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“The Role of Institutions in Explaining Economic Growth: a Comparative Analysis of Bosnia-Herzegovina and Montenegro“

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ABSTRACT

Since gaining independence, successor states of the former Yugoslavia have undertaken different paths in economic growth and development. This thesis looks to specifically explain the divergence in economic prosperity in Bosnia-Herzegovina and Montenegro, two countries which shared similar initial conditions within the former Yugoslavia. The approach taken in explaining the divergence is in line with New Institutional Economics (NIE), which focusses on institutions, as the determinant for economic growth. Under the school of NIE, a country's political institutions determine its economic institutions. This paper looks at the political environment in both Bosnia-Herzegovina and Montenegro and concludes that Bosnia-Herzegovina's political institutions, namely the Dayton constitution, are in need of reform in order to improve the country's economic institutions and economic growth. It is argued that a reform of the constitution, which was introduced as an annex to the Dayton peace agreement to end the country's brutal three-year war, would in turn allow reforms necessary for development to be implemented more efficiently. This is due to the fact that the complicated constitutional structure hinders effective decision-making and the implementation of much-needed reforms in the highly decentralised country.

Examining which specific institutions are important for economic development is not clear-cut, and different contributors to NIE argue for the relevance of different institutions in explaining growth and development. As this thesis is inspired by the work of Acemoglu and Robinson in *Why Nations Fail: The Origins of Power, Prosperity, and Poverty*, the institutions argued as important by these two contributors, who were themselves inspired by the work of Douglass North, are taken as prime. These include examining how well both countries protect property rights and enforce the rule of law. Moreover, the work of Acemoglu and Robinson is the focus of this study due their examination of the cause for different levels of economic prosperity in countries which share a similar history, geography and culture. As Bosnia-Herzegovina and Montenegro are highly similar, and were even part of the same country for hundreds of years, the application of this theory in this context is seen as highly relevant.

The methodology used in this paper, to evaluate the applicability of NIE in the context of Bosnia-Herzegovina and Montenegro, is an examination of the score of both countries under the Worldwide Governance Indicators against their gross domestic product per capita (GDP). These reason for using this index in particular, which includes indicators such as rule

of law, control of corruption, political stability and absence of violence/terrorism is due to it providing a comprehensive overview of indicators of good governance which is the policy-sphere and real-life application of NIE. Good governance is supported by international organisations such as the World Bank, International Monetary Fund (IMF) and UN. In turn, the WGI is complemented by additional indicators such as protection of property rights from the 2017 Index of Economic Freedom from The Heritage Foundation. Overall, the combination of these indicators is justified as providing an adequate overview of a country's political and economic institutions and how they affect overall economic performance as per the theory of Acemoglu and Robinson.

Keywords: good governance, corruption, rule of law, property rights, new institutional economics, institutions, political economy, development, Bosnia and Herzegovina, Montenegro, former Yugoslavia

Seit dem Erlangen der Unabhängigkeit haben Nachfolgestaaten des ehemaligen Jugoslawiens unterschiedliche Wege in Wirtschaftswachstum und Entwicklung eingeschlagen. Für den Unterschied zwischen Bosnien-Herzegowina und Montenegro, Länder mit ähnliche Grundvoraussetzungen innerhalb des ehemaligen Jugoslawiens, liefern Entwicklungstheorien kulturellen und geographischen Schwerpunktes keine angemessene Erklärungsgrundlagen. Über die Anwendung neuer institutionaler Ökonomie untersucht diese Arbeit das Verhältnis zwischen Wirtschaftswachstum und der Qualität von Institutionen anhand von good governance. Anwendung findet eine Kombination qualitativer und quantitativer Methoden bei der Werte der Worldwide Governance Indikatoren mit dem Pro-Kopf-Bruttoinlandsprodukt der Länder verglichen werden. Die Ergebnisse belegen ein stabiles aber schwaches Gleichgewicht in Bosnien-Herzegowina auf Grund der ineffizienten politischen Institutionen als Resultat des dreijährigen Krieges.

Schlüsselwoerter: good governance, Korruption, Rechtsstaatlichkeit, Eigentumsrechte, neue institutionale Ökonomie, Institutionen, politische Ökonomie, Entwicklung, Bosnien-Herzegowina, Montenegro, ehemaliges Jugoslawien

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List of Abbreviations

BIH	Bosnia and Herzegovina
CSDP	Common Security and Defence Policy
ECHR	European Court of Human Rights
EBRD	European Bank for Reconstruction and Development
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
ICJ	International Criminal Tribunal
IMF	International Monetary Fund
NATO	North Atlantic Treaty Organization
NIE	New Institutional Economics
SAA	Stabilisation and Association Agreement
SAP	Structural Adjustment Programme
UN	United Nations
WGI	Worldwide Governance Indicators

1. Introduction

1.1 Objective

The objective of this thesis will be to test whether institutions, as understood according to the definition of Douglass North and the theory of Acemoglu and Robinson in *Why Nations Fail*, can be attributed to higher economic growth. To be more precise, this thesis will look into the study of New Institutional Economics (NIE), which centres on the notion that good institutions, particularly the rule of law and protection of property rights, correlate with high long-run economic growth. Specifically, it will be examined whether NIE can account for the divergence in economic growth and GDP/per capita between Bosnia-Herzegovina and Montenegro, following the independence of both countries from the former Yugoslavia. The reason for testing this theory in the case studies of Bosnia-Herzegovina and Montenegro is due to the inability of other theories, such as those pertaining to geography, culture, natural endowments, to explain the difference in GDP per capita. Both Bosnia-Herzegovina and Montenegro share a common language, culture and history and maintained similar initial conditions while part of the Socialist Federal Republic of Yugoslavia. Yet today, Montenegro holds a stronger position in the Western Balkans in terms of economic prosperity and progress towards European Union membership. In comparison, Bosnia-Herzegovina is in an arguably stable, but bad equilibrium as evidenced by its high unemployment, migration and lack of Foreign Direct Investment (FDI). The thesis will argue that the outdated Dayton constitution is the reason for Bosnia-Herzegovina's current state of stagnation. While the country remains stable, the constitution's structure allows ethnic tensions to remain at the surface and be translated into everyday politics.

1.2 Structure

The structure of the thesis will be as so: The introduction will provide the objective, research questions, hypotheses, and the rationale for thesis. Following this, the literature review will outline contributions to the school of New Institutional Economics and the link between institutions and economic growth. Following on from this, the theoretical framework provide a discussion of the theory of institutions and economic growth as developed by Acemoglu and Robinson. This will be followed by the methodology which will outline the study methods to be employed, namely the comparison of Bosnia-Herzegovina and Montenegro's scores in the

Worldwide Governance Indicators, as compared to their annual growth in GDP per capita over the period 2006-2015. Definitions and explanations of concepts, as well as the study's limitations will be outlined. Thereafter, the initial conditions of Bosnia-Herzegovina and Montenegro within the Former Socialist Republic of Yugoslavia will be presented to demonstrate that both began their transition process from market-socialism towards capitalism from a very similar starting point. Following this, an overview of the political and economic situations in present-day Bosnia-Herzegovina and Montenegro will give an analysis of the countries' profiles. Thereafter, the study's research question will be addressed, namely whether higher scores in institutions argued to impact on economic growth do indeed equate to higher GDP per capita growth in the study's case studies. As outlined under the methodology section, the primary data source, the Worldwide Governance Indicators (WGI), which give an overview of good governance institutions, will be complemented by additional indices. To specifically look at indicators emphasised by Acemoglu and Robinson, the protection of property rights, will be compared in Bosnia-Herzegovina and Montenegro using an indicator from the Index of Economic Freedom. In addition, as the authors strongly oppose corruption and extractive institutions, the scores from an additional indicator for corruption will be included from Transparency International. The scores from the indices will then be compared against the GDP per capita in Bosnia-Herzegovina and Montenegro over a period of 2006-2015. The empirical analysis will then examine the link between economic growth and the good governance scores in both countries, taking into consideration contextual factors. This will include a discussion of how Bosnia-Herzegovina's three-year War which, among devastating human casualties and loss of infrastructure and industry, left the country with a rigid constitution that hinders political efficiency due to the implementation of the Dayton constitution. It will be noted that elite and ethnic interests make the introduction of effective economic reforms difficult. Thereafter, the thesis will consider the effects of political institutions, or rather bad governance, on the economies of both countries. This will include a discussion of why bad governance in Bosnia-Herzegovina has led to high migration and a dependence on remittances but lack of FDI. It will be discussed that the country is in a stable, but bad equilibrium which in turn makes the implementation of effective reforms difficult to achieve. Lastly, prospects for the future and improvements in the good governance scores in order to lead to economic growth will be presented. This will primarily consist of a discussion of how future European Union (EU) membership provides incentives for both countries to continue on their reform paths.

1.2 Research question

This study will aim to answer two inter-linked questions within the discipline of New Institutional Economics. Firstly, it seeks to answer whether the theory that good institutions, such as the protection of property rights and rule of law, equate to higher economic growth and can provide an adequate explanation as to why some countries are poorer than others. Secondly, in the context of the Western Balkans, the study aims to address whether this theory provides a logical explanation for the divergence in economic growth between Bosnia-Herzegovina and Montenegro, two countries which held similar initial conditions within the former Yugoslavia.

1.3 Hypotheses

Following on from the research questions, the hypotheses logically follow as so:

1. New Institutional Economics provides a logical explanation as to why Montenegro shows a higher annual growth in GDP per capita, compared to Bosnia-Herzegovina.
2. In a comparison between Bosnia-Herzegovina and Montenegro, the latter has better institutions, as shown through higher good governance indicator scores, which in turn equate to higher GDP per capita.
3. The reasons for Bosnia-Herzegovina's lower score in indicators which measure institutional quality, is due to the outdated Dayton constitution which hinders the country's ability to introduce effective reforms in a timely manner.

1.4 Rationale for thesis

An ethnic Bosniak whose parents moved to the United Kingdom as a result of the War in Bosnia-Herzegovina, I have always maintained an interest in issues relating to the Western Balkans countries. In particular, growing up in one of the world's richest countries, while maintaining links to one of the world's most challenged, ignited a curiosity as to why such stark differences existed between the two. This curiosity was even stronger when listening to common stories of how much better life was during the time of the former Yugoslavia. Standard answers to this question always blamed the War and corruption. However, more

than twenty years following the War, the underlying question of the cause for continued problems and corruption remains. Bosnia-Herzegovina is today in a state of stagnation and it is not the War which is to blame, but rather the remnants it left behind: inefficient political institutions. Moreover, not all countries in the Western Balkans faced war at the same scale as Bosnia-Herzegovina, yet they similarly trail behind Western Europe in terms of gross domestic product per capita (GDP) and show similarly high levels of unemployment. Countries such as Montenegro and Croatia show better growth and economic prosperity, but still trail behind their Western European counterparts. The differences in institutions arguably provide the answer to these questions.

2. Literature review

At present, most literature in the area of New Institutional Economics consists of empirical discussions, although some meta-regression analyses have been made.¹ Prominent names related to this school include Douglass North, who was explicit throughout his work that institutions shape economic performance, and whose definition for institutions as ‘the rules of the game’ is the primary one used by scholars today. Through his work, North advocated for the importance of institutions in reducing uncertainty, lowering transaction costs, internalising externalities and producing collective benefits from cooperation.² From the perspective of investors looking into business opportunities for investing in particular countries, the theory of institutions as advocated by North is arguably relevant. Foreign Direct Investment (FDI) is decided based on a number of factors, but primarily, businesses want to ensure that their property rights will be protected and that their contracts will be enforced. This makes business sense. Therefore, countries which score low in protection of property rights and good governance indices, which give an indication of how much power a country has in controlling and ensuring business contracts are enforced, are seen as unattractive. The advocacy of protected property rights and the rule of law is similarly seen in the work of Daron Acemoglu and James Robinson, who famously contributed to the theory of institutions in their book *Why Nations Fail*. The book builds on years of research which looks into inclusive versus extractive institutions as the underlying reason for why some countries are poorer than others. Moreover, they have tried to show that economic development depends on the political insti-

¹ E.g. see Efencic, A., Pugh, G., Adnett, Nick. (2011) ‘Institutions and economic performance: a meta-regression analysis’, *European Journal of Political Economy*, 27(3): 586-599.

² North, D. (1990), ‘Institutions, Institutional Change and Economic Performance’, Cambridge: Cambridge University Press: pg. 3.

tutions that guarantee political and civil freedoms of the rule of law. Their case studies examine almost identical countries, which have a similar culture and geography to prove the relevance of institutions as the key determinant for economic growth. In their analysis, they disregard other theories which focus on geography, natural endowments, culture and ignorance as reasons for why some countries are poorer than others. Their case studies include North and South Korea, as well as the border cities of Nogales (Sonora, Mexico) and Nogales (Arizona, USA). Their focus on the importance of property rights and the rule of law, is due to the argumentation that these institutions are respected under inclusive institutions, where many people have a say in decision-making, as opposed to extractive institutions, where an elite is in power and exploits the general population. The latter form of institutions is argued to lead to a lack of incentive to invest and innovate, and thereby hinder a country's entrepreneurial environment. In addition to inclusive political and economic institutions, they argue for the importance of a centralised state.

The arguments presented by Acemoglu and Robinson, and the application of the theory in countries which are very similar in terms of culture and geography, make it interesting to apply to the Western Balkans. In this paper's case studies of Bosnia-Herzegovina and Montenegro, standard theories for economic growth do not provide adequate explanations for the varying levels of economic prosperity today. As will be examined in more detail in part three below, both countries maintained relatively similar positions within the former Yugoslavia. The most obvious difference between the two, as repeatedly mentioned, is the fact that Bosnia-Herzegovina fell victim to a disastrous three-year war. However, although North and the joint efforts of Acemoglu and Robinson are particularly notable in the scholarly work of New Institutional Economics and will be the focus of this thesis, the contributions of others in this field is important to mention. Tracing back even further than the contributions of North, which earned him a Nobel Prize in economics, Ronald Coase is known as the founding father of New Institutional Economics. The emergence of New Institutional Economics is attributed to the work of Coase in his article 'The Nature of the Firm', where he first advocated for the importance of institutions to reduce transaction costs for firms, which was later built upon by North among others.³

In terms of the link between good governance and institutions as understood within the theory of NIE, a relative quality of literature has been produced on the subject. Notably, good governance is the focus of international organisations such as the World Bank, OECD, IMF

³ Coase, R. H. (1937) 'The Nature of the Firm', *Economica*, New Series, 14:16, pp. 386- 405.

and EU, and can even be a condition for developing countries to receive aid. Scholars have linked the concept of good governance to institutions as understood within NIE. Notably Rindermann, Kodila-Tedika and Christainsen have emphasised that good governance shapes political and economic institutions and thereby affects overall economic performance.⁴ In this regard, good governance is seen as the real-life application of NIE in the policy-sphere. However, despite the growing realisation of importance of institutions and good governance for economic growth, not enough academic research has looked into the application of good governance in the Western Balkans. Specifically, no studies have compared Bosnia-Herzegovina and Montenegro to see the linkage between the divergence in both countries' GDP per capita growth and their scores in the Worldwide Governance Indicators which reflect the quality of their institutions.

3. Theoretical framework- *Acemoglu and Robinson*

The work of Acemoglu and Robinson in *Why Nations Fail* forms the basis of this paper's theoretical framework. Both authors have contributed significantly to New Institutional Economics and are firm advocates of the importance of well-functioning political and economic institutions for higher economic growth. At the heart of the theory is the idea that innovation is vital for economic development, and that political institutions, namely those that are inclusive, will foster innovation whereas extractive institutions will impede it. They frequently cite the work of Douglass North as inspiration upon which they have built their own theory. However, many other alternative theories to institutions have tried to answer the important question of why some countries have not developed to the same extent as others. These theories have arguably emerged due to the inability of classic models for growth, such as the Solow growth model, to adequately account for varying growth levels. To take specific countries in the Middle East as an example, the discovery of valuable natural resources such as oil are explanations for increased wealth rather than higher productivity and technological advancements. Moreover, a small group of elites, rather than the population at large are the ones who reap the benefits from the accumulation of wealth in some countries. In *Why Nations Fail*, Acemoglu and Robinson refer to countries which have institutions such these as extractive institutions, as opposed to inclusive institutions where wealth is more or less shared among the population.

⁴ Rindermann, H., Kodila-Tedika, O. and Christainsen, G. (2015) 'Cognitive Capital, Good Governance, and The Wealth of Nations', *Intelligence*, 51, pp. 98.

During the 1950s and 1960s economic planning took dominance in how a country's economy should be orientated, as opposed to the 1970s when market-orientated views emerged. The 1980s then saw a convergence of views which led to the emergence of the "Washington Consensus" which lays out a desirable set of policy principles for economic growth. It was then in the 1990s that the Washington Consensus underwent a change and became more institutional-orientated. Now it was recognised that market-orientated policies must be accompanied by institutional transformations in order to take effect.⁵ The reform led to the emergence of first-order principles which include the protection of property rights and contract enforcement among others. Today these first-order principles are recognised as important for economic development within the school of New Institutional Economics, in so far as well-functioning political and economic should incorporate them for growth.

When looking at alternative theories which look to explain differences in prosperity and growth, geography and the integration view stand out as the most notable theories alongside institutions. Looking first at the former, Jeffrey Sachs and Jeffrey Diamond are two prominent names who account geography as the core determinant of why some countries are more prosperous than others.⁶ According to the theory, a country's wealth is determined by its climate, natural resources, disease burden, transport costs, diffusion of knowledge and technology from more advanced areas i.e. its geography.⁷ Geography determines the agricultural productivity of a country and, as argued under the theory, countries with hotter climates are less prosperous as their agricultural productivity is low. However, there is little empirical evidence to suggest that geography is the reason for varying growth levels among countries.⁸ Although it is true that some of the world's poorest countries are situated in some of the hottest regions in the world, countries which share borders and an almost identical geography can nevertheless undertake drastically different development paths. Acemoglu and Thomson provide various case examples to disprove the geography explanation. This includes a discussion of the divergence between North and South Korea, where the introduction of a Demilitarised Zone in 1953 in the former, was the starting point of its path towards poverty. Today North Korea's general population lives under intense poverty and its ruled by an oppressive

⁵ Bartlett, W. (2008) *Europe's Troubled Region, Economic development, institutional reform and social welfare in the Western Balkans*, Oxon: Routledge.

⁶ See: Sachs, J. D., (2001) "Tropical Underdevelopment," NBER Working Paper No. w8119; Diamond, J. (1997) *Guns, Germs, and Steel*, New York: W.W. Norton & Co; Gallup, J. Luke, Sachs, J.D. and Mellinger, A.D. (1998) 'Geography and Economic Development' NBER Working Paper No. w6849.

⁷ Rodrik, D., Subramanian A., and Trebbi F. (2004) 'Institutions Rule: The Primacy Of Institutions Over Geography And Integration In Economic Development' *Journal of Economic Growth*, 9(2), 131.

⁸ *Ibid.*

institutional system. This can be compared to South Korea's population which enjoys high levels of growth and Western European living standards. This stark difference in levels of prosperity between the North and South cannot be explained by geography, culture nor religion. Instead, the quality of institutions, i.e. the presence of extractive institutions in North Korea as compared to South Korea's inclusive institutions, provides an adequate explanation where other development theories do not suffice. In addition to geography, the second most prominent explanation for differing levels of growth among countries, as so-called by Dani Rodrik, is the integration view.⁹ Prior to his switch to geography, Jeffrey Sachs was a notable contributor in this field in addition to scholars Frankel and Romer.¹⁰ This explanation accounts market integration, or the lack of it, as the reason for explaining differing trends in development, which can be measured by flows of trade or the height of trade barriers.¹¹ However, Acemoglu and Robinson's argumentation in *Why Nations Fail* disregards each of the conventional development theories listed and as well as others which attribute cultural and technological factors as reasons for growth.

3.1 Criticism of Acemoglu and Robinson's theory

As is to be expected, Acemoglu and Robinson's explanation for why some countries are not as prosperous as others is not without its critics. Notable commentators of *Why Nations Fail* include American economist Jeffrey Sachs who has criticised the simplicity of Acemoglu and Robinson's approach. In a series of back and forth responses, Sachs' main criticism concerns the focus of political institutions as the key for economic development. He criticises the simplicity of the theory and argues that "economic development is a multi-dimensional dynamic process, in which political, institutional, technological, cultural, and geographic factors all play a role."¹² In *Why Nations Fail*, Acemoglu and Robinson's assert that tropical diseases are not the reason for widespread poverty in Africa, but rather that disease is a consequence of poverty and governments are unable or unwilling to eradicate them.¹³ In response Sachs, as an early advocate of the link between geography and poverty, argues that "it is a basic fact of

⁹ Ibid.

¹⁰ Frankel, J., and Romer, D (1999) 'Does Trade Cause Growth?' *American Economic Review*, 89(3), 379-399.

¹¹ Rodrik, D., Subramanian A., and Trebbi F. (2004) 'Institutions Rule: The Primacy Of Institutions Over Geography And Integration In Economic Development' *Journal of Economic Growth*, 9(2).

¹² Sachs, J. Reply to Acemoglu and Robinson's Response to My Book Review (2012), Online: <http://jeffsachs.org/2012/12/reply-to-acemoglu-and-robinsons-response-to-my-book-review> (Accessed 03.03.17).

¹³ Acemoglu, D., Robinson J.A. (2012) 'Why Nations Fail: The Origins of Power, Prosperity, and Poverty', New York: Crown Publishing. Pg. 51.

disease epidemiology that locations differ in the burden of disease” and that Acemoglu and Robinson are wrong when they claim that malaria in Africa is a consequence of poverty, but that it is indeed a cause of poverty.¹⁴ Moreover, the lack of empirical evidence is critiqued, to which Acemoglu and Robinson have responded that the simplicity of the book is due to its role as a framework for economic growth. They have clarified that the style of the book is to be understandable by a general audience, rather than to act as a detailed manual for policy-makers. Moreover, they argue that the accumulation of academic papers which they have written over the years on the same topic, provide empirical evidence which Sachs’ critiques as lacking in *Why Nations Fail*.¹⁵

4. Methodology

The thesis will take an arguably unconventional approach in proving the hypotheses and explaining the divergence in Montenegro and Bosnia-Herzegovina’s growth in GDP per capita. In order to answer the questions posed in this thesis, a primarily qualitative form of study will be adopted. However, the unorthodox element mentioned is the feature of quantitative elements, i.e. comparing the country’s good governance scores in the Worldwide Governance Indicators (WGI) as supplemented by two additional indices. This approach will allow for deductive analysis and detailed, country-specific argumentation. The independent variable, the WGI will be measured alongside the dependent variable which will in this case be the gross domestic product (GDP) per capita, a standard proxy used for measuring prosperity. As the WGI database provides data over a certain period of time up until 2015, and considering that Montenegro gained independence in 2006, a nine-year data over the period of 2006-2015 will be compared for simple comparison. Due to the unavailability of statistics for both countries from 2015 onwards and before 2006, the comparison will be limited to this period.

Interest in good governance and how to measure it has grown in recent years, partially due to the increase in international investment in developing countries. From the perspective of investors, they naturally want to know that their assets will not be prone to great risk and rely on such indicators as an indication of the overall political situation of a country.¹⁶ As for development organisations, in a report by the World Bank in 1998, it was claimed that only countries whose political institutions exercised good governance could effectively benefit

¹⁴ Sachs, J. Reply to Acemoglu and Robinson’s Response to My Book Review (2012).

¹⁵ Acemoglu D. and Robinson, J. A. (2012). Response to Jeffrey Sachs. Online: <http://whynationsfail.com/blog/2012/11/21/response-to-jeffrey-sachs.html> (Accessed: 03.03.2017).

¹⁶ Arndt, C., Oman, C. (2008) ‘The Politics of Governance Ratings’, Working Paper MGSOG/2008/WP003, Maastricht University.

from foreign aid.¹⁷ The growing interest in the perceived importance of good governance for aid and investment thus led the World Bank to develop indicators which rank countries according to the quality of governance by aggregating data from different available sources.¹⁸ Today, these indicators measuring good governance provide international investors, aid donors and development analysts a useful and quantifiable tool for decision-making purposes. The dataset primarily used by such bodies, and for the purposes of this thesis, will be the Worldwide Governance Indicators (WGI) as developed by the World Bank. These indicators cover six areas of good governance, namely Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption. The reason for choosing to measure governance in Bosnia-Herzegovina and Montenegro using the WGI, is the fact that they are considered to be “the most carefully constructed and widely used” indicators available.¹⁹ The WGI are utilised by policy-makers, academics and international donor agencies such as the US Millennium Challenge Corporation and the World Bank’s International Development Associations, which each year allocate billions of dollars of aid based on scores in the WGI.²⁰ In this regard, countries are rewarded on their improvements in good governance as measured by the WGI. Data from the WGI covers the time period 1996-2015 and over 200 countries. It is combined from over thirty data sources and produced by survey institutes, think-thanks, international organisations and private sector firms.²¹ The WGI project, as put together by Daniel Kaufmann and Aart Kraay provides scores for countries based on these areas to give an overall picture of the quality of good governance. Considering that the areas covered by the WGI indicators cover good functioning political institutions free of corruption, and which uphold the rule of law, they are seen as a relevant measure for applying NIE and Acemoglu and Robinson’s approach. Moreover, Kaufmann and Kraay note that “despite the long provenance of the concept [of good governance], no strong consensus has formed around a single definition of governance or institutional quality”.²² In this regard, the authors use the terms governance, institutions and institutional quality interchangeably.²³ This approach will also be reflected in the thesis. s

¹⁷ World Bank (1998) ‘Assessing aid- what works, what doesn’t, and why’. Washington DC: World Bank.

¹⁸ Thomas, M.A. (2009) ‘What Do the Worldwide Governance Indicators Measure?’, *European Journal of Development Research* (201)22, pp. 31-54.

¹⁹ Arndt, C., Oman, C (2006). ‘Uses and Abuses of Governance Indicators’. Paris: OECD.

²⁰ Arndt, C, Oman, C. (2008) ‘The Politics of Governance Ratings’, Working Paper MGSOG/2008/WP003, Maastricht University.

²¹ Worldwide Governance Indicators, Online: <http://info.worldbank.org/governance/wgi/index.aspx#home>

²² Kaufmann, D. Kraay, A. (2008) ‘Governance Indicators: Where Are We, Where Should We Be Going?’ Oxford University Press, p. 3.

²³ Ibid.

Considering the complexity of measuring good governance and the quality of a country's political institutions, the WGI are understandably subject to criticism. Prominent critics include Christiane Arndt and Charles Oman who have acknowledged the usefulness of such indicators in providing a first-hand idea of how experts perceive a country's quality of governance. However, they have also claimed that little attention which has been paid to the indicators' limitations, and that the lack of transparency of their limitations is dangerous for misinterpretation particularly in the context of aid allocation.²⁴ Other critics include Shantayanan Devarajan who critiques the generalisability of the WGI in that with 'an indicator that permits inter-country comparisons of governance: the richness of country-specific detail is lost'.²⁵ Moreover, Marcus Kurtz and Andrew Schrank have criticised the indicators as placing too much influence on the interests of business people, rather than providing a objective overview.²⁶ Thomson has questioned the validity of the WGI in measuring governance and conceptual clarity, by asking "whether they measure what they purport to measure?".²⁷ The last critiques which will be mentioned here are by Iqbal and Shah who note that the indicators mostly capture Western business perspectives using a "one-size fits all norms" and almost completely neglect citizens' evaluations on governance outcomes which reflect on the quality of life.²⁸

The researchers behind the WGI, Kaufmann and Kraay, have attempted to respond to some of the most prominent criticisms themselves in a series of articles. In general, they claim that researchers should in any regard look at a variety of indicators and sources when monitoring governance within and across countries. They also acknowledge that governance indicators include measurement error "and should be thought of as imperfect proxies for the fundamentals of good governance". Furthermore they assert that the indicators are transparent as regards to data limitations, but that there is indeed scope for developing new and better indicators, although that this will take time.²⁹ In any regard, the indicators continue to be the prime dataset for measuring good governance, as they are argued to be carefully construed,

²⁴ Arndt, C, Oman, C. (2008) 'The Politics of Governance Ratings', Working Paper MGSOG/2008/WP003, Maastricht University.

²⁵ Devarajan, S. (2008) 'Two Comments on "Governance Indicators" Where Are We, Where Should We Be Going?' By Daniel Kaufmann and Aart Kraay, *The World Bank Observer*, 23(1), pg. 21-36.

²⁶ Kurtz, M., Schrank, A (2007) 'Growth and Governance: Models, Measures and Mechanism', *The Journal of Politics*. 69(2). Pp. 538-554.

²⁷ Thomas, M.A. (2009) 'What Do the Worldwide Governance Indicators Measure?' *European Journal of Development Research* (201) 22, pp. 31-54.

²⁸ Kaufmann, D. Kraay. A. (2008) 'Governance Indicators: Where Are We, Where Should We Be Going?' Oxford University Press, p. 26.

²⁹ Ibid.

provide global coverage and are precise.³⁰ The fact that they are financed and published by the influential World Bank is another attractive feature which explains their popularity. Overall many studies have used the indicators as explanatory variables in examining the relationship between governance and growth.³¹ While criticism is present, the wide-use of the WGI and their general acceptance as an appropriate method tool for measuring good governance is presented as justification for their application to this study.

4.1 Concepts

4.1.1. Institutions

In order to analyse the quality of institutions in Bosnia-Herzegovina and Montenegro, it is necessary to first define what we mean by institutions. Despite the long history of the importance of institutions and their role in a country's growth, the notion of institutions itself is not yet a coherent concept.³² However, a good starting point, and the definition used most widely, is the one provided by leading scholar in institutional theory, Douglass North. He defines institutions as:

“the humanly devised constraints that structure political, economic, and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct) and formal rules (constitutions, laws, property rights). Throughout history, institutions have been devised by human beings to create order and reduce uncertainty in exchange.”³³

In this context, it is important to distinguish between institutions and organisations, where the latter provide structure to human interaction and come in the form of political, economic, social and education bodies.³⁴ North was influential in his conviction that institutions impact on economic performance and differentiated between institutions such as those which are

³⁰ Thomas, M.A. (2009) ‘What Do the Worldwide Governance Indicators Measure?’, *European Journal of Development Research* (201)22, pg. 33.

³¹ E.g. see: Kaufmann and Kraay, 200; Meon and Sekkat 2005.

³² E.g. see: Bartlett, W., Čučković, N. and Jurlin, K. (2007) ‘A Comparative Perspective on Institutional Quality in Countries at Different Stages of European Integration’, *Tijdschrift voor economische en sociale geografie*, 108(1): 92-108.

³³ North, D.C. (1991) ‘Institutions’, *Journal of Economic Perspectives*, 5(1), pp. 97-112.

³⁴ North, D.C. (1990) ‘An Introduction to Institutions and Institutional change’ Cambridge University Press, pp. 3-10.

informal constraints, e.g. sanctions, taboos, customs and those which are formal rules including constitutions, laws and property rights.³⁵ As the work of Acemoglu and Robinson in *Why Nations Fail* is used as the core theory of this thesis, their definition of institutions is important for the purposes of this study. Both have commented in detail how they define institutions and why they matter. From the perspective of investors and business, Acemoglu explains that ideal institutions of a country are those which create incentives for businesses to invest and provide the workers of businesses the opportunity to accumulate human capital. On the other hand, he notes that institutions which discourage these activities are ones which lead the country into a state of stagnation, arguably as is the case in Bosnia-Herzegovina today. He defines good institutions as those which create incentives for politicians to create growth-enhancing environments as opposed to those which create rent-seeking, corruption and the ‘the pursuance of personal gain at great cost for the rest of society’.³⁶

Aside from the commonly used definition of institutions by North, there is a lack of consensus on the single variable which ‘ideally’ represents institutions for the purposes of empirical research.³⁷ Although a broad cluster of institutions are shown in empirical evidence as important for economic growth, namely economic, political and legal, it has been acknowledged by Acemoglu that there is still much work to be done to understand exactly which specific aspects of institutions influence growth.³⁸

4.1.2 Good governance

How should good governance be understood for the purposes of this thesis? As outlined, in the context of this study, the concepts of good quality political institutions and good governance are used interchangeably. The reason for this is due to the fact that the most real-life applications of NIE, and the theory of institutions as the key to economic growth, refer to good governance. This is the concept regularly referred to by international organisations and development organisations in their policy making, and the institution they define as important for countries to implement in order to achieve economic growth. The importance placed on

³⁵ North, D.C. (1991) ‘Institutions’, *Journal of Economic Perspectives*, 5(1), pp. 97-112.

³⁶ Acemoglu, D. (2008) ‘Interaction between Governance and Growth: What World Bank Economists Need to know’ in North et al. *Governance, Growth and Development Decision-making*. Washington D.C: The World Bank.

³⁷ Shirley, M.M. (2008) ‘Institutions and Development’. Edward Elgar Publishing Limited, Cheltenham and Northampton.

³⁸ Acemoglu, D. (2008) ‘Interaction between Governance and Growth: What World Bank Economists Need to know’ in North et al. *Governance, Growth and Development Decision-making*. Washington D.C: The World Bank.

good governance in the policy sphere has been acknowledged in academic writing and the policy-sphere. For example, Rindermann, Kodila-Tedika and Christainsen have emphasised that good governance ‘shapes political and economic institutions and affects overall economic performance’.³⁹ Moreover, good governance is emphasised as prime for development and economic growth by the World Bank, International Monetary Fund and UN agencies, albeit this has also been argued by critics to be an imposition of western liberal values. Anders, for example, notes that since the early 1990s, good governance has become the dominant catchword for development discussions, and that “without uttering this password it has become impossible for governments to receive financial support”.⁴⁰ Others have similarly acknowledged the importance development actors and financial institutions place on good governance as a condition to receive aid. Smith has examined the shift from the 1980s when structural adjustment programs (SAPs) placed prime importance on market liberalisations, which later changed to good governance.⁴¹ Today the World Bank, as a prime advocator of good governance defines it as the *mechanisms* thought to be needed to promote it. As an example it is noted that good governance has been associated with democracy and good civil rights, with transparency, with the rule of law, and with efficient public service.⁴² The principles, as indicated by Smith, are more or less liberal democracy.⁴³ In this regard, good governance has faced criticism by opponents who argue it is an imposition of Western values.

As the theory studied at the core of this thesis is the importance of institutions as defined by Acemoglu and Robinson, their understanding of good governance is also important to consider. Acemoglu notes that “in the context of economic growth and development, governance refers to essential parts of the broad cluster of institutions”.⁴⁴ He goes on to explain that the interactions between governance and growth are linked to the interactions between institutions and economic growth.⁴⁵ Anders has also defined good governance as different

³⁹ Rindermann, H., Kodila-Tedika, O. and Christainsen, G. (2015) ‘Cognitive Capital, Good Governance, and The Wealth of Nations’, *Intelligence*, 51, pp. 98-108

⁴⁰ Anders, G. (2010) ‘In the shadow of good governance: An ethnography of civil service reform in Africa.’ Leiden: Brill. p.g 2.

⁴¹ Smith, J.D. (2012) ‘Government, Geography and Growth: The True Drivers of Economic Development’ *Foreign Affairs* 92(5), pp. 142-150.

⁴² The World Bank, ‘What is Governance?’ Online: <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/MENAEXT/EXTMNAREGTOPGOVERNANCE/0,,contentMDK:20513159~pagePK:34004173~piPK:34003707~theSitePK:497024,00.html> (Accessed: 1.04.2017).

⁴³ Smith, J.D. (2012) “Government, Geography and Growth: The True Drivers of Economic Development”. *Foreign Affairs* 92(5), pp. 142-150.

⁴⁴ Acemoglu, D. (2008) ‘Interaction between Governance and Growth: What World Bank Economists Need to know’ in North et al. *Governance, Growth and Development Decision-making*. Washington D.C: The World Bank.

⁴⁵ *ibid.*

from classic development interventions and “not about building roads not transmitting superior scientific knowledge for the purposes of ‘development’ ... [but rather] about the establishment of systems of management and self-control to improve “efficiency” and “transparency””.⁴⁶ Overall, good governance, as advocated by the World Bank, is reflected through the Worldwide Governance Indicators which is the database used for the purposes of this study.

4.2 Limitations

The methodology adopted in this study to test the theory of NIE and whether it can be applied to the Western Balkans countries is undoubtedly subject to limitations. As outlined, a combination of qualitative and quantitative aspects was adopted for a number of reasons. In studies which deal with numbers and analyse data, it is arguably desirable to adopt a more quantitative-focused approach. The study’s causation could be more readily deduced and in turn the generalizability of the study’s findings would have more depth. However, a deductive approach combining quantitative and qualitative methods was used due to the author’s inexperience with econometrics. However, the smaller case study, a comparison of Bosnia-Herzegovina and Montenegro, has allowed for more in-depth analysis as compared to the alternative which would have been to compare all countries of the Western Balkans. The focus of only comparing two countries allowed for their particular characteristics and histories to be studied in more detail. This gives the reader a full picture of why the theory that institutions are the key to economic growth is interesting to apply to the case of Western Balkans countries. Lastly, the choice of independent and dependent variables used for this study are also naturally subject to their own limitations. The reliability of the Worldwide Governance Indicators as a measure of good governance is discussed in more detail below as is the decision to use GDP per capita as a dependent variable; both of which are subject to their own limitations and criticism.

5. A comparison of Bosnia-Herzegovina and Montenegro’s institutions

5.1 Initial conditions

The phenomenon of Yugo-nostalgia, a longing for the ‘better times’ of Yugoslavia during the time of Tito, is very much evident in Yugoslavia’s successor states, including Bosnia-

⁴⁶ Anders, G. (2010) “In the shadow of good governance: An ethnography of civil service reform in Africa.” Leiden: Brill. p.g 2.

Herzegovina and Montenegro. It is difficult not to find people who agree that life for the average citizen in the former Yugoslavia was more prosperous, when there were more jobs, security and less ethnic tensions. When looking at today's high unemployment in the Western Balkans, notably in Bosnia-Herzegovina, the concept of Yugo-nostalgia is understandable. The death of Tito in 1980 would mark the slow demise of the 'better times' during the Socialist Federal Republic of Yugoslavia which also saw a rise in ethnic nationalism, leading to the bloody breakdown of the country. The 47 years of Bosnia-Herzegovina and Montenegro within the former Yugoslavia is important to consider in terms of how initial conditions, the set of economic and socio-political resources and constraints that exist when reforms are launched, affected the formation of political and economic institutions following independence.⁴⁷ Although Bosnia-Herzegovina was poorer than most Yugoslav republics, its position did not extensively differentiate from that of Montenegro's position within Yugoslavia. In this respect, the convergence in economic growth today between these two countries is interesting to examine considering both were similar within the former Yugoslavia.

As demonstrated by the well-known Tito-Stalin split, and Yugoslavia's expulsion from the Cominform, despite having common origins to other socialist states, Yugoslavia tried to distance itself from the tradition Soviet model leading to a significantly different economy. This period, following World War Two, is one of three main periods of economic history in Yugoslavia as identified by Horvat, namely: 1911-40 (capitalism), 1940-1954 (central planning) and the system of self-government socialism from 1954 onwards.⁴⁸ The last period is the most significant as the beginning of Yugoslavia's impressive growth, and the foundation for later Yugo-nostalgija, where Yugoslavia had some of the highest recorded rates of growth in the world at 8.5% per annum and an average of 10% production per year between 1953 and 1960.⁴⁹ Horvat describes the 1950s as the time when "self-government accelerated the growth of output and technical progress beyond anything known before while preserving fast employment expansion".⁵⁰

This impressive growth changed with the introduction of further reforms. The unique Yugoslav system of worker self-management has been attributed by some as the cause for the

⁴⁷ Nørgaard, O., Elgar, E., (2000) 'Economic Institutions and Democratic Reform: A Comparative Analysis of Post-Communist Countries', Cheltenham, Northampton, p. 14.

⁴⁸ Horvat, B. (1971) 'Yugoslav Economic Policy in the Post-war Period: Problems, Ideas, Institutional Developments', *American Economic Review*, 61:3, pp. 91-92.

⁴⁹ OECD (1962), *OECD Economic Surveys: Yugoslavia 1962*, OECD Publishing, Paris.

⁵⁰ Ibid.

decline in output.⁵¹ The hypothesis put forward by Sapir, is that the 1965 economic reform transformed the behaviour of Yugoslav firms, whereby they had a tendency to increase their capital-labour ratio in order to increase the net income of their members.⁵² With the reform, and the transition from central planning to worker's self-management, the Government's economic role was gradually decreased.⁵³ Further reforms, including a decentralization of power to the republics in 1974 made it difficult for the economy to adjust appropriately to external shocks such as the 1979 oil crisis. Following the death of Tito, and with the rise in nationalism, a single economic system ceased to exist and eight autonomous economic areas emerged. With the demise of federal power, each of the republics could create its own fiscal policy and develop their own five year plans.⁵⁴ Within the context of the gradual demise of Yugoslav, the Marković reform is lastly worth mentioning. The reform programme of 1988-1990, was a radical macroeconomic programme designed to eliminate inflation and led to the formation of anti-reform elites who were opposed to the idea of a liberal market economy and the losses they would incur by the privatization of socially-owned enterprises. These anti-reform coalitions were notable in Serbia, and some economic explanations for the outbreak of wars in the former Yugoslavia point to social stress caused due to rapid economic liberalization.⁵⁵ When examining the position of Bosnia-Herzegovina and Montenegro within this historic Yugoslav economic and political backdrop, both countries were in comparable positions shortly preceding the breakup of Yugoslavia. Between the period of 1988-1990, both had a comparable income per capita, as can be demonstrated in figure 1 below:

Country	1988 income per capita (pa)	1990 income per capita (current US\$)	Population in 1990	Relative income		Gini (1988 income)
				1988	1990	
Bosnia	2,124,319	2,365	4,516	76.2	67.8	24.4
Montenegro	2,062,042	2,484	644	73.9	71.1	25.6
Croatia	3,234,631	4,468	4,685	116.0	127.8	22.1
Macedonia	1,790,902	2,282	2,131	64.2	65.3	30.9
Slovenia	5,529,722	7,610	1,953	198.3	217.7	19.3
Serbia	2,523,329	3,379	5,849	90.5	96.7	25.0
Kosovo	1,062,039	854	1,983	38.1	24.4	27.7
Vojvodina	3,166,398	4,320	2,048	113.6	123.6	26.5
Yugoslavia	2,788,443	3,496	23,809	100.0	100.0	24.5

Figure 1: Income per Capita and Inequality by Region: 1988 and 1990⁵⁶

⁵¹ Sapir, A (1980) 'Economic growth and factor substitution: what happened to the Yugoslav miracle?' *The Economic Journal*, 90, p. 297.

⁵² *ibid.*

⁵³ OECD (1962), *OECD Economic Surveys: Yugoslavia 1962*, OECD Publishing, Paris. p6.

⁵⁴ Bartlett, W. (2008) 'Europe's Troubled Region, Economic development, institutional reform and social welfare in the Western Balkans', Oxon: Routledge.

⁵⁵ Woodward, S.L., (1995) 'Balkan Tragedy: Chaos and Dissolution after the Cold War' Brookings Institution Press.

⁵⁶ Kalyvas, S.N., Sambanis, N. (2005) *Bosnia's Civil War: Origins and Violence Dynamics*. In *Understanding Civil War: Evidence and Analysis*, Washington, DC: The World Bank, Volume 2, pg. 196.

As shown in the table, Bosnia-Herzegovina and Montenegro maintained similar income per capita and relative income levels in 1988 and 1990, albeit Montenegro slightly better in all but the relative income in 1988. Their similar initial conditions further reinforce the relevance of comparing these two countries for the purposes of this study, in explaining the causes for their economic divergence today as a result of the quality of their institutions. Their similarity can be further evidenced when compared to other republics in the region such as Slovenia and Croatia which maintained significantly higher income levels, notably the former.

5.2 Present-day country profiles

5.2.1 Bosnia and Herzegovina

When one thinks of Bosnia-Herzegovina, it is difficult not to associate the country with images of war and bloodshed. The outbreak of war in Bosnia-Herzegovina followed its declaration of independence from the Socialist Federal Republic of Yugoslavia in 1992. It is difficult to imagine that such large-scale atrocities and the first instance of genocide on European soil since WWII in Srebrenica could have been foreseen. The words of the late Bosnian President, Alija Izetbegović which came at the brink of War in 1992: “Narode, spavaj mirno, rata neće biti” (sleep peacefully tonight, people. There will be no war) arguably highlight this optimism, or show a sense of naiveté.⁵⁷ The optimism could be attributed to the fact that Slovenia managed to breakaway relatively peacefully with ‘only’ a ten-day war. However, Bosnia-Herzegovina did not meet the same fate as Slovenia which today has one of the highest GDPs per capita in Central Europe, with excellent infrastructure and a well-educated workforce.⁵⁸ Moreover, Slovenia boasts an impressive GDP per capita at \$33,100 (2016) and was the first of its former Yugoslavia neighbours to join the European Union in 2004.⁵⁹

Nevertheless, Bosnia-Herzegovina was subject to a brutal three-year war with fighting divided on ethnic lines. The intensity for the scale of fighting between Bosniaks, Croats and Serbs can be attributed to the fact that Bosnia-Herzegovina was and still is the most ethnically diverse region in the territory of the former Yugoslavia. Some scholars, such as Robert D. Kaplan have rather blamed the fighting on ethnic hatreds, and use the argument that the death

⁵⁷ Kampschorr, Beth. (2000) ‘*Alija Goes Bye-bye, Bosnia’s president retires gracefully*’. Central Europe Review, Vol 2, No 36.

⁵⁸ Central Intelligence Agency Factbook, Slovenia <https://www.cia.gov/library/publications/the-world-factbook/geos/si.html>

⁵⁹ *ibid.*

of Tito marked the slow demise of a country where ethnic tensions were suppressed under his leadership.⁶⁰ The present author does not agree with this view, but rather understands the extent of war in Bosnia-Herzegovina, and the breakup of Yugoslavia itself, to have arisen as a result of mass-led violence initiated due to economic reasons. Following the viewpoint of Susan L. Woodward, high debt in the late 1980s and tensions caused by the transition to a market economy allowed anti-reform coalitions to use social tensions to their advantage and for nationalist figures to manipulate the general population.⁶¹ Surveys from this time support this view and show that a greater number of citizens began to identify themselves as Yugoslavs, rather than the separate ethnic groups: an increase from 1.4% to 5.5%.⁶² Moreover, it was generally understood that Yugoslavs did not want the country to break-up as reflected in a poll which asked: “do you agree that every Yugoslav nation should have a state of its own?”⁶³ Bearing in mind that 61% did not agree at all, Woodward’s argument that the emergence of nationalism was a result of tensions caused due to the shift to a market-economy, is logical.

Through analysing the alternative explanations for the outbreak of war in Bosnia-Herzegovina, we can begin to understand how this impacted on the formation of the country’s political and economic institutions. It was not until the Dayton Peace Agreement in 1995 that a ceasefire was reached and the three-year war finally came to an end. The agreement contained Bosnia-Herzegovina’s constitution in Annex 4 which was formulated in Dayton, Ohio by international mediators and negotiated by wartime leaders.⁶⁴ The constitution provides for a highly decentralised state comprising of two separate entities, namely the Federation of Bosnia and Herzegovina and the Republika Srpska. The majority of governmental powers, particularly those which impact on citizens are held at entity level, while the central government has limited powers, mostly in relation to Bosnia-Herzegovina’s foreign affairs and international obligations.⁶⁵ James C. O’Brien notes that the Dayton Constitution “bears the scars of the process that produced it” since it was created as a compromise among the three

⁶⁰ See for example: Kaplan, Robert D. (1993) ‘Balkan Ghosts: A Journey through History’. New York: Random House (1993).

⁶¹ Woodward, S.L., (1995) ‘Balkan Tragedy: Chaos and Dissolution after the Cold War’ Brookings Institution Press.

⁶² Kalyvas, Stathis N. and Sambanis, Nicholas (2005) ‘Bosnia’s Civil War: Origins and Violence Dynamics’. In *Understanding Civil War: Evidence and Analysis*, Washington, DC: The World Bank, Volume 2.

⁶³ Sekelj L. (1992) ‘Yugoslavia: The Process of Disintegration’ Highland Lakes, N.J.: Atlantic Research and Publications.

⁶⁴ O’Brien, J.C. (2010) ‘The Dayton Constitution of Bosnia and Herzegovina’ in Miller, *Framing the State in Times of Transition, Case Studies in Constitution Making*, Washington: pp. 332-349.

⁶⁵ Szasz, P.C., Meron, T. (1996) ‘The Bosnian Constitution: The Road to Dayton and Beyond’. *Proceedings of the Annual Meeting (American Society of International Law)*. Vol. 90, (MARCH 27-30, 1996), pp. 479-485.

main ethnic groups to bring an end to the fighting.⁶⁶ Furthermore, in O'Brien's analysis he notes that the constitution both enabled and constrained Bosnia-Herzegovina's transition towards democracy, which was yet incomplete at the outbreak of war, and that the "tensions within the document remain central to Bosnia-Herzegovina's experience with state building".⁶⁷ Since the formation of Bosnia-Herzegovina's constitution, the three ethnicities continue to face daily disagreements on the country's future. Notably many Serb leaders voice their desire for Republika Srpska to become independent, while Croats display mixed feelings, some with a desire to establish a third, Croat entity called 'Herzeg-Bosna'. With fundamental disagreements on the existence of the state itself, it comes as no surprise that Bosnia-Herzegovina has a weaker performance in the good governance indicators as compared to its neighbours. High unemployment is an effect of the country's state of stagnation due to the Dayton constitution which "froze in place the ethnic politics that had fuelled the war".⁶⁸ More than twenty years following the end of the war, all levels of government continue to be split across ethnic lines which allow for discrimination and nationalism to remain evident in every day politics. Moreover, the political system introduced by the Dayton Constitution is one of the world's most complex which understandably also impedes on the efficiency of running the country. There is an abundance of cabinets and parliaments at state and entity level, and each of the ten cantons within the highly decentralised country also has its own government. Already-scarce resources go towards the wages of the many politicians the country has, many of whom, in relative terms, are among the richest in Europe.⁶⁹

The Dayton Constitution, as introduced within the Dayton Peace Agreement to end the three-year war, has allowed nationalism to remain at the surface. The continued implementation of the constitution hinders effective decision-making and good governance, and has even been critiqued by the European Court of Human Rights as discriminating against constituent peoples.⁷⁰ One of the biggest questions facing Bosnia-Herzegovina is how to escape its state of stagnation as enforced by the constitution. Due to the fact that consensus is needed among all three ethnic groups to introduce significant changes to the constitution, reform is very unlikely. Alternative options include pressure from the EU to introduce partial

⁶⁶ O'Brien, J.C. (2010) 'The Dayton Constitution of Bosnia and Herzegovina' in Miller, *Framing the State in Times of Transition, Case Studies in Constitution Making*, Washington: pp. 332-349.

⁶⁷ *ibid.*

⁶⁸ Borger, J. 'Bosnia's bitter, flawed peace deal, 20 years on' *The Guardian*, 10 November 2015, Online: <https://www.theguardian.com/global/2015/nov/10/bosnia-bitter-flawed-peace-deal-dayton-agreement-20-years-on> (accessed on 10.06.2017).

⁶⁹ *ibid.*

⁷⁰ See *Sejdić and Finci v. Bosnia and Herzegovina* (27996/06 and 34836/06).

amendments, step-by-step, in order to comply with future accession; this will be discussed in more detail later in chapter six. Otherwise historian Marko Attila Hoare has warned that realistic alternative options are for the Dayton Constitution to continue as it is, which could result in the realisation of a more autonomous Republika Srpska and future division of the country. Otherwise he fears that a new conflict would be the only other realistic option to overthrow the Dayton Constitution in place of one which would pull the country out of its state of stagnation and allow it to finally function. Hoare's ideal solution for a reform of the Constitution would be for five, or least three cantons instead of the present ten. This would allow for Bosnia-Herzegovina's current resource-draining bureaucracy to be reformed in place of one united country.⁷¹

5.2.2 Montenegro

Montenegro, whose name translates as 'black mountain' is one of the smallest countries in Europe with a total area of 12,812 km² and shares its borders with Albania, Croatia, Bosnia-Herzegovina, Serbia and Kosovo.⁷² Following the dissolution of the Socialist Federal Republic of Yugoslavia, Montenegro remained in a union with Serbia creating the Federation Republic of Yugoslavia which later became a State Union of Serbia and Montenegro in 2003.⁷³ Montenegro followed in the footsteps of the former-Yugoslavia successor states by declaring a referendum to secede from Serbia and officially became independent on 3 June 2006.⁷⁴ Reflecting the general divide in ethnic affiliation in Montenegro, where roughly half the population feels Serbian and the other half Montenegrin, the vote in favour of secession barely exceeded 55%.⁷⁵ Immediately following independence, the country adopted the euro, without being a part of the Eurozone.⁷⁶

Milo Djukanović, Montenegro's long-standing president, and at times, prime minister, has transitioned between both positions of authority for the past twenty-five years. His pro-Western stance has shown through the commitment he has made for Montenegro to join the

⁷¹ „Hoare: RS intends to secede due to asking for greater autonomy“ Vijesti.ba, 22.06.2017. Online: <http://vijesti.ba/clanak/223298/hoare-rs-ima-tendenciju-ka-otcjepljenju-time-sto-trazi-sve-vecu-autonomiju> (accessed 01.06.2017).

⁷² World Bank Data, available at: <http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD>

⁷³ Central Intelligence Agency World Factbook, Bosnia and Herzegovina <https://www.cia.gov/library/publications/the-world-factbook/geos/mj.html> (accessed 12.03.2017).

⁷⁴ Central Intelligence Agency World Factbook, Montenegro <https://www.cia.gov/library/publications/the-world-factbook/geos/mj.html> (accessed 12.03.2017).

⁷⁵ *ibid.*

⁷⁶ 2017 Index of Economic Freedom, Montenegro, pp. 264- 265, online at: <http://www.heritage.org/index/pdf/2017/countries/montenegro.pdf> (accessed 15.06.2017).

EU, having recently also joined NATO.⁷⁷ As mentioned in detail later, Russia was accused by Djukanović as interfering in the country's election and assisting in a Serbian assassination attempt on his life. Nevertheless, the country has continued to show strong devotion to EU integration and continues to implement reforms and introduce policies in line with the EU *acquis*.

In terms of the country's macroeconomic profile, Montenegro has made great progress in the transition to a market economy. Prior to the global economic crisis, Montenegrin economy showed rapid average growth of 5% per year between 2000 and 2008, mainly as a result of an influx of foreign direct investment and government spending.⁷⁸ The boost in consumption and imports left the country with an alarming current account deficit which remains one of its main structural problems today.⁷⁹ Other problems facing the economy include high unemployment due to market reforms and the decline of workers in traditional areas such as agriculture. Moreover, the country's relatively large public sector, but underdeveloped private, has not created a favourable environment for entrepreneurship.⁸⁰ As per Acemoglu and Robinson's theory, enabling business environments are vital to allow for innovation and technical advancement, and as an effect, economic growth. However, Montenegro has made strides in countering these problems in order to spur entrepreneurship. This includes an increasingly open trade regime, along with more efficient regulatory and legal frameworks which support the development of the growing private sector. However, although Montenegro's reforms have placed it ahead of Bosnia-Herzegovina in terms of its economic growth, important institutions such as the protection of property rights, effective measures against corruption and an independent court system free from political interference are still lagging.⁸¹ Its performance in all other important institutions for good governance and how it correlates to its economic growth will be discussed in detail below.

5.3 Findings: Good governance scores as measure by the WGI

In order to measure and compare the institutional quality of Bosnia-Herzegovina with Montenegro, a range of governance indicators from the Worldwide Governance Indicators Index

⁷⁷ North Atlantic Treaty Organization, News, 'Montenegro joins NATO as 29th Ally' 05.06.2017, online: http://www.nato.int/cps/en/natohq/news_144647.htm (accessed 10.06.2017).

⁷⁸ World Bank Country Partnership Framework 2016-2020

⁷⁹ *ibid.*

⁸⁰ *Ibid.*

⁸¹ 2017 Index of Economic Freedom, Montenegro, pp. 264- 265, online at: <http://www.heritage.org/index/pdf/2017/countries/montenegro.pdf> (accessed 15.06.2017).

will be used. These are namely: (1) Political Stability and Absence of Violence/Terrorism; (2) Voice and Accountability; (3) Control of Corruption; (4) Government Effectiveness; (5) Rule of Law; and (6) Regulatory Quality. Each of the indicators provide a score between 0-100, whereby 100 is the highest and 0 the lowest. The scores of Bosnia-Herzegovina and Montenegro under each of the ranks will each be presented individually for more in-depth analysis. This will allow for correlation between the scores and annual growth in GDP per capita, representing economic growth, to be investigated. In addition, components of the WGI, such as corruption, will be supplemented with additional indicators from alternative sources such as Freedom House and Transparency International which have a different focus. Lastly, indicators such as the protection of property rights and ease of doing business will also be analysed, with information taken from the Index of Economic Freedom and World Bank. This is due to the fact that Acemoglu and Robinson place particular emphasise on the importance of these indicators from the perspective of investors who look at the overall impression of a country, i.e. they are widely thought to shape the business environment in transition countries.⁸²

5.3.1 Indicator for political stability and absence of violence/terrorism

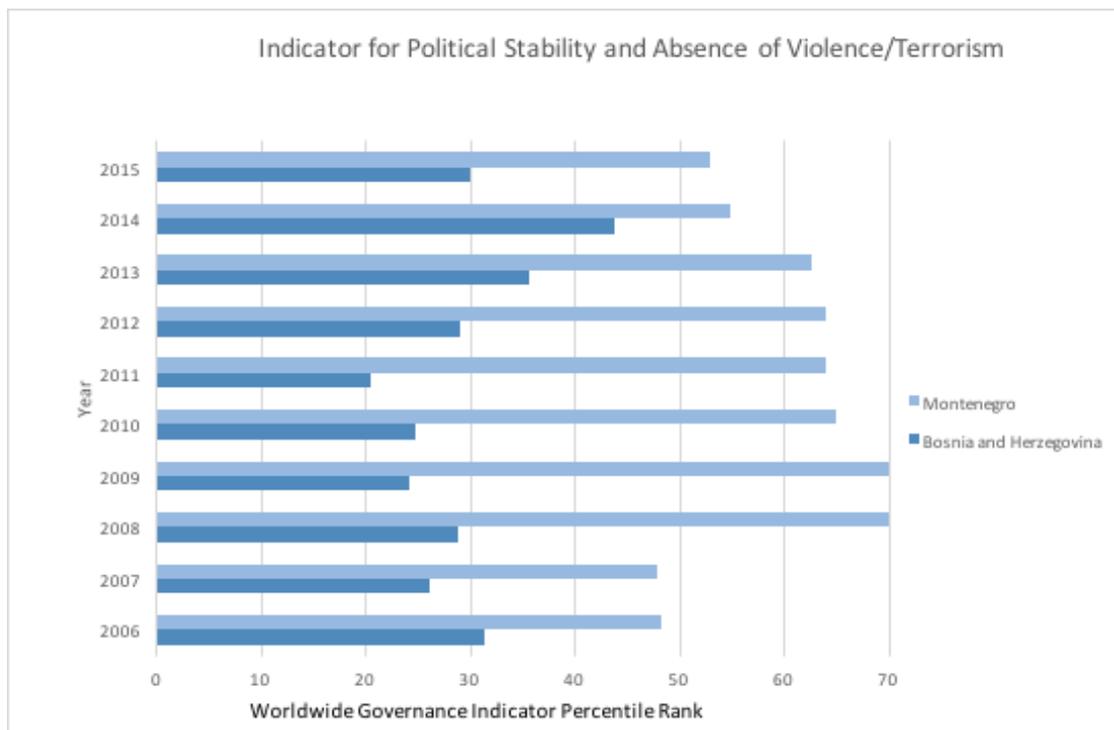


Figure 1: Comparison of political stability and absence of violence/terrorism in BiH and Montenegro, Source: *Worldwide Governance Indicators*

⁸² Bartlett, W., Čučković, N. and Jurlin, K. (2007) 'A Comparative Perspective on Institutional Quality in Countries at Different Stages of European Integration', *Tijdschrift voor economische en sociale geografie*, 108(1): 93.

The first indicator shows Montenegro to have a higher percentile rank compared to Bosnia-Herzegovina over the nine-year time period of interest 2006-2015. To provide commentary on the data provided in the bar graph, in 2006 Montenegro scored at 48.31 in the WGI's percentile rank for this particular indicator. In comparison Bosnia-Herzegovina's score for the same year was 31.40. In 2007 Montenegro's score slightly decreased to 47.83 as did Bosnia-Herzegovina's to 26.09. Both countries would see an increase in 2008, albeit Bosnia-Herzegovina only to 28.85 as compared to Montenegro which would leap to 72.12. In 2009 Bosnia-Herzegovina's score would decrease to 24.17 but Montenegro's would continue to grow to 75.93. It would begin to decrease again for Montenegro in 2010 with a score at 64.93 compared to Bosnia-Herzegovina which maintained its low score in the mid twenties at 24.64. This low score dropped to Bosnia-Herzegovina's lowest in over the nine-year time period in 2011 at 20.38. Comparably Montenegro scored slightly lower in 2011 than in 2010 at 63.98. It maintained the exact same score in 2012, whereas Bosnia-Herzegovina's drastically improved by almost eight points to 28.91. In 2013 Bosnia-Herzegovina had a rank of 35.55 compared to Montenegro's 62.56. In 2014, the scores were respectively 54.76 signaling a drop for Montenegro but increase for Bosnia-Herzegovina at 43.81. Lastly in 2015, both countries dropped to 52.86 for Montenegro and 30.00 for Bosnia-Herzegovina.

Reasons for this divergence in political stability have already been mentioned and can mainly be attributed to ethnic problems in Bosnia-Herzegovina, which are both mitigated and reinforced by the Dayton Constitution. They are mitigated in the respect that war has been avoided for the last 21 years, but are reinforced due to the fact that the division of constituent peoples, Bosniaks, Serbs and Croats in politics translates into ethnic tensions within the country. This complex institutional framework is indeed the reason for political instability in Bosnia-Herzegovina. Present-day Bosnia and Herzegovina is divided into two autonomous entities: the federation of Bosnia and Herzegovina (predominantly Bosniaks and Croats) and Republika Srpska (predominantly Serb) and a self-governing district of Brčko. The federation of Bosnia and Herzegovina is further split into ten cantons, which is then further split into 80 municipalities. The second entity, Republika Srpska is similarly split into 61 cities/municipalities. The governmental structure is likewise complicated, whereby a three-member rotational presidency consists of a Bosniak (Bakir Izetbegović), a Bosnian Serb (Mladen Ivanić) and a Bosnian Croat (Dragan Cović). The Republik of Srpska is headed by its President, Milorad Dodik, who is one prime reason for the country's political instability due to continuously challenging the authority of state-level institutions. This has included

calling for a referendum on the National Day of Republika Srpska, in defiance of the Constitutional Court of Bosnia and Herzegovina which ruled it as unconstitutional. Mr. Dodik further announced that he would plan to hold further referendums in 2017-18.⁸³ Adding to the political instability, some Bosnian Croats continue to demand a autonomous Croat entity within the Federation of Bosnia and Herzegovina, to be called Herceg-Bosna, with Mostar as its capital. Lastly, Bosniaks requested for the International Court of Justice (ICJ) to review its ruling in 2007 on Serbia's rule in the Srebrenica Genocide which was rejected.⁸⁴

With a less complicated political structure owing to its lack of war and ethnic conflicts, Montenegro understandably scores higher in the rank. Although data for 2016-2017 is not covered by the Worldwide Governance Indicators, the rank for political stability would most likely continue to drop for Montenegro due to recent trends in the country. With Montenegro having recently joined NATO, tensions have risen, both within the country itself and internationally. The former concerns the country's large Serb population which is not pro-NATO, and the latter Montenegro's growing tensions with Russia. As mentioned, the Prime Minister Milo Djukanović, accused Russia of involvement in an assassination attempt as a way to sabotage Montenegro's NATO and EU membership aspirations.

5.3.2. Indicator for voice and accountability

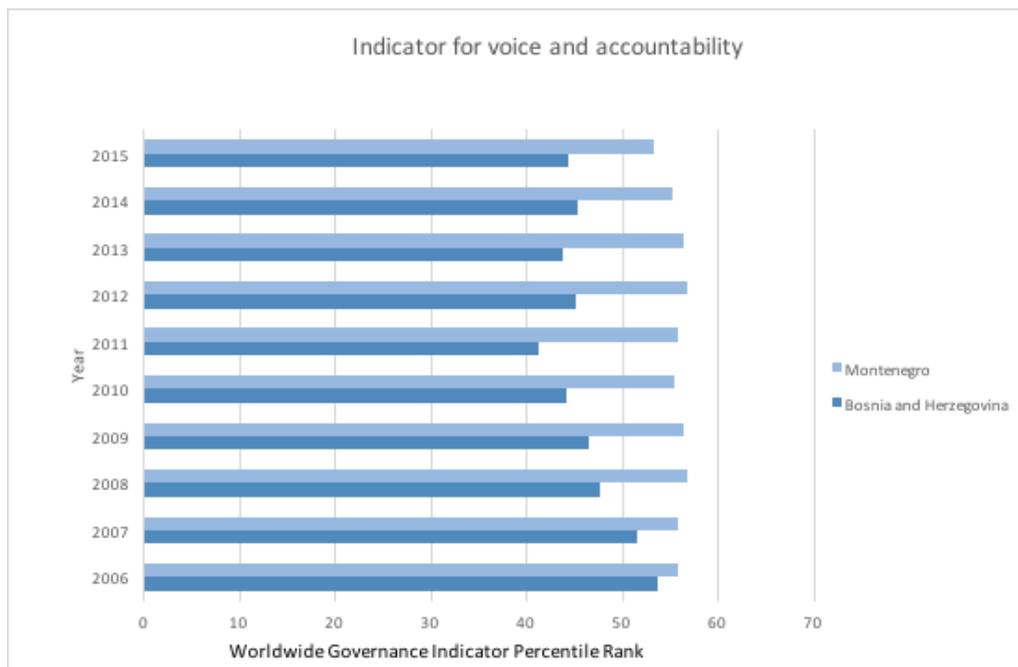


Figure 2: Comparison of voice and accountability in BiH and Montenegro, Source: Worldwide Governance Indicators

⁸³ Economist Intelligence Unit [Country Report, April 2017, Bosnia and Herzegovina] (Accessed: 06.04.2017).

⁸⁴ Ibid.

The second indicator, voice and accountability captures the perceptions of the extent to which a country's citizens are able to participate in selecting their government, freedom of expression, association and media.⁸⁵ This indicator is specifically relevant in light of Acemoglu and Thomson's emphasis on the importance of inclusive versus extractive institutions, whereby inclusive institutions are those which allow citizens to fully participate in decision-making processes. To once again walk the reader through the graph above, both countries show relative similar starting points and overall scores, albeit Montenegro maintains a higher score throughout. In 2006 Bosnia-Herzegovina scored a percentile rank at 53.37 whereas Montenegro's score was slightly better at 55.77. Montenegro would maintain the same score in the following year, as compared to Bosnia-Herzegovina which would drop to 51.33. In 2008 Bosnia-Herzegovina's score would continue to drop to 47.60 whereas Montenegro's would increase slightly to 56.73. Montenegro's score would remain relatively stable at 56.40 in 2009 as would Bosnia-Herzegovina's at 46.45. Bosnia-Herzegovina's score would then show a continued drop to 44.08 compared as would Montenegro's to 55.45 in 2010. In 2011 Bosnia-Herzegovina's score drops again to 41.31 while Montenegro's remains relatively stable at 55.87. The year 2012 shows an increase for Bosnia-Herzegovina where its score rises by 3.74 to a modest 45.07. In the same year Montenegro also saw an increase of 0.94 to 56.81. The following year Bosnia-Herzegovina's score lowered again to 43.66 and as did it ever so slightly for Montenegro which came in at 56.34. In the following two years, 2014 and 2015, Montenegro noted a decrease from 55.17 in 2014 to 53.20 in 2015. Comparably Bosnia-Herzegovina's score came in at 45.32 in 2014 which slightly dropped to 44.33 in 2015.

⁸⁵ World Bank: Voice and Accountability, online: <http://info.worldbank.org/governance/wgi/pdf/va.pdf>

5.3.3. Indicator for control of corruption

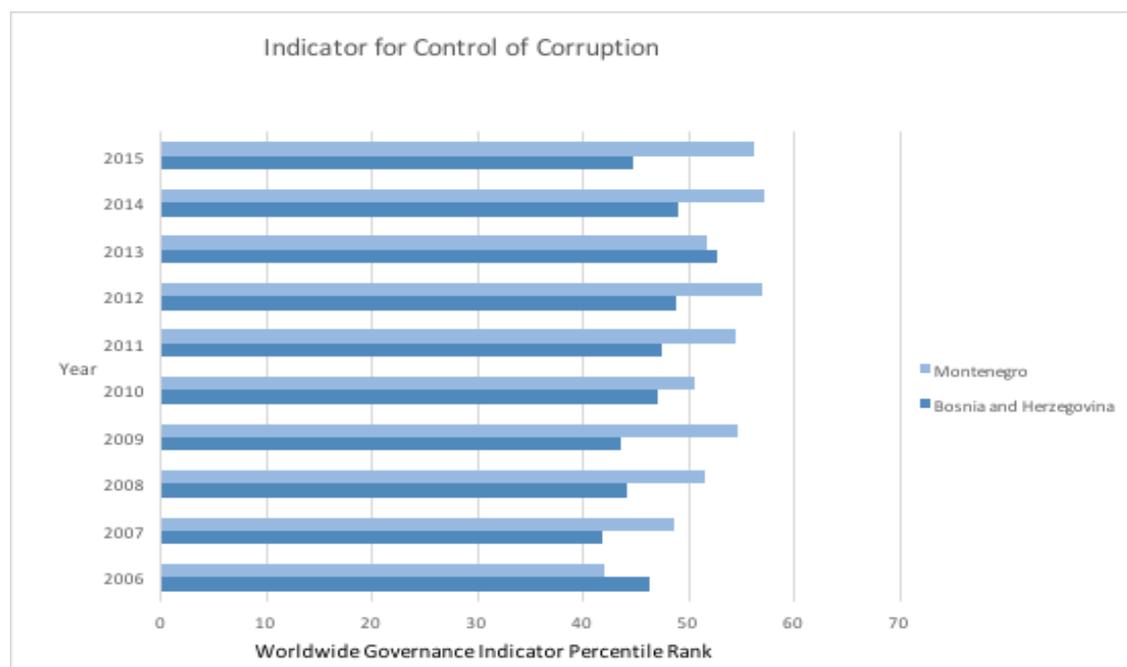


Figure 3: Comparison of control of corruption in BiH and Montenegro, Source: Worldwide Governance Indicators

The scores from the third indicator, the control of corruption, captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption.⁸⁶ Both countries score relatively weakly, which highlights that the issue of corruption is a widespread phenomenon among ex-Yugoslavia countries, rather than a specific problem to Bosnia-Herzegovina, which nevertheless scores lower. In 2006 Bosnia-Herzegovina's score would rank at 46.34 compared to Montenegro's lower score in the same year at 41.95. The year 2007 would see a decrease for Bosnia-Herzegovina at 41.75 and increase for Montenegro at 48.54. Bosnia-Herzegovina's rank would pick up slightly in 2008 at 44.17 as would Montenegro's at 51.46. Montenegro's would continue to pick up in 2009 at 54.55 whereas Bosnia-Herzegovina's would decrease to 43.54. In 2010, Bosnia-Herzegovina's score improved every so slightly at 47.14 compared to Montenegro's likewise higher score of 50.48 in the same year. From 2011 to 2015, Bosnia-Herzegovina's scores would be the following: 47.39, 48.82, 52.61, 49.04 and 44.71. Comparably and in the same order, from 2011 to 2015 Montenegro would score: 54.50, 56.87, 51.66, 57.21 and 56.25.

⁸⁶ World Bank, Info, Control of Corruption, online: <http://info.worldbank.org/governance/wgi/pdf/cc.pdf>.

As this specific indicator is derived from the sub-indices, Freedom House and Transparency International, the WGI corruption scores can be supplemented by looking more closely at the scores of each of these indices. Both have different a slightly different focus to one another and are shown in figures 7, 8 and 9 below.

2016 Rank	Country	2016 Score	2015 Score	2014 Score	2013 Score	2012 Score
64	Montenegro	45	44	42	44	41
83	Bosnia and Herzegovina	39	38	39	42	42

Figure 7: Comparison of Corruption in Montenegro and BiH, Source: Corruption Perceptions index 2016

Bosnia and Herzegovina

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
4.25	4.25	4.50	4.50	4.50	4.50	4.75	4.75	4.75	5.00

Figure 8: Indicator of corruption in BiH, where 1 represents the highest level of democratic progress and 7 the lowest, source: Freedom House

Montenegro

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
5.50	5.25	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00

Figure 9: Indicator of corruption in Montenegro, where 1 represents the highest level of democratic progress and 7 the lowest, Source: Freedom House

It is interesting to note that the indices WGI and Transparency International both show a lower score for Bosnia-Herzegovina, whereas Freedom House suggests that in 2016, both countries were in par. Looking at figure four and the index from Transparency International, out of a total of 176 places, BiH ranks at 83 with a score of score of 39 out of 100, as compared to Montenegro which comes under spot number 64 with a score of 45. Under this index, countries which have a lower rank have badly functioning public institutions such as the judiciary, and citizens often are faced with situation of bribery and extortion. In compari-

son, higher ranking countries are more efficient in granting freedom to the press, access to information about public expenditure, independent judicial systems and stronger standards of integrity for public officials.⁸⁷ However, between the years of 2007 and 2016, Montenegro is shown to have been in a weaker position to Bosnia-Herzegovina in terms of corruption, but as having improved its score since 2007. On the hand, Bosnia-Herzegovina is seen to have scored better relative to Montenegro, but instead of improving its score during the period of 2007 to 2016, its rank has dropped.

The existence of corruption in both countries has been criticised from different sources. Notably, the European Commission, in assessing Montenegro's accession process, noted that corruption continues to be a prevalent and serious problem which needs to be addressed, in addition to organised crime.⁸⁸ Moreover, in the World Economic Forum's Global Competitiveness Report from 2013-2014, corruption and inefficient bureaucracy are seen as the most problematic factors for doing business in Montenegro.⁸⁹ Montenegro's reluctance to efficiently investigate corruption allegations among officials is seen as a problem, and in this context it is both mentioning that its Prime Minister is listed among twenty of the world's richest leaders. Similar problems are prevalent in Bosnia-Herzegovina, where politicians have the tendency to build extravagant villas, despite their modest wages.

⁸⁷ Transparency International Index, Online:

http://www.transparency.org/news/feature/corruption_perceptions_index_2016

⁸⁸ Economist Intelligence Unit (2017), Montenegro Country Report 2nd Quarter. (Accessed 06.04.2017).

⁸⁹ Global Competitiveness Report 2013-2014, The World Economic Forum. Retrieved 12 March 2017.

5.3.4 Indicator for government effectiveness

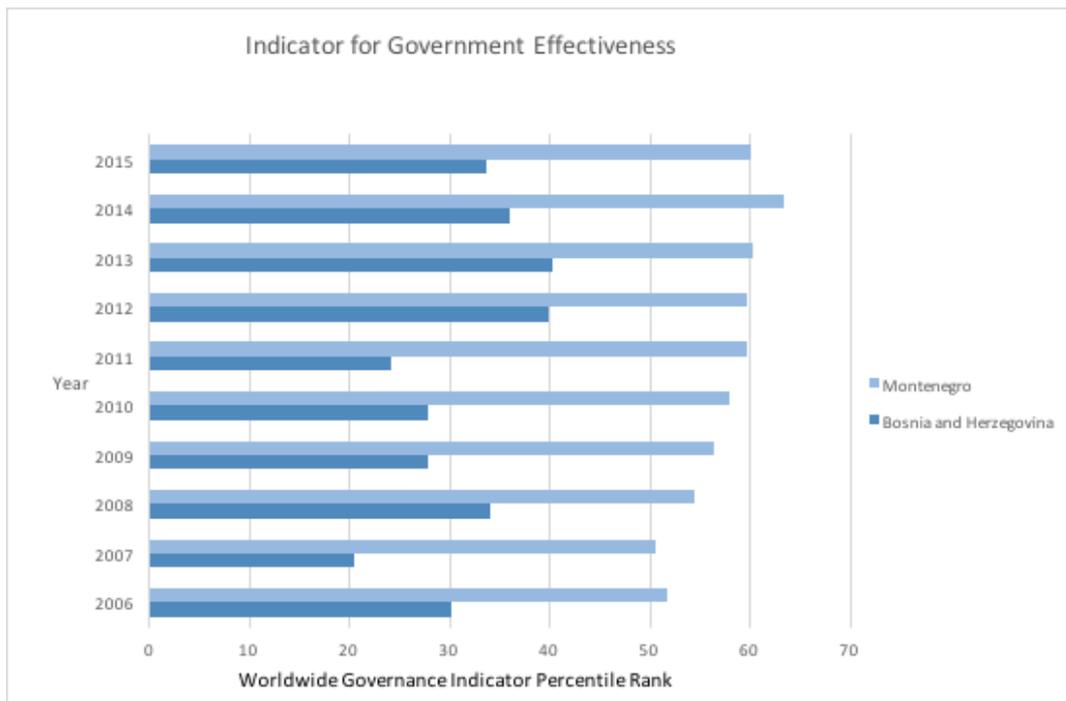


Figure 4: Comparison of government effectiveness in BiH and Montenegro, Source: Worldwide Governance Indicators

Coming back to the WGI, government effectiveness is the fourth indicator analysed within the context of Bosnia-Herzegovina and Montenegro. The difference in scores is quite drastic and highlights Bosnia-Herzegovina's inefficient governmental system which has the Dayton Constitution as its foundation. In 2006 Bosnia-Herzegovina's percentile rank was 30.24 compared to Montenegro's at 51.71. The following year would score a sharp decrease for Bosnia-Herzegovina at 20.39 compared to Montenegro's moderate decrease to 50.49. In 2008 Bosnia-Herzegovina would recover slightly to 33.98 as would Montenegro to 54.37. The year 2009 would show a relative decline for Bosnia-Herzegovina to 27.75 in comparison to Montenegro's slight increase to 56.46. In 2010, Bosnia-Herzegovina's score would remain low at 27.75 compared to Montenegro's increase to 57.89. Bosnia-Herzegovina's score would then increase even lower in 2011 to 24.17, whereas Montenegro's increase to 59.72 in the same year. In 2012 Bosnia-Herzegovina showed much progress and a drastic increase in its score to 40.28. Montenegro's score stayed the same at 59.72 in the same year. In 2013 Bosnia-Herzegovina would continue to increase to 40.28 and would Montenegro to 60.19. In 2014 the scores for Bosnia-Herzegovina and Montenegro were 36.06 for the former and 63.46 for

the latter. In 2015, Bosnia-Herzegovina’s score continued to decrease to 33.65 as did Montenegro’s back down to 60.10 in the same year.

5.3.5 Indicator for rule of law

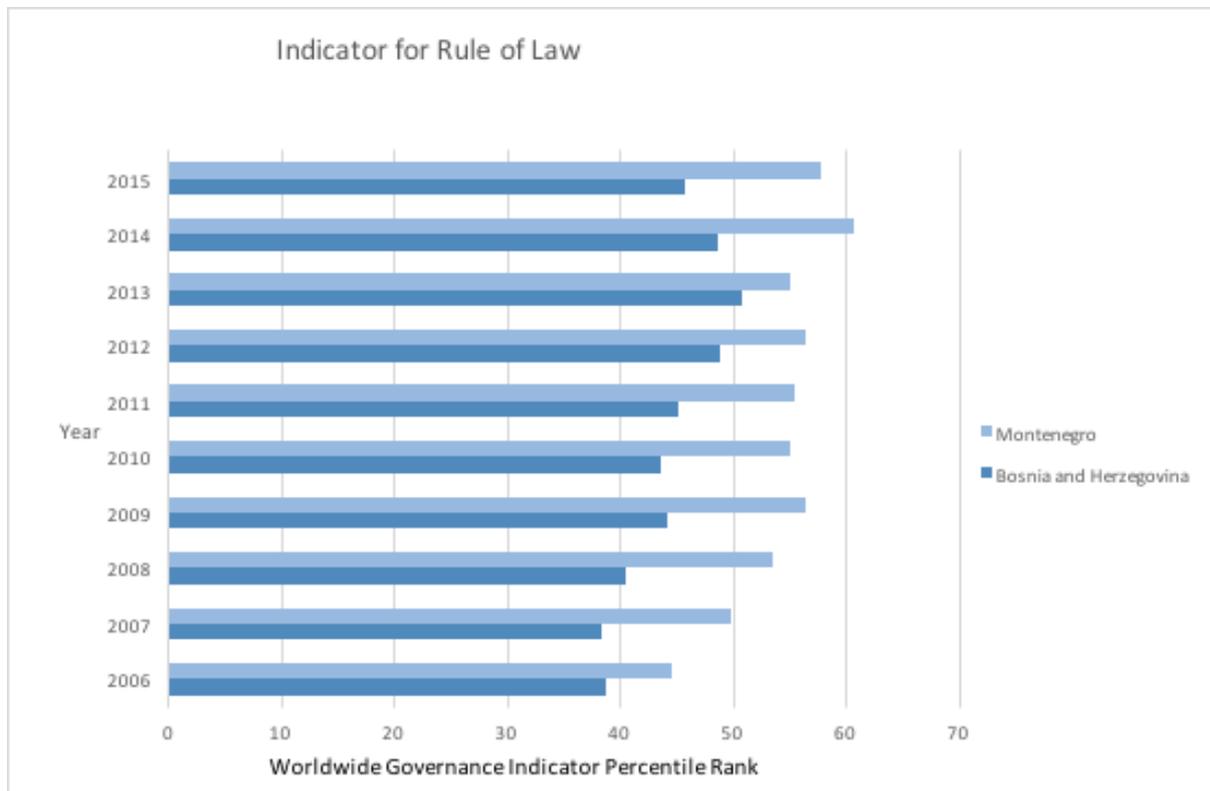


Figure 5: Comparison of rule of law in BiH and Montenegro, Source: Worldwide Governance Indicators

Montenegro averages around 10 places higher than Bosnia-Herzegovina in terms of implementing the rule of law. As shown in the graph, in 2006 Bosnia-Herzegovina’s score was 38.76 compared to Montenegro’s at 44.50. The following year Bosnia-Herzegovina’s score would remain relatively stable and low at 38.28 whereas Montenegro’s would increase to 49.76. The year 2008 would show a slight increase for Bosnia-Herzegovina at 40.38 and an even bigger increase for Montenegro at 53.37. In 2009 the trend would continue and Bosnia-Herzegovina would reach a percentile rank at 44.08 and Montenegro 56.40. In 2010 Bosnia-Herzegovina’s score decreased slightly to 43.60 as would Montenegro’s to 54.98. In 2011 Montenegro’s score slightly increased to 55.40 as did Bosnia-Herzegovina’s to 45.07. In 2012 it would continue to increase for Bosnia-Herzegovina to 48.83 and 56.34 in Montenegro. Interestingly, Bosnia-Herzegovina would record its highest score over the nine-year pe-

riod at 50.70 and Montenegro a slightly lower score at 54.93 in 2013. In 2014 the score would increase for Montenegro to 60.58 and decrease slightly for Bosnia-Herzegovina to 48.56, and continue to lower in 2015 at 45.67, compared to 57.69 for Montenegro.

5.3.6 Indicator for regulatory quality

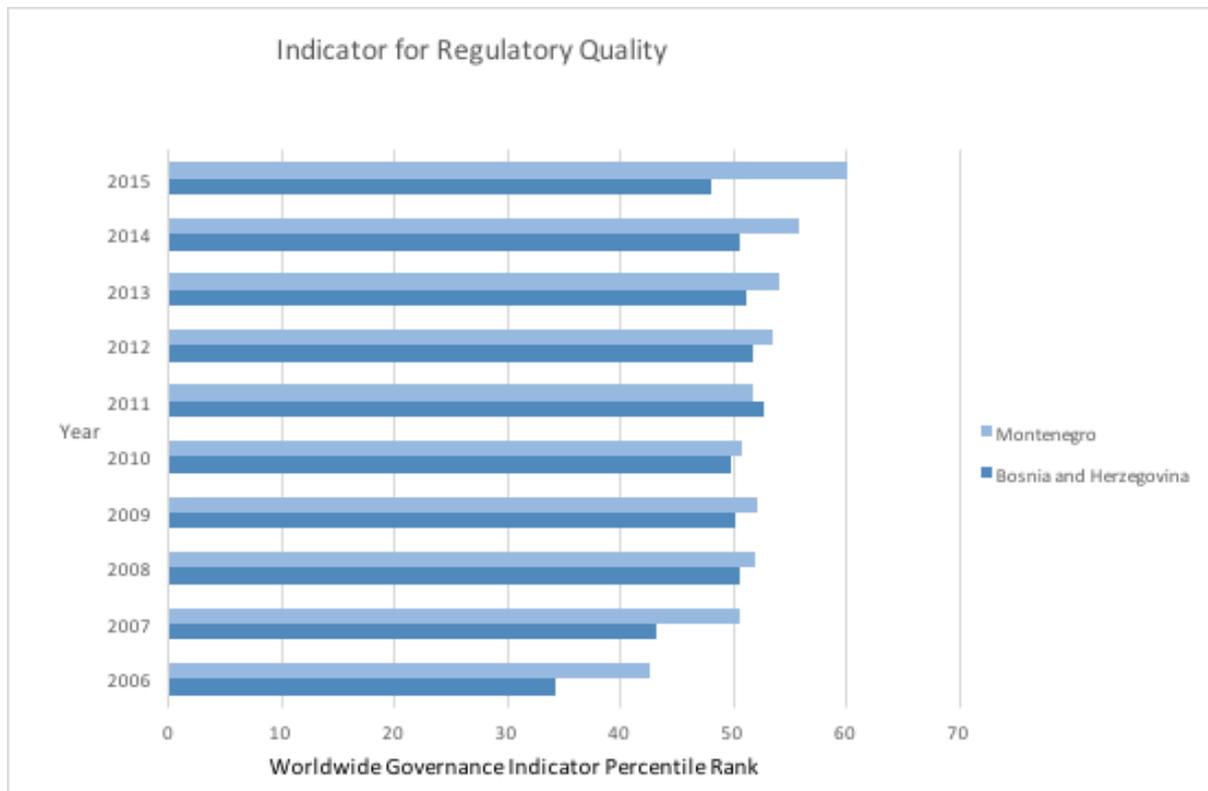


Figure 6: Comparison of regulatory quality in BiH and Montenegro, Source: Worldwide Governance Indicators

In the last of the good governance indicators from the WGI, similar trends are recorded as for each of the prior indicators. In 2006 Bosnia-Herzegovina's rank was at 34.31, just under ten places lower than Montenegro's at 42.65. Both countries would achieve a higher rank in 2007 with Bosnia-Herzegovina's at 43.20 and Montenegro's at 50.49. In 2008 Bosnia-Herzegovina's score would continue to increase to 50.49 and Montenegro's to 51.94. The following year would show a stable 50.24, compared to Montenegro's would also similarly score 52.15. In 2010 Bosnia-Herzegovina's rank would then slightly lower to 49.76 as would Montenegro's to 50.72. In 2011 the respective figures were 52.61 for the former and 51.66 for the latter. In 2012 Montenegro's rank increased to 53.55 whereas Bosnia-Herzegovina's decreased to 51.66. In 2013 Montenegro's rank again increased to 54.03 and

Bosnia-Herzegovina's decreased to 51.18. In 2014 the ranks were 55.77 for Bosnia-Herzegovina and 50.48 for Bosnia-Herzegovina. Lastly in 2015, Bosnia-Herzegovina ranked at 48.08 compared to Montenegro at 60.10.

5.4. Additional indices

To supplement the data from the WGI scores from an additional index, the Index of Economic Freedom, will be included to emphasise the significance of protected property rights as a core aspect of institutional theory. As per NIE, a good institutional environment is argued to be one which protects property rights. This once again comes back to the perspective of investors who need to be assured that they will not lose out on transaction costs in a country which does not enforce and protect their contracts. Moreover, a country which has a well-functioning property rights regime arguably minimises rent-seeking as well as corruption by private and state agents due to a more efficient allocation of the nation's resources. Measuring data over a longer period of time, due to the availability of data, we find similar trends as with the WGI:

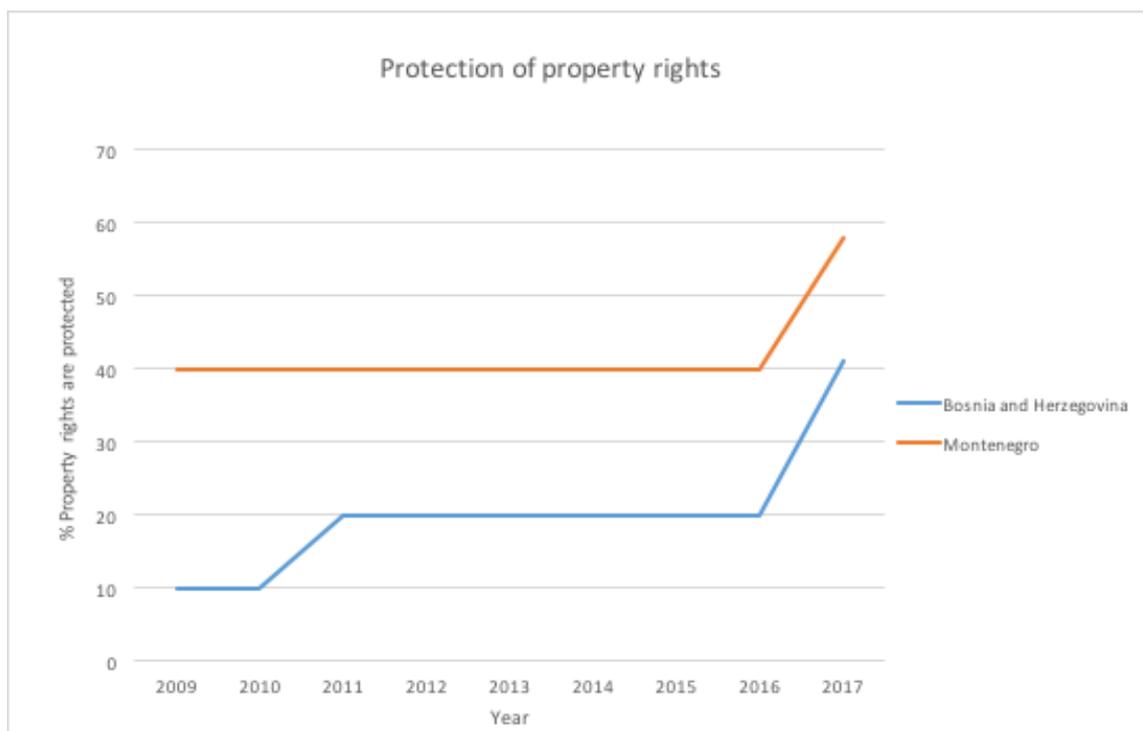


Figure 10: Comparison of the protection of property rights between BiH and Montenegro, Source: 2017 Index of Economic Freedom

Within the Index of Economic Freedom, countries are graded from 0-100 where 0 represents a state of affairs where all property belongs to the state and private property is outlawed, people do not have the right to sue others and do not have access to courts. On the other hand, 100 represents the ideal environment where private property is guaranteed by the environment and the court system enforces contracts efficiently and quickly and outlaws those who unlawfully confiscate private property. In the former corruption is a major issue, as compared to the latter where there is none.⁹⁰ On this scale, BiH ranks at 41.2% in 2017 where “the court system is highly inefficient, and delays are so long that they deter the use of the court system. Corruption is present, and the judiciary is influenced by other branches of government. Expropriation is possible.”⁹¹ In comparison, Montenegro ranks at 58% for the same year, which equates to an institutional environment where the court system is inefficient and subject to delays. Corruption may be present, and the judiciary may be influenced by other branches of government. Expropriation is unlikely.⁹²

As discussed, Acemoglu and Robinson greatly emphasise the protection of property rights as vital, in addition to upholding the rule of law, for long-term economic growth. The weaker performance shown by Bosnia-Herzegovina for this indicator reflects the fact that Bosnia-Herzegovina fails to attract Foreign Direct Investor and similarly scores very low in ease of doing business, as will be discussed in more detail below.

5.5 Comparing WGI scores against economic growth performance

An analysis of the performance of Bosnia-Herzegovina and Montenegro under each of the indicators of good governance in the WGI has shown that Montenegro scores relatively better compared to Bosnia-Herzegovina across all indicators. To see whether higher scores in good governance correlate with higher economic growth, Bosnia-Herzegovina and Montenegro’s scores in each of the respective WGI indicators is compared against their annual GDP growth per capita during the same time period 2006-2015:

⁹⁰ <http://www.heritage.org/index/property-rights>

⁹¹ *ibid.*

⁹² *Ibid.*



Figure 11: Growth in GDP per capita (%) Bosnia-Herzegovina and Montenegro, source: World Bank

Looking at Bosnia-Herzegovina’s annual GDP per capita growth over the period 2006-2015, we find the following trends: in 2006, Bosnia-Herzegovina’s GDP per capita growth was at 5.238% compared to Montenegro’s at 8.431%. In 2007 we notice a sharp increase for Montenegro at 10.505% and very slight increase for Bosnia-Herzegovina at 5.676%. In 2008 and 2009 sharp drops were noted for both countries reflecting the financial crisis at the time. Montenegro’s slightly lower GDP per capita growth of 6.733% in 2008 dropped to minus figures at -5.859%. The same could be noted for Bosnia-Herzegovina from 5.5% in 2008 to -2.819 in 2009. 2010 growth was measured at 0.832 for Bosnia-Herzegovina showing slight recovery. In the same year Montenegro similarly returned to positive growth with a GDP per capita of 2.275%. In 2011 the figures increased for both whereby Bosnia-Herzegovina’s figure was at 0.986% compared to Montenegro’s at 3.12%. The year 2012 would show a steep drop for both countries again. Montenegro’s GDP per capita measured in at -2.806% and Bosnia-Herzegovina’s at -0.833%. Both countries would show an increase again in 2013 with

growth at 2.525% for Bosnia-Herzegovina and 3.448% for Montenegro. Interestingly in 2015 the figures were not too far apart and Bosnia-Herzegovina even had a higher GDP per capita growth at 3.228% compared to Montenegro at 3.093%.

When the growth in GDP per capita is compared to the scores of both countries under the WGI and supplementary indices, we see a trend. Montenegro maintains both a higher score in each separate indicator within the Worldwide Governance Indicators, as well as the additional indices from Transparency International and Heritage. In addition, during the same time span, 2010-2015, Montenegro also averages a higher growth in GDP per capita when compared to Bosnia-Herzegovina. Arguably, a connection between higher good governance scores, which indicate good quality institutions needed for growth, and higher GDP per capita can be noted. In a contextual setting, explanations for this divergence in good governance scores and Bosnia-Herzegovina's less efficient political institutions, have been discussed. Bosnia-Herzegovina's political institutions are less effective due to the outdated and inefficient Dayton Constitution which both suppresses and fuels ethnic divisions left over from the war. In turn, the country finds it difficult to carry out timely and effective economic reforms. In comparison, Montenegro's pro-reform political institutions place EU integration as top priority. The country is able to introduce reforms in a timely basis as it is not impeded by political constraints to the same level as Bosnia-Herzegovina. Property rights are better protected and Montenegro has benefited from high Foreign Direct Investment. However, Montenegro's good governance scores are also not perfect when compared to its more prosperous regional peers and Western European countries. Notably, Montenegro has been critiqued in its handling of corruption and the rule of law.

5.6. The link between institutions and economic growth

Montenegro scores higher than Bosnia-Herzegovina in each of the WGI good governance indicators as well as the additional complementary indicators which look at property rights and corruption from a different perspective. Similarly, over the same nine-year period, Montenegro also shows a higher GDP per capita, which could prove the hypotheses that better quality institutions correlate with higher economic growth. As the WGI indicators are of a predictive nature, we see that following the introduction of good governance policies in both countries, there is growth in GDP per capita later on. International organisations which advocate for good governance maintained strong presence in the Bosnia-Herzegovina during and following the war. Similarly, following independence Montenegro continued on a reform

path and pro-EU stance, introducing market-orientated reforms and reforming its institutions to one-day reach Western European standards as can be reflected in its pro-EU stance today.

The connection between the implementation of good governance and GDP per capita growth has been discussed. The justification notes that both countries show similar increases in GDP per capita over the 2006-2011 timescale, arguably reflecting the general increase in their good governance scores over the same period. Montenegro's higher scores and higher GDP per capita growth is argued as a result of its greater success in introducing reforms, as opposed to Bosnia-Herzegovina which faces difficulties due to the Dayton Constitution. Other development theories fail to account for the different levels in growth. As mentioned, both countries are very similar in terms of geography and language. In terms of history and how it could have impacted on development as per alternative theories, Bosnia-Herzegovina share the same Slavic roots, and were a part of the Ottoman Empire, Austro-Hungarian Empire, Kingdom of Serbs, Croats and Slovenes, Kingdom of Yugoslavia, Federal People's Republic of Yugoslavia, and the Socialist Federal Republic of Yugoslavia from 1963 until its dissolution in the early 1990s. In this regard alternative theories which look at factors such as history, geography and culture, fail to provide an adequate explanation for two countries with almost identical conditions. As the topic of this thesis is inspired by *Why Nations Fail*, this is the same question asked by Acemoglu and Robinson when they compare the reasons for economic discrepancies between countries such as North and South Korea and the border towns of Nogales in the United States of America and Mexico. As is the case in the examples provided in *Why Nations Fail*, the most obvious difference between Bosnia-Herzegovina and Montenegro, two countries which had almost identical initial conditions within the former Yugoslavia, is the fact that Bosnia-Herzegovina was subject to a three-year war in the early 1990s.

It is understandable that Bosnia-Herzegovina's economic growth could not be comparable to other Western Balkans countries immediately following the War. With industrial output at only 5% of its pre-war level, electricity and coal production down to 10% and livestock and per capita income at 30% and 20% respectively, much was needed to boost growth levels. At the time it was estimated by the World Bank that around \$5.1 billion would be needed to meet Bosnia and Herzegovina's reconstruction needs.⁹³ However, Paddy Ashdown's commencement as high representative in 2000 was also a time when improvements in the country's economy could be noted. This included the implementation of a single valued-

⁹³ Bartlett, W. (2008) *Europe's Troubled Region, Economic development, institutional reform and social welfare in the Western Balkans*, Oxon: Routledge.

added tax system for the whole country, to replace two different rates in each of the two entities, growth averaged at 5% per annum. Moreover, a currency board managed by the strong and independent central bank allowed for price stability.⁹⁴ The signing of regional free trade agreements also marked an increase in much-needed exports for the country. The multitude of international presence in the country following the war, as well as the introduction of numerous reconstruction programmes provided Bosnia-Herzegovina with an economic boost. However, a reliance on donor funding and international support has made economic reforms and the transition to a market economy difficult to carry out due to the country's poor political institutions.

In this regard, reasons for Bosnia-Herzegovina's weaker GDP per capita growth more than twenty years following the war can be blamed on its political structure introduced by the Dayton Constitution. Due to the outdated and constraining constitution, the country is too weak and fragmented to pick up where the international community left off. Today, widespread corruption, inefficient and high government spending and weak protection of property rights discourage entrepreneurship.⁹⁵ These characteristics are important traits for inclusive institutions as argued by the authors of *Why Nations Fail*, as vital for a country's economic growth by encouraging innovation and technological advancements.

6. Economic implications of the WGI performance

Through a comparison of Bosnia-Herzegovina and Montenegro's good governance scores as compared to their GDP per capita growth, a correlation can indeed be found. This is particularly interesting due to the fact that both countries maintained similar initial conditions within former Yugoslavia and had similar incomes per capita as shown in figure 1. The argument presented within this thesis and in line with New Institutional Economics is that the quality of political institutions will in turn impact on a country's economic growth. The comparison of both countries' growth in GDP per capita gives ground to this theory, Moreover, today the GDP per capita of Bosnia-Herzegovina is \$10,500 compared to \$16,100 in Montenegro.⁹⁶ More startlingly, the unemployment rate in Bosnia-Herzegovina measures in at 43.2% compared to 18.5% in Montenegro. The latter has opened more than two-thirds of the

⁹⁴ Ibid.

⁹⁵ 2017 Index of Economic Freedom, Online: <http://www.heritage.org/index/country/bosniaherzegovina>

⁹⁶ "Bosnia and Herzegovina." (2017) The World Factbook, Central Intelligence Agency.

⁹⁷ "Montenegro." (2017) The World Factbook, Central Intelligence Agency.

champions in the EU *acquis* and has formally closed two⁹⁸, whereas the latter only officially applied for EU membership in February 2016 and is in the process of filling out the questionnaire.

However, both countries share the aspiration of joining the EU and are trying to introduce reforms which will improve their economies. An example of progress made by Bosnia-Herzegovina is the adoption of a comprehensive Reform Agenda in early 2015. This agenda promises to be the most significant reorientation of the BiH economy since the time of Dayton and aims to tackle major issues such as the high level of unemployment.⁹⁹ Progress has been made such as the introduction of labour laws by both entities within Bosnia-Herzegovina.¹⁰⁰ Moreover, in addition to pressure to introduce reforms from the perspective of EU accession, the recent granting of a request for an extended IMF loan, has meant that BiH is under even more pressure to fully transition to a market-economy. One such requirement has included the restarting of the privatization process in BiH, which was initially started under the Marković regime during the time of former Yugoslavia. Another attempt was restarted following the end of the war, but met with many problems. Vouchers distributed to former employees of previously socially-owned businesses were sold on the black market and led to ‘ethnic privatisation’. Such an example in Herzegovina involved wealthy Bosnian Croat enterprise managers collecting vouchers and buying up property in parts of the Federation dominated by Bosniaks. This was criticised as having adverse effects on employment due to the fact that “people [were] sacked just because they are Bosniaks or Serbs”.¹⁰¹ Today under the IMF loan agreements, the privatization process is to continue and large, strategically important enterprises BH Telecom and HT Mostar are to be privatized which is expected to lead to much social unrest similar to protests in 2014. In Montenegro, the privatization process has been different and not hindered on ethnic grounds. Today around 85% of Montenegrin state-owned companies have been privatized, including telecommunication companies.¹⁰² In addition to an overly large public sector, Bosnia-Herzegovina’s economy is too focused on consumption rather than production. This is partly due to the destruction of much of BiH’s industries during the War, and also due to the high inflow of remittances, which places the country second in Europe next to Moldova. Lastly, BiH’s underperforming export sector can be

⁹⁸ EBRD (2016-2017) Transition Report, London: European Bank for Reconstruction and Development.

⁹⁹ IMF (2016) “Bosnia and Herzegovina: Request for Extended Arrangement Under the Extended Fund Facility”, *IMF Country Report No. 16/291*, Washington, DC: International Monetary Fund.

¹⁰⁰ Ibid.

¹⁰¹ Bartlett, W. (2008) *Europe’s Troubled Region, Economic development, institutional reform and social welfare in the Western Balkans*, Oxon: Routledge.

¹⁰² “Montenegro.” (2017) *The World Factbook*, Central Intelligence Agency.

blamed on the poor business climate and transport connections.¹⁰³ The ease of doing business in Bosnia-Herzegovina is poor and BiH ranks at place 81 out of 190, notably due to a stringent and lengthy bureaucratic process for starting a business.¹⁰⁴

6.1 Bosnian diaspora and remittances

One notable feature of Bosnia-Herzegovina's economy today is the fact that, primarily due to the War in the early 1990s, it is one of the world's highest receivers of remittances which make up a significant percentage of the country's GDP, around 14%.¹⁰⁵ Relative to the size of its economy, the country even held the first spot in 1998, 1999 and 2000 as the highest remittances-to GDP ratio holder in the world.¹⁰⁶ As mentioned, forced displacement during the war is the prime reason for mass migration and high remittances whereby Bosnia-Herzegovina today has one of the world's largest diaspora communities. Around 1.7 million diaspora from Bosnia-Herzegovina live in approximately one hundred countries around the world, primarily in Western Europe, Scandinavia and North America.¹⁰⁷ This large diaspora contributes significantly to Bosnia-Herzegovina's economic development, since due to the lack of FDI, the inflows of remittances help the country maintain relative economic stability.¹⁰⁸ This varies from covering trade balance deficits and the current account, to providing a direct impact on income distribution.¹⁰⁹ Remittances were of particular importance immediately following the end of the war in 1995 as a source of sustainability for households which were faced with a lack of employment opportunities due and the absence of welfare. Around one-fourth of households surveyed in 1999 listed remittances as the top three sources of household income.¹¹⁰ The importance of remittances in the post-War years is clear, however remittances continue to be a significant part of the Bosnian economy even today. This is due to the fact that twenty years following the end of the war, its negative effects on the economy are still very much evident as voluntary migration has continued due to the poor institutional envi-

¹⁰³ Ellen Goldstein, Simon Davies and Wolfgang Fengler, 'Three reasons why the economy of Bosnia and Herzegovina is off balance', *Future Development*. 5 November 2015.

¹⁰⁴ <http://www.doingbusiness.org/data/exploreeconomies/bosnia-and-herzegovina>

¹⁰⁵ United Nations Development Programme, Diaspora for Development (D4D) project, Online: http://www.ba.undp.org/content/bosnia_and_herzegovina/en/home/operations/projects/poverty_reduction/migration-and-development1.html (last accessed, 15 May 2017)

¹⁰⁶ Jakobsen, J. (2011) 'Bosnia and the Remittances- Institutions- Development Nexus', in Vealenta, M. and Ramet S.P., *The Bosnian Diaspora: Integration in Transnational Communities*, Surrey: Ashgate Publishing Limited. Pg. 185.

¹⁰⁷ Ibid.

¹⁰⁸ Oruc, N. (2011) *Remittances and development: the case of Bosnia*, Network Migration in Europa.

¹⁰⁹ Eastwood, M. (2006) *Transnational Returns and Reconstruction in Post-war Bosnia and Herzegovina*, Oxford: Blackwell Publishing Ltd.

¹¹⁰ Ibid.

ronment. It is estimated that around 1.53 million euros are transferred to the country through diaspora remittances, however considering that this figure does not include cash in hand, it is likely to be much higher.¹¹¹ The reason for continued migration today is the fact that the war not only left Bosnia-Herzegovina with a large diaspora abroad and a destroyed society and economy, but also fragile and inefficient political and economic institutions. Bad governance, including political instability and corruption can therefore be seen as the reason for why young people are leaving not only Bosnia-Herzegovina, but other countries in the Western Balkans who similarly suffer from the ‘brain drain’ phenomenon. As most families in Bosnia-Herzegovina have family members that live abroad, the incentive to join them and earn higher salaries in countries with good governance is strong. Similar to migration patterns in most countries, and as mentioned, it is the young and educated who are the first to leave, which also means that those who are capable of pushing the government to improve its institutions are also gone. Poor political institutions or bad governance equate to higher migration and a continuing dependence on remittances; this leaves Bosnia-Herzegovina in a stable, but bad equilibrium.

Having established that bad governance and inefficient political and economic institutions are the reason for continued migration and remittances, it is important to examine the link between institutions, growth and remittances. Scholars are divided between whether remittances have more of an impact on countries with well-established and efficient institutions or those that demonstrate bad governance, such as Bosnia-Herzegovina. Arguing for the former, Catrinescu et al. finds that countries with better institutional environments are those who can benefit more from remittances.¹¹² In the other camp, Schrooten argues that remittances do not act in the same way as FDI or other forms of international capital flows as they are more transfers which go directly into homes rather than through institutional frameworks.¹¹³ Moreover, Jakobsen who has looked at the influence of remittances on the economy of Bosnia and Herzegovina, asserts that although in the short-run remittances have had an effect on growth, in the long-run FDI in larger numbers is needed if high growth rates are to be sustained as cross-country growth-rate differentials are significantly determined by the size of FDI in-

¹¹¹ Central Bank of Bosnia and Herzegovina, online: <http://www.cbbh.ba/?lang=en> (Accessed 04.04.2017).

¹¹² Catrinescu, N. Leon-Ledesma, M. Piracha, M and Quillin, B. (2009) Remittances, Institutions and Economic Growth. *World Development*, 37(1), pp. 81-92

¹¹³ Schrooten, M. (2005) Bringing Home the Money: What Determines Worker’s Remittances to Transition Countries?

flows rather than remittances.¹¹⁴ Overall, Jakobsen holds that the impact of remittances which impact on growth in Bosnia-Herzegovina is temporary and an inflow of FDI is needed in order to sustain growth in the long-term, which can be achieved through improvements in political and economic institutions. FDI and remittances are both forms of capital inflows, however there is a great difference in importance as only the former can help the country grow in the long-term. Bosnia-Herzegovina, in line with New Institutional Economics, must focus on protecting property rights and reducing transaction costs through upholding the rule of law in order to attract businesses to invest and allow FDI to inflow.

Keeping in line with Jakobsen's theory, and since remittances in Bosnia-Herzegovina are a result of brain drain and migration due to poor institutions and bad governance, their long-term dependence for growth as a substitute for lack of FDI should be avoided. Instead, a focus on improving the business environment through good governance should be established to increase FDI and prevent an increase in voluntary migration. This is vital as migration and brain drain equates to a decrease in the labour force, which will also lead to a decrease in output and a fall in GDP. If Bosnia-Herzegovina fails to improve its institutions, a lack of investment in the population and production, such as investments in education and machinery will lead to further migration and an on-going cycle of the decline in output. In this regard, a continued reliance on remittances, albeit helpful as a temporary remedy in the immediate aftermath of the war for reconstruction efforts and poverty alleviation, does not provide a satisfactory substitute for the lack of FDI. Moreover, others argue that remittances can be even detrimental to countries where they decrease labour participation, due to their perception as a substitute for work.¹¹⁵ Other detrimental patterns found in countries which depend on remittances include the fact that they can reinforce an already corrupt government which is reliant on such inflows, and also create a culture reliant on free aid or migration to other countries, rather than being willing to better the situation.¹¹⁶ However, the positive impact of remittances should not be overlooked and this chapter has not attempted to ascertain that Bosnia-Herzegovina should completely change its focus from receiving remittances to attracting FDI. Contrarily, although Bosnia-Herzegovina must in any case work on improving

¹¹⁴ Jakobsen, J. (2011) 'Bosnia and the Remittances- Institutions- Development Nexus', in Vealenta, M. and Ramet S.P., *The Bosnian Disapora: Integration in Transnational Communities*, Surrey: Ashgate Publishing Limited.

¹¹⁵ Chami, R. Fullenkamp, C and Jahjah S. (2003) *Are Immigrant Remittance Flows a Source of Capital for Development?* IMF Working Paper WP/03/189.

¹¹⁶ Trokić, A. *The Negative Long Term Effects of Remittance Inflow in Bosnia and Herzegovina*. Accessible on: [http://www.analyticalmk.com/files/2012/02/Amela%20Troki .pdf](http://www.analyticalmk.com/files/2012/02/Amela%20Troki.pdf)

its institutions in order to attract FDI, it should also continue to attract remittances. However, Bosnia-Herzegovina's relationship with its diaspora and the country's use of remittances, which are primarily for consumption, should also be refocused. One such example is that rather than perceiving diaspora as seasonal visitors who send money to their relatives and friends, their full potential should be utilised. Despite the country's large diaspora community, Bosnia-Herzegovina does not have a specific Ministry for Diaspora, but diaspora affairs are rather dealt with by the Ministry of Human Rights and Refugees. The lack of a specific ministry for diaspora, shows the country's lost opportunity in fully utilising the potential of its diaspora for development. Instead of a relationship based solely on the receipt of remittances for consumption, the diaspora of Bosnia-Herzegovina could provide a valuable contribution to the country through untapped means such as trade and investment, job creation, transfer of know-how and innovation.¹¹⁷ However, the unattractive business climate for investment and lack of support by BiH authorities act as a deterrent in realising the full potential of diaspora and remittances for development.

Coming back to Bosnia-Herzegovina's other development priority which is to low levels of FDI are due to Bosnia-Herzegovina's unattractive business environment, which is in turn due to its political and economic institutions. This has meant that remittances act as an almost substitute for FDI, as is the case in other nations with deficient institutions. Studies have shown that such substitutions for FDI are understandably a short-term, rather than long-term solution.¹¹⁸ In the long term this equilibrium where there is a dependence on remittances as opposed to FDI cannot remain stable as future generations of diaspora from Bosnia-Herzegovina are less likely to maintain current levels of remittances. If current levels of the reliance on remittances continue, Bosnia and Herzegovina could potentially suffer from Dutch disease in the future where a decrease in remittances would also lead to a reduction in consumption. Bearing this in mind, state officials agree that migrants, particularly second and third generation, should be mobilised in order to prevent them losing their connection to Bosnia-Herzegovina. However, the focus on maintaining a close connection with Bosnia-Herzegovina's diaspora should not be to continue current trends in the use of remittances, but rather to change the focus of this use. In this regard, remittances should be channelled to-

¹¹⁷ United Nations Development Programme, Diaspora for Development (D4D) project: http://www.ba.undp.org/content/bosnia_and_herzegovina/en/home/operations/projects/poverty_reduction/migration-and-development1.html (last accessed, 15 May 2017)

¹¹⁸ Jakobsen, J. (2011) 'Bosnia and the Remittances- Institutions- Development Nexus', in Vealenta, M. and Ramet S.P., *The Bosnian Diaspora: Integration in Transnational Communities*, Surrey: Ashgate Publishing Limited.

wards more productive activities such as entrepreneurship, rather than consumption.¹¹⁹ Simultaneously, the country should also focus on keeping citizens within Bosnia-Herzegovina and indeed the importance of reducing further migration has been acknowledged by policy makers. In this regard, the policy priorities are outlined as focussing on job creation, economic prosperity and better institutional efficiency, with a particular focus on younger generations.¹²⁰ However, due to vested interests and the ethnic-divided politics evident in Bosnia-Herzegovina's political institutions, introducing such changes to counteract migration will take time, as changes in institutions themselves are also a long process. In the meantime, remittances can continue to compensate for Bosnia-Herzegovina's lack of FDI and allow the country survive economically. It is hoped that potential EU membership can act as a catalyst to reform the country's political and economic institutions, improve its business climate and eventually attract FDI, to counteract future decreases in remittances.

7. EU membership as an incentive to reform institutions

In terms of how both Bosnia-Herzegovina and Montenegro can improve their political and economic institutions, a clear-cut solution is to comply with reform requirements as set-out by international organisations such as the European Union (EU), International Monetary Fund (IMF), European Bank for Reconstruction and Development (EBRD) and World Bank among other players. Most development actors tend to advocate for good governance, and in the case of the EU, within its key criteria for accession it states that countries wishing to join need 'stable institutions guaranteeing democracy [and] the rule of law'.¹²¹ Although all key organisations mentioned are very much present in the region, it is arguably the EU which provides the greatest incentive for introducing reforms due to the universal desirability of Western Balkans countries to eventually join as members. Since former Yugoslav countries such as Slovenia, and more recently Croatia, have already joined they can be viewed as good examples for remaining countries to follow in their footsteps. As it stands, Bosnia-Herzegovina is currently a potential candidate country whereas Montenegro has made more advanced progress and is a candidate country. The IMF also provides incentives for reform, and in the case of Bosnia-Herzegovina, a new \$608M lending programme was secured in 2016. In order to meet the conditions of the loan, announcements such as the plan to sell a

¹¹⁹ Oruc, N. (2011) Remittances and development: the case of Bosnia, *Network Migration in Europe*

¹²⁰ <http://www.mhrr.gov.ba/iseljenistvo/Istrazivanja/default.aspx?id=5133&langTag=bs-BA>, pg. 83

¹²¹ European Commission; European Neighbourhood Policy and Enlargement Negotiations; Conditions for membership. (Accessed: 03.04.2017): https://ec.europa.eu/neighbourhood-enlargement/policy/conditions-membership_en

45% stake in *Sarajevo Osiguranje*, Bosnia-Herzegovina's largest insurance company have been made.¹²²

Looking at the history of the European Union's policy in the Western Balkans during and immediately prior to the War, it can be characterized as a dual approach. The violent conflict in Europe's own backyard was described by Jacques Poo, former head of the European Commission Presidency as "Europe's hour of need".¹²³ However, the EU failed to live up to its outspoken commitment to assist Bosnia-Herzegovina and Kosovo, which in turn tainted its image in the Western Balkans as a peacemaker. In an attempt to compensate for its lack of action, and to also mitigate spill-over effects of the conflicts in the rest of Europe, such as economic and social instability, illegal migration, drug trafficking and criminality, the EU launched crisis management Common Security and Defence Policy (CSDP) missions as well as introduced Stabilisation and Association Processes (SAP).¹²⁴ The latter was introduced in 2003 by the Thessaloniki European Council, when the EU declared its commitment towards the countries of the Western Balkans to eventually join the European Union. It was hoped that the incentive of joining the EU would bring stability to the region and encourage the governments of each of the countries to introduce reform programmes and improve their countries for the better. Today this still holds true, although delays in expanding and comments such as from the present Commissioner for European Neighbourhood Policy and Enlargement negotiations, Johannes Hahn, who said that there would be "no new enlargement in the next five years" led to feelings of disappointment and neglect in the concerned countries. Arguably in an effort to rectify such comments which have led countries in the Western Balkans to feel as if they are no longer a priority for the European Union, it was subsequently stated that "without the Western Balkans, the EU as a union dedicated to peace, security and prosperity... will never be complete".¹²⁵

As it stands today, Bosnia-Herzegovina and Montenegro are at different stages of potential EU accession, whereby the latter is the most advanced out of all western Balkans countries, having also recently joined the North Atlantic Treaty Organization (NATO).¹²⁶ Montenegro officially applied for EU membership in 2008, two years after its declaration of

¹²² Economist Intelligence Unit [Country Report, May 2017, Bosnia and Herzegovina] (Accessed: 10.05.2017).

¹²³ Juncos, A.E. 2005: The EU's post-Conflict Intervention in Bosnia and Herzegovina: (re)Integrating the Balkans and/or (re)Inventing the EU? *Southeast European Politics*, Vol. VI, No. 2. 94

¹²⁴ Skara, G. 2014: The role of the EU as a Peacebuilder in the Western Balkans. *Romanian Journal of European Affairs*. Vol. 14:4, December 2014. 29.

¹²⁵ Morgan, S. 2016: Hahn: EU 'will never be complete' without Western Balkan countries'. *Euractiv*, last accessed 15.04.2017: <https://www.euractiv.com/section/enlargement/news/hahn-eu-will-never-be-complete-without-western-balkan-countries/>

¹²⁶ 'Montenegro joins NATO as 29th Ally' http://www.nato.int/cps/en/natohq/news_144647.htm 05.06.2017.

independence in 2006. Since then it was granted candidate status by the Commission in 2010 and negotiations proceeded on 29 June 2012.¹²⁷ To date, Montenegro has made good progress and closed all but seven chapters of the EU *acquis* and is set to open six more by early next year.¹²⁸ The rule of law continues to be noted as the country's biggest obstacle to membership as the Commission has regularly criticized Montenegro's prevalence of corruption and organised crime.¹²⁹

Bosnia-Herzegovina has similarly made progress towards future accession but still has a long way to go. Originally the country signed a Stabilisation and Association Agreement (SAA) with the EU following negotiations in June 2008, however its failure to implement the *Sejdić and Finci v Bosnia and Herzegovina* ruling from the European Court of Human Rights (ECHR) meant that its entry into force was frozen for a certain period of time.¹³⁰ Due to delays and inaction in introducing constitutional reforms as per the ECHR judgment, the EU decided to take a different approach, and in line with the International Monetary Fund (IMF), shifted its emphasis onto socio-economic instead.¹³¹ The change in approach was successful in that the parliament undertook to introduce such reforms allowing the SAA to finally come into effect in June 2015.¹³² The following month, a Reform Agenda was adopted by the central and entity governments with the aim to implement social, economic and judicial reforms and restructure the public administration.¹³³ Following on from this progress, Bosnia-Herzegovina finally submitted its application for EU membership in February 2016. The receipt of a questionnaire from the EU commission on December 9th has marked the first step in Bosnia-Herzegovina's accession process, and despite struggles among government officials in coordinating answers to the questionnaire, it is expected to be completed by the end of 2017.¹³⁴ In terms of assisting Bosnia-Herzegovina in its reform path, the EU will then continue to push for partial constitutional reforms in line with the EU *acquis*, rather than a comprehensive modification as was the case before. How it plans to do this considering that Bos-

¹²⁷ European Commission, European Neighbourhood Policy And Enlargement Negotiations

https://ec.europa.eu/neighbourhood-enlargement/countries/detailed-country-information/montenegro_en

¹²⁸ Auer, E. 'EU Policy in the Western Balkans', Lecture at the Diplomatic Academy of Vienna, Vienna, Austria, 19.05.2017.

¹²⁹ Economist Intelligence Unit (2017), Montenegro Country Report 2nd Quarter. (Accessed 06.04.2017).

¹³⁰ European Parliament: Fact Sheets on the European Union http://www.europarl.europa.eu/atyourservice/en/displayFtu.html?ftuId=FTU_6.5.2.html (Accessed: 24.03.2017).

¹³¹ Auer, E. 'EU Policy in the Western Balkans', Lecture at the Diplomatic Academy of Vienna, Vienna, Austria, 19.05.2017.

¹³² Economist Intelligence Unit [Country Report, April 2017, Bosnia and Herzegovina] (Accessed: 06.04.2017).

¹³³ Ibid.

¹³⁴ Ibid.

nia-Herzegovina failed to make any changes to its constitution eleven years after the *Sejdić and Finci* judgement in 2009, is unclear.

In line with New Institutional Economics and the topic of this thesis, it is clear that prospective EU accession has and can continue to impact on the quality of political and economic institutions in Bosnia-Herzegovina and Montenegro. Potential EU membership provides countries of the Western Balkans an incentive to reform and improve their institutions in order to qualify for accession. In the case of Bosnia-Herzegovina, prospective future membership has even been acknowledged as one of the few areas on which all three constituent people representatives, Bosniak, Croat and Serbian can agree on.¹³⁵ However, despite agreement on the wish to eventually join the EU, politicians have nevertheless shown a lack of consensus in the adoption of reforms required by the EU as well as the IMF programme.¹³⁶ Together with the IMF, the US and additional international financial institutions, the EU coordinates its approach to Bosnia-Herzegovina, in that the SAA and new IMF lending programme is to set out a broad policy framework for the period 2017-21. In terms of improving institutions, main goals of the programme include a focus on boosting the growth of the private-sector through privatization, tax and labour reforms. Moreover, its programme sets out a plan to direct more public spending towards infrastructure, healthcare and education and to harmonise banking legislation and the Central Bank of BiH's independence.¹³⁷

Through implementing these reforms, albeit at a slow pace due to complex institutional arrangements, Bosnia-Herzegovina could improve its institutions, both political and economic. Pressure from the EU and IMF to introduce reforms which would improve Bosnia-Herzegovina's good governance would create a more favourable environment for foreign investments and local entrepreneurs. This in turn could offset current migration patterns and encourage young people to stay and innovate, rather than rely on remittances as a means of survival.

8. Conclusion

The thesis attempted to answer the question of why discrepancies in economic growth among successor countries of the Former Socialist Republic of Yugoslavia, namely Bosnia-

¹³⁵ Crnadak, I. 'Bosnia and Herzegovina on the European path- expectations and challenges' Lecture at the Diplomatic Academy of Vienna, Vienna, Austria, 25.01.2017.

¹³⁶ Economist Intelligence Unit [Country Report, May 2017, Bosnia and Herzegovina] (Accessed: 10.05.2017).

¹³⁷ Ibid.

Herzegovina and Montenegro can be observed today. Alternative development theories which look at geography, culture and ignorance among other explanations, fail to account for the divergence in two countries which are very similar and were even apart of the same country. Both countries were shown as demonstrating similar initial conditions within the former Yugoslavia, whereby differences in GDP per capita were very faint within the time of Yugoslavia, whereas today the difference is much more evident. To account for this divergence, this thesis attempted to account for Montenegro's higher economic growth by turning to the theory presented by Acemoglu and Robinson in *Why Nations Fail*, notable contributors to the New Institutional Economics (NIE). As explained, this theory of the importance of institutions as the key to economic growth, which translates as 'good governance' in the policy-sphere, presents the argument that economic growth is determined by the quality of a country's, primarily political institutions, which in turn influence its economic. The rule of law and protection of property rights are noted as of specific importance.

Looking at the theory of NIE from the perspective of investors, good institutions or indicators of good governance, provide an overall impression of how attractive a country is to invest in. As mentioned, scholars within the school of New Institutional Economics such as Coase, North, Acemoglu and Robinson particularly advocate for the importance of protected property rights and observance of the rule of law. Moreover, the general perception of a country, such as how well it deals with corruption, is also significant from the perspective of firms. In this context, due to Bosnia-Herzegovina's lower score in each of the indicators and its lower GDP per capita, this can be seen as a reflection of the importance for institutions important for economic growth. Here it is argued that Bosnia-Herzegovina's political institutions are the cause for its lower level of growth in GDP per capita, as compared to Montenegro which doesn't share the same political problems. Furthermore, it is notable that due to advocacy of good governance policies, by international organisations which maintain an influence in the region, the fact that Bosnia-Herzegovina shows lower WGI scores and a lower GDP per capita can be attributed to the Dayton Constitution. Moreover, as alternative development theories such as geography and culture fail to provide adequate explanations for otherwise very similar countries, the theory of institutions as determinants for economic growth make sense.

Lastly, as Bosnia-Herzegovina faces problems in attracting Foreign Direct Investment and relies on remittances as an alternative, this has led the country into a stable, but bad equilibrium. However, despite problems for all three main ethnicities in Bosnia-Herzegovina to reach agreement for reforms and attract much-needed FDI in the long term, all three general-

ly share the same aspirations for the country to join the European Union. It is therefore hoped that motivation for EU-membership, as well as the necessity to introduce reforms as required by the recent IMF loan, should hopefully provide incentive for political leaders to speed up reforms. This would facilitate an improvement of the quality of both countries political and economic institutions, which will in the future equate to higher WGI scores, and higher GDP per capita growth.

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“On my honour as a student of the Diplomatic Academy of Vienna, I submit this work in good faith and pledge that I have neither given nor received unauthorized assistance on it.”