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Article

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Economic Review: Journal of Economics and Business

Provided in Cooperation with:

Faculty of Economics, University of Tuzla

Suggested Citation: Lough, Joseph W. H. (2014) : A Model for Economic Growth in Bosnia and Herzegovina, Economic Review: Journal of Economics and Business, ISSN 2303-680X, University of Tuzla, Faculty of Economics, Tuzla, Vol. 12, Iss. 1, pp. 15-30

This Version is available at:

<https://hdl.handle.net/10419/193831>

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A MODEL FOR ECONOMIC GROWTH IN BOSNIA AND HERZEGOVINA*

Joseph W. H. Lough **

ABSTRACT

In the early 1990s, when the break-up of the soviet bloc spread to the Balkans, dominant neoliberal economic wisdom recommended swift privatization of public assets, deregulation, and dismantling of the social safety net. Building upon the research of one of neoliberalism's leading architects, this paper examines why enacting neoliberal economic and social policies in Bosnia and Herzegovina have led to outcomes contrary to those predicted by traditional neoliberal theory. We conclude by offering five policy recommendations that should, when enacted, reduce market distortions and yield significant economic growth.

Keywords: Economic growth, Neoliberal economic theory, New economy.

JEL: L13, O11

1. INTRODUCTION

Neoliberal economic theory holds that among the leading keys for unlocking prosperity in the nations within what was once Yugoslavia are the privatization of public assets, state budget reductions, largely through reductions in public outlays, and deregulation of private enterprise, including reductions in corporate taxes. Yet, if we listen carefully to one of the leading authorities in neoliberal economic theory, then these measures could have an effect nearly opposite from that intended. Capital flows downhill, from rich to poor nations, according to Robert E Lucas, Jr., Nobel Laureate and John Dewey Distinguished

Service Professor of Economics at the University of Chicago, when market distortions and irregularities are removed. So, if one of the side effects of lower taxes, privatization of public assets, and deregulation of private industry is to throw up barriers to market growth, it would be in the interests of policy makers to understand why. Building upon the rigorous mathematical modeling set out in Professor Lucas' instant classic, *Lectures on Economic Growth* (2004), this paper offers a rough outline of some of the leading impediments to economic growth in Bosnia and Herzegovina and proposes a set of steps policy makers could implement to remove these impediments.

Professor Lucas builds upon the traditional Cobb-Douglass production function $y = Ax^\beta$, where y is income per worker and x is capital per worker. But then he supplements the traditional model with factors that allow our model to more accurately capture human capital, technology per worker, technology and human capital, monopoly or quasi-monopoly effects, and spillover or networking effects. The results are quite astonishing. Obviously, in the absence of reliable data we can only conjecture how to weight these five factors; we do not even try. Still, the model itself is sufficiently robust to help explain why capital is not flowing downhill to the more attractive labor and production market of Bosnia and Herzegovina and is therefore sufficiently robust to generate provocative policy recommendations.

* Paper is published in *Proceedings from the Third International Scientific Conference – Economy of Integration (ICEI)*, entitled "Using knowledge to move from recession to prosperity", held in Tuzla in December 2013.

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Our approach to this problem is as follows. First, we situate Bosnia and Herzegovina within the context of what Robert Brenner has called an “economics of global turbulence” (Brenner, 2006), a period running roughly from 1965 to the present. Next, we then show how his period gave rise to a range of policy decisions whose overall effects were integrative for global financial markets, but socially and politically disintegrative. We then look more closely at the five key factors that Professor Lucas finds predictive of economic growth. Next, we review the Bosnian and Herzegovinian landscape in light of these five key factors. We then examine how the post-Cold War economy in Central Europe was shaped by the economics of global turbulence elsewhere in the world. Finally, I offer five policy recommendations built around our reading of Lucas. We conclude by showing that, while these policy recommendations may be difficult to implement, they are not out of reach.

The most serious challenge Professor Lucas sets before us may be to conceptualize in a mathematically rigorous way the weight we should give to market imperfections and distortions generated by what we call here “oligarchy” and “oligarchy-effects.” That is to say, we are looking for one (or perhaps two) factors, call them ω and ψ , which, when properly weighted, will yield empirical results that accurately capture distortions in employment practices, the awarding of contracts, executive compensation packages, production costs, prices, and purchasing that are widespread wherever “oligarchs” gain too much control over a market. Clearly, however, these factors also therefore are meant to model the seepage of institutional arrangements that optimally are independent and public – legislation, law enforcement, regulation, revenue collection, revenue distribution – from public hands into private hands. Such distortions, according to Professor Lucas, constitute a huge (and

eventually prohibitive) deterrent to free-market exchanges and so prevent capital from flowing downhill.

But first we must situate Bosnia and Herzegovina within the context of an “economics of global turbulence.”

2. THE ECONOMICS OF GLOBAL TURBULENCE

As Professor Brenner reminds us, “between 1965 and 1973, US manufacturers sustained a decline in the rate of return on their capital stock of over 40 per cent. Because the US manufacturing capital stock represented such a large share of the G-7 total, the G-7 economies sustained a fall in their aggregate manufacturing profitability of about twenty-five per cent in those same years” (Brenner, 2006, p. 99). The economics of global turbulence brought economists and policy makers to reexamine and eventually to dramatically revise their largely neo-Keynesian assumptions. These assumptions gave central banking authorities a central role in stimulating and, when necessary, cooling down their nation’s economies. However, as rates of profit began to slide, economists and policy makers began to suggest that less – not more – governmental intervention might be called for: less taxes, less active intervention in the monetary supply, fewer government-initiated macro-economic stimulus packages, fewer public assets, fewer government employees, less regulation, and so on. By expanding private enterprise and reducing public intervention and regulation, policy-makers believed they could recover the kinds of rates of profit enjoyed by investors from the late 1940s through 1965.

To understand why this proved problematic, we need only remember the conditions that held true during this fifteen-year period of economic growth. We need to remember that, from 1929 to 1945 economically there were three games in town: Germany, Japan, and the

United States. And then there was one, the United States. Obviously the post-war period brought extreme hardship to families in Europe and Asia. For investors, however, the sky was the limit. So long as the United States economy was strong enough to support both the supply and demand curves, there was no need for more than one player and one game. The United States produced both capital and consumer goods, primarily for itself, but also for emerging post-war economies in Europe and Asia. Through the Marshall Plan, the United States also helped reinvigorate the economies of Western Germany and Japan. But, then, in the late 1960s, an economic pattern that had not been seen for over thirty years suddenly popped up on the international economic radar; international global competition sufficient to begin to drive down prices, and to do so on a scale that actually began to eat into rates of corporate profit, not only in the United States, but throughout the capitalist free-market world (Brenner, 2006; Harvey, 2005).

What happened next is instructive not only for the leading economies of Asia, the European Union, and the United States, but also for the emerging economies of south central Europe in general, and for the newly formed nations that occupy the territory of the former Yugoslavia in particular. As rates of profit for investors in the world's leading free-market economies began to decline, policy-makers began to question the neo-Keynesian wisdom under which they had been operating since the 1930s. To be sure, they did not doubt all macroeconomic wisdom. They still believed that only sufficient demand could provoke ongoing, sustainable growth in the long run; and they still believed that sufficient demand could only be maintained by aiming as near as possible to full employment with money calibrated to reflect actual economic growth. None of this had changed. What had changed was the rates of profit, a function of constant or rising costs combined with declining prices

and lagging or constant demand (Brenner, 2006).

Were rates of profit declining in one nation or region, and not another; or, in the alternative, were rates of profit increasing in one nation or region, and not another, then investors would have had an answer to their problems ready to hand. We could then shift investments in favor of emerging, low-cost, high-return markets. Or, again, were it a simple matter of burdensome taxes or regulations *within one national market*, then there might have been legislative solutions ready to hand. Yet, because the declining rates of profit were due to increased international competition among global free-market economies, tinkering with the regulatory and taxation mix in any one of these markets would only have limited, ephemeral consequences for the overall climate of global investment.

It was in this environment, in 1971, facing what he thought could be a serious Democratic challenge in the upcoming presidential election, that President Richard M. Nixon decided to take the dollar off the gold standard and, in effect, drive down its value. The results were nearly instantaneous. In what was still the largest consumer market in the world, the price of foreign imports suddenly sky-rocketed. Adding insult to injury, the United States President imposed an additional 10 percent tax on all imports. The price of goods produced in the United States dropped. And, at least for the moment, US job figures, which had either declined or remained stagnant, began to rise. With historically unprecedented support from Democratically aligned organized labor, the Republican candidate Richard Nixon retained the White House (Frieden, 2006).

But, for our purposes, the significance of the American president's decision was not that it gave a momentary, fleeting bump to the US economy. It was significant because it signaled

the end of Bretton Woods, the set of international agreements that had aimed to prevent the kind of economic crisis that in 1929 had sent the global economy into a tail-spin and, many economists believed, had led directly to the spread of extreme politics in Asia, and in central and western Europe. By pegging the US Dollar to the gold standard, Bretton Woods had, albeit indirectly, made sure that the *de facto* global currency, the dollar, would maintain its value, irrespective of the decisions of political leaders elsewhere in the world. When President Nixon took the dollar off the gold standard, he signaled the dawn of an age where the dollar's value, like the value of any other commodity, would be governed by the decisions of buyers and sellers. Now all that stood between the modern global economy and 1929 was a set of laws and regulations preventing investors from speculating with the federally insured deposits of their clients. But, if the dollar itself was subject to speculation on the global market, why insulate depositors from the risks and opportunities enjoyed by other investors around the world? Why indeed.

3. INTEGRATIVE AND DISINTEGRATIVE EFFECTS OF THE NEW ECONOMY

In his *Lectures on Economic Growth* (2004), University of Chicago economist Robert E. Lucas, Jr., invites us to explore why, contrary to the expectations of classical economic theory, capital does not flow down hill. His answer is that *in the long run* capital *does* flow down hill; but not on its own. Before capital can flow down hill, not only must market distortions and impediments be eliminated, but conditions conducive to growth need also to be created. So, for example, it is insufficient to rid a region of its oligarchs, warlords, traditional religious practices and local superstitions, or to eliminate its purely local laws and customs. In addition, networks of communication and transportation need to be established; independent, "universal" legal institutions and laws need to be created and

protected, and buyers, sellers, and investors need to enjoy and actually take advantage of sufficient education, knowledge, and networking opportunities to create real wealth and economic growth. What Lucas has shown is that those regions that successfully eliminated purely local characteristics that distinguished them from other regions – nobility, monarchy, clergy, religious beliefs and practices, local customs and traditions – and established laws, regulations, and institutions that aimed at the unencumbered flow of goods, services, and financial instruments enjoyed a significant economic advantage over those regions that were slow to make this transition (Lucas, 2004, pp. 112-122).

The bad news, of course, is that those regions that were early adopters of capitalism were not inclined to wait for other regions to catch up before imposing on them, often with a considerable use of force, institutional arrangements that, at least initially, exaggerated the differences between early and late adopting regions. So, for example, as Figure 3.1 shows, the gap separating the most developed from the least developed economies in 1750 was virtually non-existent, by 1900 this gap was huge and only really began to narrow mid-way through the twentieth century (Lucas, 2004, p. 20).

In the mean time, taking the beginning of the sixteenth century as our bench-mark, the early-adopter nations of Europe adopted exploitation strategies around the globe that, given their relative size, added to efficiencies of over-all global production, but often heightened inefficiencies in the regions from which they were drawing labor and extracting wealth or in which they were creating markets. That is to say, if the creation of strong independent legal and regulatory institutions or fostering transportation and communication, or cultivating an educated public are all necessary for growth, the early adopter regions of Europe were slow to see

why they should adopt policies to promote economic growth in the regions from which they were drawing labor and raw material. After all, it was from their exploitation of these regions that they were creating overall efficiencies. This helps to explain why many early adopter regions saw it in their interest to foster the creation or maintenance of the very regressive institutions – oligarchies, nobility, clergy, warlords, arbitrary legal frameworks – whose elimination had been essential for economic growth in Europe (Lucas, 2004, pp. 67-70).

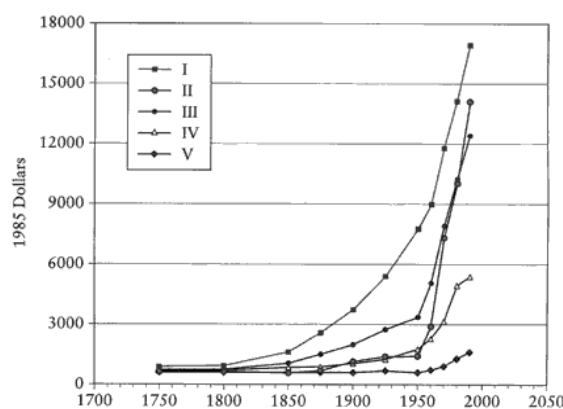


Figure 3.1 GDP per capita, five regions (Lucas, p. 119)

| 1990 in millions | Population |
|--|------------|
| I UK, USA, Canada, Australia, New Zealand | 354 |
| II Japan | 124 |
| III France | 184 |
| IV Rest of Western Europe, Latin America, Eastern Europe, Soviet Union | 986 |
| V Asia (except Japan), Africa | 3590 |

The good news, of course, is that over time, as regions abandoned their traditional religious, social, political, and cultural frameworks, and as they adopted frameworks enjoying universal recognition, these regions have

experienced the kind of economic growth experienced wherever regions have been willing to give up their local customs, traditions, beliefs and practices. Thus, using the model of diffusion of the industrial revolution proposed by Robert Tamura (1996), Lucas (in Figure 3.2 below) has shown how since 1800 the fraction of economies in the world enjoying growth has increased exponentially, approaching universality in 2000 (Lucas, 2004, pp. 100-101).

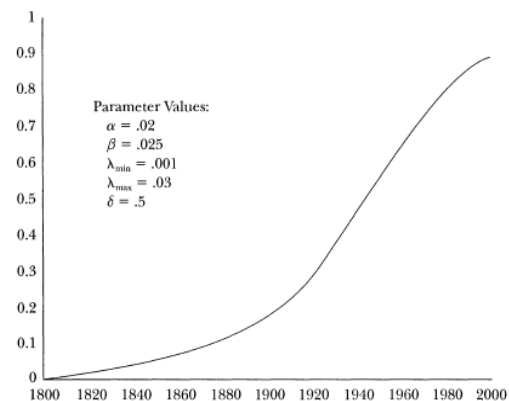


Figure 3.2 Fraction of economies growing, by year (Lucas, p. 101)

This is good news, indeed, if the growth that Lucas observes is sustainable, which he believes it is. Yet, as is so often the case in economics, the devil is in the details. This is because, in order to approach unity, Lucas not only theorizes the elimination of local practices, traditions, and customs (for example, deeply held religious practices effecting public institutional arrangements), from which it might be difficult to wean many members of Bosnia and Herzegovina society; he also theorizes the end of historical and social legal and institutional specificity. What, in fact, would it take to bring Bosnia and Herzegovina fully into the global market in such a manner that it would be at the bottom of the hill down which capital is flowing?

4. FIVE FACTORS OF ECONOMIC GROWTH

In his *Lectures*, Lucas invites us to consider several obstacles that may stand in the way of

the downhill flow of capital into Bosnia and Herzegovina. The first obstacle to consider revolves around differences in human capital. Building upon Anne Krueger's 1968 study, Lucas calls attention to the contribution any given worker's age, level of education, and market sector makes to his or her productivity when compared to a comparable worker in the US. If a standard Cobb-Douglas type model, absent any factor measuring human capital, yields a 58-fold investment advantage (in this instance) to India, factoring in human capital reduces that advantage dramatically to a mere 5-fold advantage. Nevertheless, were there in fact a 5-fold advantage for investors who chose to invest in India, then this would still fail to explain actual investment patterns.¹ To human capital Lucas therefore adds a second factor, which he calls "the external benefits of human capital" (Lucas, p. 65).

There is very little mystery to the operation with which Lucas invites us to supplement the initial model. Every worker enjoys the advantage of a certain level of technology. So the question is, how can we estimate the contribution that any given level of technology makes to the production function across countries? Although it yields only a rough estimate, Lucas assumes that any economy's technology level "is just the average level of its workers' human capital raised to a power" (Lucas, pp. 65-66). In Lucas' example comparing India to the United States, after factoring in the contribution made by technology Lucas arrives at a factor not of 58, or of 5, but of 1.04; that is to say, capital invested in India would enjoy a productive advantage of just over .04, which is much nearer still to actual experience. Yet, it still falls short. To account for this shortfall, Lucas therefore invites us to consider what he calls "capital market imperfections."¹

Here, as an example, Lucas calls our attention to the ways that capital investors under imperial conditions in the first half of the 20th century regularly enjoyed monopoly control

over the conditions of their investment; for example, over the wages they paid under non-competitive conditions to their workers, or over the sums they would have to pay to local oligarchs for use of land or for systematic violation of local laws and customs. In the case of monopoly wage controls and what were in effect rents based upon the forced seizure of land from local occupants, investors could reap fairly high returns on their investments without the local occupants themselves enjoying a dramatic increase in wealth or economic growth. Supplementing the Cobb-Douglas production function with a factor reflecting the kinds of returns investors might reasonably anticipate from near monopoly control over various capital flows under imperial conditions, Lucas arrives at a factor of 2.5.² This, explains Lucas, helps to explain "many of the institutional features of the colonial era: the carving up of the Third World by the European powers, and the frequent granting of exclusive trading rights to monopoly companies" (Lucas, p. 69). Absent such advantages, Europe's imperial powers would have been hard-pressed to find willing investors.

If we take Lucas' invitation at face value, we should be interested in learning more about possible comparative advantages investors might enjoy (or disadvantages they might be expected to encounter) in these three critical areas in Bosnia and Herzegovina: (1) the quality and character of human capital; (2) the technology this human capital can leverage; and (3) the market imperfections that could redirect economic growth either to local oligarchs (and hence diffused "politically" or reinvested abroad) or back to the capital markets of origin. In order to complete the picture, however, to these three we should also add two other factors Lucas implicates in downhill capital flows: (4) "learning by doing," the observation that up to a point workers become more proficient and more productive through "hands-on" or "minds-on" repetition

of any specific process; and (5) networking and spill-over, or the observation that the density and mobility of workers in settings conducive to exchanging ideas and information increases productivity.

As anyone familiar with post-Yugoslavian Bosnia and Herzegovina will quickly realize, each of these factors plays and will continue to play a central role in the sustained growth of the Bosnian and Herzegovinian economy. Yet, before we can consider precisely how the hand is likely to play out, we need first to return, uphill as it were, to the source from which this water, *capital*, needs to run downhill; to the capital markets which, when we left them in Section 2, were struggling with lagging rates of profit.

5. THE NEW ECONOMY AND THE OPPORTUNITY OF 1989

Economists have long recognized that insofar as the declining rates of profit that investors in free-market economies began to experience in the late 1960s were a global and not simply a regional or national problem, our search for the mechanism generating that decline must itself be global. This, at bottom, is why explanations that begin with the high costs associated with maintaining the social welfare state are insufficient. Economists point out that while the declining rates of profit were experienced globally, the costs of maintaining the social welfare state ranged from the relatively small public contribution to social welfare found in the US to the, by comparison, inconceivably large contribution made in Sweden, Holland, Norway and elsewhere in western Europe. Moreover, since this contribution bore no relationship to rates of profit in these nations and regions, a case cannot be made that these rates were effected by the specific social welfare policies in place in each given nation or region.

A far more cogent argument could be made, at least in the United States, that the political

decision not to fully fund the substantial expansion of the US Defense and State Department budgets throughout the 1960s, combined with the equally costly decision not to publicly fund health care, education and transportation placed a serious drag on the world's largest economy. Indirectly, these significant costs in the US surely helped Germany and Japan, both of which enjoyed relatively low health care, education, and transportation costs, to catch up more quickly than they might otherwise have caught up. Moreover, because of the size of its economy, the debt the US decided to carry helped to enhance the attractiveness of the financial instruments and potential financial instruments bearing that debt. In other words, as rates of return on investment in industry began to fall, the attraction held by instruments carrying debt grew in direction proportion to the rates of return investors could make on those instruments. There was only one problem: Glass-Steagall.

Glass-Steagall characterizes a body of legislation originally passed in the US in 1933 that insulated federally insured deposit accounts from the kinds of speculative, high-risk investments that proved particularly susceptible to market failures such as those experienced in 1929, 1987, 2000,¹ and, most recently, 2007. So long as these protections were in place, investors could not use the savings in federally insured deposit accounts to reap the high returns available in the more speculative, high-risk markets. And, so long as investors could not place these funds at risk, they were limited to the historically lower rates of return available for such funds in "safe" investments. Gaining access to these funds therefore became a top priority for friends of the investor community in the US Congress.

¹ These protections were annulled in 1999 with the passage of the Gramm-Leach-Bliley Act.

Significant progress toward repeal of Glass-Steagall was made in the 1970s when bank regulators adopted a sympathetic view toward the increasingly speculative investments banks and their affiliates were making with their clients' deposits. Competition among consumer banks for deposits to devote to these high-risk investments helped drive up the returns promised to consumers willing to take the risk. Besides, the deposits were federally insured.

After the election of Ronald Reagan in 1980, Reagan appointees set to work pressuring agencies responsible for regulating the banking industry to let the work of private investment perform its magic; which, albeit in a limited fashion, it did, not by attracting investments in high wage consumer goods industries such as steel and automobiles. Nearly the opposite; investors were instead encouraged to place their bets either on high-return, but also highly-speculative, financial instruments, or on off-shore industries in countries whose lack of worker protections allowed them to produce the same products at a fraction of the cost of European or North American workers. Private investors with sufficient resources "made it big." But workers that in the 1960s had enjoyed a living wage, benefits, and a pension now suddenly found themselves working for minimum wage, no benefits, and no pension in the service and fast-food industries.

The economy was expanding. So too were returns on investment. Yet, since these returns were coming from investments whose value was, at best, difficult to accurately measure, in industries that produced few if any jobs and often had no product to show at the end of the day, these "unknowns" did little to put a tamper on what one Fed Chair accurately described as "speculative exuberance." The global economic expansion of the 1990s had nothing whatsoever in common with the post-war boom, when a

superfluity of idle American assets underwrote an explosion in consumer spending in the United States and fueled the post-war industrial expansion in Germany and Japan. Where it was not completely speculative, which the bubble of 2000 proved mostly to be, the economic expansion in the 1990s left most workers around the globe with less purchasing power at the end of the decade than they had enjoyed a decade earlier. Moreover, this was true not only in the United States and Canada, but throughout all of the world's free-market economies.

But the policy-makers who had engineered the neoliberal revolution of the 1980s in the West were not finished yet. They had a job to do.

Economics professors often remind perplexed undergraduates that, so long as someone, somewhere is willing to purchase debt above its face value, there is no reason not to count that debt an asset. And on these grounds alone, Western Europe and North America were flush with assets; sufficient assets to outspend and out-consume their Soviet-bloc counterparts several thousand fold. In addition, we should not forget that, following a post-war boom of their own, Soviet-style economies were showing many of the same strains as their free-market counterparts. Indeed, in most respects, the strains experienced by Soviet-based economies were far more severe since these economies benefited little from the market efficiencies enjoyed by participants in the free market. But, while explaining the causes for these strains may be complicated, explaining their consequences is much more straightforward.

Beginning in the 1970s, the command economies of Central and Eastern Europe began to tire under the weight of having to plan every small detail of production. Moreover, maintaining the apparatus of a quasi-police state proved overly burdensome for most of these economies.² So, finally,

beginning in the late 1980s, one after another, mostly peacefully, one nation after another replaced one-party rule and central planning with multi-party elections and free-market or mixed market relations.

This is not the place to review what is by now a familiar story. Rather is it to explore the not entirely serendipitous confluence of the appearance of neoliberal economic policies in Western Europe and North America and the fall of the so-called “iron curtain.” As we know, the fall of the Berlin Wall and the opening up of Central and Eastern Europe and Russia fed into investor fantasies of hordes of cheap workers and untold mineral wealth and other public assets sold at bargain basement prices to eager investors in the West. Needless to say, the sale of these assets was not followed by a wave of hiring by newly minted industrialists. Rather was it followed by plant closures and social and political upheaval. Formerly communist states recovered most quickly only in those regions where the public managed to hang on to its assets, where strong public institutions and laws were upheld, and where state officials were able to forge mutually beneficial trading arrangements with the West.

Elsewhere the consequences were much more uneven. Where capital was not successful in knitting communities together, where it closed factories and sold off public assets but failed to produce employment, communities did not simply disintegrate or disappear. Rather were the members of these communities thrown back upon their individual differences and chance solidarities. When strong public institutions failed to materialize, newly individuated communities began to view their differences with one another, in the absence of integrating markets, as the only significant integrative force holding them together.

Here we can appreciate how the disintegration of economic communities in

Central Europe was the price investors were willing to pay in order to recover the historically high post-war rates of profit experienced from the late 1940s through the late 1960s. Indeed, the speculative investments generated by the collapse of former soviet countries helped pad private investor portfolios and so helped sustain rates of profit built largely on high-risk securities. Eventually the bubble would burst. In the meant time, part of the economic success story for Western European and North American investors during the 1990s could be built upon depredations of resources once owned by the public in Central and Eastern Europe (Harvey 2003). For most former workers in Central Europe in the 1990s there was no economic miracle. For many, instead, there was war.

6. WHY CAPITAL IS NOT RUNNING DOWNHILL TO BOSNIA AND HERZEGOVINA

There is space to consider the complex relationship between economic hardship and nationalism or between nationalism and war. We might nevertheless note how repeatedly and consistently since the late eighteenth century, the French Revolution, and the Napoleonic Wars, political elites have leveraged nationalism to seize power from their enemies. This is the place, however, to consider the barriers nationalism places in the way of the free flow of capital. Moreover, when they deliberately challenged the regulatory authority and powers of public institutions, western investors helped strengthen private local oligarchs who were inclined to divert financial resources away from the free market either into private bank accounts or into investments abroad. To complete the circuit, the fund of human capital, which might have provided a nascent network of industrial intelligence and production know-how, quickly realized that they could leverage their educational achievement far more efficiently and

effectively elsewhere in the global marketplace.

Is capital running downhill to Bosnia and Herzegovina? Not yet. But, why not?

If we consider the five functions that Lucas recommends we add to the standard Cobb-Douglas production function, we can begin to develop a consistent, compelling, and robust explanation not only for why capital is not running downhill to Bosnia and Herzegovina, but also for the kinds of institutional, legal and regulatory arrangements that would have to be instituted in order to open the flood-gates.

Below, in Section 8, we will offer our own policy recommendations. However, albeit in a preliminary manner, we can already see how, for example, the function of human capital might be shaped by specific conditions in Bosnia and Herzegovina. Unless economic actors, both public and private, can adequately incentivize the retention of human capital in Bosnia and Herzegovina, the federation will continue to suffer a steady and eventually fatal drain of human capital to Serbia, Croatia, Slovenia, Austria, Germany and other members (or soon to be members) of the European Union. Yet, incentivizing human capital is much easier to theorize than to execute. Investors are not likely to competitively compensate human capital in the absence of sufficient assurances not simply of basic legality, but also of infrastructural supports – e.g., the means to fairly enforce contracts, collect and distribute revenues, efficiently and accurately transport information, goods, and services – without which incentives become inefficient. In other words, investors would be foolish to offer incentives in exchange for human capital that they are not able to cover with receipts. But these receipts are not likely to be generated in an environment where basic infrastructural supports are lacking. Nor are such supports likely to appear where leading political and economic actors are eager to deprive public

institutions of the independence and resources they need to efficiently and effectively execute their public responsibilities.

These distortions that impede or impair the most efficient and effective leveraging of human capital also, obviously, distort how effectively and efficiently human capital can leverage technology. As capital goods and human capital flee from Bosnia and Herzegovina, this leaves a captive workforce in place that is either heavily leveraged by the oligarchy, whose capital resources are largely unproductive, or a workforce unable to technologically enhance its productivity–i.e., unskilled or semi-skilled labor. Such a workforce may be suited to operate simple equipment or staff service enterprises, but it will not be suited to generate the kind of qualitative economic growth contemplated in Lucas' model.

The proliferation of market imperfections in Bosnia and Herzegovina is a third area of concern. According to Lucas, such imperfections proliferate where un- or under-regulated investors are encouraged to take advantage of opportunities under monopoly or near-monopoly conditions. Such conditions proliferate wherever public institutions are either too weak or are insufficiently independent to effectively regulate local or regional oligarchies. Because and to the extent that such oligarchies come to occupy nominally “public” offices, they invariably “siphon off” and redistribute scarce revenues to loyal patrons, thereby frustrating the smooth, efficient, and effective functioning of free markets. These effects, however, are compounded by the recognition among other “non-connected” market actors that, in order to “play the game,” they must ignore the rules that govern normal markets and must, instead, build relationships with members of the local oligarchy. Lastly, however, the character of these market imperfections create a feedback loop that further

undermines confidence in the rule of law and the ability to enforce contracts.

This leaves Lucas' final two functions: "learning by doing" and "networking and spillover." For it might still be possible for an unskilled or semi-skilled Bosnian and Herzegovinian workforce to become highly skilled at repeating and refining a limited range of productive activities, which, precisely because of their repetition and attention to detail, could yield marketable efficiencies. There is no reason, for example, why Bosnia and Herzegovina could not become relatively efficient in a wide range of industries that, precisely because of the comparative advantage that they enjoy in wages, they could develop as their forte. Yet, if Lucas is right, then the only major impediments to leveraging this "learning as doing" may be the comparative advantage that human capital enjoys in contiguous regions (and therefore the mobility of human capital) and the moral hazard initiated by the oligarchy. This leaves the spillover and networking effects.

The advantages that accrue from spillover and networking are considerable. But they depend on a relatively free and well-regulated market and can be easily frustrated by the interposition of oligarchic rules and regulations. Where oligarchic rules and regulations predominate, human capital is likely to take advantage of spill-over and networking effects either to reinforce the political power of an associated oligarch or to leverage its knowledge in pursuit of incentives outside the national market. Neither of these strategies, however, work to expand economic growth. To the contrary, both lead to economic contraction or stagnation.

7. THE COSTS OF SUCCESS: WHY THE LONG DOWNTURN?

On one level, the story we are telling here will strike none of us as in any way odd or unusual. We know both theoretically and

mathematically that the post-World War II boom in investment was based upon an historical anomaly: the singularity of the US market and the Bretton Woods system it created. And so we also know that eventually investors would be disappointed once recovery put Asia and Germany back into the mix. And therefore we might have suspected that investors would begin to tinker with the neo-Keynesian arrangements forged during and immediately after the war and that they might pursue what some, with good reason, have termed a global "neo-colonialist" strategy (Hardt and Negri 2000). That Central and South Central Europe were among the leading candidates for exploring this strategy comes as a surprise to no one.

The free-market Western economic powers found themselves at the end of the 1960s in a straightforward economic dilemma. The United States had ridden the economic misfortune of Great Britain and Germany to its logical conclusion. In 1944, at Bretton Woods, John Maynard Keynes effectively ceded global economic supremacy, albeit with great reluctance, to the United States. The United States enjoyed an overwhelming economic advantage over every economic power around the globe, not only insofar as it had benefited greatly from running at full productive capacity throughout the war, but also insofar as it was now the universal banker of the world, eagerly seizing this opportunity from the United Kingdom.

But, the US Congress' decision to back the Marshall Plan was driven not only by the recognition that long-term US economic growth depended on robust markets in Asia and Europe, but also on pragmatic fears that France and perhaps Germany and Italy might adopt socialist or even communist economic systems that would be less than fully receptive to a flood of US consumer goods and capital. President Truman therefore marketed the Marshall Plan not only as an avenue to generate demand for US capital and consumer

goods, but also as a hedge against socialism and communism. It worked.

But it may have worked too well, since it successfully generated economies that, by the late 1960s, were actually competing successfully with US producers. The downturn in the global economy that followed upon German and Japanese competition created a taste for financial instruments that by-passed the expected macroeconomic pathway of investment, production, sales, consumption, and profit. Investment in debt – and in United States Debt – created an entirely new environment of wealth creation. It also created an entirely new playing field for competition with economies aligned with the Soviet Union. Whereas most of these economies were still thinking about the provision of consumer goods for party members and/or compliant citizens; in the rechristened economies of the West attention had turned from the neo-Keynesian satisfaction of consumer demand to the insatiable demand of private investors. The playing field had changed. And everyone knew it.

When in 1989 the Berlin Wall fell and Central and Eastern Europe were effectively incorporated into the global market, investors naturally anticipated that all assets on the other side of this wall were up for sale. In a very real sense, western investors completely forgot the two hundred years of institutional history that placed “the rule of law” and “the independence of public institutions” at the center of their social and economic system. They believed, magically, that the free market, by itself, without any history, would generate the institutional arrangements that they were simultaneously busy destroying. And so they mistakenly thought that by snapping up public resources and by undermining the authority and independence of public institutions, they were actually strengthening the private mechanisms that would make Bosnia and

Herzegovina independent and strong. They were wrong.

8. FIVE POLICY RECOMMENDATIONS FOR ECONOMIC GROWTH

Although it may seem counterintuitive, the promotion of neoliberal policies and perspectives in Central Europe may actually have placed an impediment in the path to Central European economic growth. In 1989, more than anything else Central Europe needed robust independent public institutions capable of enforcing the rule of contract law and of extracting and distributing public revenues. They needed independent public authorities able to stand up to the oligarchy. And they needed a strong and militant bourgeoisie, backed by coercive force, sufficient to stand up to and resist the nationalisms proliferating throughout the region. When they facilitated and even encouraged the dismantling of robust, independent public institutions, western investors promoted the very institutional forces that historically have resisted the spread of free-market institutions. In so doing, they also frustrated the economic growth of Central Europe in general, and Bosnia and Herzegovina in particular. Their policy preferences delivered Bosnia and Herzegovina over to local oligarchs whose economic interests were other than those of the public at large.

This historical macroeconomic analysis yields a stern imperative to the independent bourgeoisie in Bosnia and Herzegovina. This imperative follows directly from the analysis of one of neoliberalism’s most celebrated authors, Robert Lucas, Jr., University of Chicago Professor of Economics. In order to cultivate human capital in Bosnia and Herzegovina, its independent, educated bourgeoisie need to vigorously pursue the following policies:

- 1) *Correct capital market imperfections arising from oligarchic-type effects.* Everyone acknowledges that “informal,” non-competitive professional appointments, hiring, advancement, compensation, pricing, and contract awards are a serious problem in Bosnia and Herzegovina. When these decisions are made on any grounds other than merit, this results in serious, debilitating, and often fatal market imperfections. Nowhere, however, are oligarchic-type effects more damaging than under the monopoly or quasi-monopoly conditions that prevail in Bosnia and Herzegovina, where capital markets are heavily weighted towards institutions and individuals that are on public record in opposition to what has rightly been termed “universal law” (Jemielniak and Miklaszewicz 2010). Such institutions, laws, and regulations enjoy broad if not universal recognition among the comity of nations; and this means that they resist attempts to carve up public space into its respective, purely local and accidental particularities. *For nothing is more noxious to economic growth (and more friendly to oligarchic rule) than the distortions, anomalies, and market irregularities introduced by what is purely particular, individual, and, therefore, easily lends itself neither to public ownership nor private exchange, but only to the cynical exercise of raw power.*
- 2) The second step toward sustainable economic growth in Bosnia and Herzegovina will entail *an all out effort to cultivate human capital.* Again, the key to success falls to the educated bourgeoisie and their commitment to economic growth. As everyone in Bosnia and Herzegovina knows, the country’s institutions of learning are in a serious state of crisis. Content at primary and secondary schools is often dictated less by what students need to master in order to succeed at university or technical school than by purely local, particular, or individual interests of families, communities, and towns. Similarly at Universities, academic chairs and faculty are all too often the spoils of politics and not the rewards of independently reviewed and adequately vetted academic scholarship. These practices introduce distortions into the marketplace where human capital is created from which it will be difficult for Bosnia and Herzegovina to recover. As a remedy, the independent educated bourgeoisie needs to fight furiously to establish a core network of schools that offer a universal education to students from families who want their sons and daughters to enjoy the benefits of adequate university and technical school preparation. These schools will then prove their value by their superior preparation of students for universities whose boards of directors are committed to protecting knowledge and learning from the corrosive effects of private economic self-interest.
- 3) Yet, as Lucas has shown, the best human capital will naturally migrate to regions where it enjoys the optimum compensation package. Therefore, the independent educated bourgeoisie in Bosnia and Herzegovina must *adequately incentivize its human capital.* Again, this should be a lot simpler than it may at first appear. Given the substantially lower cost of living in Bosnia and Herzegovina, employers can offer employees much the same basket of goods, services, and rewards offered in more costly markets for substantially less. Moreover, in light of increasing efficiencies, employers should be ready

to offer employees incentives such as free time, education, and training that take advantage of the growing gap between necessary labor time and value created per hour of labor. Recognizing that human capital in Bosnia and Herzegovina will want the same benefits at home that they will enjoy in, say, Austria or Germany, it is also important for employees to recognize that these same benefits come with a much smaller price tag in Bosnia and Herzegovina than elsewhere.

- 4) Fourthly, the independent educated bourgeoisie in Bosnia and Herzegovina need to *invest in the next generation of technological innovations, including nanotechnology and robotics*, if they hope to compound the productivity of a new generation of human capital. This will mean resisting the pull toward the proliferation of low-wage, low-benefit service, retail, and fast-food jobs and attracting investment in high-speed transportation, communication, information, medical technology, and manufacturing. Such investments have the added benefit of seeding the independent educated bourgeoisie, which, historically, has been far more successful at standing up to entrenched oligarchies than minimum-wage, unbenefited, service and retail workers.
- 5) Finally, the independent educated bourgeoisie needs to step up efforts to *secure independent reliable sources of information and intelligence*. This entails more than the ability to access the Internet. Well-informed, intelligent consumers of goods and information feed off of and in turn feed into networks whose collective industrial intelligence is strengthened by the proliferation of independent, reliable sources of information and intelligence. Here, the content published and

broadcast by privately owned, privately interested, media in Bosnia and Herzegovina ought to be of deep concern to the independent educated bourgeoisie since it reflects the intelligence and levels of information in the public at large. Bad information distorts markets perhaps even more effectively than monopoly control. Indeed, the one feeds upon the other. Reliable information and intelligence, by contrast, cascade with spill-over effects and seepages that cannot help but facilitate economic growth.

Obviously these are not all of the policy decisions that need to be secured by Bosnia and Herzegovina's independent educated bourgeoisie. But, building upon Lucas' *Lectures on Economic Growth*, these may be the leading policies that will need to be enacted if we are to see long-term, sustainable growth in the region.

From here, however, there is a relatively easy path to economic growth. Once we have established independent public institutions with sufficient authority to enforce contract law, and extract and distribute revenues, there are few barriers to prevent investors in Bosnia and Herzegovina from reenacting the Korean miracle of "learning by doing" (Lucas, pp. 71-96). Not only is this miracle well within the reach of global investors, but, given the wage structure in Bosnia and Herzegovina, it would be a miracle were "learning by doing" not to take its natural course. Moreover, did all of these other institutional constraints enjoy support, there is no reason why networking and spill-over effects would not benefit Bosnia and Herzegovina (rather than Austria, Germany, or Serbia).

9. CONCLUSION

None of this should suggest that the path forward will be easy. Any promises of painless growth are spurious. The oligarchy in Bosnia

and Herzegovina is strong. Independent public institutions with sufficient authority to enforce the law are weak or nonexistent. Independent institutions of learning are poorly funded and under constant pressure to yield to private pressure. The attraction of human capital to migrate to more efficient markets is real.

The challenge in Bosnia and Herzegovina is to reign in the oligarchy and reinvigorate an independent, robust, empowered public sphere. On the one hand, there is no project that drives the oligarchy more than occupying and completely compromising the public sphere. This is because their returns on investment rely on rent and not on productivity *per se*. On the other hand, the independent, educated middle classes clearly hold a stake in depriving the oligarchy of its power. Yes, they *can* move . . . to Austria, Germany, and beyond. But, they can also stay and fight. The question, therefore, that we need to raise both to public and private international investors is where they stand in this fight. Are they supporting the oligarchy, in which case they are on record against economic growth in Bosnia and Herzegovina; or are they supporting robust, independent public institutions capable of enforcing the rule of law?

As in every nascent democracy, the decision between these two approaches falls to the bourgeoisie. They will decide between the oligarchy and the rule of law. What is surprising – perhaps even astonishing – is that this choice is presented to us by one of the architects of neoliberal economic policy and theory. Perhaps we should listen.

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¹ Lucas reaches these numbers by supplementing his revised production function $y = Ax^\beta h^\gamma$, “where y is income per effective worker, x is capital per effective worker, and h is human capital per worker,” with a formula for the marginal productivity of capital: $r = \beta A^{1/\beta} y^{(\beta-1)/\beta} h^{1/\beta}$ (Lucas, p. 66). He interprets h^γ as an external effect. He then uses Edward Denison’s (1961) comparison of US productivity in 1909 and 1958 to estimate γ and uses “[Anne] Krueger’s cross-country estimates of relative human capital stocks in 1959 to obtain a new prediction on relative rates of return on capital” (Ibid.). Plugging in these figures to compare the US with India, “the predicted rate of return ratio between India and the US became $(3)^{1-\beta} 5^{-1} = 1.04$ ” (Ibid.).

² While it falls outside the purview of this article, it is worth noting how slow economists have been to recognize formal and therefore analytical similarities between the command economies of the soviet bloc and free-market capitalist economies in Asia, Western Europe, and the Americas during the twentieth century. No doubt this is in large measure due to the ideological fog that once hung over economic science. Still, if we allow that the central feature of capitalism is the role that labor plays in shaping value (Smith, p. 34), there is nothing preventing us from exploring along something like Marshallian lines, the distortions accruing to value formation from the multiple political and institutional interventions imposed between demand and supply. At the end of the day, both goods and credits in these labor-based economies could not

help but find their value in labor, which certainly helps to explain why, given the added weight labor was made to bear, these economies found it impossible to compete with their labor-based cousins in the free-market world.