



Bosnia and Herzegovina after the February 2014 protests:

**is there a potential for
renewed violent social unrest?**

AI-DPC BiH Security Risk Analysis

Policy Note # 02

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PREFACE

This DPC-Atlantic Initiative Policy Note is part of a series of occasional thematic papers which collectively compose the second edition of DPC and the AI's Security Risk Analysis Study. The first edition, published in October 2011, assessed a full spectrum of risk factors: the functionality of government institutions at all levels, political use of conflict rhetoric in the media, police, army, privately-held weapons, private security companies, religious and ethnic radicalism, socio-economic strain, juvenile delinquency and sports violence, and the posture of the international community in BiH.

This second edition assesses these same factors from the vantage point of the present day, including new information previously unavailable to the authors. These papers are not mere updates of the first edition; each Policy Note is a stand-alone assessment of the theme in question. However, where information from the 2011 edition remains relevant, it is included.

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EXECUTIVE SUMMARY AND RECOMMENDATIONS

Despite a multitude of challenges and structural problems inherited from the pre-war and wartime socio-economic system and the post-war state structure, Bosnia and Herzegovina (BiH) saw remarkable economic recovery and growth from 2004-06. This was partly due to some state-building reforms including the introduction of a unified VAT rate and a Single Account for indirect tax collection and revenue distribution, made possible by serious international engagement that in turn boosted the reform willingness of domestic political elites. However, hopes that domestic elites would continue structural reform on the way to Euro-Atlantic integration quickly proved unfounded when the West, in a policy shift in 2005/06, began handing increasing responsibility to domestic actors. Not only did the ruling elites not follow through with reforms, but they *expanded* the existing political-economic patronage system. The main elements of this patronage system are burgeoning public employment and a system of status-based social benefits for certain social groups, especially war veterans. Both elements are ethnically based and use administrative resources to tie the political loyalty of large social groups to the ruling ethnic parties. The exploding cost that went with the excessive expansion of patronage ate up the effects of the previous economic growth and fiscal performance and made Bosnia and Herzegovina enter the global economic crisis in 2008 on homemade terms.

The country succeeded to escape from recession after 2010, but it failed to move towards socio-economic recovery and sustainable growth. The slow-down of the global recession and the implementation of basic initial structural reforms on domestic soil stopped the dramatic economic downturn. But the structural causes of the socio-economic weakness, and above all the patronage system, remained untouched. In order to uphold a fragile socio-economic stability, the ruling elites increasingly relied on foreign and domestic borrowing and on international financial institutions such as the IMF. The IMF has continued to provide credit arrangements since 2010, even though structural reforms were not being implemented and reform commitments were not being honored, and despite rising political instability. The reasons for this generosity lie primarily with the EU's policy of that period: unable to muster the political will to confront domestic political resistance to reforms in BiH, the Union has lowered or dropped altogether its reform conditions. In 2013, the EU provided direct support to the BiH State budget without any serious conditionality. With rapidly rising levels of public indebtedness and social disaffection, this approach proved unsustainable in the long run – as became evident in the violent outburst of social frustrations in February 2014.

The protests ended essentially without any results; all the socio-economic and political factors that provoked them in 2014 remain in place and pose a continuing security risk for the future of BiH. It remains to be seen if the EU's new BiH initiative, spearheaded by Germany and the UK, really has the potential to promote serious structural economic and social reforms.

In order to prevent a renewed outburst of violent social unrest that risks being diverted towards inter-

ethnic conflict, international and domestic actors should take a series of urgent steps:

- The EU and the IFIs must consistently use financial conditionality in order to push for structural economic and social reforms, not shy away from potential consequences, not compromise once conditions have been set, and remain united.
- The EU and the IFIs must set the sequencing of specific reform areas so that the foundations of the country's patronage system are tackled first.
- The EU must stop bargaining over the reform agenda with domestic political leaders behind closed doors, and instead establish a genuine partnership with BiH citizens by way of public outreach focused on citizens' needs and interests.
- Domestic political and government actors must focus their structural economic reforms on overcoming the fragmentation of the market and of economic policy in BiH – a precondition for joining the EU as a genuine single market and for a growth-oriented economic policy. If such reforms prove impossible or ineffective in the existing institutional setting, competencies must be transferred to the State level, and/or new institutions created.
- Another focus of domestically-driven and internationally-supported reforms needs to be on the establishment of a truly unified and free market.
- The trade unions must reform themselves in order to become true social interest groups. Government measures are needed to support unions in becoming relevant actors in the private sector.
- Civil society must transform itself and move towards strategic advocacy on behalf of citizens and social interest groups, supported by a shift in the donor community's funding philosophy.

Introduction

The violent outburst of social unrest that occurred in Bosnia and Herzegovina in February 2014 provided a clear answer to a question that loomed in the background of discussions on the negative development the country has been undergoing for almost a decade now: Might the deteriorating socio-economic situation – a direct consequence of rising political instability that has turned an already complicated governance system into complete institutional paralysis – lead to large-scale social unrest that affects the security situation? Burning government buildings and party offices and hundreds of injured civilians and policemen suggested that the answer was a ‘Yes’. BiH citizens gave an answer that refuted all those domestic and foreign commentators and diplomats who for years had been insisting that the structural political and institutional crisis could not turn into a security problem, mainly trusting in the country’s citizens’ traditional political passivity and ability to endure hardship.

The violent unrest sent a clear message of rejection to the country’s political class as a whole. It genuinely shocked and terrified the political elite for a few days, generating both hope and fear in the general population. Yet after one day of violence and a few weeks of peaceful protests and citizens’ plenums, the unrest ended without much of a result – if any. A general election in October 2014 saw the same elites succeed at the ballot box, with just a few adjustments to the relative power of the established parties.

As neither the causes of the political and institutional instability nor its destructive effects on the socio-economic situation have fundamentally changed since February 2014, the question of the potential for renewed violent social unrest forms a key aspect of any security risk assessment on BiH. Such an assessment has to consider economic and social relations and their future prospects, as well as analyze the causes of the 2014 protests and of their ultimate failure.

The post-war economy – slow recovery amidst structural problems

Local The severity of the challenges and structural constraints that BiH’s economy has been facing since the 1992-95 war is best illustrated by the fact that even today, almost two and a half decades on, the country has still not reached its pre-war GDP.¹ In the immediate post-war period, the country was faced with the double challenge of reconstruction and of transformation of the former socialist economy. Large parts of its economic capacities and much of its infrastructure had been destroyed or damaged. Heavy population losses included especially the better educated who had sought refuge abroad and never returned. The transition to a market economy was further weighed down by old and new structural problems. BiH’s socialist economy had been based strongly on outmoded heavy industry in energy, raw materials and military production.² While economic recovery was already hampered by the

¹ Author’s own calculations. Taking into account that BiH was among the less developed republics of Socialist Yugoslavia and that at the beginning of the 1990s the economies of the republics had already declined through an economic crisis that started in the mid-1980s, GDP is an even stronger indicator of the weakness of BiH’s post-war economic recovery.

² *IMF Country Report* No. 10/347, November 2010, p.11.

slow post-war re-establishment of public security, weak rule of law, and systemic corruption, it faced a new structural problem in the complicated institutional structure of the system of government enshrined in the Dayton peace accords. The state with its 13 governments and a burgeoning public administration posed a heavy burden on the developing real economy while at the same time preventing the formulation of a consistent economic policy. Dayton left the state with almost no instruments for macro-economic policy.³ Only customs regulation and monetary policy were left at the central-state level. The establishment of the Central Bank of BiH and its Currency Board and the introduction of the Bosnian Convertible Mark (KM) pegged to the Deutschmark (now the Euro) created the preconditions for a stable monetary system, but prevented the use of the monetary system for macro-economic policy. Below the central-state level there remained a territorially fragmented, divided economic system and market, in which fiscal and economic policy by and large fell within the competencies of entities and cantons.

In spite of these various constraints, BiH saw a fairly impressive stabilization of the socio-economic situation during the first post-war decade, in large part due to massive international support – an estimated 60-70 billion USD from 1996 to 2002⁴ – and the presence of tens of thousands of foreigners working in international organizations. At the same time, this created a dependency on foreign aid and made structural economic reforms less attractive. The international community's state-building policy concerned itself only partly with the economy. Together with the internationally-supported establishment of the Currency Board, the privatization of the banking sector, which led to the domination of foreign capital and banks, created a largely stable banking system. But for the rest of the economy the privatization process, which was based on Western models and proceeded in the absence of an effective judiciary, turned into *nomenklatura* privatization, benefitting insiders and corrupt officials. This process, which applied the fast-money principle of the war economy, resulted in the disappearance of large parts of the production capacities and the loss of many jobs. By far the most important and successful structural reform that took place in the state-building framework was the establishment of the Single Account and of the Indirect Taxation Authority (ITA) and the later introduction of a single-rate VAT in 2006. Fiscal authority was transferred to the state level and the country's tax system was unified to a certain degree, which strengthened economic discipline and substantially reduced tax evasion.⁵ While the market and economic policy remained fragmented, these reforms nevertheless generated continuous economic growth from 2004-08, with an average annual GDP rise of 6%. State and entity budgets stabilized and dependency on foreign assistance diminished during that period.⁶

³ Dragoljub Stojanov, "B-H since 1995: transition and reconstruction of the economy," in: Žarko Papić (Ed.), *International support policies to South-East European countries: Lessons (not) learned in B-H*, Sarajevo 2001, p.64/65.

⁴ *Politička, ekonomska i socijalna kriza u BiH 2012/2013*, IBHI, Sarajevo April 2013.

⁵ "Program document for a proposed first programmatic public expenditure development policy loan/credit to BiH," *World Bank Report No. 49359-BA*, April 8, 2010, p.8.

⁶ *Ibid.*, p.10.

Joining the global economic recession – on entirely homemade terms

In 2009 BiH slumped back into full-fledged recession. While the country did so together with the rest of the world, the origin and causes of economic regression were almost entirely domestic. These dated back to 2006, an election year in which the international community shifted its post-war policy approach towards ‘local ownership,’ the handing over of full political responsibility to the local political elites in the hope they would continue the reform path in the framework of Euro-Atlantic integration. These hopes were quickly dashed after new parties entered government, notably Milorad Dodik and his SNSD in the RS. Instead of continuing with structural reforms, the elites made use of the rise in public revenues during 2004-06 to expand the political patronage system by diverting more resources into it.⁷ As a result, public fiscal management started to deteriorate sharply in 2007 and public expenditures rose rapidly in 2007 and 2008.

The rapidly expanding patronage system consisted of two main elements. First, a system of social benefits politically linked to ethnic interest groups – most importantly, war veterans – made up a large part of political parties’ voter base. The system consisted of so-called privileged pensions and non-insurance, cash-transfer benefit payments. In the Federation, where that system further metastasized due to the entity’s double-ethnic, Bosniak-Croat structure, the number of beneficiaries of privileged pensions multiplied after 2006, and non-insurance transfer costs nearly doubled in two years, increasing from 4.8% of the entity’s GDP in 2006 to 7.5% in 2008.⁸ While in the RS the increase in social transfer payments was less pronounced, it still saw a 60% rise in overall veteran benefits in 2008.⁹ The second element of the expanded patronage system was a rise in public employment, both in public administration and in state-owned companies. Public employment rose in the Federation after 2006 and exploded in the RS, where it formed the main tool for the creation of a *de facto* one-party system. Between 2006 and 2008 the RS government’s wage bill rose by 40%.¹⁰

The politically induced recession that peaked in 2009/10 affected all economic and social indicators. The economic growth rate turned negative, with GDP growth dropping from 6% to -3%. Industrial production fell by 3.3% in 2009. Foreign direct investment dropped sharply and reached an all-time low of €12.3 million in the last quarter of 2010. Already very high, unemployment rose even higher: it was 6% higher in April 2011 than in 2008, while the number of persons employed fell by 10% in two years.¹¹ The social effects were dramatic. In late 2009, the World Bank projected that half the gains in reducing poverty made from 2004-07 – a 2% reduction – would be lost.¹² Consumer prices rose by 3.1% in 2010. Average wages in the country stood at slightly over KM 800 (approximately €400), while trade unions set the price of a consumer basket to support a family of four at KM 1,800.¹³ At the same time, remittances

⁷ “Program document for a proposed first programmatic public expenditure development policy loan/credit to BiH,” p.10.

⁸ *Ibid*, p.8.

⁹ *BiH Challenges and Directions for Reform. A public expenditure and institutional review*, World Bank, February 2012, p.39.

¹⁰ “Program document for a proposed first programmatic public expenditure development policy loan/credit to BiH,” p.11.

¹¹ “Zaposlenih manje 10, nezaposlenih više 6 posto,” *Oslobodjenje*, July 13, 2011, p.20.

¹² “Protecting the poor during the global crisis. 2009 B&H poverty update,” World Bank, December 2009; *Human Rights Report BiH 2010*, Justice and Peace Commission of the Bishop's Conference B&H, 2011, p.34-35.

¹³ Central Bank of BiH, *Bulletin No.1/2010*, December 2010; “I dalje bez snažnije ekonomskog oporavka,” *SWOT Kvartalni Ekonomski Monitor*, No. 4, Banja Luka July 2011, p.8.

from family members living abroad declined due to the global crisis. Remittances traditionally played an important stabilizing role and were estimated to make up 15-18% of GDP.¹⁴

On the budgetary side, rising costs were initially compensated for by rising revenues, but that trend reversed when revenues began to drop in late 2008. This led to a budget deficit of 4% of GDP and a serious budget crisis in the Federation of Bosnia and Herzegovina (FBiH).¹⁵ In the RS, where the deficit remained somewhat lower, the government in 2009 started to use about half a billion Euros from the privatization of strategic public enterprises, first and foremost RS Telekom, to finance the public deficit.¹⁶ Still, the governments of the two entities had to enter larger credit arrangements with international financial institutions. A Standby Arrangement signed with the International Monetary Fund in 2009 was linked to conditions to cut public wages in both entities (10% in FBiH, 10-25% in the RS) and undertake reforms of the pension and social transfer payment systems.¹⁷ It marked the beginning of a sharp rise in public debt, especially in public foreign debt.

Structural problems, political challenges

The recession exposed the negative effects on the BiH economy of a multitude of persistent structural problems, all of them of a more or less political nature, as they either form a constituent part of the country's patronage system or keep being decisively affected by it.

The burgeoning public administration and public employment represents one important structural problem. The administration and public companies constitute a heavy burden on budgets; they are marked by overemployment, high salaries, and low productivity since employment is primarily determined by party affiliation rather than qualification and performance. At the same time the public sector with its high salaries and other privileges often prices out the private sector in attracting workers, thus substantially distorting the labor market.

Social transfer payments are also burdening public budgets and have a destimulating effect on the economy. The system is essentially an ethno-national copy and multiplication of the old Yugoslav socialist system for World War II partisans. Targeted at social interest groups such as veterans, it offers status-based rather than needs-based social assistance in return for ethno-political loyalty. In addition to direct cash-transfer payments, the so-called privileged pensions for veterans that were on average higher than regular pensions and allowed retirement at a relatively young age undermined the financial health of the entity pension funds. On the back of the ethno-political narrative, beneficiary numbers became terribly inflated in a process marked by high corruption. The pension funds are further financially undermined by the socialist entitlement to early retirement and generous definitions of disability. The health-care system suffers from a similar financially unsustainable, unfavorable ratio between those who finance it and those who receive health care without paying in. The expenditure

¹⁴ *IMF Country Report No. 10/347*, p.3.

¹⁵ "Program document for a proposed first programmatic public expenditure development policy loan/credit to BiH," World Bank Report No. 49359-BA, April 8, 2010, p.12.

¹⁶ *Ibid.*, p.12.

¹⁷ *Ibid.*, p.14; "Krizna generalna rast nezaposlenosti," *SWOT Kvartalni Ekonomski Monitor*, No. 1, Banja Luka June 2010, p.10.

side suffers from a high level of inefficiency and high costs due to institutional fragmentation based on the state structure; political employment has swelled the ranks of non-medical administrative staff. Finally, as in socialist times, a system of effective social assistance for those in need is still missing.¹⁸

Another structural problem is the strong nexus between the political elites, the state institutions, and the economic elites. As a result, BiH's market economy largely exists on paper only. This informal link is mainly the product of a corrupt privatization process, the opaque financing of parties and elections campaigns by affiliated 'businessmen,'¹⁹ complicated and often conflicting administrative rules and procedures, and a weak rule of law. The banking sector adds to the economy's non-free market features. As a response to the recession, when many companies could not service their debts and the entities have started commercial lending, the banks, especially foreign-owned ones, have become extremely reluctant to provide credit to the private sector;²⁰ this has left the field to domestically-owned banks that are corrupt, and to the entities' development banks that serve as a political tool in the hands of the ruling parties. As a consequence, a private company can only get a credit "if you are good friends with the bank director or a powerful politician."²¹ This non-free market economy is focused on fast profits and concentrated in the non-production sectors of the economy; it leaves by the wayside the productive, labor-intensive sector. This state of affairs is mirrored on the political side by the absence of a development-oriented economic policy on all levels of government (with the municipal level being a partial exception).

This situation produces multiple problems, including a highly uncompetitive business environment and a market that is not attractive for large-scale direct foreign investment.²² As most BiH products remain uncompetitive internationally, the country is suffering from a large, ongoing trade deficit. The structural weakness of the commercial legislation and inspectorates, which is beneficial to politicians, combined with the effects of the social transfer payment systems, is nurturing a large grey economy²³ that in return negatively affects the state budgets, produces a deep crisis of pension and health-care funds, and puts at a disadvantage the bit of the private sector that is operating legally.

On the social side, the resulting structural problems are devastating. BiH's employment rate is among the lowest in Europe, and the high unemployment rate is mostly made up of structural, long-term, and youth unemployment.²⁴ Large wage differences between the public and the private sector carry the potential for social explosion. Pension and health-care funds are in a structural financing crisis. And in a country with a substantial poverty rate, the existing system of social assistance remains highly inefficient.

¹⁸ *BiH Challenges and Directions for Reform. A public expenditure and institutional review*, World Bank, p.17-50. 59-76; IMF Country Report No.13/121, May 2013, p.8-11. Interview with IFI expert on the social benefit system, Sarajevo, August 2015.

¹⁹ "Duše su nam prodali," *capital.ba*, August 12, 2015, available at: <http://www.capital.ba/komentar-duse-su-nam-prodali/>

²⁰ "BH privrednici s bankama u vrzinom kolu," *Radio Slobodna Evropa*, September 3, 2015, available at: <http://www.slobodnaevropa.org/content/bh-privrednici-s-bankama-u-vrzinom-kolu/27224172.html>

²¹ "Pročitajte savjete holandskog investitora vlastima Srpske," *capital.ba*, March 21, 2014, available at: <http://www.capital.ba/procitajte-savjete-holandskog-investitora-vlastima-srpskoj/>; interview with IFI representative, Sarajevo, August 2015.

²² *Human Rights Report BiH 2010*, Justice and Peace Commission of the Bishop Conference B&H, 2011, p.37.

²³ IMF Country Report n. 10/347, p.13-15.

²⁴ *Ibid.*, p.11.

Finally, one of the most serious structural problems is the question of fiscal sustainability. With rising public expenditure aimed at nurturing the patronage system and its negative effects on economic development, and hence public revenues, the country has seen a steady rise in public debt, both domestic and international, that will be unsustainable in the medium and long term.²⁵

Political instability getting out of control: socio-economic trends since 2010

While the recession peaked in 2009/10, economic recovery has remained very limited since then, and the socio-economic situation has continued to be highly unstable. This was mostly due to the structural political instability which reached new highs during the 2010-14 term mandate. Both the State and the Federation became almost ungovernable thanks to government formation crises at both levels. The absence of a new BiH Council of Ministers for fifteen months following the October 2010 elections left the State with only a ‘technical’ budget in 2011, while the entities broke the law in passing budgets before this was done at state level.²⁶ Political chaos had a negative impact on the business climate, while the willingness to enter into structural economic reforms remained limited and public indebtedness continued to rise. This deterioration reached its culmination in 2014 with violent social protests in February and massive floods in May that seriously hurt the economy, and also had a political aspect to it.

Despite some initial, basic reforms, the costly core of the patronage systems was largely left untouched. In disregard of serious budgetary problems, public-sector employment continued to rise between 2010 and 2014.²⁷ It is telling that no reliable public employment data are available in BiH. The World Bank in 2012 estimated the share of public administration in overall employment at 19%, while an RS assessment from 2011 puts the figure at 25% in that entity. Reliable data for employment in public companies is also missing, but assessments point to substantial overemployment, or hidden unemployment.²⁸ Figures for public administration wages show a low ratio between entry-point salaries and those at top civil servant level of approximately 2.0, while a high ratio exists for elected officials and political appointees. This clearly demonstrates that public employment is based on political affiliation and loyalty, not performance. The austerity measures undertaken by the entities in 2010 in the form of public-sector wage cuts had limited to no effect. In the Federation, the Law on Savings was quashed by the BiH Constitutional Court as the government had missed to adjust the necessary laws, bylaws, and collective agreements with trade unions. The repayment of wage cuts with interests ordered by courts in tens of thousands of court cases initiated by public-administration employees leaves the Federation

²⁵ See for example: “Je li RS na ivici fincijskog kolapsa?” Buka.com, September 12, 2011, available at: <http://www.6yka.com/novost/13257/je-li-republika-srpska-na-ivici-finansijskog-kolapsa>.

²⁶ According to the law, in the absence of an elected government, that is with a technical government in place, the budget is defined quarterly, based on the previous year’s budget. According to the same budget legislation that was part of the 2004 reforms that introduced the Single Account, the overall budget of the state and the division of the budget between state-level and entity governments are to be adopted first, before the entities are to adopt their budgets.

²⁷ Entities statistical agencies, Annual Report 2014 of the Central Bank of BiH (CBBiH).

²⁸ Interview with International Financial Institutions (IFI) representative, Sarajevo August 2015; World Bank, *BiH Challenges and Directions for Reform. A public expenditure and institutional review*, February 2012, p. 51.

with an additional liability assessed at over €500 million, for which there is no budget coverage.²⁹ In the RS, the government already in 2013 reversed half of the wage cuts and would have completely reversed them in 2014 had it not been for the budget constraints inflicted on the entity by the May floods.³⁰

In both entities, the number of beneficiaries for privileged pensions continued to rise even after the onset of recession, although at a slower pace. In the Federation, it had increased seven-fold between 2004 and 2012. In 2012 the RS, and the following year also the Federation, undertook similar reforms of their privileged-pension systems. The contributory part of pensions was separated from the privileged portion and the latter tied to budget financing; pensions were harmonized across similar groups and pension levels reduced; incentives for early retirement were abolished and eligibility audits were implemented. These reforms brought some order into the system, but savings remained limited. The reform also brought new groups of beneficiaries into the system. In the RS, the savings were to a large part equalized by new transfer payments for those groups most affected by pension cuts, by raising veteran payments for housing. In the Federation, the audit process was turned into an ethno-political battle and Croat-majority cantons prevented the eligibility screening of existing beneficiaries. In both entities, despite commitments to the IMF and the World Bank, governments never even began a reform of the non-insurance veteran benefit payment system.³¹

With limited reforms of the pension and health-care systems, entity funds remained financially unsustainable. Structural problems of the pension funds persisted. Due to the low retirement age, 40% of pensioners in the RS are under the age of 65; at the same time, the number of disabled pensioners in both entities has risen to almost 50% of old-age pensioners. Combined with privileged pensions and the low number of contributors (due to high unemployment and the large informal labor market) this compounds a serious financing problem. In the Federation, the pension fund in 2013 suffered a KM 65 million deficit, while uncovered liabilities towards the fund by debtors such as public companies and entity and cantonal institutions amounted to no less than €550 million. In the RS, the pension fund in 2014 had a deficit of KM 34 million, while liabilities amounted to around €200 million.

The entity health care funds remained burdened with a thin financial base; the ratio of those employed and paying into the funds to those entitled to health care, calculated by the World Bank in 2010 at 1:5, has not changed since then. As a consequence, the entity funds are highly indebted. The RS health fund's overall debt at the end of 2014 was estimated at €215 million. As another consequence, out-of-pocket payments by citizens for health care remain at an unsustainably high level and present a serious factor of household poverty, adding some 2-3 percentage points to the country's already high poverty rate.³²

²⁹ "Zakon o radu i neradu," *Slobodna Bosna*, July 30, 2015, p.16-18.

³⁰ IMF Country Report No. 14/189, July 2014, p.12.

³¹ IMF Country Report No. 13/121, May 2013; *BiH Challenges and Directions for Reform*; interviews with IFI representatives, Sarajevo, 2012-15. The author wants to thank Jessie Hronesova for a valuable exchange of analysis and data on the issue of veteran benefits.

³² WB, *BiH Challenges and Directions for Reform. A public expenditure and institutional review*, February 2012, pp. 59-76; World Bank Report No. 49359-BA; "Mladen Milić, direktor Fonda PIO RS: Dug zdravstva gura u minus Fond PIO," *Glas Srpske*, available at: <http://www.glassrpske.com/drustvo/vijesti/Mladen-Milic-direktor-Fonda-PIO-RS-Dug-zdravstva-gura-u-minus-Fond->

With the foundations of the patronage system intact, general government expenditure remained at a very high level after 2010, making up 46-48% of GDP.

The system in place has continued to seriously affect economic indicators. In the World Bank's *Doing Business Index*, BiH dropped from 116th to 131st place between 2010 and 2014. Foreign direct investment continued to drop, too. It had peaked in 2007 at €1,3 billion, mostly due to strategic privatizations in the RS; dropped by half in 2008, and by almost 90% in 2009 compared to 2007; then doubled again until 2011; and has been falling again since then.³³ The country's GDP only slowly recovered after the 9% fall in 2008/09. It rose by about 1% in 2010 and 2011, fell by 1.2% in 2012, reached its highest post-recession level in 2013 with 2.5% but dropped again in 2014 to 0.7% due to the effects of the May floods. It stood at €13.5 billion in 2014 as compared to €12.4 billion in 2009.³⁴ Industrial production largely followed this trend. It rose 3.7% from 2009 to 2010 and 7.2% from 2010 to 2011, sharply dropped by 6% in 2012 and rose by 6.8% in 2013. Production growth fell to a low of 0.18% in 2014 due to the floods.³⁵ The country's foreign trade deficit remained stuck between €3.6 billion and €4 billion annually; while in 2009, 44.8% of all imports were covered by exports, the ratio was 53.6% in 2014.³⁶

The floods of May 2014 put an additional burden on the economy with an estimated total damage and loss of €2 billion, equivalent to 15% of GDP. The fiscal deficit rose from a projected 2.0% to 4.4%. The floods hit the agriculture, transport, and production sector the hardest. Yet they were not just a natural disaster: for years, public funds earmarked for preventive measure had been used instead to reduce the general budget deficit. The governments' poor flood relief performance contributed to the economic damage.³⁷

The absence of serious structural reforms and economic growth is reflected in a persisting dramatic social picture: the average monthly wage in BiH rose from KM 813 in 2011 to KM 830 in 2014; if inflation is taken into account, this was actually a drop. At the same time, the consumer basket for a four-member family remained at around KM 1,800 KM, meaning that an average salary covers just 40% of a typical household's expenditure. An additional troubling factor is the enormous wage difference between the public and private sectors: employees in the public sector often earn more than KM 1,000 or even KM 2,000, while workers in the private sector often earn below the average wage, with many receiving only the minimum wage of KM 380. Workers' remittances that add to household income have almost returned to the pre-recession level and stood at around €1 billion in 2014.³⁸

While incomes are low, the structural unemployment problem has persisted. The real unemployment

PIO/lat/179291.html; "Dug Fonda zdravstva 420 miliona maraka?" RTV BN, available at: <http://www.rtvbn.com/348726/Dug-Fonda-zdravstva-420-miliona-maraka>;

³³ CBBiH Annual report 2014, IMF data.

³⁴ *Macro Monitoring Report Q1 2015*, World Bank; CBBiH Annual report 2014.

³⁵ *Ekonomski trendovi januar-mart 2013*, Directorate for economic planning, BiH Council of Ministers; CBBiH Annual report 2014.

³⁶ *BiH Ekonomski trendovi. Godišnji izvještaj 2014. godina*, Directorate for economic planning, BiH Council of Ministers.

³⁷ *Bosnia and Herzegovina Floods, 2014. Recovery Needs Assessment*, joint BH authorities-IFIs report.

³⁸ BH Agency for Statistics, available at: http://www.bhas.ba/?option=com_content&view=article&id=247; CBBiH Annual report 2014.

rate has remained almost unchanged since 2010 and stands at around 27%; whereas the rate of those officially registered as unemployed has slightly risen from 42.6% in 2010 to 43.9% in 2014. What is worse, 85% of unemployed are long-term unemployed (more than 12 months) and the youth unemployment rate stands at 60%. With an employment rate of just 31.7% in 2014, BiH keeps a negative record in Europe. In the same year, 701,627 persons in BiH were employed and 549,522 unemployed; in the Federation, it was 443,587 employed and 391,427 unemployed; in the RS, 241,544 employed and 145,919 unemployed.³⁹

In both entities, the number of pensioners rose between 2010 and 2014 while the level of pensions dropped in real terms. In 2014, there were 644,200 pensioners in the whole of BiH: 394,900 in the Federation who received an average of KM 365 a month and 249,300 in the RS who received an average of KM 338. The ratio of those officially employed who pay into the pension fund and of pensioners is currently at a completely unsustainable 1.1:1.⁴⁰

The poverty rate in the country has also moved in a negative direction. While the period of economic growth saw a poverty reduction between 2004 and 2007 from 17.7% to 14%, the last household survey, conducted in 2011, puts the rate at 17.8% – a complete elimination of the gains achieved over previous years. While no newer data exist, the poverty rate is more likely to have risen than to have dropped since 2011. Last year's floods may have added another two percentage points to the rank of the poor.⁴¹ This negative trend is not followed by any reform of the inadequate system of social assistance – today, less than 20% of all non-contributory social assistance cash transfers go to the poorest 20% of the population.⁴²

Perhaps the most worrying trend within the overall socio-economic development during 2010-15 is a rise in public debt. The annual budget deficit of the general government (that is, all levels of government taken together) peaked in 2009 with 4.4% of GDP (about €500 million out of an overall government budget of €5 billion), and was lowest in 2011 with 1.3%; for the remaining years it stood at around 2%, the level in 2008.⁴³ At the same time, overall public indebtedness rose rapidly. Total public debt stood at 30.8% of GDP in 2008 and rose to 36.1% in 2009 and 39.3% in 2010; by 2012 it had risen to 45.1% and after a drop reached 46% in 2014.⁴⁴ The general government's foreign debt almost doubled between 2008 and 2014, from €2.1 billion to €4 billion. Foreign debt servicing rose accordingly since 2009: by a factor of three during 2009-14, doubling from 2011-13 alone. With €300 million it stood at almost 6% of the total general government expenditures in 2013.⁴⁵ To this one needs to add so-called contingency liabilities – public debts not shown or hidden in the books, such as unpaid bills to the private sector or manipulated budget data.⁴⁶

³⁹ IMF Country Report No. 14/189; Ekonomski trendovi; CBBiH Annual Report 2013 and 2014; Anketa o radnoj snazi, Agency for Statistics of BiH.

⁴⁰ Ekonomski trendovi; CBBiH Annual Report 2013 and 2014; entity pension funds statistics.

⁴¹ Politička i ekonomska kriza u BiH 2012/2013; Bosnia floods 2014.

⁴² *BiH Challenges and Directions for Reform. A public expenditure and institutional review, February 2012, pp. 41 ff.*

⁴³ CBBiH Annual Report 2014.

⁴⁴ IMF data based on BiH authorities' statistics.

⁴⁵ CBBiH Annual Report 2014.

⁴⁶ Interview with IFI representative, Sarajevo August 2015.

The February 2014 protests – potential for renewed violent social unrest?

When violent social protests erupted throughout the Federation on February 7, 2014, they seemed a logical product of prevailing socio-economic conditions and their political background. Yet most domestic commentators, academic and political, and international officials had for years denied the possibility that BiH citizens would ever rise up in a public display of discontent.

Regardless of the motivations behind such claims, it is true that a number of factors operate against the outbreak of social unrest.⁴⁷ The paternalistic political system is the strongest among these factors, as it ties large parts of the citizenry to the ruling elites via public-sector jobs and various forms of budgetary transfer payments. At the same time, this system has corrupted all of the traditional social interest groups such as veterans' organizations or trade unions and neutralized them as potential protest leaders. Trade unions have, in a sense, inherited their incorporation into the ruling political system from previous times. While unions in socialist Yugoslavia were the organizations of the management, not the workers, and this directly integrated them into the party-state apparatus, in the current system they maintain their close links to the ruling political elites through the domination of branch trade unions from the public sector, especially public administration, within the entity associations of trade unions. The high degree of unionization among public employees with their membership fees set as a share of their privileged salaries, and the low level of unionization in the private sector—thought to be below 20% and possibly even below 10%—set trade unions apart from those in Western industrial societies by structure and function.⁴⁸

The potential of civil society to act as an agent for the expression of social interests is limited in BiH thanks to the NGO sector's high level of professionalization, largely donor-induced, which leaves very little space and motivation for political outreach to citizens. Workers' remittances played a stabilizing social role already in socialist times; they have grown substantially since the war due to large-scale migration, and mitigate the destructive social effects of the paternalistic political system.

Another constraint against social discontent is the political passivity of BiH citizens and a certain capacity to endure hardship. This attitude builds on the thin democratic tradition of the country, the experience and traumas of the recent war that have left many citizens accepting any situation as long as there is no new war, and finally the political system of Dayton itself which for years demonstrated to citizens that attempts to express their basic interests, needs, or discontent through institutional political channels are pointless. Another aspect of the Dayton state helps reduce the likelihood of social unrest; the country's various levels of governance have dispersed authority and left no clearly identifiable address for the political expression of social discontent. This problem was further aggravated by the government formation and recomposition crisis from 2011-14, when it was often hard for citizens to even identify which political parties were currently in power, and thus politically responsible.

Against this backdrop, why did the protests still occur? Part of the answer is because almost none of these factors are one-dimensional. Paternalism also has a political downside. At least some of the

⁴⁷ *Politička, ekonomska i socijalna kriza u BiH 2012/2013*, IBHI, Sarajevo April 2013, p.13.

⁴⁸ Bodo Weber, "Die neue Arbeitsgesetzgebung in BuH, die EU-Reformagenda und die internationalen Finanzinstitutionen – überfällige Strukturreformen oder neoliberaler Abbau von Arbeiterrechten?" FES BiH Discussion paper, 2015 (forthcoming).

workers of five privatized companies in Tuzla who started the protest wave were motivated by a conservation of the socialist work ethic and pinned their hopes to the political elites with demands that were impossible to fulfill even within a paternalistic, post-socialist economic framework.⁴⁹ As a consequence of the growing fiscal unsustainability of the patronage system, even the half-hearted adoption by the entity governments of structural economic reforms such as draft labor legislation during the period from 2011-13, put trade unions under bottom-up pressure and strained the informal alliance with the political elites. The diversity of political actors also included a new party that built its ideology on social populism, the Party for a Better Future (SBB), which helped to heighten social tensions in the Federation. At the same time, the constant reshuffling of ruling coalitions and ongoing struggle between political parties over the control of governments compounded the situation. In Tuzla canton, for example, individual parties manipulated the workers' protests through their connections with individual unions, and thus contributed to the escalation of social discontent.⁵⁰ Finally, what may have appeared as mere political passivity was also an expression of a total disconnect between BiH citizens and both political elites and government institutions. This disconnect produced rising despair and anger that finally broke through the surface in February 2014.

These factors shaped the form that the social protests took; but the factors that enabled this public expression of discontent also determined the limited outcome of the protests, their ultimate political failure. As a violent outburst of social anger, the protests lacked both leadership and clear political direction. The Tuzla protests, for example, brought together workers from five privatized companies with different motivations and aims, company trade unions that never developed into potent social actors, an association of unemployed that never received much support from trade unions, previously marginal and controversial Facebook activists, younger academics, and hooligans from the local soccer club. There was no clearly identifiable cause that would have united these groups.⁵¹ The plenums that followed the street protests all over the country prevented party and NGO representatives from participating, but produced no leaders. Political demands articulated by the protesters and then taken up by the plenums shied away from addressing systemic causes and becoming 'political,' and hence remained of limited effect.

The lack of leadership, a political tactic and, even more so, the lack of a political strategy⁵² meant that protests in the Federation gradually faded and ultimately stopped. In the RS, protests had remained limited from the outset amid massive propaganda spread through the media and an intimidation campaign by the government against potential protesters.⁵³ In the end, protests remained limited to what they had been in the first days and during the violence on February 7 – a spontaneous outburst of long-brewing social frustration and anger and a collective repudiation of the political class of BiH as a whole. Yet while protests in the end went nowhere, the social anger and frustration are still there, and

⁴⁹ Interview with Tuzla canton government official, January 2015.

⁵⁰ Interview with Tuzla canton government official, February 2014.

⁵¹ Kurt Bassuener/Bodo Weber, "EU Policies Boomerang: Bosnia and Herzegovina's Social Unrest," DPC Policy Brief, Berlin-Sarajevo February 2014.

⁵² I thank my DPC colleagues Valery Perry and Kurt Bassuener for these observations based on plenum participation and numerous conversations with social protest representatives.

⁵³ Interview with RS social activist, February 2014.

so are the factors that shaped their violent public expression.

The international factor: The IFIs, the EU, structural reforms, and political conditionality

When BiH's economy slipped into recession and its excessive public spending created serious problems for the entity budgets in 2009, the issue of foreign borrowing became acute and the international financial institutions (IFIs) became a serious player for the first time since the end of the war.⁵⁴ In 2009, the IMF concluded a three-year Standby Arrangement (SBA) that offered more than a billion U.S. dollars in credits with favorable conditions. This opened up a struggle within the international community on the use of financial conditionality to push the political elites in BiH towards structural reforms. The 2009-2012 SBA was based on a set of conditions aimed primarily at stabilizing the budgets: measures to enhance fiscal policy and discipline, serious cuts on the public-expenditure side, structural reforms of the social benefit systems, and curbs to the exploding public wage bill. Despite initial reform commitments, the authorities made a quick U-turn, especially after elections in October 2010. The government formation crisis ended only in mid-2012, towards the end of the SBA, and from 2011 onwards, the conditions for the continued payout of instalments were no longer given as no real budget and fiscal framework was in place. This means that the SBA ended with just \$338 million having been disbursed out of the \$1 billion allocated. The ruling elites were lucky that an unexpected rise in revenues in 2011 made up for the underperformance in cutting the expenditure side – mostly from failure to reform the social transfer payments and to cut the wage bill.

The IMF nevertheless agreed in 2012 to sign a new SBA.⁵⁵ Although it contained conditions that were overall tougher, the Fund had given up on its earlier demand for reforming the costly veteran payments. "The IMF did not want to remain the only international institution defending the State of Bosnia and Herzegovina," as an IFI representative put it⁵⁶ in a comment that was aimed particularly at the EU, which had cultivated a policy of undercutting its own conditionality in the face of political resistance. In 2013, despite the caution of some member states, the EU paid out two tranches totaling €100 million in budget support to BiH, part of a support package for the countries of the region in the context of the global recession. The Union proceeded despite lasting political chaos in the country, despite the complete blockage of structural reforms by the authorities – reforms that would have resulted in much higher savings than the EU support. The EU's own, weak conditions originally set for the payout had not been substantially met and there was resistance from a couple of member states; nevertheless, the EU proceeded with the payout.⁵⁷

After the October 2014 elections, Germany and the UK presented a new initiative for BiH that soon became the new EU policy approach to the country.⁵⁸ The new approach is centered on a

⁵⁴ Two Standby Arrangements in the first postwar decade amounted to less than 100 million USD each.

⁵⁵ IMF Country Report No. 12/282, October 2012; Stand-by aranžmani BiH s MMF-om, Central Bank of BiH, available at: http://www.cbbh.ba/files/mfi_suradnja/mmf/stand_by_aranzmani_bs.pdf.

⁵⁶ Interview with IFI representative, Sarajevo, November 2012.

⁵⁷ Interviews with various EU member states' diplomats, Sarajevo, 2013.

⁵⁸ Bassuener/Perry/Vogel/Weber, *Retreat for Progress in BiH? – The German-British Initiative*, Democratization Policy Council (DPC) Policy Paper, Berlin/Brussels/Sarajevo, November 2014,

comprehensive set of structural economic reforms dubbed the ‘reform agenda.’⁵⁹ The agenda is a re-hash of the ‘Compact for Growth and Jobs,’ a policy change that the previous enlargement commissioner Štefan Füle had introduced in the wake of the February 2014 unrest, towards the end of his term in office, when he was forced to declare the failure of the Union’s previous BiH policy. At the same time, the package of reforms is not specific to BiH but based on the ‘European Semester’ – essentially an extension from EU member states to the enlargement countries of the EU’s harmonization of fiscal and economic policies and the strengthening of economic governance.

The basic idea, or hope, behind this approach appears to be that socio-economic reforms are harder to infect with ethno-nationalist narratives and may receive the support of BiH citizens given that the February 2014 protests had been primarily socio-economic by nature. However, serious questions remain on the initiative’s prospects. It is unclear why the political elites would undertake structural economic reforms that would destroy the foundations of their political patronage system. On the international side, the IFIs and the EU have shown more unity and resolve than ever before. But will they be prepared to stick to their financial conditionality, even if that leads to a resumption of social unrest? In fact, the EU has already begun to back down in the face of RS resistance: in the summer of 2015, it accepted the possibility of a future rise of the VAT rate in order to reach an agreement over the text of the reform agenda. By doing this, the EU broke ranks with the IFIs, especially the IMF, which wanted to see measures aimed at broadening the tax base implemented first before starting to consider raising the VAT.

Another problem inherent in the IFIs’ approach is that it leaves the sequencing of reforms listed in the agenda entirely in the hands of domestic authorities. This means that the IFIs risk being outmaneuvered by domestic political elites, who may well decide to adopt those parts of the reform agenda that hurt them least politically, take the IMF money based on these initial reform steps, and then drop the more substantial and politically painful structural reforms.⁶⁰

The fate of the EU’s new policy approach to economic reforms will also largely depend on the sustainability of government budgets and of public debt. This question became more acute when in June 2015 the IMF announced that it would not pay out the final two tranches of the 2012-15 SBA as reform conditions had not been met. The program has subsequently been closed. The prospects for a successful completion of negotiations over a new credit arrangement with the IMF that started with an exchange of letters before the summer break remain open. Instead of a new SBA, the IMF is offering to BiH authorities an Extended Funding Facility (EFF) that is tailor-made for countries that are planning structural economic reforms. It offers more generous credit repayment conditions – a three-year grace period to be followed by a ten-year repayment period, compared with an SBA’s two and five years, respectively. Should the authorities fail to meet the conditions for a new arrangement, they are left with limited options to cover the budget deficit. In the words of an IFI official: “They can borrow from

available at: [http://www.democratizationpolicy.org/uiimages/DPC Policy Paper - Retreat for Progress in BiH.pdf](http://www.democratizationpolicy.org/uiimages/DPC%20Policy%20Paper%20-%20Retreat%20for%20Progress%20in%20BiH.pdf).

⁵⁹ *Reformska agenda za Bosnu i Hercegovinu za period 2015-2018. godina*,

available at: <http://www.fbihvlada.gov.ba/pdf/Reformska%20agenda%20.pdf>.

⁶⁰ Interviews with German and British diplomats, Berlin-London, November-December 2014; interviews with IFIs representatives, Sarajevo August 2015.

commercial banks, raise taxes and cut budget spending on investments...With these measures the governments could survive another 10-12 months before they enter into serious budget problems.”⁶¹

Conclusions & Recommendations

Bosnia and Herzegovina after 2010 has left behind its homegrown recession, but it has not returned to significant economic growth. It did so with a combination of limited, half-hearted structural reforms and rising revenues. Yet the core of the system of political patronage with its destructive socio-economic effects has largely been left untouched. The socio-economic situation in BiH remains unstable, and the social picture dire.

The situation has not developed into a more serious budget crisis or even insolvency due to a substantial rise in public indebtedness and credits from international financial institutions such as the IMF. This support continued despite growing political instability and the political elites’ persistent resistance to reform because of a lack of political will on the part of the international community, and particularly the European Union, to enforce reform conditionality through the lever of financial assistance. This has helped in the short run to keep the socio-economic system from collapsing and assured the survival of the patronage system as well as of the political elites that depend on it – but it is fiscally, financially, and socially unsustainable in the medium and longer term, as the social unrest of February 2014 suggests.

This situation made an outburst of social anger, the violent form it took, as well as its ultimate failure fully logical. Yet with none of the structural problems resolved after the end of the protests, the serious security risk stemming from the overall socio-economic situation and its political foundations remains high.

In order to prevent a renewed outburst of violent social unrest that risks being diverted into inter-ethnic conflict, international and domestic political actors should take a series of urgent steps:

Recommendations for the EU and IFIs:

- The EU and the IFIs must consistently use financial conditionality in order to push for structural economic and social reforms, not shy away from potential consequences, not compromise once conditions have been set, and remain united.
- The EU and the IFIs must set the sequencing of specific reform areas so that the foundations of the country’s patronage system are tackled first: reform of public administration and restructuring or privatization of public companies, reform of the social benefit transfer system, completing the privileged pension audit in the Federation, reforming the health care and pension systems, creating a social assistance system that targets those in real need, and so on.
- If the EU really wants to use the bottom-up pressure generated during the 2014 protests, it must stop bargaining over the reform agenda with domestic political leaders behind closed

⁶¹ Interview with IFI representative, Sarajevo, August 2015.

doors. Instead, it must establish a genuine partnership with BiH citizens by way of public outreach that spells out the socio-economic destructiveness of the current system and the concrete benefits for individual social groups (farmers, workers, unemployed youth, etc.) that will follow from the successful implementation of EU-conditioned reforms.

Recommendations for domestic authorities and social actors in BiH:

- Domestic political and government actors must focus their structural economic reforms on overcoming the fragmentation of the market and of economic policy in BiH – a precondition for joining the EU as a genuine single-market economy and for a growth-oriented economic policy. If such reforms prove impossible or ineffective in the existing institutional setting, competencies must be transferred to the State level and/or new institutions created, along the line of BiH's successful reforms that enabled exports of dairy products to the EU following Croatia's entry into the Union. The EU must take the lead in international support for such a reform approach, as it did with the 2008 partnership document.
- Another focus of domestically-driven and internationally-supported reforms needs to be on the establishment of a truly unified and free market in BiH. This must include special attention to commercial and labor legislative reform, the reform of banking surveillance institutions and of the entities' development banks, and the strengthening of various state inspectorate services (labor, industrial).
- The trade unions must undertake structural reform in order to free themselves from the internal domination of the public sector and their sectoral unions, supported by government measures that enable a higher degree of union organization in the private sector.
- Civil society must transform itself and move towards strategic advocacy on behalf of citizens and social interest groups. The international donor community must support such a shift by basing its funding philosophies on the need for real social change and the potential leading role of civil society.