as one of the six republics of the re-established Communist Yugoslavia, which was led by Marshall Tito. He exercised a strict and authoritarian ruling style, which kept the ethnic antagonism in check. Tito’s death, together with the growing economic dissatisfaction, lead to the beginning of the Yugoslavian disintegration.\textsuperscript{51} The disintegration was hastened by the rise to power of Slobodan Milosevic as president of the Serbian republic, and his support of an extreme Serb nationalist agenda. That agenda implied a creation of a Greater Serbia that unites all Serbs in a single state.\textsuperscript{52}

BiH declared independence from Yugoslavia in December, 1991, and asked for recognition by the EU. In March 1992, a referendum was held where the Bosnian voters chose independence and President Alija Izetbegovic declared the nation as an independent state.\textsuperscript{53} Following the independence, there was a mass demonstration by citizens of Sarajevo on the 5\textsuperscript{th} of April. Serbs, Croats and Muslims demonstrated for peace among the three major communities. Snipers from the Yugoslav National Army and Serb nationalist militants, hidden on surrounding rooftops, opened fire on the demonstrators and killed scores of unarmed citizens. The Yugoslav National Army units began the following day to shell Sarajevo from prepared positions on the hillsides overlooking the city. At the same time, columns of troops and tanks crossed the Drina River from Serbia into eastern Bosnia. Two days later, the United States and most European countries officially recognized BiH’s independence. On May 22, 1992, BiH became a full member of the United Nations. However, at the request of the Belgrade government in 1991, an arms embargo was imposed on all of the former Yugoslavia by the United Nations. This prevented the internationally recognized government of BiH to acquire the means to exercise its right to self-defence, which is guaranteed under the UN Charter.\textsuperscript{54}

Bosnians were initially armed only with police side arms and hunting rifles when they tried to defend their newly independent country. The Sarajevo-government was not prepared for war, neither military nor financially. It had to use extraordinary measures in order to protect the new independence of BiH. Bosnian Serbs on the other hand had, with the help of the Yugoslav State Security, armed themselves in the pre-war period. Preventing from being

\textsuperscript{49} Infoplease – Bosnia and herzegovina
\textsuperscript{50} Riedlmayer – A brief history of Bosnia-Herzegovina
\textsuperscript{51} Infoplease – Bosnia and herzegovina
\textsuperscript{52} Riedlmayer – A brief history of Bosnia-Herzegovina
\textsuperscript{53} Infoplease – Bosnia and herzegovina
\textsuperscript{54} Riedlmayer – A brief history of Bosnia-Herzegovina
overrun by the Bosnian Serb army, the Sarajevo-government had to arm its weak army in the only way possible; by using established and newly created smuggling channels. The smuggling operations were carried out by various groups in the Sarajevo-government army and secret police in cooperation with criminal networks. These groups, however, were not allowed by the political elites to only engage in the smuggling of arms, fuel etcetera, which were needed to fend off the Bosnian Serb army. They were also allowed to engage in pure criminal activities such as trafficking of women and drugs, looting and war profiteering. The Sarajevo-government was also, in the early stages of the war, heavily dependent on criminal combatants in order to fight of a better-equipped Bosnian Serb army. The major criminals in the city led the defence in the early stages of the war, and at the same time run huge black market smuggling operations. Later through the war, as BiH got military help and financial assistance from Muslim countries, these criminals became less important for the matter of defence, but they continued to carry out the smuggling operations.55

The war did not start to approach its end until NATO stepped in, bombing Serb positions in BiH in August and September 1995. After the U.S-sponsored peace talks that took place in Dayton, Ohio, the Dayton Accords, The General Framework Agreement for Peace in Bosnia and Herzegovina, were implemented in 1995. The Dayton Agreement created the independent state of Bosnia and Herzegovina. The Agreement also founded two multiethnic entities within the state of BiH, The Federation of Bosnia and Herzegovina (FBiH) and the Republika Srpska (RS), along with the independent District of Brcko. The ethnic majority in the Federation are Bosnian Muslims (Bosniaks) and Croats, and in RS the Bosnian Serbs. The Constitution created a federal democratic republic, where it assigned many governmental functions to the two entities, which have their own governments. The Accords also gave the Office of the High Representative (OHR) the right to oversee implementation of civilian provisions, and the power to impose legislation and remove officials who obstruct the implementation of the Dayton Accords.56

3.2 The political situation today

The political situation in BiH is instable. In April 2006, the first package of reforms of the Dayton Constitution failed to pass in Bosnia-Herzegovina Parliamentary Assembly, worsening the political dynamics in the country. A prolonged process of government formation at all levels occurred as the political climate continued to deteriorate. The trend continued in 2007 leading to a halt to the Dayton Accords implementation and European Union reforms. In February 2007, the new government of BiH was formed. The ruling coalition was formed by the Serb Union of Independent Social Democrats (SNSD) and the Party of Democratic Progress (PDP), the Bosniak Party of Democratic Action (SDA) and Party for BiH (SBiH), the Croatian Democratic Union (HDZ) of BiH, and HDZ 1990. Parties with opposing stances on almost every substantial issue constitute the Council of Ministers. Particularly antagonistic have been parties with the influential leaders Haris Silajdzic and Milorad Dodik on the Bosniak and Serb sides, respectively. The RS Prime Minister Dodik has

55 Devine and Mathisen (2005)
56 US Department of State – Bosnia and Herzegovina
on several occasions during 2007 announced the possibility of a referendum on the secession of RS. Such a referendum would be against the constitution and was opposed by the international community, but Dodik’s eloquence served to radicalize the political atmosphere.\textsuperscript{57}

There were low expectations for the new government and they sank further. At the entity level, Dodik projected an image of a proactive and economy-oriented government, but stalled the majority of reforms at the state level. He was even questioning those reforms that had already been adopted. FBiH needed nine months to be formed and, thus, performed very poorly at the entity level. It did not, for that matter, perform any concrete results in any substantial manner with reform in BiH after it started working. Instead the whole political focus was on the distribution of entity’s biggest economic assets among the political parties\textsuperscript{58}.

Leaders from both entities demonstrated great inflexibility in reaching compromises on necessary reforms. The EU demanded a reform that would free the police from political interference and design regional police areas on the basis of functional policing criteria. Competences for police legislation and budget would be placed at the state level. After months of intimidating negotiations, the leaders failed to reach an agreement on police reform and, thus, stalling the EU initialling of a Stabilization and Association Agreement (SAA) with BiH. High Representative (HR)/EU Special Representative (EUSR) Miroslav Lajčák put, in an attempt to secure BiH’s progress, his own proposal for police reforms reflecting the parties’ major concerns. This was however refused by both the Bosniak and Serb side. The Croat parties on the other hand accepted any kind of police reform that would secure an SAA for BiH. Later on, even the Bosniak parties started to accept the proposal, but Dodik continued with his earlier argument that the preservation of the RS police means the preservation of RS and once again rejected the HR/EUSR’s proposal. Disappointed with the outcome, the HR/EUSR concentrated instead on the full implementation of the Dayton Peace Accords where he put forward a set of state-strengthening decisions. His motivation was to aim the “ailing” state system in BiH and to strengthen the functionality of its institutions. This was violently opposed by the RS politicians as they threatened to withdraw their representatives from the state institutions, threatened the authority of the HR and threatened with a referendum on secession from BiH. The FBiH on the other hand saw HR’s incentives as an attempt to restore the authority of the HR office and as a long overdue effort to unblock the BiH decision-making system. A meeting of the ruling political party leaders shortly after prevented momentarily the escalation of the political crisis. On this meeting, in the presence of the HR, they agreed to implement police reforms according to the future constitutional arrangement respecting the three EU principles; democratic equality, representative democracy, and participatory democracy. By the end of 2007, still no police reforms were implemented.\textsuperscript{59}

The year 2008 began with a failure of the institutions to agree on the state budget. Hopes however grew as the BiH House of Representatives (BiH HoR) approved a police reform.

\textsuperscript{57} Jelisic (2008)
\textsuperscript{58} Ibid
\textsuperscript{59} Ibid
This was expected to pave the way for the final signature of an SAA with the EU. The reform became once again doubtful as the largest Bosnian party SDA abandoned its previous acceptance of interparty agreements on a two-stage police reform. This led to high pressure and heavy involvement by the OHR, which finally resulted in a breakthrough where the Parliament passed the reform package in April and the SAA was signed in June.\textsuperscript{60}

Meanwhile, Dodik and his SNSD claimed the right to self-determination, including secession by the RS. Shortly after Kosovo’s declaration of independence on February 17, the RS National Assembly claimed that, if a majority of UN and EU countries recognized Kosovo’s independence, the RS had the right to secede from BiH. The international community, however, stated that the two entities had no rights to secede under the Dayton Peace Accords. The parties in FBiH constantly opposed the RS government actions, but had no progress in making the situation in FBiH itself any better. The adoption and implementation of the legislation has been less efficient, mainly due to the difficult political atmosphere. The year ended, just as it started, with the institutions failing to agree in time on the budget for 2009.\textsuperscript{61}

Data presented by the nongovernmental organization Center for Civic Initiatives (CCI) shows how inefficient the country’s government had become due to political battles and stalled reforms. Only 47 percent of the total work program for 2008 has been realized by the Council of Ministers. CCI also indicated that the leading politicians’ verbal commitments to EU-related reforms were not matched by considerable devotion of time and effort. Near paralysis in state institutions was caused in 2008 due to competitive nationalism among the three main ethnic groups of BiH, resulting in a failure for the country to achieve concrete progress in addressing conditions relevant for the Euro-Atlantic integration. The overall situation has not been changed due to the signature of the Stabilisation and Association Agreement with the EU in June either, and the Council of Ministers continued to place their divergent political priorities ahead of the goal of EU integration and its associated obligations.\textsuperscript{62}

3.3 The economical development

Due to a favourable external environment, the currency board, and the effects of reforms in key sectors, output growth in BiH has, as can be seen in figure 3.1, averaged approximately 6 percent per year during 2003-08\textsuperscript{63}. Domestic consumption, higher world market prices for metals, and new investments and streamlining in mainly the metal processing industry have all contributed to the growth.\textsuperscript{64} Benefiting from bank privatizations and reforms in the financial sector, along with improved growth prospects, BiH attracted large capital inflows and long-term borrowing by foreign bank subsidiaries. Recently, the introductions of the VAT, income tax reforms, and relatively large privatization in RS have contributed to stronger public finances. All this led to the signing of the SAA with the EU.\textsuperscript{65}

\textsuperscript{60} Jelisic (2009)
\textsuperscript{61} Ibid
\textsuperscript{62} Ibid
\textsuperscript{63} IMF (2009) – Bosnia and Herzegovina
\textsuperscript{64} Sveriges Ambasad (2008) – Bosnien Hercegovinas ekonomi januari 2008
\textsuperscript{65} IMF (2009) – Bosnia and Herzegovina
The global financial crisis however has contributed to a slowdown in the growth through two main channels; a drop in external demand and tightening of external financial conditions. The effect of the crisis has been aggregated by underlying imbalances in BiH’s economy. As presented in table 3.1, real GDP is expected to fall by 3 percent in 2009. In 2010, the output is expected to grow moderately as confidence is restored and balance sheets begin to readjust. The low inflation is expected to sustain due to a large negative output gap over 2009-10 and wage restraints.  

<table>
<thead>
<tr>
<th>Table 3.1: Key Macroeconomic Indicators, 2007-10</th>
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<tr>
<td>2007</td>
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<td></td>
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<tr>
<td>Real GDP growth (percent)</td>
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<tr>
<td>CPI (change in percent; average)</td>
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<tr>
<td>Current account balance</td>
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<tr>
<td>General government balance</td>
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<tr>
<td>Reserve cover (months of imports)</td>
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<td>Gross external debt</td>
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<td>Public debt</td>
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The unemployment rate in BiH is high, even if there have been prominent improvements during the 21st century. The official registered unemployment in 2006 was 30 percent, which can be compared to the 40 percent in year 2000. There should however be noted that a large group of people in the working force are not taken into account when the unemployment rate has been measured. This is because they are not seen as being active on the labour market.

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66 IMF (2009) – Bosnia and Herzegovina  
67 Ibid  
68 Inid
There are 2.7 million in the working force and only 1.2 million are seen as active. This implies that the real unemployment is close to 60 percent.\textsuperscript{69}

The economy in BiH depends heavily on import. As illustrated in figure 3.2, the trade balance is negative, even if the export industry has grown the last five years. The structural reforms in recent years, privatizations, and foreign direct investments have improved the export capacity, but the trade balance deficit remains a macroeconomic challenge. Especially since the trade balance corresponds to 30 percent of the GDP.\textsuperscript{70}

![Figure 3.2: Import and Export\textsuperscript{71}](image)

When we talk about the situation on a macroeconomic level, it is important to distinguish between larger cities, especially Sarajevo, with smaller cities and regions. The prices in Sarajevo can be up to three times higher than they are in smaller cities. This naturally also implies that the wages in cities differ greatly. As a result problems arise when evaluation of the country is made on a macroeconomic level. By doing research on a microeconomic and individual level we hope to avoid this kind of problem to some extent, and to give a more fair view of the economical situation that general public find themselves in. The results are presented in section 4.3.

\textsuperscript{69} Sveriges Ambasad (2008) – Bosnien Hercegovinas ekonomi januari 2008

\textsuperscript{70} Ibid

\textsuperscript{71} IMF (2009) – Bosnia and Herzegovina
4. Corruption in BiH

During the war 1992-95, Bosnia and Herzegovina experienced a breakdown in governmental structures. This created an environment in which the corruption could flourish. After the war, as the new governments worked to establish themselves under the Dayton Peace Accords, the corrupted activities continued to thrive. While many, if not all, countries in transition are victims of corruption, BiH especially is at a great risk; it is undergoing a transition from wartime to peacetime at the same time as it is moving from a centrally controlled economy to a free market economy and from a socialist style government to a democracy. A Transparency International Report summarized in 1998 the situation in which BiH found itself after the war:

“As the most causal observer would know, the country of Bosnia and Herzegovina faces problems that should intimidate even the most resolute. It has not only emerged from a bloody conflict with its physical infrastructure quite literally shattered and with the legacy of bitterness and distrust which the inter-communal violence has spawned, but also with a peace process that is not yet assured. Further compounding this was the rampant corruption and profiteering which had flourished during the war, creating criminal centers of power and influence – smuggling organisations and links throughout the region that remain intact and busy today...These would be difficult enough to cope with. However, Bosnia and Herzegovina has also all the deep-seated problems it inherited from the communist regime and a style of government that was essentially top-down, with "rule of party" rather than "rule of law", and an absence of accountability and transparency let alone a culture of consultation and consensus-building.”

The government officials in BiH rarely demonstrate the political will necessary to successfully combat corruption. Together with the weak government structures, this has led to a lack of anti-corruption modus operandi. Thus, corruption has found a fertile ground in BiH, where it encounters little government resistance.

The corruption in BiH is without question widespread and is a huge problem. All of the interviewees that were interviewed during the July 2009 claim that they have seen corrupted acts around them; at work, at the universities, in hospitals, in courts and so on. The hopes for better life are not flourishing either since 16 of the 20 interviewed do not believe that anything can be achieved without acts of corruption. The general apprehension is that corruption is bad. Some individuals however claimed that it could be both good and bad, depending on who is paying and who is getting paid. The most frequent types of corruption in BiH, and the institutions that are most affected by corruption, are detailed and discussed below.

4.1 Politicians, governing and institutions

Politics continues to be a hot and sensitive topic in BiH. In the interviews that took place in the July 2009, the interviewed subjects were pointing out the ruling political parties as the most corrupted organizations in the country. All of the 20 interviewee claim that the politicians steal the most. Some even go as far as to say that the whole national system is
corrupted. There were almost no trust in the institutions either, 17 of the 20 interviewed subjects had no trust in the institutions at all. They were indifferent between various institutions, claiming that they are all the same. Ironically, only if they knew the public employee that worked in a certain institution could they expect that their errand would be done honestly.

One example, concerning the institutions, that a municipal worker gave was that the Central Bank of BiH borrowed an extreme amount of money to one specific individual so that he could buy hotels in Sarajevo. Consequently he got a monopoly of the hotel-business in one major part of Sarajevo.

4.1.1 Corruption in political parties
The multilayered constitutional setup, an effect of the Dayton Peace Agreement, paved government along ethnic lines. The entities were provided with an autonomy that gave the political parties control over all means necessary to run a well coordinated criminalized economy. They control state assets, housing policy, licensing, appointments to public offices and to management and executive functions of state owned companies, public utilities, tax collection, privatization processes, the security sector and so on. These political parties meet the modest criteria of being an organized group that stands for public office. The political platforms are weak or non-existent and the internal democracy is weak. The political parties are mostly inactive, only to arise before elections to attract sufficient votes based on nationalist agenda. They do not take responsibility for the problems at local level and have no strategies to remedy the problems.\(^75\)

After the war, BiH opted for a voucher privatization. The vouchers could be used by the citizens to buy socially owned apartments or shares in enterprises to be privatized. The issuing of a massive amount of vouchers created a market for trading in these vouchers, which led to that those who had money, usually members of the nationalist elites, bought these vouchers from poor people for a fraction of their face values. These vouchers could then be used in the privatization of enterprises at their full face value. An interviewed municipal worker in a higher position gave an example about the Prime Minister, to whom the state gave 265,000 KM to buy an apartment. He paid 900 KM in cash and the rest with the vouchers. The rest of the 265,000 KM went into the pockets of the Prime Minister.

4.1.2 Corruption in the Police and other Enforcement Structures
UNDP made a perception study for the third quarter of 2004, confirming that citizen’s trust in the police is further decreasing.\(^76\) In the same study for the fourth quarter of 2008, there were still only just over 50 percent of the citizens in BiH that were satisfied with the work of the police. 40.4 percent in the urban area believed that corruption was common in the Police, while 36.8 percent in the rural area believed the same.\(^77\) At the traffic police level, the citizens of BiH are likely to be in touch with the police. This opens up for an opportunity for illegal transactions to take place between the citizens and the policemen. For example, if a driver

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\(^{75}\) Devine and Mathisen (2005)

\(^{76}\) UNDP (2004)

\(^{77}\) UNDP (2008)
oversteps the speed limit by 10km/h a negotiation between the driver and the policeman is likely to occur. The driver gives the policeman a bribe that is smaller than the fine he would otherwise receive, and the policeman does not insist on an invoice that he would otherwise need to issue. There are however more serious aspects of the corruption of the police and other enforcement agencies in BiH. Involvement in organized crime is one big problem. Forced prostitution and human trafficking can thrive when the local police are paid to ignore the problem, or too frightened to start an investigation. The problem does not lie with the inability of the local police do efficiently deal with these kind of issues. Instead the problem lies with the forces that exert over these issues, where police actions, or inactions, become arbitrary and selective and serve political interest groups rather than the citizens. One of many examples is the operation that Special Police Units from Banja Luka carried out in late 2004 in the Herzegovinian town of Trebinje, cracking down a group that were illegally trading with stolen cars. The local police in Trebinje were apparently aware about the scheme, but police officers either received kickbacks from the deals or were forced to turn a blind eye.\textsuperscript{78}

\subsection*{4.1.3 Corruption in the Judiciary}

The war in BiH caused a huge change in the established juridical institutions. Many of pre-war juridical judges and other staff members have emigrated and the gap has been filled with political appointees of the “right” ethnic group, often without the professional competence for the job. This resulted in the creation of a highly politicized system with strong connection to respective national elites.\textsuperscript{79}

During 1998-2000, the Judicial System Assessment Program (JSAP) run under the sponsorship of the UN mission in Bosnia and Herzegovina (UNMIBH) and found that judges were not independent, did not consider themselves independent and were not treated as independent by other institutions. Local political figures exercised influence over the judiciary in a blatant manner, with court files containing letters from politicians about specific cases. When judges try to act professionally as they deal with cases that involves important figures, they find themselves subject to dismissal attempts or, even worse, physical assault.\textsuperscript{80}

JSAP also found that the most of the judges were working according to their own performance indicators, which lacked any relevance to the public interest. The delay in the resolution cases were blamed on external factors such as shortage of judges, a claim that is disproved by simple statistics, and too low salaries. The decision-making processes were avoided by phenomena such as adjournment of cases, calling for more witnesses and unnecessary expert testimonies.\textsuperscript{81}

\subsection*{4.1.4 Corruption in public utilities}

The public utilities in BiH provide a great opportunity for theft and corrupt activities. A report by the Special Auditor, based on an international inspection into public electricity companies in BiH, was issued in February 2003. The inspection discovered that the company

\begin{thebibliography}{9}
\bibitem{78} Devine and Mathisen (2005)
\bibitem{79} Ibid
\bibitem{80} UNMIBH – Political Influence: The Independence of the Judiciary in Bosnia and Herzegovina (2000)
\bibitem{81} UNMIBH – Serving the Public: The Delivery of Justice in Bosnia and Herzegovina (2000)
\end{thebibliography}
Elektroprivreda Republike Srpske was losing KM 166 million annually in potential earnings due to mismanagement, conflicts of interest and theft. In the press release surrounding the publication of the inspection report concerning the public electricity companies, it was also stated that this kind of abuse can be seen to a greater or lesser extent in all BiH’s major public corporations.\(^{82}\)

### 4.1.5 Corruption in the privatization process

In 1997, the privatization process in BiH started and is one of the essential elements for economic recovery and growth, both for the survival of BiH as a state and consequently the success of the Dayton Peace Agreement. The process, however, turned out to be slow.\(^{83}\) This indicates that there is still no authentic political support from the Bosnian leadership to move the privatization process forward. This is most likely due to the fact that the privatization of the assets would take away the control and opportunity for the leadership to drain off funds for their own benefit. As of today, the privatization process remains one of the biggest obstacles to economic growth. The Federation Privatization Agency claims that responsible politicians have not established necessary regulations for the inflow of private capital.\(^{84}\)

The individuals that currently control the assets are the ones that are in a position to participate in the bidding process for companies, since they alone have sufficient economic power to do so. This complicates the situation further because these individuals are, theoretically, in a position to sell assets that they currently control to themselves, thereby strengthening and legalizing their economic power and influence.\(^{85}\)

### 4.2 Corruption in the Public Sector Service Delivery

#### 4.2.1 Corruption in the Health System

It remains difficult to determine the extent of corruption in the health sector in BiH, due to the lack of data collection. Corruption does, however, exist on several levels and can be detected at a systematic level, i.e. large-scale theft of public money and in the major segments of the health sector, i.e. hospital care, and the health administration. Corruption at the systematic level arises because of the structure of the BiH health care system. Without a uniform health care system and a common health policy at State level, the opportunities for mistreatment rise. The lack of government supervision and the absence of common benchmarks encourage corrupt practices. As a result, patients make direct payments in order to ensure more responsive treatment and, hopefully, a better quality of services.\(^{86}\)

One municipal interview subject claimed that the health system is the public service sector that is most affected by corruption. People are more or less forced to pay bribes in order to

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\(^{82}\) OHR – High Representative removes senior managers from Elektroprivreda RS, enacts law on Ministerial and Government appointments

\(^{83}\) Devine and Mathisen (2005)

\(^{84}\) Privatizacija u Federaciji BiH – Information on the realization of the privatization plan for the period I-VIII 2004 and the projection of realization to the end of 2004

\(^{85}\) Devine and Mathisen (2005)

\(^{86}\) Ibid
receive appropriate medical service. Without bribery, the appropriate diagnosis will often not be received. This is due to the fact that doctors are not willing to give a proper diagnosis if he or she does not receive the demanded amount of money. The background of the patient is often investigated, and only if it shows that the patient is coming from a wealthy family or has good connections i.e. he or she is able to pay, then will they receive proper health care.

Most of the doctors that work in public hospitals also have their own medical clinic. Public hospitals are used to pick up clients and send them to their own private clinic, where the doctors will be paid for their service. It is not due to the mere fact that public hospitals do not have adequate equipment and knowledge to help these patients, but rather an opportunity for doctors to extract more money. A usual comment according to the interviewees is “the waiting time for your diagnosis is long, but if you want to receive fast service and help I can recommend you to go to this private clinic.” They are then appointed to the doctor’s own private clinic or his friend’s clinic. An additional complication of the problem is the principal-agent problem, where the patients do not know what kind of treatment they need, making it easier for the doctors to deceive and extract money.

4.2.2 Corruption in the Education System

The Citizen’s Forum, a Tuzla-based non-governmental organization (NGO), conducted a larger survey to determine students’, professors’ and university staffs’ views on the presence of corruption at Tuzla University. 946 students and 67 teachers and other staff members from the university participated in the questionnaire. More than half of the students (52.2%) believed that corruption exists at the university. Almost one third of the students (29.5%) have heard of its existence but are not certain if it exists. This would imply that 81.7% of all students do not exclude the presence of corruptive practices in their faculties. Only one forth (23.9%) of the university staff state with certainty that corruption exists. On the other hand, only 16.4% believe that corruption is non-existent on the university. Transparency Internationals report “Stealing the Future” presents similar results. TI has carried out two surveys over a period of 10 days in summer 2004 and spring 2005 at the University of Sarajevo and the University of Banja Luka. A total of 299 interviews were held in Banja Luka, and 500 interviews in Sarajevo. Same questionnaire was used for both universities. At both universities, more than 60% believed that corruption did exist at their institution. 11.4% of the students at Banja Luka University had encountered corruption directly and 56.5% had heard of it affecting their colleagues. Interestingly, 42.1% of the surveyed students at the universities said that they would not report the incident if they were asked to pay a bribe. Moreover, the investigation identifies the payment of bribes to pass exams as the most frequent corrupt behaviour.

We also find that the biggest and most important type of corruption in the education system is the payment for passing exams. The students apprehend this phenomenon as normal, where they openly talk about it and pay the professors without questions. If they do not pay, they will be prevented from passing the exam, even if they have enough knowledge to pass. During

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87 The Citizens Forum – Korupcija na univerzitetu
88 Transparency International (2005)
our visits in BiH, we often encounter students who had to do the exam several times before finally passing it; an incident often linked to the fact that they do not have the economical possibility to pay the professors. This has led to a polarization where there are rich students and poor students. The rich students pay and pass exams easily without any adequate knowledge. We have also during our visits in BiH encountered situations where the student walks into the professor’s office for an oral exam, and walks out after just one minute with the highest grade. The poorer students on the other hand need to struggle and fight for their rights, resulting in lower motivation among these students to study. An often cited phrase is “why should I try when I know that I need to pay in order to pass”. Complaining is no option because if the professors find out, the individuals who complain will never graduate. The corrupted professors are linked and work together. This has led to a situation where knowledge does not matter anymore and consequently to inefficiency in the education system.

One former student explained why he never was able to graduate. In his fourth year of studying, one professor demanded a large sum of money if he would to let the student pass his course. The professor openly told the student that if he wanted to pass he must pay. After eight attempts without passing, the student gave up. The older education system in BiH did not allow students to continue if they had not passed all the courses.

4.3 Employment, salaries and the standard of living

12 of the interviewed claim that they needed to engage in some sort of corrupted acts in order to get their current job. The recruitment process is heavily distorted by corruption. This comes as no surprise since a major problem for citizens in BiH today is to find a job. When students graduate from the universities, many of them find themselves without a work. There is without any doubt an excess demand for new jobs.

The most popular places of work are government institutions and government owned businesses. The reasons are that these places are seen as safe where government pays out salaries regularly. To receive a job in a government institutions or government owned businesses in an honest way, without the use of corruption, is difficult and merely possible. These jobs are given to people that have a broad contact-network and that have good relationship with some individuals in key positions. One source told us about the recruiting process in BH Telecom, the largest public firm in BiH today. The source claimed that in order to get a job in the company, individuals have to take a credit loan of KM 50 000 and pay to an employer within the firm. This employer in turn has an agreement with one or several banks, which will grant the applicant the credit loan without the need of fulfilling any credit risk criteria. When the applicant gets an employment, he receives a good salary, KM 2000 per month, with which he can pay back the loan and, at the same time, have enough of money to make a good living.

The private sector, on the other hand, is enclosed by different problems. Reports of workers not receiving their salary on regularly basis, and sometimes not receiving the salary they have earned at all, are frequent. 4 of our interviewees have been in the situation where the employer has not paid out any wages at all for months, claiming that the firm was not doing
so well at the moment, but that the whole earned wage will be paid out at a later moment. This forced the workers to continue to work at the same firm because they did not want to lose their earned money, only to find out that they later got a fraction of the whole salary. One other commonly used method to exploit citizens searching for employment is to hire people registered at the employment office. When firms in BiH hire worker from the employment office, the first six months, according to the municipal worker we interviewed, is a trial period of employment. During this trial period, the State pays the worker’s salary through the employer. The employer illegally takes one to two thirds of that money for himself and pays out the rest. As the trial period approaches its end, the employer dismisses the worker, claiming that the worker is incompatible for the job. He then once again turns to the employment office and repeats the procedure. The result is that the employer receives a worker that works for him for six months, and to whom he does not pay salary with his or the firm’s money. At the top of that the employer also manages to steal a great part of the worker’s salary. The job-recruitment process is not a secret and the citizens are well aware of the situation, but without any power to do anything about it.

As a result, the salaries themselves are low for the working class, especially in smaller cities, ranging from 200 KM to 500 KM. In larger cities the workers enjoy a little higher payment for their work. Again, in Sarajevo, they range from 400 KM to 800 KM. This difference disappears to some extent when taking the prices into account. There is however one big issue here; prices for such as wheat, cocking oil, sugar, milk and so on, are basically the same in the whole BiH and are much higher than in western European countries such as Germany and Sweden. The price for one litre cocking oil for example is 3 KM which is almost twice as much as the price in Sweden. Taking into account the fact that the salaries in BiH are ten times lower than in Sweden, the economic situation on a microeconomic level becomes gloomy. While it is hard to provide any exact number, we suspect that many people are living on, or even, under the subsistence minimum.
5. Causes of corruption in BiH

In this fifth chapter we identify and discuss possible causes of corruption in BiH. We divide them into three categories; root causes, causes due to political atmosphere in the country and causes due to the economical issues in the country.

5.1 Root Causes

It may seem difficult to locate the origin of the corruption in BiH, and it is indeed a challenge. We have however reason to believe that the causes of corruption are rooted in BiH’s bureaucratic traditions, political development, and social history.

First, once citizens of Yugoslavia, we highly doubt that the Yugoslav communist state before its disintegration was free of corruption. Being a dictatorship and govern by Tito, we believe Yugoslavia had weak democratic values and weak institutions. Together with the weak economic growth and lack of transparency and accountability, this makes us believe that the bureaucracy, just like today in BiH, had no incentives to carry out their operations efficiently, which led to a situation where ordinary citizens would ask for corrupt transactions in order to speed up the workings of the bureaucracy. We also believe that the inefficient planned economy forced companies to turn to the black market and underground economy, which naturally created a fertile ground for corruption. This kind of behaviour from leaders, bureaucracy and citizens passed on from the Yugoslav state into BiH, where it can be found today.

Second, the war in BiH was fought on ethnic and identity grounds, where greed and consideration for national survival went hand in hand. Because of the smuggling operations that took place during the war, we believe that a criminal elite with close ties to nationalist political parties emerged from the war. Consequently, this same legacy shaped the post-war reconstruction and building of the nation. The decisions and actions regarding the smuggling during the war are not seen as wrong or harmful. Instead they are considered as legitimate, where the individuals involved are heroes and a source of national pride; they did after all defend Sarajevo and its inhabitants in the early stages of the war. We also believe that party leaders encouraged and protected these individuals through the war, and that they still do. This connotes that the criminalized political parties will not introduce anti-corruption measures because that would eliminate their current power base and illegal source of income.

Another consequence of the war that we believe is a root cause for the corruption in BiH is the Dayton Peace Agreement. With Dayton Peace Agreement came a very complicated structure with three governments, and where the country is divided into two entities, the Federation and Republika Srpska. The remarkable size of the public sector creates space for corrupt acts to take place at the same time as it is difficult and complicated to inspect the actions made by all the officials, politicians and bureaucrats.
5.2 Causes due to the political atmosphere

The bad political atmosphere provides a great setting for corruption. Some crucial elements for a well-working and developing state are in one way or another negatively affected by the political instability and the ruling parties with their greedy politicians.

We have seen how the highly important institutions in BiH are affected and exploited by corruption, how the local politicians are influencing the judiciary in blatant manners, serving their own purpose. We have also seen how policemen constantly strive for a situation where they can extract bribes, and how doctors and teachers are overpaid to do their work. This is all a consequence of structural distortions such as lacking policies and weak institutions. With better policies and goals from the state, better and far more efficient institutions would arise. The decision-making process, however, is very slow in BiH and there are no real incentives from the ruling politicians to establish these policies. Since parties with opposing stances on almost every important issue constitute the Council of Ministers, and since no one is willing to compromise, it is difficult to force through any kind of reforms or projects. Dodik’s radicalizing of the political atmosphere and RS’s unwillingness to accept major projects also worsens the situation. Instead there is a focus on the ongoing battle between ministers and ruling parties that takes away all the attention that the actual reconstruction of the country would have. The lacking incentives from politicians to establish policies may also be due to the fact that they have no personal gains from it. On the contrary, a corrupt juridical system for example may serve officials in higher positions better than a system that is not corrupt. The politicians may also have friends or relatives in various institutions that exert corrupt actions. As a result BiH faces weak and exploited institutions without policies, and it is the general public that pay the highest price.

As if it was not enough that the institutions are weak in BiH, they also seem to lack control. Tanzi (1998) argues that institutional controls are a reflection of the attitude of the political body toward the willingness to catch those who commit crimes. As already argued, the politicians in BiH have no incentives to make the institutions more efficient. This implies that they also do not care to implement any working institutional controls. The lack of institutional controls may also serve the politicians’ interests better than if they actually existed. When there is no control in the institutions, the chance of getting caught is remarkably lower. This encourages more corrupt and illegal activities.

Just as the lack of institutional controls, weak penalties for those getting caught encourages corrupt and illegal activities. In BiH few public officials seem to be punished for corruption. This is due to several reasons. First, the judges who will impose the penalties have most likely been selected by the public officials to get these jobs and would never sell them out. Second, the police may not want to do careful investigations to find important evidence. A policeman with higher ranks most likely knows these prosecuted public officials; they probably all belong to the same ethnic group and these public officials may even have given the policeman his current job. This suggests that the policeman most certainly will turn a blind eye. These kinds of corrupt behaviours leads to complicated bureaucratic procedures and lack of valid evidence, resulting in long processes before a public official is punished. These circumstances weaken the penalty system, and promote corruption among public officials.
Furthermore, the huge bureaucracy that can be found in BiH forces citizens to constantly be in touch with the authority. As Tanzi (1998) points out, in these circumstances the authority has a monopolistic-alike power. It is no different in the case of BiH, where this monopolistic-alike power gives opportunities to the officials to use their public power to derive bribes from those in need of various authorizations. They can for example refuse the authorizations, purposely delay the process, or in any other way prevent the citizens the needed licenses, permits or authorizations. We believe that the complicated bureaucracy in BiH is unnecessary and could be more efficient if politicians would actually want to invest time and effort into making it better. A more efficient bureaucracy would however most likely result in fewer employments, and jobs that were distributed by the local politicians to members of the ethnic majority group, their family and to other relatives or friends would disappear. This instantly implies that no effort will be made by the politicians to render the bureaucracy more effective since there would be a risk that members of family, relatives and friends would lose their work and positions.

To end the discussion about political causes we would like to point out that we believe that BiH is faced with a very bad quality of bureaucracy. The politicians in BiH care about power and money, but do not care about the means used to acquire it. More money leads to higher status and more power and that is what counts. We believe that this is an inherited tradition from the former Yugoslav state. There is no merit-based promotion since connections decide who will get a specific job. This undermines the value of hard and honest work.

5.3 Causes due to economical issues
A well-working economy is an important factor in a society. In BiH though, the economy seems to be associated with corruption. When a country is faced with a bad economic situation and poverty, it will most certainly be a victim of corruption. Poverty creates many possibilities for corrupt activity, where the poor can be exploited or used in various ways. We have already described the situation regarding employment and wages, students and the education system and the health system. Poverty in BiH makes it possible for public officials to exploit the general public in all these areas. When in poverty, citizens are desperate and take any job they can find under any kind of agreement. They may accept low wages, bad working conditions and so forth. The employers use this desperation for their own gain through corrupt acts.

In the health sector, there is a high probability that the poor are often last in the line for the treatment since, as the municipal worker claimed, the patients are more or less forced to pay for the treatment. The poor have neither money nor connections. It is not even granted that when they actually get an appointment that they will receive the best or proper help. This encourages corruption since people with money and status are those prioritized by doctors. When there is a distinct line between the poor and the wealthy, as the case seems to be in BiH, corrupt acts are about to occur in the health sector.

Students are also easy to exploit in the midst of bad economical conditions and it is not difficult to see why. As the economy is weak and it is hard to find a job, many students are
hoping for a better life when they graduate. This gives the professors an opportunity to exploit students by purposely putting obstacles in the students’ ways. Students are prepared to do anything in their power in order to get around these obstacles; after all, their future is at stake.

To end this discussion about economical causes of corruption we would like to state that Tanzi’s (1998) argument about distorted public expenditure is highly applicable to BiH’s economical situation. BiH’s public officials have a budget to spend. A part of that budget is used for various projects, and when a country is in a post-war era it is all about rebuilding projects. When the politicians are deciding upon a construction firm, we believe that they do not choose the best and most efficient firm. They choose a construction firm that has some kind of connection to the politicians. It could be that this particular firm pays “commission” to the politicians or it could be a family member, a relative, or a good friend that runs or owns the firm. This may be the reason why the politicians tend to have difficulties to agree on the state budget.
Corruption is believed to have crucial and devastating effects on economic growth, especially in developing countries, at the same time as it is hard to combat. We tackle these issues in the second part of this paper, where we discuss how corruption affects growth in Bosnia and Herzegovina and how it can be fought in the country. We also discuss possible effects on growth in Bosnia and Herzegovina if corruption is successfully fought. Chapter 6 presents the growth model of Ellis and Fender. In chapter 7 we discuss how the economic growth in Bosnia and Herzegovina could be affected by corruption. In chapter 8 we provide our anti-corruption program. Chapter 9 is dedicated to discuss how the economic growth in Bosnia and Herzegovina could be affected if corruption is reduced. Chapter 10 presents some concluding remarks.
6. Corruption in a growth model

This chapter is dedicated to present the theoretical model that will be used to analyze the influence of corruption on economic development and growth in BiH. The model addresses the issue through a variant of the growth model developed by Ramsey (1928), Cass (1965) and Koopman (1965). First, we will describe the structure of the model where we explain assumption, the economy and the behaviour of the politicians and the citizens. By doing so we will derive the utility function that the citizens try to maximize and the function of the stream of corruption payments that the government tries to maximize. Second, we will solve the optimization problem and derive the stationaries that are solution to the model. Third, we will solve the dynamic system for the saddle path stable steady state in order to get the necessary tools that we need to analyze the corrupt economy of BiH. This entire chapter is based on the model of Ellis and Fender (2006).

6.1 Structure of the model

6.1.1 Assumptions and the economy

We assume that the economy consists of the government and two consumer/producers. The consumer/producers differ only in the sense that each supplies a heterogeneous labour input, \( l^i(t) \ i = 1,2 \), each of which combine to produce effective labour according to \( l(t) = \min[l^i(t)] \).

Output, \( y(t) \), is produced using two inputs, effective labour \( l(t) \) and public capital, \( p(t) \). Using Cobb-Douglas production technology, the output function becomes

\[
y(t) = f(l(t), p(t)) = l(t)^a p(t)^\beta
\]

where \( 0 < \alpha, \beta < 1 \). Public capital is supplied by the government according to the linear technology

\[
\frac{dp(t)}{dt} = \dot{p}(t) = \tau(t - \omega) - b(t - \omega) - \delta p(t)
\]

where \( \tau(t - \omega) \) is the taxes paid at an interval of length \( \omega \) in the past, \( b(t - \omega) \) represents the portion of past tax payments that were corruptly appropriated by the government for its own use, and \( \delta \) is the depreciation rate of public capital. The interval \( \omega \) is the production lag, which is essential in the forthcoming analysis. An additional assumption regarding the interval \( t - \omega \) shall be made; since taxes paid at time \( t - \omega \) do not yield public capital until time \( t \), it is not possible for the consumer/producers to know that resources have been corruptly appropriated until the promised public capital fails to be materialized. In a general sense, \( \omega \) captures how long it takes for the private sector to discover what the government has done with the resources at its disposal, and is by the means the lag between a policy promise

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\(^{89}\) Romer 2006

\(^{90}\) Ellis and Fender (2006)
and verification that the promise has been kept. This can be interpreted as the degree of fiscal transparency in the economy or the quality of economic institutions.

The objective of the consumer/producers is to maximize the present value of the utility derived from the consumption, \( c^i(t) \), and leisure, \( -l^i(t) \), given preferences described by

\[
Max \int_0^\infty u^i(t)e^{-rt}dt = \int_0^\infty u(c^i(t),l^i(t))e^{-rt}dt = \int_0^\infty [c^i(t) - l^i(t)]^\theta e^{-rt}dt
\] (6.3)

where \( r \) is the discount rate and \( 0 < \theta < 1 \) is the intertemporal substitution parameter. It is assumed the instantaneous budget constraint

\[
\sum_i c^i(t) = y(t) - \tau(t)
\] (6.4)

must be satisfied. It is furthermore assumed, for the sake of simplicity, that \( y(t) \) is non-storable, and that the consumer/producers have the choice of either work \( l^i(t) = 1 \), or not work \( l^i(t) = 0 \). This connotes that \( c^i(t) \geq l^i(t) = 1 \) may be viewed as the consumer/producers’ instantaneous participation constraint.

The government has an objective where it wants to maximize the discounted present value of corruption payments

\[
\int_0^\infty b(t)e^{-rt}dt.
\] (6.5)

How the government decides to fulfil this objective depends on the nature of the political process.

6.1.2 The political process

At any given time \( t \) a particular government holds power. At some point in the past, this government has made a promise to deliver a time path of consumption to the consumer/producers by setting particular time paths for taxes and public capital investment. At every moment, the government has the option of either honouring this promise or pocketing all tax revenues as corruption. If the first option is chosen the same set of options obtain at the next moment; if the second option is chosen the government knows that it is not investing in the public capital necessary to deliver the promised consumption stream, and that this will be detected after an interval of length \( \omega \) (after the production lag). The reaction of the consumer/producers to the failure of a government to deliver the promised consumption stream depends on the nature of the existent political process. In a democratic system the government would probably be voted out of office; if the political system is less open it might require some form of revolution, rebellion or mass protest to replace the regime. However, if a corrupt government controls the means of coercion in a society, it will only choose to give up office if it finds it in it’s own interest to do so. We assume that in response to detected defection on a policy promise, each consumer/producer can respond either by choosing to continue working or to withdraw their labour. The withdrawal of labour may, in a democratic
regime, be viewed as an initial threat that causes a corrupt government to "voluntarily" step down, while it in a less open political system may be an actual process where regime change occurs. Consequently, all that the analysis requires is that the withdrawal of labour, or the initial threat of a withdrawal of labour, by a group of consumer/producers reduces the value of the government continuing in power below that of its next best alternative.

This can be analyzed from a game theoretical perspective. The government and the consumer/workers play the following game in which the government first decides whether or not to honour its promise. Then the two consumer/workers simultaneously choose whether to work or withdraw their labour.

![Figure 6.1: Prisoners' dilemma](image)

There are two Nash Equilibria in the subgame if the government honors its promise, \{Work, Work\} and \{Withdraw, Withdraw\}. If we make the assumption that the worker/consumers each believe that with probability 1 the other will play work, and, since the \{Work, Work\} equilibrium Pareto dominates the other, it is natural to assume this is focal and that the players develop beliefs that coordinate them on this equilibrium. If the government chooses to defect, then, as was in the previous case, both \{Work, Work\} and \{Withdraw, Withdraw\} are Nash Equilibria. However, the strategy \{Withdraw, Withdraw\} here weakly dominates the other, so we assume that in this instance the consumer/workers hold beliefs that coordinate them on the \{Withdraw, Withdraw\} equilibrium.

The consumer/producers are aware that the government always can take the money and run, i.e. to steal everything for an interval of length $\omega$ and quit. From this follows that the only promises the producer/consumers will believe in are those that at each instant satisfies the corruption constraint

$$\int_{j=t}^{\infty} b(j)e^{-\tau j} dj \geq \int_{j=t}^{t+\omega} \tau(j)e^{-\tau j} dj \quad \forall t. \quad (6.6)$$

The time path of corruption, with its implied investment and consumption promises, that the government follows must yield a time-path for corruption payments of higher present value
than the option of appropriating all taxes until they are detected. The corruption in the economy at this level is irreducible. Because of the political competition between potential governments for these rents, this constraint holds with equity. Furthermore, the governments are only interested in corruption payments, which implies that competition for \( \int_{t=1}^{t+\omega} \tau(j)e^{-\tau j}dj \) ensures that the time paths of \( b(t) \) and \( \tau(t) \) chosen maximize the discounted present value of the consumer/producers’ utility.

From now on the distinction between the two consumer/producers plays no important role in the analysis. Therefore we combine these two into a “household sector” with consumption \( c(t) \), labor \( l(t) \) and utility \( u(t) \).

### 6.2 The dynamic optimization problem

The optimization problem is, given the economical and political structure above, to maximize the discounted present value of the utility stream enjoyed by the household sector, or

\[
\text{Max} \int_0^\infty \left[ l(t)^a p(t)^b - \tau(t) - l(t) \right]^q e^{-rt} dt, \tag{6.7}
\]

by choosing the paths of \{\( \tau \}\} and \{\( b \}\} with \( l(t) = 1 \) subject to

\[
\dot{p}(t) = \tau(t - \omega) - b(t - \omega) - \delta p(t), \tag{6.8}
\]

and the demand that it satisfies the corruption irreducibility constraint

\[
\int_{j=t}^{\infty} b(j)e^{-\tau j}dj \geq \int_{j=t}^{t+\omega} \tau(j)e^{-\tau j}dj \quad \forall t. \tag{6.9}
\]

This optimal control theory problem requires the use of “delayed controls”. The solution method is to take the derivative of the corruption constraint with respect to time and transform the problem into one in which controls are not delayed. First we differentiate the corruption irreducibility constraint with respect to time and yield

\[
-b(t)e^{-rt} = \tau(t + \omega)e^{-\tau(t+\omega)} - \tau(t)e^{-rt} \tag{6.10}
\]

When we divide (10) with \( e^{rt} \) and then lag the resultant expression back an interval of length \( \omega \) yields

\[
-b(t - \omega) = \tau(t)e^{-\tau \omega} - \tau(t - \omega) \tag{6.11}
\]

Substituting (11) into (8) yields

\[
\dot{p}(t) = \tau(t)e^{-\tau \omega} - \delta p(t). \tag{6.12}
\]

The problem now reduces to
Using the production function (1) and the flow budget constraint (4) when rearranging, we can write the problem in the more familiar form

\[ \text{Max } \int_0^\infty [p(t)^\beta - \tau(t) - 1]^{\theta} e^{-r t} dt \]

s. t. \( \dot{p}(t) = \tau(t)e^{\tau \omega} - \delta p(t). \) \hspace{1cm} (6.13)

Using Hamiltonian for problem (14) yields

\[ \text{Max } H = [c(t) - 1]^{\theta} e^{-r t} + \xi(t)[p(t)^\beta e^{-\tau \omega} - c(t)e^{-\tau \omega} - \delta p(t)]. \] \hspace{1cm} (6.15)

Solving this optimization problem yields following pair of differential equations

\[ \dot{p}(t) = P(t)^\beta e^{-\tau \omega} - c(t)e^{-\tau \omega} - \delta p(t), \] \hspace{1cm} (6.16)

and

\[ \dot{c}(t) = \left(\frac{1}{\theta - 1}\right)[\delta - \beta P(t)^{\beta - 1} e^{-\tau \omega} + r][c(t) - 1]. \] \hspace{1cm} (6.17)

The dynamic system is presented below in a phase diagram, where the stationaries are given by

\[ c(t) = p(t)^\beta \frac{\delta p(t)}{e^{-\tau \omega}} \] \hspace{1cm} (6.18)

and

\[ c(t) = 1 \text{ or } p(t) = \left(\frac{\beta e^{-\tau \omega}}{\delta + r}\right)^{\frac{1}{1-\beta}}. \] \hspace{1cm} (6.19)
As can be seen in the figure, the model shows four steady states; tree with a positive level of consumption and public capital stock, i.e. (B), (C) and (D), and one associated with the “shutdown” equilibrium (A). We can immediately see that the low public capital stock equilibrium (B) is unstable, while the high public capital stock equilibrium (D) is a stable source and the high consumption level equilibrium (C) is stable saddle. For any initial public capital stock \( p(0) > p \) the saddle path represents level of consumption along its entire path that exceeds the consumption level at the stable source. This implies that a government, when competing for the irreducible corruption payoff, will offer the consumption path that is associated with the saddle path. This can be done if the paths of taxes and investment are appropriately selected.

When solving the dynamic system for the saddle path stable steady state C, we get that

\[
\bar{c} = \left[ \left( \frac{\beta}{\delta + r} \right)^{1-\beta} - \delta \left( \frac{\beta}{\delta + r} \right)^{1-\beta} \right] \left( e^{-\omega} \right)^{\frac{1}{1-\beta}},
\]

(6.20)

and

\[
\bar{p} = \left( \frac{\beta e^{-\omega}}{\delta + r} \right)^{1-\beta}.
\]

(6.21)

With these solutions we have the necessary tools to analyze the impact of corruption on economic growth.
7. Effects of corruption on economic growth in BiH

In this chapter we intend to show how the economic development in BiH in the post-war era, i.e. from 1995 and forth, has been affected by corruption. For any positive level of public capital there is a unique initial level of consumption, and we want to show the possible developing path BiH has taken. The model of chapter 6 will be used. After that we discuss possible channels through which corruption affects economic growth.

7.1 The development path

We explain and illustrate two possible developing scenarios that BiH could have experienced. As the reader will se, both of them leads to different outcomes. We will then go on showing the relationship between the corruption and growth in BiH.

7.1.1 Scenario 1

BiH has endured a long war and, thus, it comes as no surprise that the initial level of both capital and consumption are low. However immediately after the end of the war, BiH received huge economical aid from foreign countries, and it experienced remarkable capital inflow. This capital inflow has then continued for several years and sources point out that BiH has received more money in aid than Germany did after the Second World War. This reasoning suggests an initial level of consumption such as point A in the phase diagram below; close to the shut-down solution, with \( p(0) < \left( \frac{r_e - r_u}{\delta + r} \right)^{\frac{1}{\nu}} \). This means that in point A, \( \dot{p}(t) > 0 \) and \( \dot{c}(t) < 0 \). As the huge capital inflow occurred, BiH jumped to a level of consumption such as point B, escaping its fall. In point B, both \( \dot{p}(t) > 0 \) and \( \dot{c}(t) > 0 \). The capital inflow continued for several years and the public capital stock was constantly increasing. The consumption was also increasing, but not as much as it could. The politicians failed to select appropriated paths of taxes and investments, preventing the economy to converge along its saddle path to a steady state such as point C, with high level of consumption and public capital. Instead the development occurred as according to the path in the phase diagram.

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91 VoANews.com – Jacques Klein – Medjunarodna zajednica na BiH potrosila vise nego je za obnovu dato Njemackoj i Japanu
One could wonder why the citizens did not object to this governmental failure. The reaction of citizens when the government fails to deliver the promised consumption stream depends on the nature of the existing political situation. When the political system is less open, as is the case in BiH, the government does not choose to give up office, and a form of revolution or mass protest is needed. The problem, however, is that citizens believe that other parties, when receiving the ruling power, will be just as corrupt as those that run the politics now. This reduces incentives to protest at the same time as it undermines the political competition between different parties. It is also difficult to follow government actions as the political system is less open. Citizens for example are not aware of the huge capital inflow that has occurred. This means that the State with its ruling parties gets away without fulfilling its obligations. Furthermore, as the political competition is less meaningful, the corruption constraint

$$\int_{j=t}^{\infty} b(j)e^{-\tau j}dj \geq \int_{j=t}^{t+\omega} \tau(j)e^{-\tau j}dj \ \forall t$$

does not need to hold with equity. Recall that the time path of corruption, with its implied investment and consumption promises that government follows, must yield a time-path for corruption payments of higher present value than the option of stealing all taxes until they are detected. Political competition for these rents implies that the constraint should hold with equity. As the political competition is undermined, the constraint does not need to hold with equity and the ruling political parties can enjoy higher streams of corruptly appropriated capital.

Roughly ten years after the war ended, $p(10) > \left(\frac{b_e^{-\tau \omega}}{\delta + \tau}\right)^{\frac{1}{\gamma}}$, implying that, in order for the discounted present value of the utility stream enjoyed by the household sector to be maximized and its constraints to be satisfied, $c(t) < 0$ and $p(t) > 0$. where consumption started to fall and the public capital growth continued to be positive. This decline continued for a
couple of years, until the global financial crisis broke out (Point D). BiH being a small, corrupted and unstructured country, heavily dependent of other nations, was hurt badly by the crisis. The growth fell sharply (Point E). This is where BiH stands today. The development path is consistent with figure 3.1.

We especially tested for the intertemporal substitution parameter \( \theta \) during the financial crisis\(^{92} \), i.e. July 2009. The results suggest that \( \theta \) is closer to 1. The parameter \( \theta \) enters the utility function

\[
\int_0^\infty [c(t) - 1]^\theta e^{-rt} dt.
\]

It can immediately be seen that \([c(t) - 1]^\theta\) is increasing in \( \theta \). The conclusion from this is that citizens in BiH value today’s consumption the most, and do not have any incentives to save. The higher the consumption is today, the higher will their utility be. Since the output declined sharply during the financial crisis, the reasoning about intertemporal substitution parameter \( \theta \) also suggests that the citizens are in need of money and could be living under the substance level.

According to the model, as illustrated in the phase diagram, BiH will in the long run reach the stable source F. How long this adjustment will take is difficult to say and depends on many decisions that will be made, or not made. What happens with corruption when the stable source is reached? While there are no tools to analyze the corrupt behaviour in the stable source F, it can be analyzed in the stable saddle C. The quantitative results should differ between C and F, but the qualitative results are the same. We are interested in the amount of corruption as a share of total output in the stable saddle, \( \bar{b} / \bar{y} \). Combining equation (6.21) with (6.1) yields an expression for \( \bar{y} \). Solving equation (6.11) for \( b \) yields an expression for \( \bar{b} \). This gives that

\[
\frac{\bar{b}}{\bar{y}} = (1 - e^{-r\omega})(\frac{\delta \beta}{\delta + r}). \quad (7.1)
\]

Differentiating this equation with respect to \( \omega \) yields

\[
\frac{\partial (\bar{b}/\bar{y})}{\partial \omega} = re^{-r\omega}(\frac{\delta \beta}{\delta + r}) > 0. \quad (7.2)
\]

This implies that the level of corruption as a share of total output is increasing in the production lag \( \omega \). Recall that \( \omega \) measures transparency or the quality of institutions. This result is consistent with our earlier discussion about the institutions. If \( \omega \) increases, the interval over which the government can steal all tax revenues and flee also increases. To

\(^{92}\) We did so by asking question 8 in the questionnaire and then calculate how much the citizens in BiH value their consumption today. A number of 20 interviewees implies a total sum of 20x1 000 000 = KM 20 million. Out of these KM 20 million, the interviewees would take a total sum of KM 4 million. 1-(4/20) = 0.8, which is the intertemporal substitution parameter.
prevent the government from exercising its “steal everything” option, citizens must, for any given level of output $\bar{y}$ tolerate the government to enjoy a higher state flow rate of corruption, $\bar{b}$. As this occurs the government cannot be investing enough tax revenues to sustain the initial steady state equilibrium capital stock since its equilibrium flow rate of corruption is higher. Following this line of reasoning, both the steady state capital stock, $\bar{p}$, and the steady state level of output, $\bar{y}$, must fall. Thus the share of corruption in output must rise. Because a greater share of output is corruptly appropriated, the consumption in output also must fall. This is consistent with the intertemporal preferences of the citizens, $\theta$, and may explain why they, after 15 years of peace-time, value the consumption of today much higher than future consumption. Each KM that they pay in form of taxes today generates less capital output and consumption in the future.

Second order effects from the equation provides

$$\frac{\partial^2 (\bar{b})}{\partial^2 \omega} = -r^2 e^{-r \omega} \left( \frac{\delta \beta}{\bar{b} + r} \right) < 0.$$  

(7.3)

This analysis suggests that corruption in the stable source is still positive, but that it is slowly diminishing. The wealthier BiH becomes, the lower the corruption as a share of output will be. The analysis also questions the nature of the causality between corruption and growth; does corruption cause the slowdown of growth, or does the low growth cause corruption? The case may be that the causality goes in both directions, but in this section we are only interested in the former.

### 7.1.2 Scenario 2

The second scenario we tend to illustrate is gloomier. The economy of BiH once again finds itself at a point such as A in figure 7.2, close to the shut-down solution with $p(0) < \left( \frac{\beta e^{-\gamma \omega}}{\delta + r} \right)^{\frac{1}{1 - \gamma}}$, where both the capital stock and consumption level are low because of the war, and where $\dot{p}(t) > 0$ and $\dot{c}(t) < 0$ and.

![Figure 7.2: The phase diagram and the scenario 2-development](image-url)
As it already has been stated, after the war BiH experienced a huge capital inflow in form of foreign aid. In this scenario though, the capital inflow did not manage to lift the economy above the $\dot{p}(t) = 0$ locus, and the economy finds itself on a level such as point B instead. In point B, $p(t_B) < \left( \frac{h e^{-\tau_{locust}}}{\delta + r} \right)^{\frac{1}{1+r}}$, implying that, in order for the discounted present value of the utility stream enjoyed by the household sector to be maximized and its constraints to be satisfied, $\dot{c}(t) < 0$ and $\dot{p}(t) > 0$, where consumption started to fall and the public capital growth continued to be positive. This leads to a downward-sloping development of the whole economy, as illustrated in figure 7.2. When the financial crisis hit BiH (point C), the economy experienced a steeper fall in the consumption level than before, and a slower growth of the public capital stock. Point D is where the economy stands today. For an economy to find itself in a situation such as illustrated by point D is dangerous. As illustrated in figure 7.2, the economy will sooner or later go bankrupt due to the constant fall in the consumption level. The public capital stock is still increasing, but the corruption is preventing the higher capital stock to benefit the citizens where they would be able to enjoy a higher stream of consumption.

7.1.3 The corruption-growth relationship
By taking the growth rate data for BiH\(^93\) and combining it with the Transparency International’s transparency index for BiH\(^94\) we can study the corruption-growth relationship. Since we have three variables, growth, transparency and period, we create a three-dimensional graph, see figure 7.3. The X-axis measures the periods. One period represents one year and the seven periods corresponds to the years 2003-2009. The Y-axis measures the growth rate in BiH, presented in percentage points. Finally, the Z-axis measures the transparency; the higher the transparency the lower is the corruption.

![Image](image.png)

*Figure 7.3: The corruption-output relationship*

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\(^{93}\) IMF (2009) – World economic outlook

\(^{94}\) Transparency International’s corruption perception index
The figure illustrates a strong relationship between the corruption and growth. Studying the figure backwards, i.e. from period 7 and down, we see that the growth rate is rising at the same time as transparency is increasing. Such a strong relationship exists mainly due to the fact that BiH finds itself in a post-war era. When a country is in a post-war period there is a lot of work that needs to be done to restore the country. When politicians concentrate on devoting resources to the rebuilding process and actually doing their work, the growth will see a noticeable increase. If politicians on the other hand steal capital and do not do their work, the growth rate will decline. In a post-war era, the elasticity between how much work is put in the rebuilding process and the actual growth is high, which leads to a strong corruption-growth relationship.

7.2 Channels through which corruption affects growth
Social capital is excluded from all major growth models such as Solow’s growth model, the growth model of Ramsey-Cass-Koopman, and the Diamond model. This is most unfortunate since social capital is an important factor in an economy and is a leading contributor to growth. When social capital is distorted, it affects the economic growth negatively. In BiH, social capital is affected by corruption. Since there is much corruption in the country, many citizens try to corrupt various institutions. We do not believe that these citizens actually want to use these methods, but that they are rather forced to use them. BiH also seems to have too much social capital tied up in different organizations and networks. There is a huge social polarization in the country, resulting in formation of groups along the ethnic line. The country itself is also divided into two entities with different ethnic backgrounds, where the political parties are formed along the ethnic line. The more unbiased and incorrupt the entities, parties, and various institutions become, the more social capital will be liberated. This all suggests that there is very little confidence for the State, between entities, and between fellowmen, and is consistent with the empirical research. The loss in confidence and consequently the social capital throws a spanner into works for economical development and slows down the growth.

Obstacles to domestic and foreign investments also undermine the growth in BiH. As already argued, when doing business in BiH, different kind authorizations and licenses are required. These various regulations and authorizations force citizens to constantly come into contact with the authorities. This is where the corrupted deals arise. Consequently, the authorizations and licenses make it harder to start new businesses. The small enterprises are important for the growth of BiH and corruption hinders them to arise and work properly. It acts as a cost-increasing mechanism. This does not only count for the domestic investors, but also for foreign investors. The authorizations and regulations hold back investors and prevent efficient markets to arise. Furthermore, the abuses of public utilities that have occurred delay the restructuring of strategic companies in BiH. This prevents the country to use all its capabilities for development. The distorted public spending that we have discussed earlier also leads to slowdown in the growth. When public officials do not choose the best-suited and most effective companies to carry out their investment processes, inefficiency in the market arises and slows down the growth.
Moreover, corruption increases poverty since it has a tendency to make the poor even poorer. The poor do not have enough money to bribe officials and are left behind. The few social services, investments, and changes that occur are not favourable to the poor. When we were interviewing one poor farmer, he was complaining about how it has become much more expensive and unfavourable for farmers to sell their agricultural products. He was referring to the increased cost for the right to sell at the piazza. Citizens with money are prioritized by the officials. This means that the poor are lagging behind the small growth that takes place, and they sometimes even go in the opposite direction, i.e. becoming even poorer.

Last, while it is difficult to actually measure the size of the black market economy, our apprehension is that it is quite large in BiH. Corruption, through the distortion of social capital, authorizations and regulations, and increasing poverty drives the economy towards a black-market economy. Many citizens, especially the poor, have no other choice but to enter the black market; these people must do what is necessary for their survival. First, the regulations and authorizations prevent them from doing business legally; second, the distortion of social capital creates disbelieves for the governments, encouraging citizens to turn their back on them; third, poor citizens are not prioritized by public officials, forcing them to engage in the underground activity.

The underground activity is a huge problem in BiH, which affects the economic growth extremely negatively. The consequences are several and have already partly been discussed. When going underground, citizens allow themselves to take greater risks, which reduce the social welfare. Products may not be of the same quality and may lack any sort of guarantee when buying them on the black market. The State on the other hand looses tax incomes. The time that needs to be devoted to the transactions of some goods or services, however, may actually be less than if buying these from a legitimate business. This contradicts the empirical literature. The thick and inefficient bureaucracy in BiH is, as already stated, time-consuming to go through. This suggests that a reason for citizens to go to the black market may be to just speed up things.
8. The anti-corruption program

Fighting corruption is a difficult task that requires intervention from all parts of the society. Our motivation in this chapter is to bring forth an anti-corruption program where we highlight what we believe are important actions in the fight against corruption. Even if this program may not be enough to defeat the corruption in BiH, we greatly believe that it is a good start. Since corruption is a complex phenomenon, the measures designed to fight it must also be complex. There are no general methods that describe how corruption should be fought. Each country that is victim of corruption has its own unique problems that require different measures.

8.1 Altering the will of the politicians

We have already discussed the issues regarding the politicians will to fight the corruption. We have stated that the politicians are those who are most involved in corrupt acts, and therefore have no will or incitement to engage in anti-corruption measures. So, how could one affect the political will and attitude toward the corruption problem? This is perhaps the biggest and most difficult, and certainly the most central, issue in BiH regarding the fight against corruption. If the fight against corruption is to be waged successfully, this problem is the first one that requires a solution. Only when the will of the politicians is altered so that politicians actually want to reduce the corruption in the country can we move forward to specific anti-corruption measures. Therefore, it falls natural to tackle this problem first when conducting our anti-corruption program.

Recall the objective function (6.5) from chapter 6,

\[ \int_{0}^{\infty} b(t)e^{-rt} dt, \]

where the government wants to maximize the discounted present value of corruption payments \( b(t) \). It is safe to assume that the higher the present value of \( b(t) \) is, the higher will the utility of the politicians be. The corrupt stream of income is however not the only thing that enters a corrupt politician’s utility function. There are other things like family, freedom, pride and so on, that affects the politician’s subjective wellbeing. While our motivation is not to try to create a specific utility function for each politician in BiH, we can sum up all those others factors that affect the politicians’ utility in one variable, call it \( \phi \). In this case we could set up a general utility function for each politician as

\[ U = \int_{0}^{\infty} \phi(t)e^{-rt} dt + \int_{0}^{\infty} b(t)e^{-rt} dt, \]
where each politician tries to maximize the present value of corruption payments, \( b(t) \), and the present value of all other factors that affect the utility, \( \phi(t) \). Rearranging the utility function provides

\[
U = \int_0^\infty [\phi(t) + b(t)]e^{-rt} dt. \tag{8.1}
\]

In order to first and foremost prevent the politicians from engaging in corrupt acts, obviously some sort of measures must be taken. When politicians try to increase their utility by engaging in corrupt acts, i.e. through \( b(t) \), these measures must decrease the politicians’ utility more through other factors, represented by \( \phi(t) \). Thus, the measures must be of the quality where one percent increase in \( b(t) \) leads to more than one percent decrease in \( \phi(t) \), i.e. they must satisfy the elasticity constraint

\[
\frac{\partial b(t)}{\partial \phi(t)} \frac{\phi(t)}{b(t)} < -1. \tag{8.2}
\]

To make this statement more clear we differentiate equation 8.1 with respect to time, all else equal, which yields

\[
\frac{dU}{dt} = \int_0^\infty [\phi'(t) - r\phi(t) + b'(t) - rb(t)]e^{-rt} dt. \tag{8.3}
\]

This result shows that the utility increases when the marginal product of \( \phi(t) \) is higher than the discount rate of \( \phi(t) \), all else equal, and when the marginal product of \( b(t) \) is higher than discount rate of \( b(t) \), all else equal. Since we assume the discount rate is the same for both \( \phi(t) \) and \( b(t) \), we can rewrite 8.3 to better highlight our statement:

\[
\frac{dU}{dt} = \int_0^\infty [\phi'(t) + b'(t) - r(\phi + b)]e^{-rt} dt.
\]

When choosing measures against corruption, they must be of the quality where an increase in the marginal product of \( b(t) \) will lead to a larger decrease in marginal product of \( \phi(t) \). When the decrease in \( \phi'(t) \) is higher than the increase in \( b'(t) \), the whole utility will decrease, encouraging the politicians to not trying to increase their utility through \( b(t) \), that is through corruption. Eventually, when politicians cannot receive higher stream of utility by engaging in corrupt actions, it is rational for them to increase their utility stream through \( \phi(t) \), which amongst others includes hard and honest work. Establishing for example a more fair, just, and efficient society for the citizens will lead to higher stream of utility for the politicians.

There are many measures that posses this required quality. Becker’s work on crime prevention for example provides two of those measures; increase the probability to capture those that are engaged in corrupt acts and higher penalty for those who get caught. The former includes amongst others better institutional controls and more resources to the police. The
latter includes amongst others reforms in the judiciary system. When the probability to get caught and the penalty for corruption are increased, the criminals, when engaging in corrupt actions, will enjoy lower $\phi(t)$ through the risk of for example loosing freedom and time spent with their family and friends. Encouraging and supporting the media to spread news when for example a politician is caught stealing is another effective measure as it would put shame on the politician and thus hopefully reduce his or her utility through lower $\phi(t)$. This reasoning also implies that measures such as increasing the wages in the public sector are inefficient in the fight against corruption. Higher wages would increase a politician’s utility through higher $\phi(t)$, but would not prevent the same politician to further increase his or her utility through higher $b(t)$.

This approach has one problem left that needs a solution. How can BiH take measures such as to implement better institutional controls and reform the judiciary system in order to alter the political will before the political will actually is altered? As discussed, politicians today have no incentives to reform the judiciary system because they have more use of a corrupt system than a legal one. This is matter of international community. There must be higher pressure from international agents such as the High Representative and the EU. They must put politicians in BiH, such as Dodik, up against the wall. They may be able to do that due to two reasons; BiH wants to be a member of the European Union, and the High Representative has influential powers according the Dayton Peace Accords. The EU and the HR can together implement the measures that are needed to alter the political will.

We strongly believe that this is the sort of discussion that policymakers first and foremost need to discuss. The political will must be altered in order to fight the corruption in BiH. When these measures are done, the fight against corruption can be taken to a new level via strategies and policies streaming from national level.

8.2 Country strategies and policies

In this second part we turn to strategies and policies at national level and discuss three areas that should be used in the fight against corruption; government anti-corruption strategies, access to information, and anti-corruption education.

8.2.1 Government anti-corruption strategies

With government anti-corruption strategies we refer to strategic actions developed and implemented by the government in order to fight corruption. Developing anti-corruption strategies at a national level enables BiH to involve both state and non-state stakeholders, including social society and the private sector, in its anti-corruption efforts. The designing and implementation of government anti-corruption strategies at a national level in BiH is extremely difficult, even after the will of the politicians is altered, since the country is divided into two entities. This implies that a lot of decision-making must be transferred from the entity level to the State level. However, the lack of cooperation will between the two entities, The Federation and RS, considerably slows down this transfer-procedure. This does not exclude the fact that each entity also can and should design and implement similar anti-corruption strategies as those on the national level.
The anti-corruption strategies themselves must be holistic, i.e. the corruption-phenomenon must be tackled in its entirety. This implies that the strategies should involve as many institutions and levels in BiH as possible and feasible. The solution to the corruption cannot be found if the problem is tackled sector-wise or the like. The strategies must also be measurable. Measuring the successes and failures of strategies provides an accurate picture of the situation. This can only be done with continuous assessments. As a result, good strategies in BiH should seek to establish a systematic and concerted approach to combat corruption, using various institutions at its disposal. We therefore argue that the anti-corruption strategies at national and entity level should include following measures:

**Reforming the public sector**

There must be strategies regarding the public service rules where the aim is to increase accountability and transparency of the public service sector. To achieve this, the official discretion must be regulated. There must be oversight of discretionary decision-making. As we have discussed, the government officials are constantly trying to come in contact with the citizens in order to extract bribes. There must be systems to ensure that the contacts between government officials and the citizens are properly realized, systems that assure clear and transparent procedures in all government regulated transactions such as licensing and tax payments. This can be achieved partly by establishing simplified regulatory environments that eliminate the ambiguous and excessive regulations that exists in BiH today, and partly by establishing effective internal and external reporting procedures such as appropriate auditing procedures.

To increase the transparency in the public sector, BiH needs also to take measures to establish a professional and ethical employee culture, with open, transparent, efficient and fair employment systems for public officials. This is particularly important because BiH needs to move away from the cultural behaviour that it has inherited from former Yugoslavia. Furthermore, as we have reported there are cases in BiH where incompetent people work with important tasks. The employment systems should therefore aim to enforce highest levels of competence and encourage hiring and promotion that avoid nepotism and favouritism. If the politicians are willing to fight against corruption, the professional and ethical employee culture can be achieved through promotion of codes of conduct with corresponding education and supervision to better understand and apply these codes.

**Necessary laws and enforcements**

Law and enforcement strategies are important in the fight against corruption. BiH needs to establish criminal law provisions that regulate specific bribery and corruption wrongdoings in both the public and private sector. As we have discussed, the slow administrative procedure that follows before a public employee is punished, together with the need to provide incontestable evidence, is the main reason why the effectively imposed penalties do not seem to reflect the penalties in the laws and regulations. Thus, the established law provisions must be accompanied by adequate criminal procedure and regulate the investigation and prosecution of cases. Furthermore, BiH needs to establish specific anti-corruption laws that enable establishment of specific anti-corruption institutions and agencies. Besides specific
anti-corruption laws there must be laws that regulate issues concerned with access to information, whistleblower protection, freedom of expression and media independency.

**Institution building and reform**

Strengthening the key institutions in BiH is one of the most essential measures in the fight against the corruption in the country. The task consists of two objectives; to free the institutions of corruption and to strengthen them so that they can be used in the fight against corruption. To be able to complete this task, BiH needs to do reforms in the institutions to ensure institutional independence, impartiality, and competence of the working force. Besides reforms at entity and State government levels, there must also be reforms of the institutions on the local government level. When citizens access the public services, the local government is often where the first contact between the citizens and the public takes place. These local governments are ineffective in BiH, and reforms that ensure efficient public service delivery and fiscal transparency must be designed and implemented. In addition to the reforms, BiH needs to establish new and specialized anti-corruption institutions. Those are needed in BiH due to the lack of insufficient prevention and law enforcement strategies in the country today. Naturally, these institutions must be independent and have sufficient resources.

**Monitoring and evaluation**

We mentioned that the strategies must be measurable. Strategies should therefore include proper monitoring and evaluation mechanisms. The evaluation mechanism in BiH should be developed so that they can be used on short, medium and long-term basis. It is important to quantify the corruption at different stages of the strategy using for example surveys. Moreover, there needs to be monitoring at national and international level. At a national level, this needs to be done on an ongoing basis using the civil society. Monitoring at international level in BiH has already been tried and is somewhat still going on. Especially the High Representatives and the European Union have taken incentives to try to implement monitoring mechanism in the country. The results have apparently been poor, and new monitoring mechanisms need to be designed. These should be designed in a way where the government in BiH needs to report to the HR and EU on specific anti-corruption measures that have been taken.

**8.2.2 Access to information**

Access to information is a human right that is internationally recognized, and is a key factor when striving for transparency. Our apprehension is that the general public in BiH have very little information regarding the government activities, which creates mistrust. If BiH enables better access to information, it can attract more domestic as well as international investors, something that is crucial for the development of the country. Moreover, when there is better access to information in BiH, official record can be used to uncover corruption. Even more importantly, access to information gives more transparency, which in turn prevents future corruption. We believe that the secrecy surrounding powerful elites in BiH must be challenged if corruption is to be addressed.

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95 OHR – A comprehensive anti-corruption strategy for Bosnia and Herzegovina
96 UN - The Universal Declaration of Human Rights, article 19
To make the democratic system in BiH friendlier regarding the access of information is not easy. There must be a specific law at national level that specifies the rights and practical processes for accessing information. In the Dayton Agreement, Article 2 of the constitution of BiH (Annex 4) states in paragraph 1, 2 and 3 that:

“1. Human Rights. Bosnia and Herzegovina and both Entities shall ensure the highest level of internationally recognized human rights and fundamental freedoms […].

2. International Standards. The rights and freedoms set forth in the European Convention for the Protection of Human Rights and Fundamental Freedoms and its Protocols shall apply directly in Bosnia and Herzegovina. These shall have priority over all other law […].

3. All persons within the territory of Bosnia and Herzegovina shall enjoy the human rights and freedoms referred to in paragraph 2; these include:… h) freedom of expression.”

There are clear laws regarding the freedom expression, but the freedom of information may not be the same freedom of expression. This is a matter of interpretation. The Venice Commission however has done a research regarding this issue where it states that freedom of expression, as mentioned in Article II.3.h of Annex 4 of the General Framework Agreement includes freedom of access to information. According to this, BiH has the relevant legislature regarding the access of information, with internationally accepted principles. If this is the case, why are the political activities in BiH still surrounded by secrecy? We believe first and foremost that this is due to the unawareness of the citizens. The citizens are not acquainted with the laws and they do not know what kind of information they are entitled to. Second, we believe this also once again is due to the political will. If the political will is altered according to section 8.1, the politicians may be willing to ensure a successful development and implementation of an effective access to information regime. It is then important to train the public officials in how to succeed in the development of an access to information regime, having adequate resources assured. The politicians must assure that the public institutions in BiH systematically provide information about themselves and their activities, including their objectives, budget and financial reports, the decision-making processes, and organizational structures.

8.2.3 Anti-corruption education

Anti-corruption education is a vital component in our anti-corruption program. The citizens in BiH must be able to demand accountability from government if it abuses its power, and the citizens must be aware that they have that right. Thus, the means of anti-corruption education is to strengthen public awareness and participation regarding the political sector, and to mobilize the public to stand up against corruption. Moreover, we find that decision-making on ethical basis is greatly lacking in BiH. Thus, the anti-corruption education must strengthen individuals’ ethical behaviour and ethical decision-making.

How can anti-corruption education be carried out BiH? While there are surely many different methodologies for anti-corruption education and different target groups to be educated, we

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97 NATO - The General Framework Agreement
98 Venice Commission - Opinion on Freedom of Expression and Freedom of Access to Information as Guaranteed in the Constitution of BiH
focus on education that we believe is the best for BiH. This includes institutional ethics training, public education, and youth education.

**Institutional ethics training**
Institutions play an important role in our anti-corruption program. Thus, ethic training and education for institutional workers plays an important role in the process of institutional strengthening and reform. The training and education program within the institutions in BiH can and should be constructed by conducting a “cultural audit” of some sort. The audit’s job should be to educate the workers about ethical practices within institutions. We believe that case-studies are an effective training method. The audit should also compare existing attitudes and values with the institutions overall goals. Finally, it is important for the audit to evaluate the effectiveness of the training program in order to be able to conduct new and better training programs.

**Public education**
To educate the public in BiH regarding the corruption in the country is indeed difficult. Public actors and non-government organizations in BiH must work together and towards greater citizen participation in politics. This can be achieved by promoting for example democracy education programs. Media is also an effective tool that can be used to raise the public awareness of the corruption around them. Furthermore, there must be civic education aiming to educate about the respective roles and responsibilities of citizens, the political parties, the government on national level and the governments on entity level, the private sector, and the media. This is an ongoing process that should be conducted via for example schools and universities.

**Youth education**
We believe that the education of the youth is one of the most crucial measures against corruption in BiH. As we have experienced it, the children, as growing up in a highly corrupted environment, loose the sensibility to separate right from wrong and honest behaviour from dishonest behaviour. By educating the youth, we believe that the corruption can, to a certain extent, be prevented in the longer run.

The youth in BiH can amongst others be educated through the school, using a rather practical than theoretical approach. The pupils can for example be assigned to carry out simpler surveys or polls, which will help them to understand the nature of corruption. School trips to parliamentary sessions or public institutions are also important education methods because they can help the youth to understand how democracy works, something that is important to understand in a corrupt-hostile environment.
9. The anti-corruption program and the development path

If the anti-corruption program is successfully implemented, it will have effects on the future growth and development of BiH. It may be a great interest to the citizens and various actors and agents to see and understand the results and outcomes of a reduction in the corruption. Therefore, we dedicate this chapter to analyze how BiH’s developing paths, derived in chapter 7, are going to change if the corruption in BiH is being effectively fought.

9.1 Scenario 1-alternative development

In chapter 7 we first pictured a brighter scenario for BiH’s development, where we concluded that BiH today finds itself on a development stage such as point E in figure 9.1 below, where both \( \dot{p}(t) > 0 \) and \( \dot{\epsilon}(t) > 0 \). We also stated that BiH eventually would reach the stable source F, but we were not able to tell how long it would take. Now we want to see how the development path from point E and forth will change if our anti-corruption program is successfully implemented.

![Figure 9.1: The phase diagram and the scenario 1-alternative development](image)

What actually happens in this scenario in the case of a successfully implemented anti-corruption program is that the social capital is increased and better utilized. When politicians become honest and express their will to fight the corruption, they will get honest followers. The mistrust in the country will then decrease and the social capital will increase. As the system becomes more honest, the poorer citizens will be less neglected than before, giving them a chance to a better life. A successful implementation of the anti-corruption program would also make it more favourable to do honest business and will eventually reduce the black-market activity. This implies more income to the State in form of taxes and higher social welfare for the citizens as they no longer need to put themselves to various risks by doing business in the black market, they receive better quality goods and guarantees, they need to devote less time to the transactions and so on. Last, since this scenario represents a
brighter future development of BiH in absence of an anti-corruption program, it also assumes that there will be some investments to enable this development. However, if the corruption is being fought according to our program, we believe that the investment will increase to some extent. The increase will mainly occur due to increased activity of foreign investors, as the markets in BiH become less risky.

This will lead to a situation where the developing path is turning upwards and ending above the horizontal \( c(t) = 0 \) locust, as illustrated in figure 9.1. Above this locust \( p(t) > 0 \) and \( c(t) < 0 \) if the discounted present value of the utility stream enjoyed by the household sector is to be maximized and its constraints to be satisfied. This reasoning concludes that the alternative developing path also eventually leads to the stable source \( F \). Both developing paths, the alternative path when the anti-corruption program is successfully implemented and the path without the anti-corruption program, may lead to same stable source \( F \), but the situation when the stable source is reached differs depending on which development path BiH has taken. Recall equation 7.2

\[
\frac{\partial \left( \frac{b}{Y} \right)}{\partial \omega} = re^{-\rho \omega} \left( \frac{\delta \beta}{\delta + r} \right) > 0
\]

from which we stated that the level of corruption as a share of total output in the stable source is increasing in the production lag \( \omega \). If BiH develops according to the alternative developing path, production lag \( \omega \) will be smaller and BiH will have a lower level of corruption as a share of total output. Furthermore, recall also equation 7.3

\[
\frac{\partial^2 \left( \frac{b}{Y} \right)}{\partial^2 \omega} = -r^2e^{-\rho \omega} \left( \frac{\delta \beta}{\delta + r} \right) < 0
\]

from which we stated that corruption as a share of output in the stable source is slowly diminishing. The wealthier BiH becomes, the lower the corruption as a share of output will be. When BiH develops according to the alternative developing path it will be on a stage far ahead in the diminishing process when it actually reaches the stable source, i.e. the lower the corruption as a share of output BiH has when reaching the stable source, the wealthier the country be. The different development paths may imply that BiH find itself on different stages in the development when reaching the stable source, stages that are years of development away from each other. One reason for this is that the citizens in BiH, during the convergence towards the stable source, are constantly enjoying a higher level of consumption when developing according to the alternative development path. The longer it takes for BiH to reach the stable source, the greater will the difference in the development levels between the two development paths be when reaching the source.
9.2 Scenario 2-alternative development

The second scenario pictured in chapter 7 showed a gloomier situation for the development of BiH. We stated that BiH today found itself on a stage such as point D in figure 9.2, where \( \dot{p}(t) > 0 \) and \( \dot{c}(t) < 0 \). Such a situation will eventually lead to a collapse of the country as it will reach point E where \( c = 0 \). We will now study what happens with the development of BiH from point D and forth when our anti-corruption plan is successfully implemented.

![Figure 9.2: The phase diagram and the scenario 2-alternative development](image)

In this case, an anti-corruption program would favour the domestic investment the most. Since the whole economy is going downwards, there cannot be sufficient investments in the country. By reforming the public sector according to chapter 8, it will be easier for the general public to start up small private businesses. These small businesses are the main driving force for growth in gloomy situations such as the one illustrated in scenario 2. They will hopefully lead to a development such as illustrated in figure 9.2 where the country does not collapse and \( p(t) > \left( \frac{\beta e^{-\tau w}}{\delta + r} \right)^{1/\gamma} \). When \( p(t) > \left( \frac{\beta e^{-\tau w}}{\delta + r} \right)^{1/\gamma} \), both \( \dot{p}(t) > 0 \) and \( \dot{c}(t) > 0 \), and BiH will start to develop towards the stable source.

The anti-corruption program will not immediately decrease the black-market activity, nor will it immediately increase social capital. In a gloomy situation, survival is the only thing that matters. This implies that there still will be huge underground-activity at the same time as people will not be able to fully trust each other. Only when \( p(t) > \left( \frac{\beta e^{-\tau w}}{\delta + r} \right)^{1/\gamma} \), and the situation becomes similar to the one illustrated in scenario 1, will the black-market activity start to decrease and the trust and social capital start to increase. Nevertheless, measures against corruption in this situation are vital for the survival of BiH as a state.
10. Conclusions

During the war, a criminal elite with close ties to nationalist agenda arose. As the elite emerged from the war it shaped the reconstruction of BiH. Moreover, the citizens of Bosnia and Herzegovina have from the Yugoslavian state inherited a tradition where corruption is perceived as means to reach personal goals rather than a crime. This behaviour, together with the fact that the criminal elite shaped the reconstruction of BiH, has led to several flaws and weaknesses in the society of BiH. BiH faces today weak policies, weak institutions and weak penalty systems. There are strong regulations and no institutional controls. The economy is weak and leads to poverty. We believe that it is through these weaknesses in the society that corruption in BiH has arisen, and has consequently infected all major sectors and institutions in the country; it can be seen in the political parties, the Police and other Enforcement Structures, the Judiciary, public utilities, the Health System and the Education System. Corruption has furthermore slowed down the privatization process and is used by employers during recruitment processes to exploit citizens in need of a job.

As if it were not enough with the existing flaws in the society in BiH, corruption brings with it its own distortions. In this paper we have focused on the devastating effects that corruption has on growth. It distorts social capital by creating mistrust between various actors in the country, hinders both domestic and foreign investment, increases poverty and encourages growth of the black market. We have discussed two possible development paths BiH could be taking; one gloomy and one that is brighter. We cannot say which of these two paths is more true or probable. The exact future development path depends on the decisions that are still to be made, and is most likely a combination of the two development paths illustrated in this paper. The two development paths in this paper provide a frame for the future development of BiH rather than an exact illustration.

These results have also provided an illustration of the nature of corruption and its causality. They confirm that corruption is a complex phenomenon where the causality sometimes goes in both directions. We have discussed how the weak economic situation with the resulting poverty leads to corrupt behaviour in BiH. We have also showed how corruption, on the other hand, leads to weak economic development. While we have only stressed the issue regarding the effects of corruption on economic growth and nothing more, we can only state the dual causality in the matter of economic growth. Does the causality of corruption in the political parties go in both directions? Weak institutions leads to corruption, but does corruption also lead to weak institutions? These are important questions in understanding the phenomenon we call corruption, and we therefore recommend further research in the area regarding the causality of corruption.

Being a complex phenomenon, corruption also requires complex anti-corruption measures. To be able to fight the corruption, BiH needs help from the European Union, the Office of high Representative and possibly other international actors. They must help BiH to implement strategies that will give the leading politicians incentives to fight corruption. We find the lack of politicians’ will to fight corruption in BiH today as the biggest and most central issue in the
fight against corruption. We therefore stress in our anti-corruption program the importance of anti-corruption measures that first and foremost deal with this problem. Only when this issue is resolved can we move to anti-corruption strategies on national level. The anti-corruption strategies on national level themselves should contain effective government anti-corruption strategies. They should also promote anti-corruption education and secure free access to information. We do not believe that there is a general method that explains how corruption should be fought. Every country that is a victim of corruption has its own unique problems that require different measures. With that said, we believe that anti-corruption measures is an area that still requires a lot of research and thus recommend further research to be directed to find more and better ways to fight corruption.

If corruption in BiH is successfully fought there will be positive effects on the economic growth; the country will experience higher domestic and foreign investment, the mistrust will decrease and result in higher social capital, and both poverty and the black-market activity will be reduced. How big each of these effects will be depends on which development stage BiH finds itself at. If the economic growth is such as illustrated in scenario 1, the anti-corruption measures will ensure citizens to have a higher constant utility stream. If, on the other hand, the state of the economic growth in BiH is as gloomy as pictured in scenario 2, the anti-corruption measures must be taken if the country is to survive.
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Appendix – The questionnaire

Gender:

Age:

1. Do you think there is any difference between “stela“ and corruption?
2. Are you employed/unemployed?
3. Are you student?
4. In order to get your current job/place at the university, were you in need of help from that “special somebody”?
5. Do you feel that you must use corruption in order to achieve something?
6. Does it happen that you come across what you believe are corrupted acts?
7. How far up do you believe that corruption in Bosnia goes eg. do you believe it is frequently used in the political process?
8. Suppose that you won 1 000 000 KM which you can receive in 4 years. How much of this sum would you take in order to receive your money today instead?
9. What is your general thought on corruption, eg. is it good or bad?
10. Do you have any belief in the economic and governmental institutions?
11. What thoughts come into your mind when you hear the word corruption?

99 “Stela” is a commonly used word for corruption in BiH and refers to a lighter form of corruption.