

MA Politics and Economics of Contemporary Eastern and Southeastern Europe

Department of Balkan, Slavic and Oriental Studies

MASTER THESIS

Regional Competitiveness and Growth Strategy in Western Balkan countries- The case of FYR Macedonia, Serbia and Albania

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Abstract

For the Western Balkan countries, the transition from socialism to capitalism and democracy was less smooth than in other parts of Emerging Europe. Once the war ended and peace returned, these countries did more than rebuild: they began a transformation into market economies, liberalizing prices, privatizing many state- and socially-owned enterprises, and building the institutions needed to support a market economy. Nevertheless, progress over the last two decades has been evident in every country, resulting in rising incomes and living standards.

Perhaps the most tangible achievement of all lies in the fact that most of the Western Balkan countries are on a path towards European Union accession, something that seemed far off in the 1990s. It is incumbent upon us not to understate the serious challenges that lie ahead, both in terms of macroeconomic stability and even more so with regard to longer-term development.

Yet, I remain confident that the region will rise to the challenge, as happened time and again in the past. Western Balkan countries understand that, without macroeconomic stability, there can be no hope of durable growth.

Introduction

The countries of the Western Balkans have undergone a major economic transformation over the past 15 years, and many are unrecognizable compared with where they stood at the turn of the century. Following the conflict-ridden 1990s, these countries set out to comprehensively rebuild and reform their economies. They opened up to global trade and became increasingly export-oriented, expanded the role of the private sector, dismantled regulations that stifled business development, and began to build institutions needed to support a market system. Banking systems were built up—literally from scratch in some cases—with the aid of foreign capital and know-how. The result of these efforts has been robust economic growth, a significant rise in incomes and living standards, and enhanced macroeconomic stability.

Growth in the post crisis period in the Western Balkan countries has been uninspired. The external environment has been weak, but it is the incomplete reform process that is holding back convergence to income levels of richer European Union economies. And faster growth, in itself, may not be enough. The Western Balkan countries also need to generate jobs to reverse the weak labor market outcomes that are leaving so many behind.¹

The fundamental problem of low productivity reflects years of under-investment, weak institutions and a difficult business environment. The private sector is the main contributor to economic output in all countries; nevertheless, the state retains a dominant role in key industries in several countries of the region, and a significant privatization agenda lies ahead. Small and medium-sized enterprises (SMEs) dominate the private sector and account for about two-thirds of value added on average.

Narrowing the gap in living standards will require an intensification of reforms needed for building sustainable market economies. Weak institutions and the absence of appropriate incentives for high levels of long-term productivity are at the heart of this prosperity gap. Countries in the region are a long way from

¹ Zuzana Murgasova, Nadeem Ilahi, Jacques Miniane, Alasdair Scott, Ivanna Vladkova-Hollar, and an IMF Staff Team. 2015. The Regional Economic Issues (REI) The WESTERN BALKANS- 15 Years of Economic Transition. ISBN: 978-1-49835-651-0

embracing a sustainable market economy, defined as one that is competitive, well-governed, green, inclusive, resilient and integrated. Comprehensive reforms are needed to promote a dynamic, vibrant private sector, backed by strong investment flows, both domestic and foreign. The state must play an important growth-enabling role by providing the rule of law, a stable macroeconomic environment and clear rules of the game for businesses.²

1. Economic transformation in the Western Balkans

In 1990s, mired in conflict, the Western Balkan countries have experienced a notable transformation over the last 15 years. They have transitioned toward market-based systems, privatized many inefficient state- and socially-owned enterprises, rapidly adopted modern banking systems, and enhanced the external orientation of their economies. The result has been a significant catch-up in living standards relative to their richer neighbors in advanced European Union economies. However, the pace of structural reform has been disappointing, owing to a combination of reform fatigue, difficult politics that have constrained reform efforts, and delayed membership in the European Union.³ As a result, the Western Balkan countries still lag well behind the New Member States of the European Union in terms of economic transformation and income levels, which are around one-third of those in Advanced EU economies.

Economies have become increasingly export-oriented, with FYR Macedonia and Serbia experiencing particularly noticeable gains. And this has been accompanied by increasing diversification of their export markets, with greater trade within the region and with the New Member States, and, concomitantly, lesser reliance on exports to Advanced EU economies. And just as Western Balkan firms were discovering new markets, foreign direct investment (FDI) into the region also took off.

² Sanfey P. & Milatovic J. 2018. EBRD. The Western Balkans in Transition: diagnosing the constraints on the path to a sustainable market economy

³ Zuzana Murgasova, Nadeem Ilahi, Jacques Miniane, Alasdair Scott, Ivanna Vladkova-Hollar, and an IMF Staff Team. 2015. The Regional Economic Issues (REI) The WESTERN BALKANS- 15 Years of Economic Transition. ISBN: 978-1-49835-651-0

One sector that has been entirely transformed by foreign investment is *banking*, which has facilitated a more efficient allocation of capital. Starting in the early 2000s, foreign investment into banking, combined with increased deposit bases, boosted private sector credit.

Altogether, the region experienced significant gains in terms of incomes and living standards, although perhaps not as much as could have been expected. Still, income convergence of the Western Balkans cannot be seen as entirely satisfactory. In particular, the New Member States caught up with Advanced EU economies significantly faster at similar stages of transition, which raises the question why the Western Balkans did not advance at the same rate.

1.1 Catching up with Advanced Europe

In the years leading up to the global financial crisis, the increase in capital flowing into the Western Balkans was as significant as that into Central and Southeastern Europe. These capital inflows were intermediated by domestic banks, and the resulting extension of credit went beyond what fundamentals would have warranted. Indeed, according to some metrics, only half of the increase in credit-to-GDP ratios in the Western Balkans could have been explained by economic fundamentals.

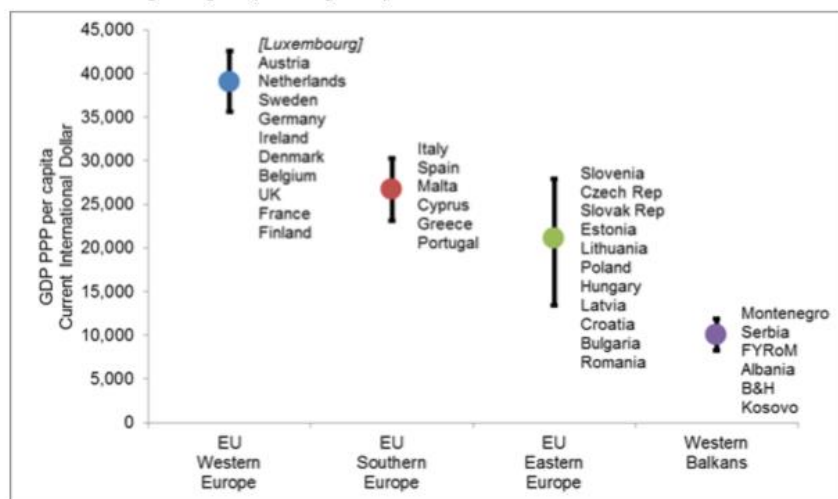
Perhaps the biggest flaw in the Western Balkan economic model has been the chronic underutilization of human resources. In 2008, the unemployment rate in the region still averaged more than 20 percent. Employment levels tell an equally disappointing story, hovering between 40 and 45 percent on average since 2000, a full 10 percentage points lower than in the New Member States.

Like elsewhere, boom times came to an end, imperiling income convergence. With the onset of the global financial crisis and the associated pull-back in global liquidity, capital flows reversed in the Western Balkans as they did elsewhere. As a consequence, credit growth slowed sharply, and current account deficits contracted by more than 10 percent of GDP on average. Growth simply slowed down in most Western Balkan countries. The problem is that seven years after the

onset of the crisis, growth remains lackluster in the region, and hence income convergence has stalled. At currently projected growth rates, Western Balkan economies will only close a small fraction of the gap with Advanced EU economies' income per capita levels by 2030. And it is not just about incomes: faster growth is also needed to provide employment opportunities to the large surplus of unutilized labor in the region.⁴

In some countries, the growth and jobs challenge is compounded by the need to pursue fiscal consolidation. As happened elsewhere in Europe, a substantial share of the rise in tax revenues during the boom years proved in hindsight to be cyclical, and this share disappeared once economic growth slowed or went into reverse. The boom had also prompted some countries in the region to lower tax rates. Once the crisis hit, Western Balkan countries found it hard to scale back spending to match the decline in revenues, not least because their share of recommitted spending is higher than in the New Member States or Advanced EU economies. As a result, some of the countries, notably Serbia and Croatia, now have very high public debt levels, exacerbated by ongoing fiscal deficits that need to be brought down.

Chart 1: GDP per capita (PPP adjusted)



Source: IMF World Economic Outlook.

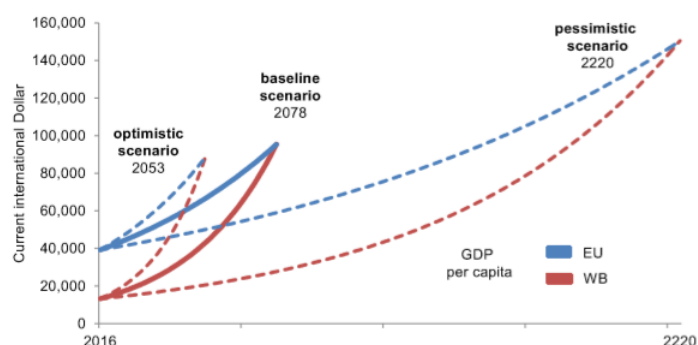
Note: Countries are ordered within sub-regions from highest to lowest. Luxembourg is an outlier in terms of GDP PPP per capita and is not included.

⁴ Zuzana Murgasova, Nadeem Ilahi, Jacques Miniane, Alasdair Scott, Ivanna Vladkova-Hollar, and an IMF Staff Team. 2015. The Regional Economic Issues (REI) The WESTERN BALKANS- 15 Years of Economic Transition. ISBN: 978-1-49835-651-0

The (weighted) average annual growth rate of the Western Balkans region between 2001 and 2016 was 3.2 per cent, compared with 1.4 per cent in the EU. However, this period can be divided into two distinct phases: the pre-crisis period (2001-08) and the post-crisis period (2009-16). During the former, annual growth (weighted average) in the WB-6 was more than three percentage points higher than in the EU (5.3 versus 2.2 per cent). In the latter period, there were double dip recessions in 2009 and 2012 and average WB-6 growth in this period was just 1.2 per cent, compared with 0.7 per cent in the EU. The speed of convergence has thus slowed down markedly over the past seven years.⁵

Full convergence with average EU living standards could take many decades. A baseline scenario, which uses the average growth rates for the period of 2001-16, implies that the WB6 region, on average, could achieve the average GDP per capita in the EU in about 60 years time. An optimistic scenario, which uses pre-crisis growth rates, would yield catch up with EU living standards in just under 40 years, while a pessimistic scenario, which uses the postcrisis average growth rates, means that catching up takes place after 200 years (Chart 2). The speed of catch up would depend on the pace of addressing the challenges that hamper the region from developing its full potential.⁶

Chart 2: Convergence scenarios



Source: IMF World Economic Outlook; authors' calculations, based on assumptions outlined in the text.

⁵ For further analysis see "How the Western Balkans can catch up" by Peter Sanfey, Jakov Milatovic and Ana Kresic, (EBRD Working Paper No. 185).

⁶ Sanfey P. & Milatovic J. 2018. EBRD. The Western Balkans in Transition: diagnosing the constraints on the path to a sustainable market economy

Convergence on inflation has largely occurred. All Western Balkans economies are currently enjoying a high degree of price stability, with inflation rates similar to those of advanced EU countries. Low inflation in the eurozone and the fall in global commodity prices have been important contributors, but stable exchange rate regimes are also key pillars of this stability. A floating exchange rate is present in Albania and Serbia but excessive fluctuations are kept in check by central bank interventions. In the remaining Western Balkans countries the exchange rate is immovable in relation to the euro, either because the euro is the only legal tender due to unilateral adoption (Kosovo and Montenegro) or because the rate is fixed through a currency board (Bosnia and Herzegovina) or a long-standing peg (FYR Macedonia).

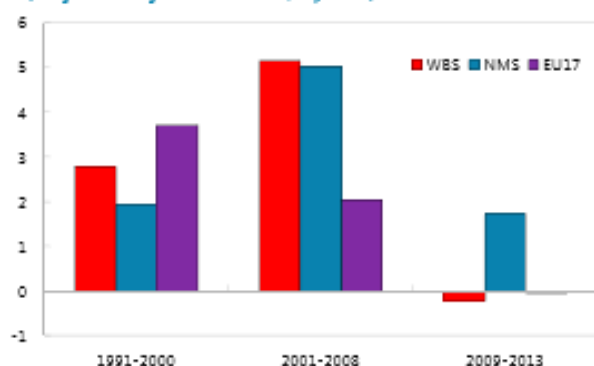
The key challenge facing the region going forward is to complete the structural transformation process that began two decades ago. The impressive reform process born out of the ashes of socialism had largely stalled by the mid-2000s and was left incomplete, a victim of reform fatigue, a difficult political economy, vested interests that had grown in power and sophistication, and disillusionment with the way some reforms were executed. The process of accession to EU membership—arguably the main catalyst of reforms in the New Member States—remained a distant prospect for most of the Western Balkans. But abundant global liquidity gave the illusion, albeit temporarily, that fast economic growth was possible without reforming. Today, the region lags well behind the New Member States in terms of structural transformation. In some Western Balkan countries, resistance to private ownership has meant that many inefficient state- or socially-owned enterprises have survived and continue to impose a drag on public finances and resource allocation. Throughout the region, red tape and corruption continue to hamper economic activity, while corporate governance reform remains a long overdue promise. Importantly, wide political support for far-reaching reform—a crucial element in the transformation in the New Member States—has been elusive in most Western Balkans countries. There is a sense in

the Western Balkans that reforms have under delivered, and that the spoils of growth have benefited only a few.⁷

1.2 Growth and Convergence

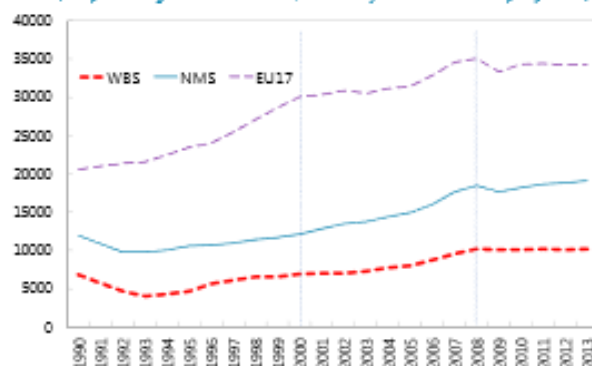
All the Western Balkan countries enjoyed high and sustained economic growth starting at the turn of the century, in line with the rest of Emerging Europe.

Average Real GDP Growth
(Weighted average across countries, in percent)



Sources: Penn World Table; WEO; and IMF staff calculation.

Real GDP per Capita
(Simple average across countries; in PPP adjusted U.S. dollars per person)



Sources: Penn World Table; and IMF staff calculations.

A simple growth-accounting exercise suggests that capital accumulation and total factor productivity gains were the biggest growth drivers in both the New Member States and the Western Balkans during the precrisis years. Indeed, both the Western Balkans and the New Member States experienced investment booms in the 2000s owing to substantial capital inflows and low global interest rates. The large productivity gains likely resulted from the transformation toward market economies, although the relatively small contribution of labor inputs and the consequent high importance of productivity—a residual—could be also partly explained by the large informal economies in the Western Balkan countries, which tend to be more labor-intensive.⁸ Nonetheless, similar patterns have been observed elsewhere—in particular, recent evidence suggests that the uptick in

⁷ Zuzana Murgasova, Nadeem Ilahi, Jacques Miniane, Alasdair Scott, Ivanna Vladkova-Hollar, and an IMF Staff Team. 2015. The Regional Economic Issues (REI) The WESTERN BALKANS- 15 Years of Economic Transition. ISBN: 978-1-49835-651-0

⁸ Gerxhani, Klarita. 2004. "The Informal Sector in Developed and Less Developed Countries: A Literature Survey." Public Choice 120: 267–300.

growth in emerging market economies during the 2000–12 period is mainly explained by higher total factor productivity.⁹ In addition, the very low contribution of labor and human capital to GDP growth in the Western Balkans is in line with findings of other studies.^{10 11 12}

Yet despite a limited contribution from labor, the impulse to growth from other factors was strong enough to generate substantial improvements in living standards, as well as a reduction in poverty. By 2008, the Western Balkan countries had made impressive progress and reduced their gap in GDP per capita vis-à-vis Advanced EU economies by 30 percent. But contrary to predictions of standard economic theory, the speed of convergence was slower in the poorer Western Balkans than that of the richer New Member States during the boom years.

Why did the Western Balkans converge more slowly? One possible explanation is that the closer physical distance of the New Member States to advanced EU economies may have offered advantages in terms of access to markets and investments, and facilitated the transfer of knowledge. These relative advantages are only recently partially offset by improvements in infrastructure links between the Western Balkans and Advanced EU economies. Yet even after controlling for the physical distance, econometric evidence suggests that, except for the postwar recovery period, the pace of convergence in the Western Balkans has been slower than in the New Member States. This is partly due to the absence of convergence within the Western Balkan region, because poorer countries such as Albania and Bosnia and Herzegovina failed to grow significantly faster than the richer countries, such as Croatia.

⁹ Tsounta, Evridiki. 2014. “Slowdown in Emerging Markets: Sign of a Bumpy Road Ahead?” Working Paper No. 14/2015, International Monetary Fund, Washington.

¹⁰ Campos, Nauro F., and Fabrizio Coricelli. 2002. “Growth in Transition: What We Know, What We Don’t, and What We Should.” *Journal of Economic Literature* 11: 783–836.

¹¹ International Monetary Fund (IMF). 2009. “What’s the Damage? Medium-Term Output Dynamics after Financial Crises.” *World Economic Outlook*, International Monetary Fund, Washington, October.

¹² European Bank for Reconstruction and Development (EBRD). 2013. *Transition Report*. London: European Bank for Reconstruction and Development.

What other factors may have constrained faster convergence? There is a growing literature on the impact of structural factors on convergence, though mostly on larger panels of countries. Findings suggest that domestic financial development speeds up convergence^{13,14} and that human capital is more important to growth for countries that are less developed (Fung 2009); (Ciccone and Papaioannou 2009)¹⁵. Better institutional infrastructure and selected labor market reforms have been shown to facilitate convergence at the regional level¹⁶. Reform priorities for sustaining convergence have been found to vary with income levels. Empirical evidence suggests that in lower-middle-income countries, priorities should be reforming banking and agricultural sectors, reducing barriers to FDI, increasing competition in product markets for a more vibrant services sector, improving the quality of secondary and tertiary education, and alleviating infrastructure bottlenecks. In upper-middle-income countries, boosting productivity growth would require deepening capital markets, developing more competitive and flexible product and labor markets, fostering a more skilled labor force, and investing in research and development and new technologies¹⁷. Finally, a survey of various studies that focus specifically on the transition process concludes that institutional quality and market liberalization policies to promote private sector growth have a positive impact on economic growth, despite their initially disruptive effect¹⁸.

In line with these findings, the analysis here shows that improving the quality of governance, and developing market-oriented institutions, a strong human capital base, and deeper financial systems help poorer countries catch up. In contrast,

¹³ Aghion, Philippe, Peter Howitt, and David Mayer-Foulkes. 2005. "The Effect of Financial Development on Convergence: Theory and Evidence." *The Quarterly Journal of Economics* (February): 173–222.

¹⁴ Fung, Michael K. 2009. "Financial Development and Economic Growth: Convergence or Divergence?" *Journal of International Money and Finance* 28: 56–67.

¹⁵ Ciccone, Antonio, and Elias Papaioannou. 2009. "Human Capital, the Structure of Production, and Growth." *Review of Economics and Statistics* 91(1): 66–82

¹⁶ Che, Natasha, and Antonio Spilimbergo. 2012. "Structural Reforms and Regional Convergence." Working Paper No. 12/106, International Monetary Fund, Washington.

¹⁷ Dabla-Norris, Era, Giang Ho, Kalpana Kochhar, Annette Kyobe, and Robert Tchaidze. 2013. "Anchoring Growth: The Importance of Productivity-Enhancing Reforms in Emerging Market and Developing Economies." Staff Discussion Note 13/08, International Monetary Fund, Washington.

¹⁸ Campos, Nauro F., and Fabrizio Coricelli. 2002. "Growth in Transition: What We Know, What We Don't, and What We Should." *Journal of Economic Literature* 11: 783–836.

the dominance of the public sector in the economy hinders the catching-up process. And the Western Balkans have lagged behind the New Member States in these areas. In light of the critical importance of economic transformation, the next section explores progress to date.

1.3 Economic Structure

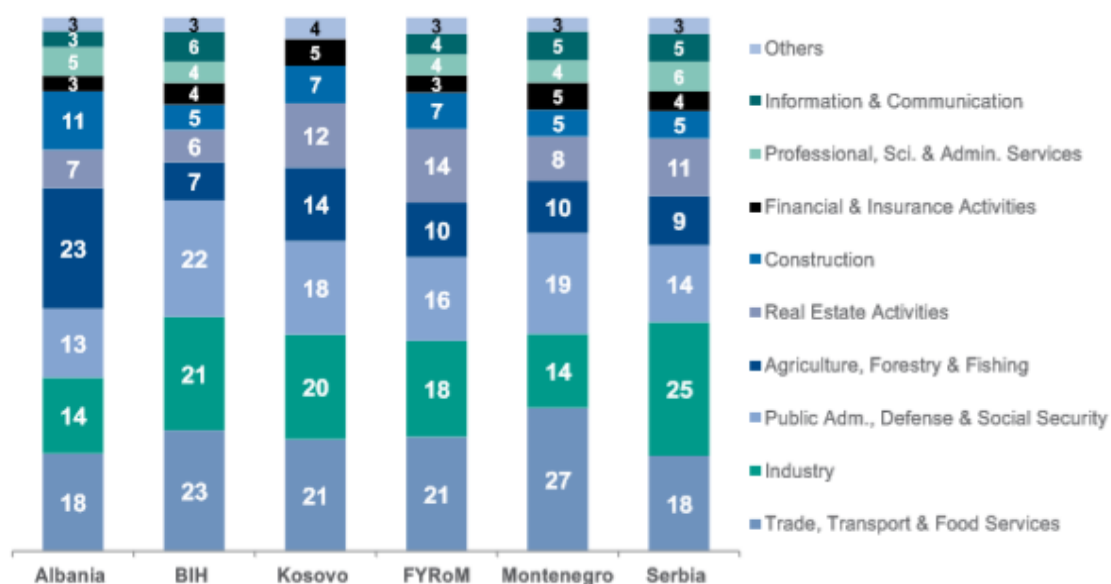
Economies in the Western Balkans region tend to be diverse, rather than relying on one or a few sectors. Nevertheless, four sectors stand out as being of particular importance, namely: domestic trade, industry, public administration and agriculture. The Chart below shows the contribution of different sectors in each country to gross value added (GVA).¹⁹ Domestic trade, including transport and storage, accommodation and food services, is on average the largest sector of the Western Balkans economies, ranging from 18 per cent of GVA in Albania and Serbia to 27 per cent in Montenegro. While the wholesale and retail trade subsector accounts for about 15 per cent of the economies in the region, the importance of the accommodation and food services subsector in tourism-dependent Montenegro, with a share of 8 per cent, is what distinguishes this country from the rest of the region. Industry accounts for one-fifth of GVA on average. However, this varies significantly across countries. The role of industry is particularly important in Serbia, where it represents an equally important part of the economy as in the average EU-11 country. Manufacturing is the predominant industrial subsector, especially in Serbia, FYR Macedonia and Kosovo. Public administration is the third largest economic sector. The sector includes defense, education, social services and other public administration, and accounts for 17 per cent of economic activity on average.

This ranges from only 13 per cent in Albania to over one-fifth of the economy in Bosnia and Herzegovina. In general, the region is quite agriculture-intensive. Agriculture (together with forestry and fishing) accounts for 12 per cent of value added on average, ranging from 7 per cent in Bosnia and Herzegovina to 23 per

¹⁹ GVA is linked to gross domestic product (GDP) through the following relationship: $GVA + \text{taxes on products} - \text{subsidies on products} = GDP$.

cent in Albania. Agriculture plays a vital role in the Western Balkans, both socially and in terms of employment. This contrasts significantly with the EU-11 where on average the sector accounts for only 4 per cent of GVA. Serbia stands out as having a clear comparative advantage in farming, mainly due to fertile agricultural soil in its northern province of Vojvodina. Some large producers have been able to take advantage of both economies of scale and access to major export markets, primarily the European Union but also Russia, with which Serbia has a free trade agreement (the only country in the region in this position). The other five countries have less advanced agricultural sectors, mainly consisting of small-scale and inefficient subsistence farming. The potential for agribusiness to develop further in the region is significant provided countries can consolidate agricultural holdings, improve the quality of collection, storage and marketing, and develop agricultural support services such as insurance.

GDP breakdown by sectors



Source: National statistical offices.

SMEs dominate the economies of the Western Balkans. According to a recent OECD-led study, SMEs make up about 99 per cent of businesses in all countries of

the Western Balkans.²⁰ On average, SMEs provide jobs for around three-quarters of the total number of employed, ranging from just below 70 per cent in Bosnia and Herzegovina to more than 80 per cent in Albania. At the same time, on average, SMEs add an estimated two thirds of the countries' total annual value added, a proportion similar to the EU average, ranging from just above 50 per cent in Serbia to just below 70 per cent in Albania.

The EU is by far the region's most important trading partner. Two-thirds of the region's exports are with the EU. The share ranges from 80 per cent in FYR Macedonia to just 23 per cent in Kosovo. All countries have a Stabilization and Association Agreement with the EU, which gives the countries preferential access to EU markets for most goods. On average 20 per cent of Western Balkans exports go to neighboring countries. This figure covers a range from a 46 per cent share in Kosovo to a mere 9 per cent in Albania. Exports from the WB-6 countries grew by about 60 per cent on average over the past 10 years, and most of this growth was driven by the rise of exports to EU countries. One reason for this might be in the similarity of the Western Balkan countries' main export products, although there are important differences among the six countries in terms of revealed comparative advantage.²¹

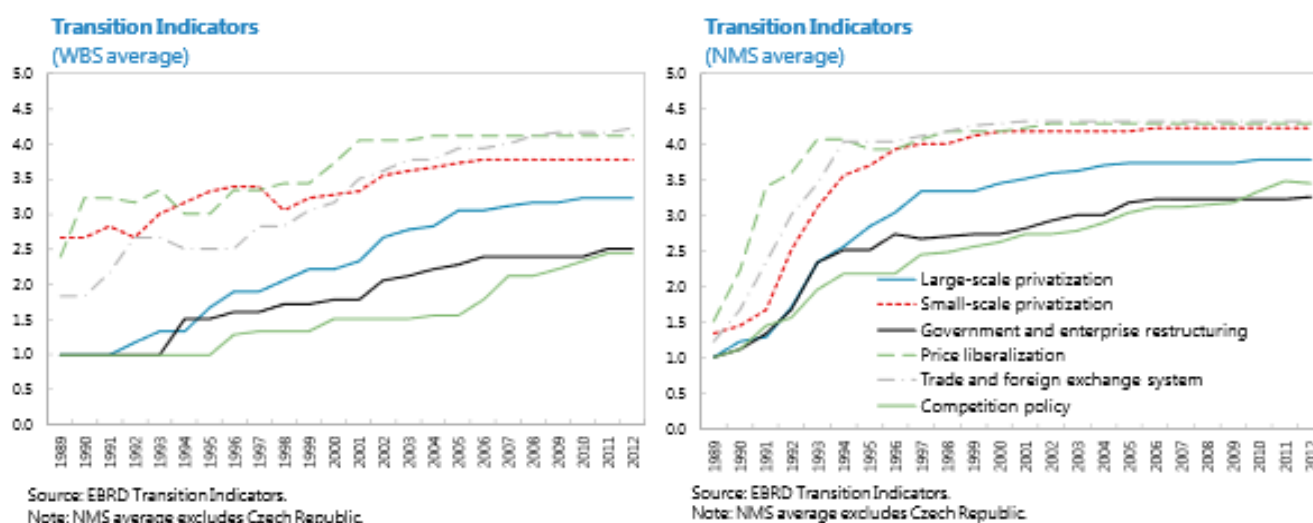
1.4 Progress in Economic Transformation

Structural reforms are an integral part of the process of transformation into a market economy. So how did the Western Balkans fare in their implementation? The sequence of reforms was similar to that in the New Member States. Specifically, price liberalization and reforms to trade and foreign exchange systems preceded privatization, and were followed only later by reforms to governance and competition policy. However, the pace of reforms was quite different, and the Western Balkans has not progressed as far as the New Member

²⁰ SME Policy Index: Western Balkans and Turkey 2016, <http://www.oecd.org/countries/albania/sme-policyindex-western-balkans-and-turkey-2016-9789264254473-en.htm>.

²¹This issue is analyzed further in: "Firm performance and obstacles to doing business in the Western Balkans: evidence from the BEEPS" by Ana Kresic, Jakov Milatovic and Peter Sanfey (EBRD Working Paper No. 200).

States along a critical set of structural reforms. One notable feature of the early transition period was the unique economic system, known as “market socialism”, that was in place in the former Yugoslavia well before the 1990s, where heavy reliance on administrative controls coexisted with a vibrant private sector of small and medium enterprises without Soviet-style central planning (Boughton 2012). Albania, on the other hand, started the transition process as an isolated and autarkic state with virtually no elements of a market economy, but made swift progress, particularly in trade and foreign exchange liberalization, where reforms went further than in the rest of the Western Balkan states as early as 1992.



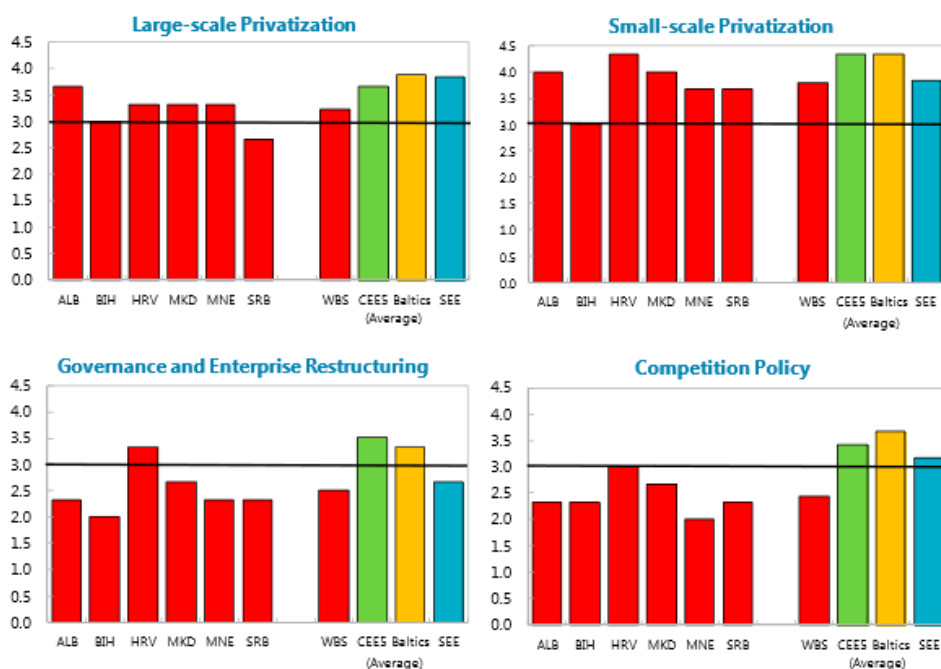
Despite a difficult decade, by 1999 the Western Balkans as a group had reached a fairly advanced stage of transition (measured by a value of 3 or higher for the Transition Indicators of the European Bank for Reconstruction and Development) in the areas of price liberalization, trade and foreign exchange, and small-scale privatization by 1999, trailing the New Member States by only a few years. However, other reforms, such as large-scale privatization, were delayed, and the Western Balkans are yet to reach the advanced stage of transition in governance and competition policy areas. A key culprit was another Yugoslavia-specific feature—the “socially-owned” system of enterprise ownership, in contrast to state ownership in centrally planned economies elsewhere— which posed important challenges to large-scale privatization. The absence of a legal property

owner required sorting out how to convert social to private ownership; the method of conversion varied across the different countries (Hashi 2001). The nature of the privatization process and the resulting stakeholder structure in those enterprises had implications for corporate governance and incentives to restructure:

- The progress in large-scale privatizations was uneven across the region. While many Western Balkan countries had already initiated these privatizations in the late 1990s and early 2000s, Bosnia and Herzegovina, Serbia, and Montenegro joined the process at later stages. There was also considerable variation across sectors: privatizations in the banking, telecommunications, and in some cases energy sectors generally moved ahead, but large public enterprises in historically important industries—such as metals, shipyards, utilities, and railways—proved particularly difficult to privatize. Stalled privatizations often reflected large social opposition, high short-run costs, and few serious bidders.
- Corporate governance and enterprise restructuring of former state-owned enterprises remained a challenge across the region and state support often continued. For example, in Bosnia and Herzegovina the management of privatized enterprises was hampered by diffuse or ill-defined ownership rights.

In FYR Macedonia, most socially-owned enterprises were sold to insiders rather than to strategic investors with capital and know-how, and many firms thus survived with substandard performance. Progress in winding down a few large loss-making enterprises has been slow. In Serbia, weak governance and output price controls resulted in large enterprise at a significant financial cost.

Selected Transition Indicators, 2012



Source: EBRD Transition Indicators and IMF staff calculations.

Note: The scales range from 1 to 4+, where 1 represents little or no change from a rigid centrally planned economy and 4+ represents the standards of an industrialized market economy. A value of 3 indicates an advanced stage of transition. Data for Czech Republic and Kosovo is not available.

The Western Balkans made substantial progress in reducing red tape and improving the business environment in the mid-2000s. Steps were taken across the region to lighten the regulatory burden. Several countries initiated “regulatory guillotines” to eliminate unnecessary regulations, set up one stop-shops for starting a business and obtaining construction permits, reduced non-tax fees, strengthened bankruptcy procedures, improved investor protection, introduced or expanded the coverage of real estate cadastres, introduced or improved investment promotion laws, and set up entrepreneurial zones with good infrastructure and land free of ownership uncertainty. Large infrastructure projects were initiated to fill critical gaps. According to the World Bank’s Doing Business Indicators, significant progress across the region was made on some fronts: registering property is cheaper in the Western Balkans than in the Advanced EU countries, and the tax burden is lighter. Yet it is still time-consuming for businesses to trade, pay taxes, or resolve insolvency, and costly to start a business or enforce contracts. Most countries in the region continue to face large

infrastructure needs in transportation as well as in energy. Overall, rigid business environments often continue to hamper foreign investment, though there are isolated success stories.

A formidable challenge facing the region is reforming governance. While better governance facilitates higher per capita incomes, empirical evidence does not point to a virtuous cycle whereby higher growth automatically brings about improvements in governance.²² This underscores the need for a concerted effort to improve the quality of governance. The Western Balkans still lag far behind the EU and New Member States peers in rule of law, control of corruption, and political stability, according to the World Bank's World Governance indicators. Cross-country analysis shows that the quality of such institutions depends on several factors, particularly openness—that is, countries with greater openness to trade and finance tend to have better economic institutions.²³

1.5 Structural Reform Priorities for Faster Growth²⁴

It is generally accepted that ambitious structural reforms can boost economic growth. But which specific reforms would deliver the strongest growth dividend in each of the Western Balkan countries? This question is tackled here by first identifying country-specific reform gaps, and then comparing the performance of the Western Balkan economies along a wide set of competitiveness indicators with the performance of New Member States and the average EU country.²⁵

²² Kaufmann, Daniel, and Aart Kraay. 2002. "Growth without Governance." World Bank Policy Research Working Paper No. 2928. Washington: World Bank.

²³ The EBRD's 2013 Transition Report notes that openness is a particularly powerful tool to improve institutional quality, as it is achievable across a wide range of political systems. The report posits that international integration may help institutions through several channels. The increased presence of international firms helps to disseminate international business practices and standards. It may also put pressure on national and local authorities to improve the quality of government services. Dual listing of company shares may contribute to improved corporate governance.

²⁴ Kosovo could not be included in the empirical analysis of reform priorities in the Western Balkans given data constraints.

²⁵ The analysis is based on data from the World Economic Forum's Global Competitiveness Report. Competitiveness is defined as the set of institutions, policies, and factors that determine the level of productivity of a country. The database covers 144 countries, including six of the seven Western Balkan countries under consideration. Data for Kosovo are not available.

Growth regressions are then used to rank reforms according to their importance for growth. The results allow for proposing country-specific reform priorities in areas where both the competitiveness gap is large and the estimated growth impact of reform is high.

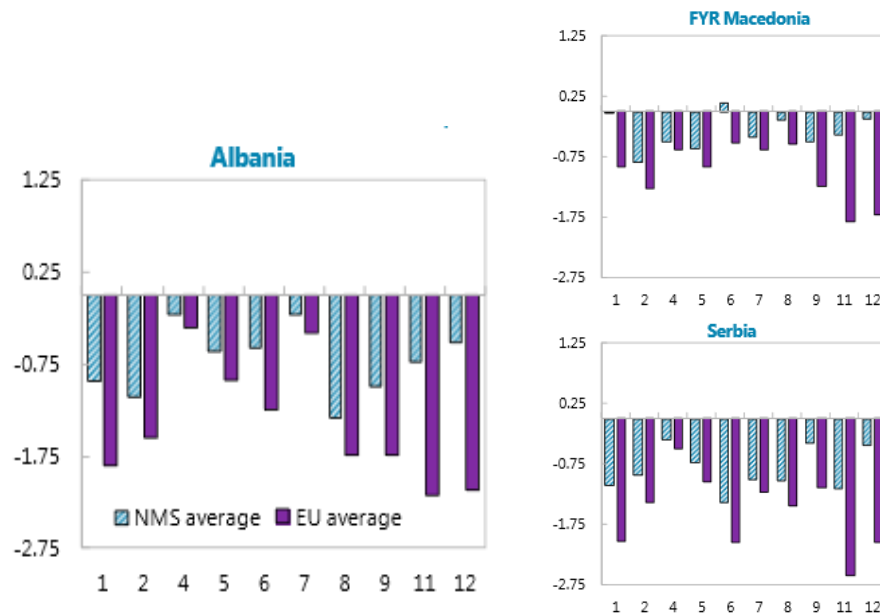
In the IMF report²⁶ there are aggregated set of factors that determine productivity and growth, encompassing 10 broad areas such as institutions, infrastructure, and innovation, among others.²⁷ Along a few dimensions the Western Balkan states have closed the distance with New Member states, but those most gaps are still negative. When assessed against EU averages, however, the pending reform agenda looms large. Where do the main gaps lie?

- *Relative to NMS*, Montenegro and, to a lesser extent, FYR Macedonia compare relatively favorably: most of the estimated gaps are small, and a few are slightly positive—meaning that in these specific areas the competitiveness profile of these two countries is similar to that of NMS. The results for Albania, Bosnia and Herzegovina, and Croatia are more mixed—while the gap is relatively small in some areas, in other areas these countries lag behind significantly. For Albania and Bosnia and Herzegovina, the notable gaps are in infrastructure and financial market development. Serbia generally faces more formidable structural challenges, as it compares unfavorably to NMS along all 10 indicators.

²⁶Zuzana Murgasova, Nadeem Ilahi, Jacques Miniane, Alasdair Scott, Ivanna Vladkova-Hollar, and an IMF Staff Team. 2015. The Regional Economic Issues (REI) The WESTERN BALKANS- 15 Years of Economic Transition. ISBN: 978-1-49835-651-0

²⁷While the Global Competitiveness Report covers 12 reform areas (pillars), we omit two: Macroeconomic Environment and Market Size. The macroeconomic environment is analyzed in Chapter 3.

Main Reform Gaps in the Western Balkans (Standard deviations)



Sources: World Economic Forum; and IMF staff calculations.

Note: Kosovo data is unavailable. Global Competitiveness Report Pillars: 1 - Institutions, 2 - Infrastructure, 4 - Health and Primary Education, 5 - Higher Education and Training, 6 - Goods Markets Efficiency, 7 - Labor Markets Efficiency, 8 - Financial Markets Development, 9 - Technological Readiness, 11 - Business Sophistication, 12 - Innovation. Excluded are Macroeconomic Environment (pillar 3) and Market Size (pillar 10).

- *Relative to the EU average*, the gaps in all Western Balkan countries tend to be wider, highlighting significant structural reform needs in almost all areas. This is also true for Montenegro and FYR Macedonia, which compare reasonably well to the New Member States. Overall, the major gaps throughout the region are in institutions, infrastructure, goods market efficiency, and financial market development. The estimated gaps in business sophistication and innovation are particularly large compared to the EU, both relative to other reform areas and in contrast to generally good performance of the region along this dimension relative to New Member State peers.

If all structural reforms were equally important for growth, the size of the reform gap would signal reform priorities. However, the growth impact of reform areas differs. Results suggest that the growth impact of reforms varies with income levels— institutions and infrastructure are estimated to be relatively more important for lower- and middle-income countries, whereas innovation and business sophistication appear relatively more important for high-income countries.

Leaning on these findings by combining reform gaps and the relative importance of each reform area for growth, we can identify reform priorities. According to my methodology, the reform priority is higher the more important the specific reform area is for growth and the larger the corresponding reform gap is. This derived structural reform map serves to provide an indicative overview of where reform priorities may be.²⁸

The results suggest that, compared to New Member States, reforms across the Western Balkans are particularly needed in the areas of institutions, infrastructure, goods market efficiency, labor market efficiency, and financial market development. Each of those areas is found to be among the top five reform priorities for at least four of the six Western Balkan states; infrastructure was identified as a top reform priority in all six countries.

When it comes to institutional reforms, the *protection of property rights* is a common problem in most of the Western Balkan countries, particularly relative to the EU average, though to a lesser extent in FYR Macedonia.

In Serbia, and to a lesser extent in Croatia, Bosnia and Herzegovina, Albania, and Montenegro, reform needs are large in areas linked to corporate *sector performance*. Specifically, this includes the strength of reporting standards, efficacy of corporate boards, and protection of minority shareholders.

²⁸ The methodology is appealing in its simplicity and tractability, but with the caveat that the calculated impacts are only partial and not part of a fully elaborated equilibrium framework. While this approach does not make it possible to identify synergies between reform areas and does not say much about the timing of reforms, it is likely that improvements in institutions and parallel implementation of various reforms in other areas will lead to additional synergies.

Encouragingly, Albania and FYR Macedonia score relatively well in terms of *burden of government regulation*, even compared to the EU average. For Serbia, however, the gaps in this area remain large.

The analysis of specific reform gaps within the broader infrastructure pillar suggests that the Western Balkan countries have had a mixed performance when assessed vis-à-vis their peers. In terms of *overall quality of infrastructure*, Croatia ranks better than its New Member State peers, while the largest overall quality gaps exist in Serbia. All Western Balkan countries, except Croatia, lag behind the EU by a wide margin.

The gap analysis points to important reform potential in *railroad infrastructure* in Albania, FYR Macedonia, and Serbia. Compared to the average EU country, *road and air transport infrastructure* gaps are large in all countries, though to a lesser extent in Croatia.

The results of the analysis suggest that the Western Balkan countries impose a relatively low *tax burden* on businesses. Total tax rates²⁹ are well below those of NMS and EU average in FYR Macedonia, Montenegro, and Bosnia and Herzegovina. Similarly, all countries but Bosnia and Herzegovina perform well or are broadly at par in terms of *procedures and time to start a business*.

Gaps in *trade barriers, tariffs, and impediments to foreign ownership and foreign direct investment (FDI)* are relatively moderate in most Western Balkan countries, but almost always negative. Rules on FDI and foreign ownership seem to be stricter in Croatia and Serbia.

Agricultural policy cost seems to be a significant burden for the economy in Croatia and Serbia, and to a lesser extent in Albania.

²⁹As defined in the World Economic Forum's Global Competitiveness Report, the total tax rate is "a combination of profit tax (% of profits), labor tax and contribution (% of profits), and other taxes (% of profits)."

1.6 Unemployment rates

In the Western Balkans, high rates of unemployment and low rates of employment predated the global financial crisis, pointing to deep structural problems. The New Member States— and particularly the Baltic’s— experienced large cyclical swings of both employment and unemployment during the 2000s, but in a qualitatively different context of markedly lower unemployment and higher employment. In contrast, workers in the Western Balkans failed to significantly benefit from employment gains during the boom years, while still registering significant job losses in the aftermath of the crisis (ILO 2012).

The persistence of unemployment in the Western Balkans regardless of cyclical conditions is confirmed through econometric analysis of contemporaneous responses of the unemployment rate to changes in economic growth, which suggests that responses of labor market outcomes to swings in economic cycles are smaller and statistically insignificant. This is in sharp contrast with larger and statistically significant response coefficients found in most Central European and Baltic economies.³⁰ Looking ahead, this implies that unemployment is likely to persist in the Western Balkans even as economic growth picks up and output gaps close in the post crisis period.³¹

So why have labor market outcomes been so much worse in the Western Balkans than elsewhere? One reason is that the Western Balkan countries are latecomers to the transition process, and hence FDI stocks, diversification from traditional sectors, and private sector job creation are still lagging compared with New Member States. At the same time, the countries have experienced very large emigration and brain drain, resulting in high remittance inflows that likely raise

³⁰ It is important to recognize that high (structural) unemployment could coexist with relatively flexible labor markets (IMF 2013).

³¹ In the postcrisis environment, sluggish responsiveness of job creation to growth is likely aggravated by weakened balance sheets affecting financing conditions (ILO 2013). Also, job creation is impaired by a need for firms to build up new collateral to finance their activities (Calvo, Coricelli, and Ottonello 2012), while concurrently, fiscal consolidation could have depressed aggregate demand (ILO 2014).

reservation wages, hamper external competitiveness, and contribute to long unemployment duration.^{32 33 34}

While significant, skill gaps were not as binding in the Western Balkans as in the New Member States, which are more integrated into European supply chains and have a greater presence of large manufacturing firms. According to EBRD-World Bank Business Environment and Enterprise Performance Surveys (BEEPS), skilled labor shortages are considered a major or severe constraint by about one in five companies in the Western Balkan countries, just behind infrastructure and corruption. Nevertheless, anecdotal evidence from employer associations and individual companies seems to suggest that in the Western Balkans, skill mismatches, which existed prior to the recent global economic slowdown, have become more prominent in the aftermath of the global financial crisis.

Strong employment and social protection systems were important features of centrally planned economies.³⁵ These labor markets were shaped by the particular legacy of the “self-management” system for enterprises, and the existence of so-called “social ownership”.³⁶ This led to a high level of job protection for the “insiders” and to overall rigidity.³⁷

Since the disintegration of the socialist economies, substantial labor market reforms have been undertaken, with the reform momentum having picked up since the middle of the 2000s, particularly in the areas of flexibility of wage determination and redundancy costs. Nonetheless, increased labor market

³² Kovtun, Dmitriy, Alexis Meyer Cirkel, Zuzana Murgasova, Dustin Smith, and Suchanan Tambunlertchai. 2014. “Challenges and Solutions for Fostering Job Creation in the Balkans.” In *Jobs and Growth: Supporting the European Recovery*. Washington: IMF.

³³ International Monetary Fund (IMF). 2013. “Faster, Higher, Stronger—Raising the Growth Potential of CESEE.” *Regional Economic Issues* October 2013—Central, Eastern, and Southeastern Europe (Washington: IMF).

³⁴ Migration can also occur as a response to growth shocks, thus dampening their impact on unemployment. However, the remittance-reservation wage channel is likely to be dominant, because in contrast to the New Member States, most of the Western Balkans did not have easy formal access to labor markets in Advanced European economies for most of the sample period.

³⁵ See Kovtun and others (2014), World Bank (2008), and Gligorov and others (2008).

³⁶ Kuddo, Arvo. 2013. “South East Europe Six: A Comparative Analysis of Labor Regulations.” Technical Note (August). World Bank, Washington.

³⁷ These are particularly relevant to those with jobs in state-owned enterprises and the public sector in the form of strict rules for terminating employment and generous severance payments.

flexibility in the Western Balkan countries is a recent phenomenon that will likely take some time to manifest itself in improved labor market outcomes.

In addition, the region still ranks less favorably—relative to its more dynamic peers—in terms of a number of competitiveness indicators capturing labor market flexibility.

As discussed above, cyclical, structural, and institutional considerations all play a role in determining poor labor market outcomes in Western Balkan countries, but their interplay is far from clear.

- The Western Balkan countries are fairly similar in terms of the importance of *demographic characteristics* of individuals for determining labor market transitions. For instance, previously unemployed persons are more likely to remain unemployed, and higher levels of education are generally associated with better chances of finding employment. There are, however, a few notable differences.³⁸ Specifically, younger people seeking employment face significant headwinds in all countries, but have a somewhat better chance of finding a job in FYR Macedonia and Serbia.
- *Macroeconomic indicators* have an important bearing on the dynamics of labor market transitions. Higher real GDP growth and more buoyant investment-to-GDP ratios are generally associated with better chances of finding a job, but in the absence of other reforms improvements in either indicator yield fairly limited results.³⁹ Similarly, higher rates of private credit growth seem to encourage more people to seek employment, but the impact on the probability of employment is also rather muted. Fiscal stimulus (for example, higher general government fiscal deficits expressed as a percent of GDP) is associated with more people joining the labor force and with higher probabilities of finding employment, particularly if not associated with higher government-expenditure-to-GDP ratios, which offers

³⁸ While cultural and religious factors may have a bearing on the variety of cross-country trends, these differences likely also reflect significant heterogeneity of labor market institutions observed across the region.

³⁹ The marginal impact of a 1 percent increase in either indicator is only 0.01 on the probability of employment.

evidence in favor of a smaller role of the state in the economy.^{40 41} Finally, there is strong evidence that higher remittance inflows discourage people from seeking employment and are associated with longer unemployment spans.⁴²

- Stronger *labor market institutions* are critical for better outcomes. The analysis shows that a more decentralized wage bargaining processes, more flexible hiring-firing practices, and lower redundancy costs are all strongly associated with not only additional people joining the labor force but also with a greater probability of employment.⁴³ Similar results hold for an environment with greater reliance on professional managers chosen based on merit and qualifications. In contrast, our analysis confirms that an environment where pay is only weakly related to worker productivity is more likely to discourage people from seeking employment. Finally, as one would expect, higher female participation in the labor force is found to moderately increase competition among the job seekers.
- Broader structural reforms are also very important. The empirical evidence suggests that countries that are more advanced in overcoming the legacies of centrally planned economies and completing transition to a market-based economy are also the ones that generate significantly higher chances for job seekers of finding employment.

2. Regional Cooperation in the Western Balkan Countries

Economic activity has been enhanced by growing regional cooperation in the Western Balkans. The increase in regional cooperation in the past decade,

⁴⁰ One explanation for this finding could be that the fiscal impulse is picking up the statistical effect of a lower tax burden; higher fiscal deficits mean lower tax burdens for any given level of government expenditure. With low-tax countries shown to grow faster than high-tax countries (see Easterly and Rebelo 1993), this implies more employment opportunities for potential job seekers.

⁴¹ Loosening the fiscal stance by 1 percent of GDP would increase employment probability and reduce the probability of being inactive by about 0.025 and 0.035, respectively.

⁴² The IMF analysis shows that 1 percent of GDP higher remittance inflows are associated with a 0.03 increase in probability of being inactive.

⁴³ A 25 position improvement in each of the corresponding Global Competitiveness Indicators is estimated to increase employment probability by about 0.05.

following the conflicts in the 1990s, has been one of the greatest recent achievements of the Western Balkans, and has brought with it two key benefits. First, it reduces tension and strengthens regional stability, allowing more attention to focus on common economic challenges and increasing the attractiveness of the region as an investment destination. And second, it brings various practical benefits that stem from higher levels of intra-regional flows of people, goods, services and capital, thus enhancing the competitiveness of relatively small economies. A new format for high-level regional cooperation has been established. On 24 February 2014, the EBRD hosted at its Headquarters in London a Western Balkans Summit, which brought together, for the first time in such a format, the prime ministers of all six countries of the region, de facto launching a new format of regional cooperation: “Western Balkans Six at the level of Prime Ministers”. Besides promoting the Western Balkans as an investment destination, the summit contributed to the strengthening of regional stability and improving regional cooperation. In particular, it strongly promoted the need for better prioritization and coordination of major regional connectivity projects among the beneficiaries, as well as between the European Commission (EC), international financial institutions (IFIs) and bilateral donors, and the importance of inclusive partnership and the need to bring the EBRD and other IFIs on board at the earliest stage in the consideration and design of major regional projects.

Extension of the Trans-European Network to the region was one of the major results of this regional cooperation and coordination. The efforts to advance a few major priority connectivity projects in transport and energy culminated in an agreement, reached at the high-level meeting between the EC and Western Balkans prime ministers in Brussels in April 2015, on the regional core transport and energy network for the Western Balkans as an extension to the region of the Trans-European Network (TEN-T). This ensures closer integration of the region with the EU and is the basis for leveraging investment in infrastructure. The EC announced an allocation of €1 billion over seven years for funding these priority projects. As part of the efforts to improve coordination in developing regional projects, all Western Balkans countries established National Investment Committees (usually headed by the prime ministers) and national coordinators,

tasked with preparing Single National Project Pipelines for priority investments, as a precondition for EU grants funding for transport investment. Soft connectivity is increasingly in focus. The Western Balkans Six process received the strongest political boost at the August 2014 Summit in Berlin, which paved the way for the Berlin Process.⁴⁴ The biennial Western Balkans Summits at the EBRD are complementary to the annual summits of the Berlin Process, while maintaining their initial strong focus on investment promotion. The third Western Balkans Summit at the EBRD, which was scheduled for 26 February 2018, continued the work on investment promotion and on promoting concrete regional projects in transport and energy to unlock key regional bottlenecks. But there is more to regional integration than physical infrastructure alone. The additional new theme of this EBRD summit is the “soft connectivity” agenda. A key element of the latter is the creation of a single investment space, which includes harmonizing legislation, removing nontariff barriers, improving both the depth and horizontal links of capital markets, strengthening the business environment in the region, and facilitating foreign investment. This is a contribution to developing the EU-supported Regional Economic Area. An action plan for an EU-compliant regional economic area in the WB-6 is in place. One of the outcomes of the Western Balkans Summit in July 2017 in Trieste was the adoption of a “consolidated multi-annual action plan for a regional economic area in the Western Balkans six.” The intention is to move the six countries beyond the existing free trade agreement and towards a more comprehensive economic cooperation. There are four components of the Regional Economic Area to be addressed by the action plan:

- (i) trade,
- (ii) investment,
- (iii) mobility and
- (iv) digital integration

⁴⁴ The Berlin Process is a series of annual meetings of the six Western Balkans prime ministers and six EU states with a particular interest in the region, hosted by different EU countries, launched in August 2014 in Berlin, and serving to discuss important regional topics related to future EU membership of the region. The 2014 summit in Berlin was followed by Vienna in 2015, Paris in 2016 and Trieste in July 2017; the next, in July 2018, will be held in London.

All six countries have committed to deepening their collaboration within the current regional free-trade agreement (CEFTA) to the point where goods, services, investments and skilled people can move freely within the region without tariffs, quotas or other unnecessary non-tariff, and other, barriers. Bilateral relations in the region have also advanced. The strengthened coordination between the WB-6 and the key international stakeholders has been accompanied by progress in the reconciliation and strengthening of good neighborly relations in the region. Highlights include, among others, the EU-facilitated dialogue between Belgrade and Pristina aimed at the normalization of the relations between the two, and the rapprochement between Serbia and Albania.⁴⁵

3. How Competitive is the Western Balkans region relative to others?

The notion of “competitiveness” can mean different things to different authors. A country is highly competitive if it has the right combination of institutions and policies, such as effective governance and an enabling business environment, and factors of production to achieve high levels of productivity. To understand why the region finds itself in its current state, and to assess the potential for catch-up, it is important to see where these countries stand across a range of indicators vis-à-vis its comparators in the European Union. How competitive are the Western Balkans countries? The natural starting point to answer this question is the World Economic Forum’s Global Competitiveness Report (GCR), a publication that bills itself as the “world’s most comprehensive assessment of national competitiveness”.⁴⁶ But the GCR by no means captures all aspects of this concept. Other surveys and studies can complement the report by providing greater insights into specific aspects of the business environment and governance that hold back private sector development and deter investment. In this part of my

⁴⁵ Sanfey P. & Milatovic J. 2018. EBRD. The Western Balkans in Transition: diagnosing the constraints on the path to a sustainable market economy

⁴⁶ See World Economic Forum Global Competitiveness Report 2015-2016, available at: <http://reports.weforum.org/global-competitiveness-report-2015-2016/>.

Dissertation I explain the competitiveness of three Balkan countries- Albania FYR Macedonia and Serbia relative to EU region.

Table 1 shows the 2015-16 GCR global rankings for the three Western Balkan countries, along with three benchmark comparators: the European Union, the EU-15 (the 15 member states prior to the 2004 expansion) and the EU-11 (the 11 countries in central Europe, the Baltic states and south-eastern Europe that joined in 2004 or later).⁴⁷

Table 1: Rankings in Global Competitiveness Index 2015-16

		ALB	MKD	SRB	WB	EU-11	EU	EU-15
Basic requirements	1st pillar: Institutions	84	52	120	91	72	47	30
	2nd pillar: Infrastructure	88	78	75	83	52	33	18
	3rd pillar: Macroeconomic environment	118	47	125	93	47	59	66
	4th pillar: Health and primary education	52	76	62	54	45	30	20
Efficiency enhancers	5th pillar: Higher education and training	47	46	71	63	40	30	20
	6th pillar: Goods market efficiency	63	33	127	84	53	39	29
	7th pillar: Labour market efficiency	97	84	118	101	68	54	45
	8th pillar: Financial market development	118	52	120	89	56	53	48
	9th pillar: Technological readiness	89	63	51	67	37	26	16
	10th pillar: Market size	104	108	75	103	66	54	37
Innovation and sophistication factors	11th pillar: Business sophistication	95	72	132	105	63	39	19
	12th pillar: Innovation	118	58	113	95	58	37	20
Global Competitiveness Index		93	60	94	86	50	36	23

Source: World Economic Forum's Global Competitiveness Index Historical Database.

Note: WB refers to the Western Balkans, ALB to Albania, MKD to FYR Macedonia, and SRB to Serbia.

The table shows the clear competitiveness gap between the Western Balkans region and the European Union. On average, the region is ranked 86th (ranging from FYR Macedonia in 60th to Serbia in 94th place), compared with an average 50th place for the EU-11 and 36th for the European Union as a whole. The gap is particularly large with respect to the EU-15, where the average ranking is 23rd. The GCI is made up of three broad categories, which are divided into 12 pillars, and the rankings of the five Western Balkans countries by categories and pillars

⁴⁷ The EU-15: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the United Kingdom. The EU-11: Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.

are also contained in Table 1. The rankings differ widely, both within and across countries. The region scores reasonably well on indicators associated with health and primary education, as well as higher education and training (except for on-the-job training), electricity and telephone infrastructure and information and communications technology (ICT) use. However, the most problematic areas are: efficient use of talent, that is, capacity to attract talent from abroad and retain talent, as confirmed by the brain drain problem; and reliance on informal (family and friend) relationships rather than on professional management.

The second area dragging down the overall ranking is business sophistication. Despite the high heterogeneity, on average countries lack well-developed business clusters and are characterized by shallow value chains. Transport infrastructure ranks badly mostly due to the limited passenger carrying capacity in airline traffic, but also because of the poor quality of overall infrastructure, including roads, railways and ports. On a more positive note, Table 2, which shows the 2007-08 GCR scores compared with the latest available (2015-16), suggests that there has been a gradual improvement in competitiveness since the pre-crisis years. In contrast, scores of the EU countries have remained on average almost the same as before. The biggest jump in competitiveness is in FYR Macedonia, where the score has improved by 0.6 points (on the GCR's 1 to 7 scale) and now lies just behind the EU-11 average. Notable advances have also occurred in Albania, but less so in Serbia. In an important sense, therefore, the Western Balkans economies are converging with EU comparators in terms of competitiveness.

Table 2: Global Competitiveness Index, evolution of the scores

	2007-08		2015-16		Difference in scores
	Score	Rank	Score	Rank	
Albania	3.5	109	3.9	93	0.44
FYR Macedonia	3.7	94	4.3	60	0.55
Serbia	3.8	91	3.9	94	0.10
WB	3.7	96	4.0	86	0.31
EU-11	4.4	48	4.4	50	0.05
EU	4.7	34	4.8	36	0.03
EU-15	5.1	21	5.1	23	0.01

Source: Calculations based on the World Economic Forum's Global Competitiveness Index.

The GCR scores are a useful starting point for investors who wish to get a sense of how competitive a country is. However, other cross-country surveys and reports can provide complementary perspectives and insights, especially when it comes to economic governance and the overall quality of the business environment. To shed further light on these two areas, there are three other surveys and reports: two from the World Bank (Governance Indicators and Doing Business scores) and the joint EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS).

As with the GCR scores, there is some distance to go for Western Balkans countries to match EU standards. But again, a look at the scores over time suggests that the gap is, on average, narrowing steadily. The biggest increase over the past 15 years has been in political stability, which is an indication of the region's growing political maturity. However, due to a low starting point, on present trends it would take several decades before Western Balkans countries catch up with EU members in terms of governance. Still, this convergence is expected to speed up in the process of EU approximation.

The World Bank's annual Doing Business scores provide further insight into the obstacles faced by enterprises in the region.⁴⁸ The latest rankings on overall ease of doing business vary widely, from 12th (FYR Macedonia) to 97th (Albania) out of 189 countries. The width of this range exaggerates the differences among countries of the region. The rankings therefore need to be interpreted cautiously: few would argue that it is really easier to do business in FYR Macedonia than in Canada or Germany, for example, despite their relative positions in the overall scores. However, as with other indicators considered here, the sub-components and their trends over time can be more revealing. Common problems across the region include: dealing with construction permits (Albania ranks in last place globally on this measure⁴⁹); getting electricity; and paying taxes, despite recent improvements in some cases. On the other hand, all countries made notable

⁴⁸ The full scores are available at: www.doingbusiness.org.

⁴⁹ Albania's overall ease of doing business ranking was downgraded by 35 places to 97th. This was almost entirely because the country's position in the category relating to construction permits dropped, caused by the government's decision to suspend the issuing of construction permits during the territorial reform process until urban plans are in place.

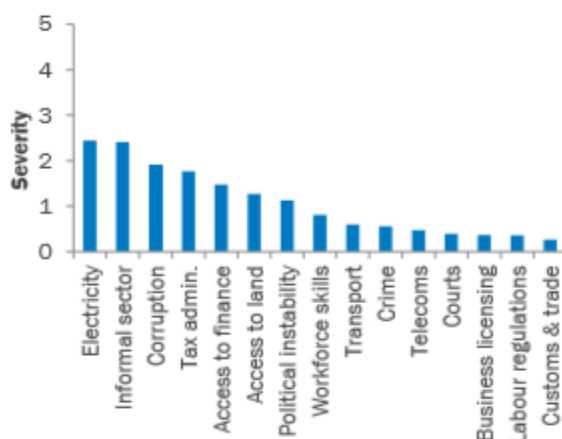
progress in ease of starting a business, registering property and trading across borders.

To gain further insight into the obstacles, as perceived by businesses, we turn lastly to the EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS). The BEEPS, carried out every three to four years since the first round in 1999, is a face-to face survey of top managers that looks at various aspects of the business environment through both quantitative and qualitative questions. One of the parts of the survey is an opinion-based question that asks respondents to grade areas according to their perception of how severe an obstacle is. The responses range from “not an obstacle”, which can be scored at 0, to “a very severe obstacle”, scored 4.

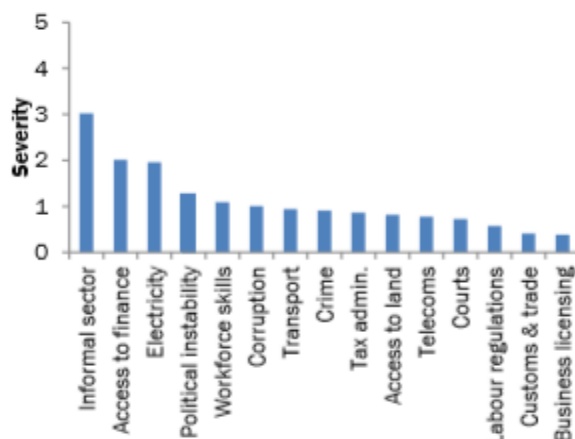
Chart 3 highlights the main obstacles, ranked by severity, for a hypothetical “average” firm in each country. In virtually all countries, competition from the informal sector stands out as a key constraint. This is a long-standing problem in the region and efforts to address it have been sporadic at best. The Albanian government’s recent initiative to tackle the problem is welcome and may yield concrete results. Having reliable access to electricity is also identified by many businesses in Albania as a major obstacle, consistent with the analysis of the World Bank’s Doing Business report.

Chart 3: Business environment obstacles

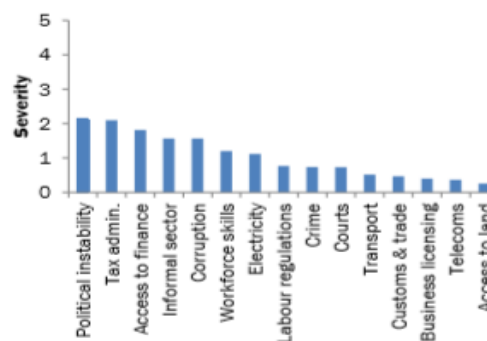
Albania



FYR Macedonia



Serbia



Source: EBRD-World Bank BEEPS V, 2013.

Note: Estimated for a hypothetical "average" firm. Higher values correspond to a more severe obstacle to doing business.

To conclude this section, it is fair to say that the Western Balkans region lies behind western European comparators in terms of competitiveness, governance and ease of doing business. But there are plenty of reasons to be optimistic about future trends. In particular, institutions and governance standards are being slowly but steadily improved, especially in the EU candidate countries. The next section outlines some of the potential advantages of the region not fully captured by the cross-country data sets mentioned above.

4. What can the Western Balkans offer investors?

There are six features of the region that, are worth emphasizing. They are: prospective EU membership; macroeconomic stability; strategic location; diverse economies; Favourable taxes and low labor costs combined with a relatively educated population. Each of these will be discussed in turn.⁵⁰

4.1 Prospective EU membership

The new European Commission Enlargement Strategy,⁵¹ released in November 2015, has reaffirmed the European prospective of all Western Balkans countries, without exception. Although full membership is not on the cards for any of these countries during the mandate of the present Commission (2014-19), the past year has seen further progress in most countries in the enlargement process. The most advanced in this regard is Montenegro which, having started membership negotiations in June 2012, had by December 2015 opened more than half of the negotiation chapters of the EU *acquis communautaire*, including the most challenging Chapters 23 and 24 relating to judiciary and fundamental rights; and justice, freedom and security, respectively. Serbia opened its first chapters in December 2015, including the one on normalization of its relations with Kosovo, almost two years after the symbolic opening of the accession negotiations in January 2014. Albania, a candidate country since June 2014, is deemed in the latest European Commission report to be “making steady progress”. Only FYR Macedonia, a candidate since 2005, has failed to make demonstrable progress since then as its name dispute with Greece remains unresolved. The latest EC Enlargement Strategy has introduced a new methodology to assess the progress of aspirant countries. The report includes a five-point scale in a few pilot areas, including rule of law (functioning of the judiciary, fight against corruption and fight against organized crime), public administration reform, and key economic

⁵⁰ Sanfey P., Milatovic J., Kresic A. 2016. EBRD. How the Western Balkans can catch up. . Working Paper No. 186

⁵¹ Accessed at: http://ec.europa.eu/enlargement/pdf/key_documents/2015/20151110_strategy_paper_en.pdf.

criteria (the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the European Union). These are: (1) Early stage; (2) Some level of preparation; (3) Moderately prepared; (4) Good level of preparation; and (5) Well advanced (see Table 3).

Table 3: State of progress on EU approximation

		ALB	MKD	SRB
Public administration reform		3	3	3
Rule of law	Functioning of the judiciary	1	2	2
	Fight against corruption	2	2	2
	Fight against organised crime	2	2	2
Economic criteria	The existence of a functioning market economy	3	4	3
	The capacity to cope with competitive pressure within the European Union	2		
			3	3

Source: European Commission Country Reports, 2015.

Note: Scores are on a scale of 1 for early stage progress to 5 for well advanced

None of the Western Balkans countries will become full EU members in the next five years. But the long-term prospect of membership comes with substantial funding mainly in the form of the Instrument for Pre-Accession Assistance (IPA) for supporting reforms. Table 4 shows per country financial allocation from IPA funds for the period 2014-20, covering reforms in areas such as democracy and governance, rule of law, environment, transport and energy, competitiveness, social policies and agriculture and rural development. As many benefits of the European Union for the region accrue before full membership is obtained, it is important, therefore, that the current momentum in the process is maintained or even enhanced in the years to come.

Table 4: EU's Instrument for Pre-Accession Assistance 2014-20, € million

		ALB	MKD	SRB
1	Reforms in preparation for EU membership	321	206	543
1a	Democracy and governance	224	123	278
1b	Rule of law and fundamental rights	97	83	265
2	Socio-economic and regional development	168	299	565
2a	Environment and climate action	68	113	160
2b	Transport	56	113	175
2c	Energy	0		125
2d	Competitiveness and innovation	44	73	105
3	Education, employment and social policies	69	53	190
4	Agriculture and rural development	92	106	210
Total, € million		649	664	1,508

Source: EC, http://ec.europa.eu/enlargement/instruments/overview/index_en.htm

Note: *2014-17. In addition, there is €2,959 million in funds for multi-beneficiary projects in the Western Balkans and Turkey.

4.2 Macroeconomic stability

For many years, countries in the Western Balkans region have enjoyed a high degree of macroeconomic stability. A stable economy anchors expectations and is a basic prerequisite for attracting the interest of foreign investors. Stable exchange rate regimes and low inflation rates are key pillars of the region's macroeconomic stability. In four of the six countries the exchange rate is immovable vis-à-vis the euro, either because the euro is the only legal tender (Kosovo and Montenegro), or because the rate is fixed through a currency board (Bosnia and Herzegovina), or a long-standing peg (FYR Macedonia). Floating exchange rate regimes prevail in Albania and Serbia but excessive fluctuations are kept in check by central bank interventions; for instance, the Albanian lek has been at the rate of approximately 140 lek per euro for the last five years. As a

result, all countries have had very low inflation for many years (see Table 5), aside from Serbia where the rate had reached high single digit levels (or even briefly double-digit territory) but is now comparable to other Western Balkans countries, as well as being below the central bank's target range.

Table 5: Macroeconomic aggregates, five-year averages

	Inflation		Fiscal balance		Current account (BOP)	
	2003-08	2009-14	2003-08	2009-14	2003-08	2009-14
Albania	2.7	2.5	-4.1	-4.6	-9.1	-12.5
FYR Macedonia	2.2	1.8	-0.1	-3.2	-5.7	-2.9
Serbia	9.8	7.1	-0.9	-5.0	-12.8	-7.5

Source: World Economic Outlook, IMF, April 2015.

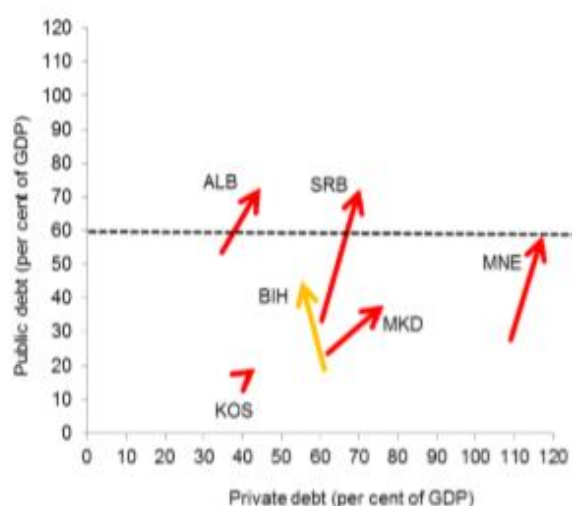
Note: Fiscal balance and current account expressed as a per cent of GDP. Inflation rates are period averages.

The figures on current account and fiscal deficits are less impressive (also shown in Table 5); average current account deficits in the region (as a per cent of GDP) were 9.9 per cent in the period 2009-14 while fiscal deficits were 3.8 per cent over the same period.

In parallel, both public and private debt has increased significantly in most countries since 2007 (Chart 4). Serbia experienced the highest percentage-point-increase in public debt; for private debt it was FYR Macedonia. At the end of 2014 public debt levels were well above 60 per cent of GDP (one of the Maastricht criteria for eurozone members) in Albania and Serbia. While this poses a risk to macroeconomic stability, strong mitigating factors are also in play. Albania and Serbia are both in formal programs with the IMF. The two countries have adhered closely to commitments made under their respective arrangements, which in both cases are explicitly designed to tackle fiscal imbalances and put public debt on a sustainable path.

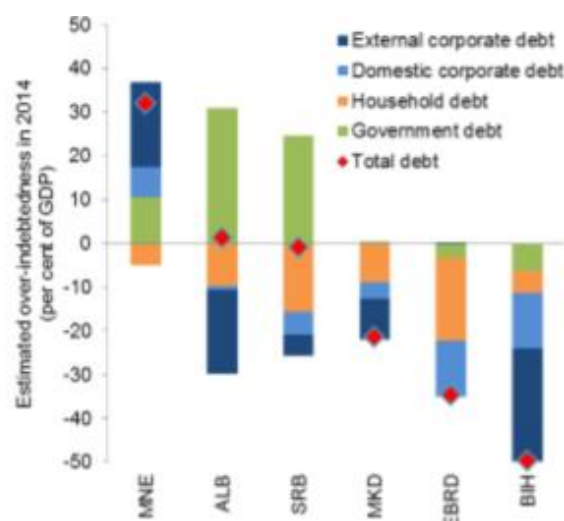
The level of private debt is particularly high in Montenegro, at more than 110 per cent of GDP, while still low in Albania and Kosovo.

Chart 4: Changes in levels of public and private debt as % of GDP, 2007-14 **Chart 5: Relative over-indebtedness in 2014**



Source: EBRD *Transition Report*, 2015-16.

Note: Data comprise public debt, domestic private-sector debt and external debt of non-financial companies. The initial observation for Kosovo relates to 2009.



Source: EBRD *Transition Report*, 2015-16.

Note: A negative sign reflects under-indebtedness relative to global comparators. See the EBRD *Transition Report*, 2015-16, Chapter 1, for further explanation.

Interestingly, however, debt levels across all countries where the EBRD invests are still, on average, lower than those of other emerging markets with similar characteristics.⁵² This relative underleverage is driven both by lower levels of household and corporate debt (see Chart 5). Therefore, this analysis suggests that in all Western Balkans countries there is room to increase household debt and also, in all countries except Montenegro, there is space for a corporate debt increase. Evidence suggests that domestic corporate credit has a greater positive impact on growth prospects compared with household debt or external corporate debt, and the countries that appear to have the greatest scope to increase domestic corporate debt are FYR Macedonia and Serbia.

4.3 Strategic geographic location

An important advantage for the Western Balkans region is its easy and free access to EU markets. This has been enabled by its geographic proximity to major

⁵² See the EBRD *Transition Report*, 2015-16: Rebalancing finance, Chapter 1, for an elaboration of this argument.

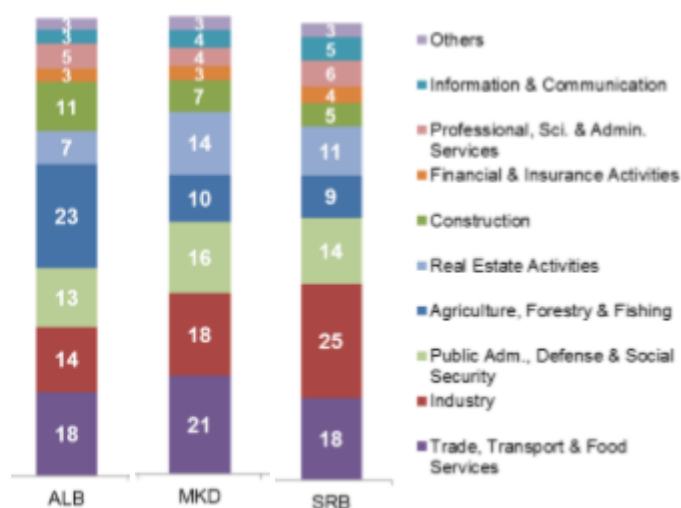
European markets and the free trade agreements that the countries of the region have signed with the European Union. The region is linked with the rest of Europe through the Pan-European corridors X (connecting the central Europe with Turkey through Austria, Slovenia, Croatia, Serbia, FYR Macedonia and Greece), VII (connecting the Black Sea with the Ionian Sea and passing through Bulgaria, FYR Macedonia and Albania), and Vc (connecting central Europe with the Adriatic Sea via Hungary, Croatia, Bosnia and Herzegovina and Croatia again). Owing to its geographic position between the East and West, the region is often referred to as a gateway to Europe. As sea shipping remains the cheapest way to transport goods from the Far East to Europe, China plans to establish a rapid transport connection from the Greek port of Piraeus, the first major European container port for ships entering the Mediterranean from the Suez Channel, through the Balkans further to the EU markets – the Balkan Silk Road. This will come as the part of the “One Belt, One Road” initiative unveiled by the Chinese President in 2013. The Balkan Silk Road will be based on the existing railroad network linking central Europe with the Aegean Sea via Serbia, FYR Macedonia and Greece. The first operational move to realize the plan was made when the Chinese shipping giant Cosco Pacific took over half of the Piraeus port in a 35-year concession with the aim of turning the port into one of Europe’s top five container ports. However, to take full advantage of the port, investments into transport links across the Western Balkans are needed, such as the €1.5 billion worth high-speed railway between Belgrade and Budapest as signed between China, Hungary and Serbia. Location is also a major factor why the Western Balkans could play a role in improving the EU’s energy security through possible investments in new gas pipelines.

4.4 Diverse economies

Economies in the Western Balkans region tend to be quite diverse, rather than relying on one or a few sectors, and therefore offer a wide range of opportunities for investors. A diverse economy is also one that allows human capital development to expand in many different directions. Chart 6 shows how the

economies of Albania, FYR Macedonia and Serbia are structured, that is, the contribution of different sectors in each country to gross value added (GVA), the measure of the value of goods and services produced in a country.⁵³ The category “domestic trade, transport and storage, accommodation and food services” is on average the largest sector of the Western Balkans economies, ranging from 18 per cent of GVA in Albania and Serbia to 21 per cent in FYR Macedonia.

Chart 6: Structure of economy, per cent of gross value added, 2014



Source: National statistical offices

Industry accounts for one-fifth of GVA on average. However, this varies significantly across the countries. The role of industry is particularly important in Serbia (where it represents an equally important part of the economy as in EU-11). Manufacturing is the predominant industrial subsector, especially in Serbia and FYR Macedonia. Meanwhile public administration, defense, education and social services account for 17 per cent of economic activity on average, from 13 per cent in Albania to 16 per cent of the economy in FYR Macedonia. In general, the region is quite agriculture-intensive, and agriculture (together with forestry and fishing) accounts for 12 per cent of value added on average, ranging from only 9 per cent in Serbia to 23 per cent in Albania. Agriculture plays a vital role in the Western Balkans, both socially and in terms of employment. This contrasts

⁵³GVA is linked to gross domestic product (GDP) through the following relationship: $GVA + \text{taxes on products} - \text{subsidies on products} = \text{GDP}$.

significantly with the EU-11 where on average the sector accounts for only 4 per cent of economies. Serbia stands out as having a clear comparative advantage in farming, mainly due to fertile agricultural soil in its northern province of Vojvodina. Some large producers have been able to take advantage of both economies of scale and access to major export markets, primarily the European Union but also Russia, with which Serbia has a free trade agreement (the only country in the region to do so). The other five countries have less advanced agricultural sectors, mainly consisting of small-scale and inefficient subsistence farming. The potential for agribusiness to develop further in the region is significant provided countries can consolidate agricultural holdings, improve the quality of collection, storage and marketing, and develop agricultural support services such as insurance. Real-estate-related activities account for one-tenth of economies, on average, and construction around 7 per cent, on average, but more than 10 per cent in Albania. The financial sector, professional/scientific/technical sector and ICT each account for just 4 per cent of value added, on average. This is again in contrast with the EU-11, where these sectors account for a larger share, in particular the professional sector which is twice the size. These areas can be important attractors for future FDI. Furthermore, several countries have strong potential for further growth in the tourism sector. In 2013, receipts from international tourists amounted to 21 per cent of GDP in Montenegro and 13 per cent of GDP in Albania.⁵⁴ Both countries, as well as others in the region, expect tourism numbers to increase significantly in the coming years, especially as the quality of infrastructure and services improves towards the standards of the most advanced western markets.

4.5 Favorable taxes

A stable and favorable tax climate and incentives for foreign businesses are sometimes deciding factors when foreign investors make decisions about location of investment. Most countries in the Western Balkans have made significant progress in reforming their tax systems in line with best international practice.

⁵⁴ See World Bank, World Development Indicators, International tourism, receipts (current US dollars).

During the past decade, tax rates in the region have been relatively stable, there has been a fall in the administrative burden of submitting taxes and efforts have been made towards widening the tax base. To substantiate these points, various sources are pointed. First, the World Bank's Doing Business report, together with PwC for this area, covers three dimensions of paying taxes: total tax rate with contributions of different types of taxes; number of tax payments per year; and time needed to comply with the tax rules.⁵⁵

Although there are differences among the countries in the Western Balkans region, the total tax burden is clearly lower than in any of the benchmarks (EU-11, EU, and EU-15). This is driven by both lower profit and a smaller labor tax burden. In fact, FYR Macedonia has one of the lowest total tax burdens in the world – largely because there are no labor taxes (that is, social insurance contributions borne by companies), but also because it levies taxes on corporate profits only once they are distributed as dividends and has low levels of other taxes.⁵⁶ Albania and Serbia are the only two Western Balkans countries where the total tax share of profits is almost at the EU-11 level of 40 per cent.

Chart 7: Paying taxes: number of taxes, 2015

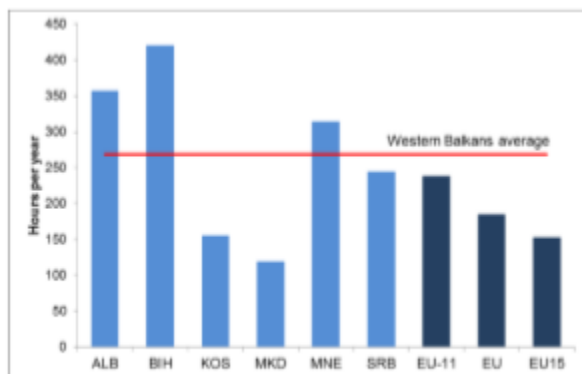


Chart 8: Paying taxes: hours needed, 2015



Source: The World Bank's Doing Business database.

⁵⁵ As with other Doing Business sub-indices, the category "paying taxes" uses a case study scenario. This means that the same set of financial statements and assumptions about the company and transactions is used by a number of tax experts in each country to calculate what the company would have to do to satisfy tax procedures. Results are therefore comparable across the countries and give a richer picture than that obtained by simply looking at rates prescribed by laws.

⁵⁶ Other taxes considered are property tax, vehicle tax, capital gains tax, financial transactions tax, environmental tax, etc. VAT is excluded from the calculation as it is not borne by the company itself.

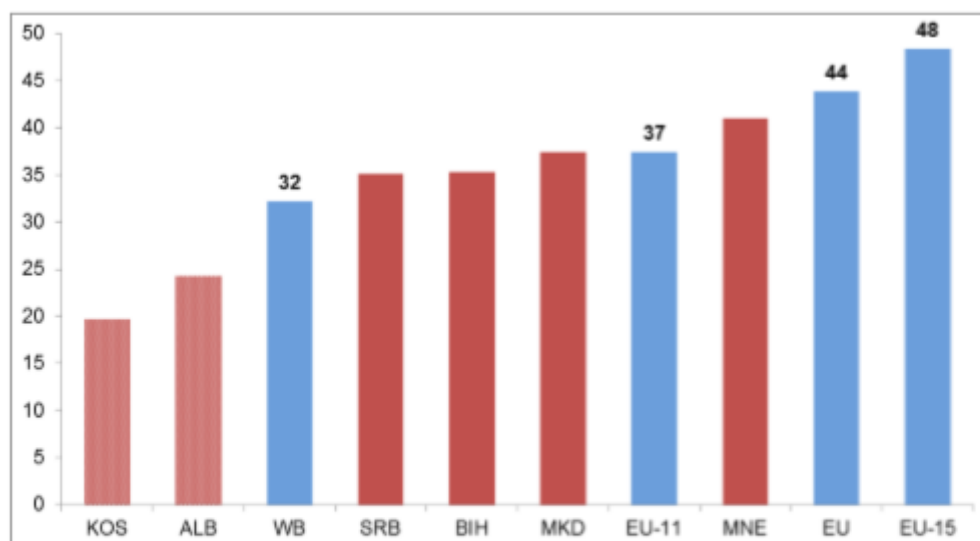
Encouragingly, there have been positive changes over the years. A few countries have introduced online registration centers, with FYR Macedonia being the most advanced. Over the years FYR Macedonia has efficiently implemented a so-called “regulatory guillotine” project under which it drastically reduced regulatory burdens and red tape, and it is now the only country in the region with a successfully functioning one-stop shop for opening a business. Registering a business in this one-stop shop can be done in four hours⁵⁷ and includes the allocation of a Tax Identification Number. Additional tax reforms were carried out over the last eight years, bringing down the number of tax payments per year from 43 in 2006 to only 7 from 2014 onwards. The most progress in simplifying tax payments was made by introducing electronic filing and payment systems in 2008, and further improving and encouraging their use for corporate income and value added taxes in 2014.

4.6 Low labor costs with a relatively educated population

A further advantage of the region is the relatively low cost of labor, as shown by unit labor costs (ULC), defined as gross labor cost divided by GDP. While ULC is not a perfect approximation of representative firm labor costs, it gives a good idea of a country’s labor cost competitiveness. Chart 9 shows that all Western Balkans countries have lower ULCs compared with the EU average. This is important for export-oriented companies in the region because, Western Balkans exporters typically specialize in labor-intensive industries.

⁵⁷ Providing no additional licenses, approval or other specific documents are needed. Also, besides the general tax registration at the one-stop shop, under some conditions visiting the Public Revenue Office might be necessary (e.g. for foreign legal entities).

Chart 9: Unit labor costs, 2014



Source: Statistical offices from the respective countries, Eurostat.

Note: Unit labour cost is calculated as $[(\text{average gross wage} \times \text{number of employed}) / \text{GDP}] \times 100$. In the cases of Albania and Kosovo, average net wage is used due to lack of data on gross wage. One should keep in mind the high discrepancy between ULC in gross and net wage terms – 12 on average in other Western Balkans countries.

The advantage of low labor costs is complemented by the relatively educated population. The Global Competitiveness Report discussed earlier confirms this point as the health and primary education pillar is among the highest ranked out of all 12 dimensions measured in the GCI. Basic statistics on education such as literacy rates, as well as educational attainment and current enrolment, are favorable. All countries record high adult literacy rates, scoring on average 98 per cent in 2011.⁵⁸ The educational attainment structure of those older than 25 shows that almost three-quarters of the population has at least secondary education (EU average is 81 per cent).⁵⁹ Current enrolment rates in primary and secondary school are comparable to EU levels in most of the countries, and all countries except Albania (Kosovo not included) had a lower share of early school leavers than the EU average in 2013, with a decreasing trend over the last three years.⁶⁰

⁵⁸ UNESCO: Education database, 2015 and ETF, 2015, Torino Process 2014: South Eastern Europe and Turkey.

⁵⁹ UNESCO: Education database, 2015.

⁶⁰ Early school leavers are defined as a share of 18-24 year olds with at most lower secondary education and not in further education or training.

Although the share of population with secondary education is on average higher in the Western Balkans than in the European Union, the quality might lag behind, as shown by the PISA exams,⁶¹ which test skills and knowledge of 15-year-old students. The share of those with tertiary education is about half that of the EU average. However, the structure of those currently enrolled in tertiary education is similar to EU countries (see Chart 10). Nonetheless, the share of science, technology, engineering and math (STEM) students in tertiary education, an important indicator capturing human capital crucial for adopting and creating technologies, is a bit lower on average than in EU countries. Still, this is not the case in Serbia, which has double the share of students in this category compared with the other Western Balkans countries, due partly to the importance of Belgrade as a regional university centre. Improving vocational education and training in line with private sector requirements is where more work can be done. This chimes with firm-level evidence from the BEEPS which points to difficulties in hiring people with adequate skill sets. However, on a more positive note, Western Balkans countries have made an effort to meet international standards by participating in the Torino process and the South East European Centre for Entrepreneurial Learning (SEECEL). As a result, countries in this region have adopted policy documents for medium- and long-term visions of their vocational education and training (VET) systems, with clear strategic objectives. They have also integrated entrepreneurship into VET curricula, thereby recognizing the importance of small and medium-sized enterprises in the region and their connection to VET.

5. The Regional Competitiveness Initiative⁶²

Since 2000, the economies of the Western Balkans (Albania, Bosnia and Herzegovina, Croatia, the Former Yugoslav Republic of Macedonia, Kosovo, Montenegro and Serbia) have undertaken significant reforms to improve their business environments. These reforms led to the doubling of GDP per capita from

⁶¹PISA stands for the OECD's Program for International Student Assessment.

⁶² OECD. WESTERN BALKANS REGIONAL COMPETITIVENESS INITIATIVE

2000-2010 and a tenfold increase in inflows of foreign direct investment between 2000 and 2008. The economies of the region also signed an ambitious trade agreement, CEFTA 2006, which has facilitated greater intra-regional investment and trade flows.

However, the global economic crisis in 2009 threw most of the region into a recession. Faced with tightening public budgets and mounting social pressures, governments of the region realized that they could no longer rely on domestic consumption and credit expansion alone to generate growth and jobs.

With increasing global competition, the region's future lies in creating and exporting higher value products and services. Human capital and innovation lie at the heart of this new growth model for the Western Balkans.

The Regional Competitiveness Initiative (RCI) aims to help Western Balkan economies unlock new sources of growth and competitiveness by tapping their innovation potential and developing the skills of their workforce.

Financed by the EU and led by the OECD Investment Compact for South East Europe, the RCI partnered with governments over a three year period to test targeted innovation and human capital initiatives in their national contexts. Over 2010-2013, each country selected and implemented an innovation related pilot project with the support of national and OECD experts. Projects included assessments of current country performance based on business surveys, study trips to learn about good practices in OECD member countries, and a detailed action plan. Regional working groups on innovation and human capital development supported peer learning and good practice by sharing knowledge gained through the pilot projects.

The RCI project's impact, effective partnership with the region, and innovative approach was recognized by a first place award from the European Projects Association.⁶³

⁶³ In the category for concluded projects financed by the European Union's Instrument for Pre-Accession.

In the next section I am going to analyze separately how the RCI project is implemented in three countries (Albania, FYR Macedonia and Serbia).

5.1 ALBANIA: Launching a business plan competition

Albania wanted to organize its first business plan competition with the support of the OECD. The purpose of the competition was to connect promising business ideas with sources of financing, inspire potential entrepreneurs and promote innovation in the private sector.

The country's main project actions are:

- Published call for applications on the website of the Albanian Investment Development Agency.
- Matched each application team with a voluntary mentor to help them develop their business plan.
- Organized a workshop to train entrepreneurs on how to develop a successful business plan.
- Selected the top 8 business plans for the final competition and held a workshop on how to create 'elevator' pitches for their business plan.
- Held the final competition in Tirana on 8 November 2012, with a jury including representatives from the Ministry of Economy, Trade and Energy, Albanian Investment Development Agency, the European Commission, an Albanian entrepreneur, and the OECD.

Albania's key achievements considering the initiative were that the country organized its first nation-wide business plan competition involving 18 teams of young entrepreneurs; the OECD supported the top three winners of the business plan competition with additional advisory services in the form of market research to help improve their products and services and the involvement of officials from the Ministry of Economy, Trade and Energy throughout the project also ensured

the transfer of know-how. As a result, a second and more ambitious business plan competition was planned for November 2013 in Tirana.

5.2 FYR MACEDONIA: Strengthening the national innovation system

With the support of the OECD, the government of The Former Yugoslav Republic of Macedonia developed an innovation strategy and an action plan.

However, there were some barriers to innovation, such as weak capacities of research institutions, low propensity to innovate in the business sector, poor framework for knowledge transfer and lack of co-ordination at the policy-making level.

The key achievements of the country are:

- FYR Macedonia carried out the first comprehensive assessment of its innovation system.
- The assessment involved the contribution of over 500 businesses through surveys and focus groups. Based on the results of this assessment, FYR Macedonia developed and adopted its first Innovation Strategy and Action Plan.
- A new Innovation Law was passed and the implementation of the Strategy, supported by a \$20M loan from the World Bank, is being led by the Office of the Deputy Prime Minister in charge of economic affairs.
- The 20-member inter-ministerial team involved in the project gained valuable experience in the design of innovation policies.

Some of the Project Recommendations considering the initiative are connected to:

- Foster innovation in the private sector through information campaigns, events, competitions and awards
- Adapt education policy to develop skills needed for innovation
 - Increase the quality of vocational training
 - Promote lifelong learning

- Create a regulatory environment that supports innovation
 - Provide an effective regulatory environment for academics and research institutions
 - Generate a competitive business environment through an effective competition policy
- Increase knowledge flows
 - Strengthen linkages with the Diaspora
 - Foster business networks and clusters

5.3 SERBIA: Developing a competence technology center

Serbia's priority was to focus on the development of a competence technology centre in either the agri-food or biomedicine sectors. Such a centre aims to accelerate innovation and economic growth by facilitating interactions between industry, researcher and the public sector.

Serbia's project actions are focused on:

- Reviewed practices of existing competence centers and technology institutes in OECD countries
- Presented excellence and competence centers to Serbian officials during a study visit to Slovenia
- Surveyed businesses and research institutions in the agrifood and biomed sectors
- Consulted with experts in the agri-food and biomed sectors
- Assessed the feasibility of a competence technology centre in Serbia.

The country's project recommendations are connected to orient centers toward firms and researchers in the agri-food or biomedicine sectors, establishing centers as autonomous, non-profit organizations linked to a university, expanding their scope of work in two phases (no modifications needed to sub-bullets), ensuring a stable source of funding and locate close to centers' business/research users.

Serbia's key achievements considering RCI are:

- A feasibility study and an implementation plan were developed for the establishment of a competence technology centre in Serbia.
- Over 300 members of the Serbian business and research community were consulted through a combination of surveys, focus groups and workshops.
- The Ministry of Economy is using the results of the pilot project to support the biomedicine sector.
- The project strengthened the capacity of public officials to design new innovation-support measures such as technology brokers and innovation vouchers.

The Western Balkan economies suffer from a growing gap between the skills of its labor force and the needs of a fast-evolving market. Skilling up the workforce is critical if the region is to create higher value and more globally competitive products and services.

To support the region in bridging the skills gap, the RCI created a Working Group on Human Capital comprising policymakers, business representatives and members of the research community. The Working Group came together between 2011-2012 to: Incorporate human capital building activities into the seven pilot projects, raise awareness of various methods and tools to measure skills gaps; e.g. the skills sector approach, foresight techniques, and skills gap measurement methodologies developed by CEDEFOP and O*Net, build policy maker capacity on how to conduct skills gap analyses and transfer good international practices.

6. Obstacles and challenges to private sector development

The private sector across the region is held back by numerous obstacles. Many previous studies and cross-country indicators have shown the various ways in which Western Balkans countries lag behind EU standards, whether in terms of overall competitiveness, weak institutions, low standards of governance or barriers to trading across borders, to take some of the most commonly cited problems. But which obstacles are the most severe, and are there important

differences across the six countries? The following analysis, based on background research papers, attempts to answer these questions.⁶⁴

Corporate productivity is adversely affected by a range of common obstacles in the region. An econometric analysis of total factor productivity (TFP) at the firm level in two countries – FYR Macedonia and Serbia – demonstrates a statistically significant impact of several variables on productivity.⁶⁵ Most notably, corporate over-indebtedness is associated with lower productivity, as is a high degree of market concentration. The impact of these two factors seems to be higher in FYR Macedonia than in Serbia but is significant in the two countries. Another important finding is that enhancing the quality of the business and macroeconomic environment and improving the transport and telecommunications networks would be linked with significantly increased productivity of firms in Serbia. Similarly, companies in Serbia would benefit from higher youth inclusion, which is an important topic at the regional level given the high youth unemployment rates in all Western Balkans countries. Improving the quality of institutions in Serbia also implies a boost to corporate productivity, while in FYR Macedonia it would be accompanied with a decreasing public sector. There are also several country-specific corporate productivity drivers. In Serbia, higher productivity at the firm level is also associated with better corporate governance (as demonstrated by the finding that greater delegation of authority within a firm tends to increase firms' productivity), while in FYR Macedonia productivity improvements could come from an increase in the quality of higher education and training. Although there is a widespread perception that SOEs in

⁶⁴ This sections draws mainly on two background research papers: "Firm performance and obstacles to doing business in the Western Balkans: evidence from the BEEPS" by Ana Kresic, Jakov Milatovic and Peter Sanfey (EBRD Working Paper No. 200), and "Productivity drivers in the Western Balkans" by Sanja Borkovic, Peter Tabak and Emir Zildzovic (EBRD Working Paper – forthcoming).

⁶⁵ See Borkovic et al. who use firm-level data drawn from the BvD ORBIS database for the period 2007-15. The data are matched with firm-, sector- and country-level data covering a range of potential TFP determinants such as governance, infrastructure, access to finance and employment opportunities, among many others. The methodology underlying this analysis can be summarised as follows: first, a standard production function (assuming a Cobb-Douglas form) is estimated by regressing sales on labour, capital and intermediate inputs (all in logs). Under certain assumptions, TFP can be calculated straightforwardly as a residual, using the estimated coefficients on the three explanatory variables. Second, these TFP estimates can then be used (in difference form) as the dependent variable in a second-stage regression, where the explanatory variables now include a variety of firm-specific, macroeconomic, institutional and business environment variables.

the region are generally less productive than private companies, the econometric results confirm it only in the case of FYR Macedonia.

Survey results also point to common problems across the region. The BEEPS includes questions about the subjective perceptions of business owners and senior managers about different potential problems, and as such it can be quite revealing about the actual situation on the ground. The survey approaches the issue in two ways: one method is to show respondents a card with 15 potential obstacles and ask them: *Can you tell me which of the elements of the business environment included in the list, if any, currently represents the biggest obstacle faced by this establishment?* Table 6 shows the results for the six Western Balkans countries. The second approach is to ask interviewees through the survey to rate the severity of each obstacle on a five-point scale, ranging from “no obstacle” up through “minor”, “moderate”, and “major” to “very severe”. These results, showing the percentage who say major or very severe, are in Table 7.

Table 6: Biggest obstacle to doing business, percentage vote by country

	ALB	BIH	MKD	KOS	MNE	SRB	Average
Competition from informal sector	16.8	4.1	26.0	23.3	12.5	9.8	15.4
Political instability	4.8	30.2	8.8	3.6	4.8	26.7	13.2
Access to finance	12.9	14.9	18.6	14.6	6.3	9.0	12.7
Tax rates	9.8	7.9	7.6	5.0	26.4	15.0	11.9
Corruption	6.3	7.8	1.4	9.8	0.9	10.9	6.2
Electricity	13.6	1.5	5.7	7.0	1.8	0.2	5.0
Customs and trade regulations	1.0	7.6	1.8	8.4	6.3	3.1	4.7
Tax administration	11.6	1.2	2.4	3.9	1.8	4.9	4.3
Inadequately educated workforce	1.9	2.0	5.9	6.3	1.9	5.7	3.9
Courts	0.2	3.3	4.5	1.3	0.2	4.2	2.3
Access to land	5.9	0.8	1.1	1.8	0.9	0.9	1.9
Labour regulations	0.1	6.5	0.6	0.4	3.0	0.1	1.8
Crime, theft and disorder	1.5	1.9	1.0	2.2	1.8	1.2	1.6
Transport	2.7	2.8	1.0	0.9	0.7	0.4	1.4
Business licensing and permits	1.3	3.7	0.4	1.3	0.3	1.2	1.3
Don't know	6.5	2.0	0.5	1.8	15.9	4.1	5.1
Refused	0.0	1.4	9.9	8.0	9.1	1.1	4.9
Does not apply	3.3	0.5	3.0	0.5	5.6	1.7	2.4

Source: BEEPS V.

Note: All companies; no differentiation between the industries; individual observations weighted (strata weights). The categories sum up to 100.

Unfair competition from the informal sector stands out as the most serious perceived business obstacle in the region. More than 15 per cent of all firms cite it as the number one obstacle, and more than one-quarter deem it a major or very severe obstacle. Other prominent issues in the region include lack of access to finance, political instability, tax rates and tax administration, and problems with electricity supply. The problem of corruption also crops up prominently. Although few firms name it as the top obstacle, nearly 23 per cent of respondents say it is a major or very severe problem.

Table 7: Obstacles to doing business, by percentage who perceive a major or very severe problem

	ALB	BIH	MKD	KOS	MNE	SRB	Average
Competition from informal sector	19.9	16.0	34.6	58.9	11.2	12.6	25.5
Political instability	11.1	34.3	21.7	45.7	0.4	31.5	24.1
Corruption	17.0	26.4	13.3	51.0	3.2	24.5	22.6
Electricity	21.6	10.2	28.9	49.5	6.0	6.6	20.4
Tax rates	12.8	20.3	16.0	30.2	8.7	25.5	18.9
Access to finance	6.5	14.1	19.3	44.9	7.6	15.7	18.0
Tax administration	13.1	13.1	10.3	28.2	2.7	17.4	14.1
Crime, theft, disorder	3.8	7.2	9.1	46.6	4.1	7.4	13.0
Inadequately educated workforce	6.4	7.4	14.0	25.9	0.3	11.3	10.9
Customs and trade regulations	2.0	5.7	6.6	34.2	3.0	4.9	9.4
Access to land	12.9	4.6	9.8	17.7	0.3	3.6	8.1
Telecommunications	3.1	4.9	16.3	13.0	4.0	3.9	7.5
Courts	1.5	8.2	6.7	13.0	1.1	13.9	7.4
Transport	4.1	3.7	5.4	22.7	2.0	4.6	7.1
Labour regulations	1.8	11.1	4.0	4.9	0.4	6.9	4.9
Business licensing and permits	3.5	8.4	5.1	4.6	0.3	3.7	4.3

Source: BEEPS V.

The estimated monetary costs of some of these obstacles are substantial. The combined losses from four obstacles whose impact is easily quantified – crime, corruption (that is, informal payments to “get things done”), power outages, and transport breakages and spillages – is estimated by BEEPS respondents at more than 13 per cent of total annual sales revenues. This is well above most countries in central Europe and the Baltic states (CEB). Considering that these four dimensions represent only a subset of the obstacles used in the BEEPS questionnaire, the level of the invisible tax on output/productivity due to an

inadequate business environment is doubtless even higher. Some obstacles are especially burdensome for small businesses. An econometric analysis of the revealed costs of business environment deficiencies in the Western Balkans region provides further insights.⁶⁶ For example, unfair competition from the informal sector is a particular burden for smaller, local market- and service-oriented businesses, and corruption especially detrimental to more innovative firms. The problems of high tax rates and lack of access to finance are more binding for firms in the manufacturing sector than in services. The econometric results also permit a more rigorous ranking of obstacles based on a “benchmark” company, taking into account the institutional setting of each country. However, the results are broadly similar to those based on unconditional means (cited earlier) and, once again, highlight the importance of tackling informality in the economy. In general, the business environment for small businesses is particularly difficult.

7. Transition qualities in the Western Balkans

Western Balkans countries lag behind the EBRD regional average in terms of progress towards a sustainable market economy. During 2017, the EBRD undertook a major exercise to quantify and measure progress in transition across the six qualities of a sustainable market economy.⁶⁷ The six qualities are: competitive, well-governed, green, inclusive, resilient and integrated. The scores for the Western Balkans countries are presented in Table 8, along with the average across all EBRD countries, as well as those for the EU-11. The results show most Western Balkans countries lagging behind in competitiveness and governance, in common with the rest of the EBRD region. But the gap between the Western Balkans and the overall EBRD region is fairly consistent across qualities, ranging from 0.3 to 0.5 points on the 1 – 10 scale. The difference in

⁶⁶See Kresic et al. (2017).

⁶⁷ The full scores for all countries and the associated methodology are presented in the EBRD Transition Report 2017-18, available online at: <http://2017.tr-ebird.com/>. See also the annex to this paper for a summary of the qualities and the scores for all EBRD countries.

relation to EU countries in central and Eastern Europe is much more pronounced, with gaps ranging from 1.3 to 2.0 points.

Table 8: Transition scores for six qualities of a sustainable market economy

	Competitive	Well-governed	Green	Inclusive	Resilient	Integrated	Average
Albania	4.4	4.3	4.9	5.1	4.9	5.8	4.9
Bosnia and Herz.	4.7	3.7	4.8	4.8	5.3	5.5	4.8
FYR Macedonia	5.4	5.2	4.9	4.7	5.3	6.0	5.3
Kosovo	3.4	3.7	3.8	4.7	5.1	4.9	4.3
Montenegro	4.9	5.1	5.2	5.6	5.9	5.6	5.4
Serbia	4.9	4.4	5.8	5.2	5.6	6.4	5.4
WB-6	4.6	4.4	4.9	5.0	5.3	5.7	5.0
EU-11	6.5	5.7	6.3	6.3	7.3	7.5	6.6
EBRD	4.9	4.8	5.4	5.4	5.7	6.0	5.4

Source: EBRD.

Serbia holds the leading role in most sections; however FYR Macedonia transitions scores are better in terms of competitiveness and governance.

7.1 Competitive

Western Balkans economies lack competitiveness, largely because of difficulties in the business environment. Countries in this region typically score poorly relative to EU countries on annual cross-country measures of competitiveness and the business environment such as the World Economic Forum's perceptions-based Global Competitiveness Index and the World Bank's Doing Business report. Enterprise surveys suggest that one of the biggest obstacles to doing business is unfair competition from the informal sector. Other significant obstacles include corruption, getting electricity and access to finance. Competitiveness is also hampered in some countries by a still-large state presence in key industries and inadequate implementation of the competition policy framework.

Western Balkans countries score poorly on a broad cross-country measure of competitiveness. The latest scores from the World Economic Forum's Global Competitiveness Index, a perceptions-based measure of the concept of competitiveness, show the clear gap between the Western Balkans region and the EU-11. On average, the region is ranked 80th (ranging from FYR Macedonia in

68th to Bosnia and Herzegovina in 103rd place), compared with an average 50th place for the EU-11.

Table 9: Rankings in Global Competitiveness Index 2017-2018 for Albania, FYR Macedonia and Serbia

Global Competitiveness Index		ALB	MKD	SRB	WB	EU-11
		75	68	78	80	50
Basic requirements	1st pillar: Institutions	68	67	104	86	74
	2nd pillar: Infrastructure	94	80	75	84	54
	3rd pillar: Macroeconomic environment	75	44	72	74	33
	4th pillar: Health and primary education	36	92	52	60	46
Efficiency enhancers	5th pillar: Higher education and training	49	76	59	67	45
	6th pillar: Goods market efficiency	57	34	110	78	57
	7th pillar: Labor market efficiency	91	95	92	95	67
	8th pillar: Financial market development	81	57	101	78	59
	9th pillar: Technological readiness	78	61	72	66	38
	10th pillar: Market size	105	110	74	103	65
Innovation and sophistication factors	11th pillar: Business sophistication	74	75	110	95	64
	12th pillar: Innovation	87	51	95	89	62

Source: World Economic Forum's Global Competitiveness Index Historical Database.

Several components of competitiveness are especially problematic. The region scores reasonably well on indicators associated with the perceived quality of health and primary education, as well as higher education and training (except for on-the-job training) and technological readiness, such as information and communications technology (ICT) use. However, the most problematic areas in the GCI, apart from market size, are: (i) labor market efficiency related – namely, efficient use of talent (that is, capacity to attract talent from abroad and, even more importantly, to retain talent), as confirmed by the “brain drain” problem; and (ii) weak business sophistication, that is, the reliance on informal (family and friend) relationships rather than on professional management, the lack of well-developed business clusters, and shallow value chains. The largest difference in ranking between the WB-6 and EU-11 is in the areas of macroeconomic

environment (particularly emphasizing the challenging fiscal situation in the region compared with the EU-11), market size, business sophistication, infrastructure development, innovation capacity and labor market efficiency.

The overall assessment on innovation is pulled down by low scores on company spending on research and development (R&D) and the limited availability of scientists and engineers. For instance, data from UNESCO show that, in per capita terms, the overall spending on R&D in the region is just one-fifth of that in the EU-11, and way below EU levels. Transport infrastructure ranks badly mostly due to the limited passenger-carrying capacity in airline traffic, but also because of the poor quality of overall infrastructure, including roads, railways and ports.

Problems in the business environment are persistent. The World Bank's annual Ease of Doing Business rankings vary widely in the region. FYR Macedonia is ranked 11th out of 190 countries in the 2018 report, the highest ranking in the region and the second highest among all EBRD countries of operations. Kosovo, Montenegro and Serbia are ranked between 40th and 43rd position, Albania is 65th, while Bosnia and Herzegovina is ranked the lowest in the region at 86th position. However, the width of this ranking range exaggerates the differences among the six countries. Common problems across the region include: dealing with construction permits and getting electricity.

Competition from the informal sector is perceived as the biggest obstacle facing businesses. As noted earlier, this finding emerges from the latest round of the EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS).⁶⁸ When asked to say which obstacle from a list of 15 represented the biggest problem for the establishment, more than 15 per cent of firm owners and managers (on average) cited informal competition as the main one.⁶⁹ The problem is seen as especially damaging in FYR Macedonia (chosen by 26 per cent of respondents as the top obstacle). More than one-quarter of firms in the region rate the problem as "major" or "very severe" (the two highest categories on a five-point scale). Informal competition affects smaller, locally oriented firms in

⁶⁸For results from the individual countries, see: "How the Western Balkans can catch up" by Peter Sanfey, Jakov Milatovic and Ana Kresic, (EBRD Working Paper No. 185).

⁶⁹ Krešić et al. (2017).

particular. An econometric analysis linking the revealed cost of informality with observable characteristics shows that the smaller the company, the more likely it is to find informal competition to be a major problem.⁷⁰ This is also the case for manufacturing (rather than service) companies and those with a local, rather than international, orientation. Perceived costs of informality are also higher for companies that have engaged in innovation in the previous three years. Access to finance is among the major obstacles to doing business, according to BEEPS. A quarter of all surveyed firms across the EBRD region described themselves as credit constrained, meaning that they need a loan but are either rejected when they apply for a bank loan or feel discouraged from applying. In the Western Balkans, the proportion of firms credit-constrained is significantly higher on average. The main driver behind the credit constraint was the discouraging level of interest rates at the time of the survey. Despite the high number of banks in the region, competition among lenders appears to be limited and SMEs in particular struggle to get the funds they need to grow their businesses. Other reasons that discourage firms from applying for bank credit include: complex procedures, collateral requirements and size of the loan.

Entry and exit of firms are hampered by weak enforcement of competition policies. Competition laws and institutions are in place, but the authorities in the region face major challenges in building up sufficient capacity to respond to fast-changing environments. According to the latest EC reports, the three candidate countries in the region (Albania, FYR Macedonia and Serbia) can be considered as “moderately prepared” in this area.⁷¹ The region faces medium to large transition gaps in SME development. According to the EBRD’s assessment of transition challenges, which captures the five dimensions of SME development, including: (i) bank financing, (ii) the legal framework for bank finance, (iii) non-bank financing, (iv) business skills and standards, as well as (v) the business environment disproportionately affecting SMEs, Albania is assessed to have large transition gaps, while the other countries medium transition gaps. Two particularly

⁷⁰ Krešić et al. (2017).

⁷¹ The 2016 European Commission reports on candidate and potential candidate countries available at: https://ec.europa.eu/neighbourhood-enlargement/countries/package_en.

problematic dimensions are: (i) non-bank financing, and (ii) business skills and standards.

7.2 Well-governed

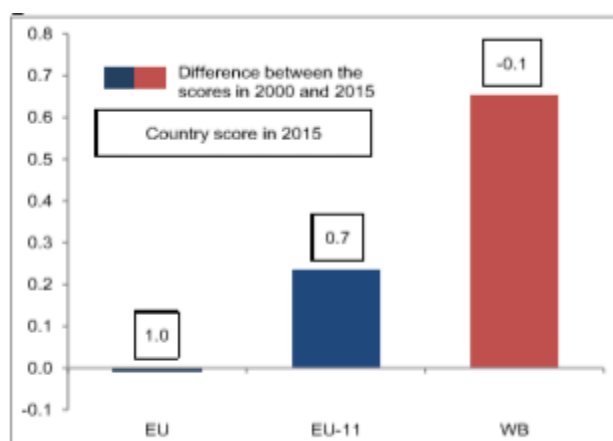
Governance problems are pervasive throughout the region. The World Bank's Worldwide Governance Indicators show the largest distance between the Western Balkans and the EU member countries lies in the rule of law. The distance is also large in the areas of control of corruption, government effectiveness and regulatory quality. Evidence from the latest round of the EBRD/World Bank Life in Transition Survey highlights the prevalence of the belief in this region that political connections are key to success in life. With regard to corporate governance, the EBRD's Office of the General Counsel's assessment of corporate governance frameworks points to a number of deficiencies in Western Balkans countries that would need to be addressed in order to meet best practice in this area.

All aspects of public governance lag behind EU standards. Using the World Bank's Worldwide Governance Indicators as a benchmark, the most problematic areas in the Western Balkans are corruption, followed by the rule of law; government effectiveness and political stability. Voice and accountability and regulatory quality have the highest scores, but good marks for the latter may reflect implementation of the EU acquis, rather than genuine independence and capacity of the regulators.

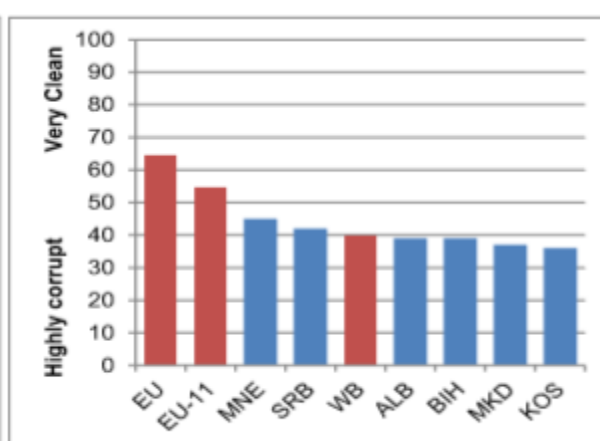
Governance scores have been improving. Although there is still some distance to go for the WB-6 to match EU governance standards, a look at the scores over time suggests that the gap is on average narrowing steadily (Chart 10). The biggest increase over the past 15 years has been in political stability, with notable improvements also in rule of law and government effectiveness. The smallest improvement in the scores has been in control of corruption. Systemic corruption is a persistent problem. The latest EC progress reports assessed each WB-6 country's fight against corruption as being at "some level of preparation" (second

lowest point). The private sector also sees corruption as a major obstacle. In BEEPS V, 23 per cent of firms in the region deem corruption to be a major or very severe obstacle. The costs of corruption, measured by per cent of annual revenue paid as informal payment to “get things done”, are estimated at almost 1 per cent of annual sales.⁷² Also, all countries are ranked relatively low on Transparency International’s Corruption Perceptions Index (CPI).⁷³ The WB-6 average CPI score is 40 (on a scale of 0 (worst) to 100 (best)), compared with an average of 65 in the EU (see Chart 11).

Chart 10: Change in average score for governance indicators 2000-15 **Chart 11: Corruption Perception Index Score 2016**



Source: The World Bank.



Source: Transparency International.

Political connections are seen by many people as key to success in life. According to the third round of the EBRD/World Bank Life in Transition Survey (LiTS III), an average of more than one-third of people in the Western Balkans rate political connections as more important than either effort and hard work, or intelligence and skills, as the key to success in life.⁷⁴ In this regard, the Western Balkans countries stand out among all EBRD sub-regions, highlighting the absence of meritocratic job selection and prevalence of clientelism and vested interests.

⁷² Krešić et al. (2017).

⁷³ The Transparency International corruption perceptions scores are available at: <http://www.transparency.org/research/cpi/overview>.

⁷⁴ EBRD (2016), Life in Transition: a decade of measuring transition, London, EBRD.

The corporate governance framework suffers from a number of weaknesses. The EBRD's assessment of corporate governance legislation and practices in the region points to problems with stakeholders and institutions, structure and functioning of the board, internal control, and disclosure (particularly of non-financial information). In addition, environmental, health and safety, and social issues need to be integrated into corporate governance practices to align with good international practice.⁷⁵

7.3 Inclusive⁷⁶

Labor market reforms are needed to promote participation, address the skills deficit and boost job creation. All countries in the Western Balkans suffer from severe regional disparities, high levels of unemployment, especially among the youth, regular emigration flows and low levels of labor force participation. Ageing populations pose a significant challenge to long-term growth and the sustainability of social security systems.

Employers in the Western Balkans face significant problems in acquiring employees with the required skills. In the BEEPS 2013-14 surveys, 34 per cent of firms in the Western Balkans reported that an inadequately educated workforce was an obstacle to current operations, with one-third of these firms deeming the problem to be major or very severe. More than half of all firms said that total annual sales would increase if this obstacle were removed. Although the sectoral composition of skills mismatch varies across countries, the needs are mostly concentrated in sectors within manufacturing and services, specifically hospitality and agribusiness (see Table 10).

⁷⁵The EBRD corporate governance assessments, by country, are available at: <http://www.ebrd.com/what-wedo/sectors/legal-reform/corporate-governance/sector-assessment.html>.

⁷⁶ This section is based on an internal EBRD note: "Skills mismatch in the Western Balkans" by A. Dincer, and on an EBRD-commissioned report: "School-to-Work transition in Western Balkans: Challenges and opportunities", prepared by a team from Ernst and Young and the BLIC Policy and Management Institute

Table 10: Skills deficits in the Western Balkans

	Inadequately educated workforce is a major or severe obstacle to current operations	Undersupplied sectors
Albania	6%	Agriculture and forestry, hospitality, food processing
Serbia	11%	Manufacturing, trade, construction
FYR Macedonia	14%	Automotive, trade, professional activities

Source: BEEPS 2013-14; Employer survey of National Employment Service in Serbia, Gishti and Shkreli (2015, Albania), Skill Needs Analyses (2014, Albania).

Labor forces in the region lack both hard and soft skills, industry knowledge and practical experience. Due to the rapid development of technologies during the last decade, there is high demand for hard skills, in particular the mastering of new technologies. Additionally, surveys of the skill needs of employers, often undertaken by donor-funded programs, have identified important gaps in soft skills (communication, teamwork and collaborative problem solving) in Western Balkans countries.⁷⁷ Vocational education and training (VET) institutions struggle to flexibly adapt education programs, teaching methods and infrastructure to changing needs. These factors impose limits on the quality provision of practical training and skills development through VET institutions.⁷⁸ This is a critical shortcoming which can be eliminated only through practical training in enterprises. However, only a minority of businesses (41 per cent) in the Western Balkans address skills mismatch through formal training programs. Employers typically invest relatively little in on-the-job-training, and private sector involvement in skills policies remains limited.⁷⁹ Young people have limited access

⁷⁷Arandarenko, M., & Bartlett, W. (Eds.). (2012), "Labour market and skills in the Western Balkans", FRENFoundation for the Advancement of Economics.

⁷⁸ The severity of skills-related issue goes beyond the acquisition of technical skills. According to the OECD's PISA in 2015, the majority of 15 year old students in Albania, FYR Macedonia, Kosovo and Montenegro do not possess basic mathematics skills (53, 70, 78 and 52 per cent, respectively, compared with 30 per cent at OECD). In Serbia, which participated in PISA 2012, 39 per cent of the 15 year old student population, compared with 26 per cent in the OECD, did not reach the basic level in mathematics.

⁷⁹ Arandarenko, M., & Bartlett, W. (Eds.). (2012).

to training and resources to establish their own businesses. Only 28 per cent of young people indicate that they have access to training to start and grow a business in the Western Balkans and only 22 per cent state that they have access to finance.

Consequently, self-employment within the young labor force remains low at 11 per cent for men and 7 per cent for women in the Western Balkans.⁸⁰

Skills-related challenges make growth less inclusive. The slow rate of job creation, even in times of economic growth, is a common feature of Western Balkans countries. For example, five years of consistent economic expansion between 2004 and 2008 with an average annual growth rate of 5.8 per cent was accompanied by high rates of unemployment. More strikingly, during this period of economic boom the employment rate in Albania dropped from 52 to 46 per cent. As a result, youth unemployment rates in the Western Balkans remain very high⁸¹ and the private sector struggles to recruit skilled and motivated people. The resulting skills deficit is of particular concern, creating real operational challenges for companies such as high staff turnover and low productivity. Moreover, high levels of youth employment inhibit the process of human capital formation and increase the dependency on support systems, which puts an excessive burden on public finances in the form of higher social benefits.

7.4 Integrated

Improvements in regional connectivity are required to strengthen cross-border trade and investment links, and hence raise productivity. Current levels of trade and investment are well below potential and are held back by weak connectivity links. The region's needs for improved transport and energy links are huge, but sources of finance are limited. A judicious use of EU grants, IFI and bilateral loans (including from China, as part of the "Belt and Road Initiative"), along with private

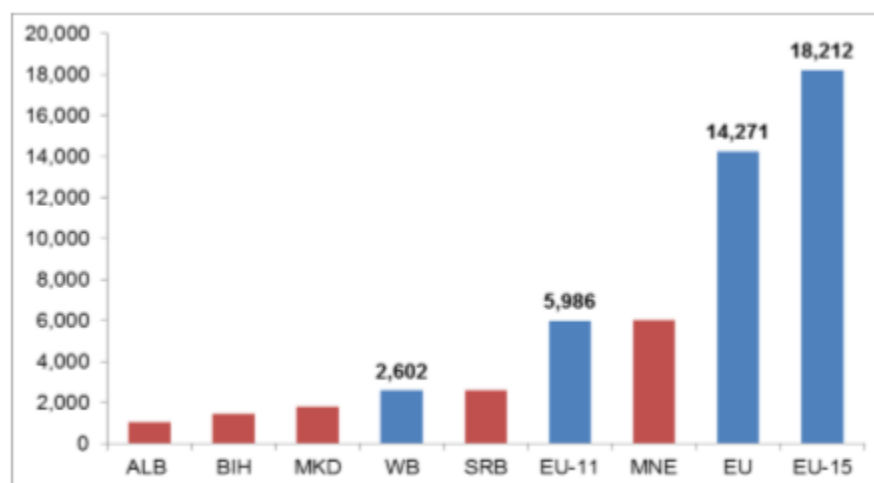
⁸⁰ Notably, young women are 49 per cent less likely to have access to training and 67 per cent less likely to access to finance to start and grow business.

⁸¹ The percentages are: 29.2 per cent in Albania, 57.5 per cent in Bosnia Herzegovina, 49.5 per cent in Serbia, 55.3 per cent, 39.5 percent in Montenegro and 50.8 percent in FYR Macedonia (World Development Indicators, 2014).

sector investment, could make the region more attractive to investors and exploit the region's potential as an energy and logistics hub.

Foreign direct investment (FDI) has lagged well behind levels in the EU. A visible impact of the global crisis was the sharp drop in FDI to the region, followed by a stagnating trend. While Serbia is the biggest recipient of FDI in aggregate terms, Montenegro received the biggest share of foreign capital in each of the last seven years in per capita terms. Still, the region lags significantly behind the European Union in terms of FDI stock per capita received; average FDI stock per capita in the Western Balkans is around €2,600 while in the European Union it is around €14,300 (Chart 12).⁸² Even compared with the EU-11 average, the Western Balkans region's average FDI stock per capita is less than half that of the EU-11. However, over the past five years, Albania and Serbia have all experienced annual FDI inflows at a rate above the OECD average of 4.1 per cent of GDP, which is encouraging.

Chart 12: FDI stock per capita (€)



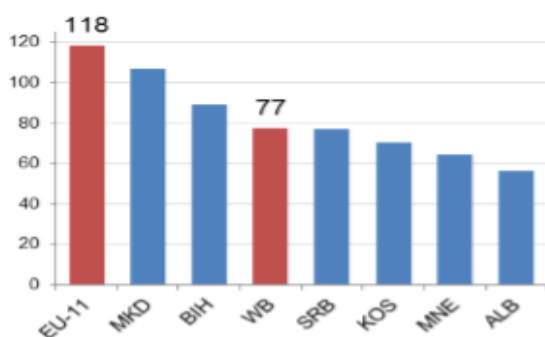
Source: IMF World Economic Outlook.

A more simple and reliable investment framework is needed to attract enhanced inflows of FDI. All Western Balkans countries legally observe a level playing field between foreign and domestic companies, but restrictions on foreign investments still remain. According to the Heritage Foundation/Wall Street Journal Index of

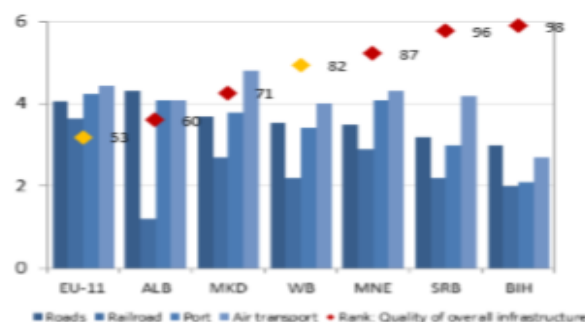
⁸² UNCTAD's International trade database, 2015 – see Sanfey et al. (2016).

Economic Freedom, which summarizes information on areas where countries formally limit foreign investments, on a scale of 0 to 100 (with 100 representing a perfectly free country) Western Balkans countries score 67.5 on average, while the EU scores 80.9. Additionally, problems often emerge not from the written laws but their implementation and enforcement, which are much more difficult to measure. International trade is below expectations, given the size, level of development and geographical location. In terms of trade openness, defined as the sum of exports and imports divided by GDP, the region lags behind central European and Baltic comparators, at 65 per cent of the EU-11 level (Chart 13). Exporters in the Western Balkans typically face bigger obstacles to doing business than those in comparator countries, including the poor quality of infrastructure. According to the World Bank's Doing Business report, the main difference between the Western Balkans and the EU-11 (in the area of costs of trade) lies in the cost to export, with that of the Western Balkans countries more than double that in the EU-11. Time to export is also longer although the differences are less pronounced. Challenges for both domestic and cross-border connectivity arise from the poor quality of transport infrastructure. Years of neglect and under-investment have left even major road and railway networks in a poor state. In the WEF's GCI, the comparison with EU countries highlights the extent of the challenge facing the region (see Chart 14). An analysis of the sub-indices in the GCI suggests that the rankings are impaired by weaknesses of railroads in all countries, as well as by the poor quality of roads, limited air transport and inadequate (river) ports infrastructure in Serbia.

Chart 13: Trade share (% of GDP, 5-year average) **Chart 14: Quality of infrastructure**



Source: UN COMTRADE and IMF WEO.



Source: WEF's Global Competitiveness Index.

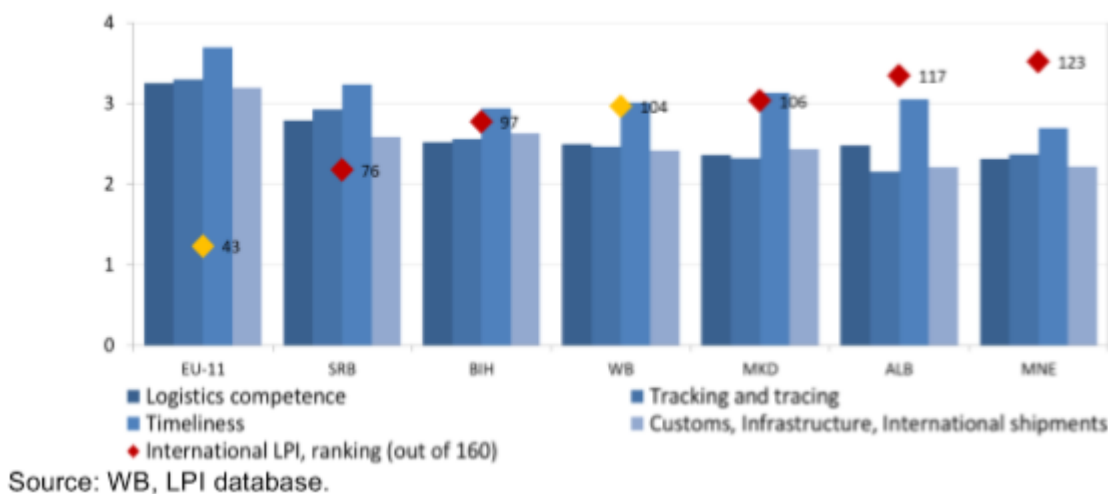
Customs and trade regulations are a major problem for many exporters. The bureaucracy associated with exporting or importing is often onerous. The time and costs to trade are much higher compared with the EU-11 average. For instance, World Bank estimates place the average cost to export in the EU-11 at US\$ 34 per unit compared with US\$ 65 in Albania. At the same time, average time to export in EU-11 is five hours per unit, compared with six hours in Serbia. Although the overall severity of this obstacle in the BEEPS is ranked low, the results may be distorted by the large number of locally oriented firms which are not concerned with this issue. Those firms with an international orientation tend to rank the obstacle much higher as a problem for doing business.⁸³

The Western Balkans region is not well integrated into European supply chains. Results from an OECD study indicate that the Western Balkans is integrated mostly into the final stages of international supply chains in food, beverages and tobacco in addition to textiles and clothing, and mostly the intermediate stages of wood and cork, paper, printing and publishing, other non-metallic mineral products and fabricated metal products, as well as both first and intermediate stages of basic metals.⁸⁴ The product mix within the Western Balkans countries also explains the limited integration to date into European supply chains. Over 50 per cent of the region's manufactured goods are classified as "labor and resource intensive" or "low-skill and tech intensive", in comparison to about 30 per cent in the European Union. In contrast, only 18 per cent fall into the category "high-skill and tech-intensive goods" in comparison to 27 per cent in the EU-11. Poor logistic performance is another bottleneck of economic development. The World Bank's Logistic Performance Index ranks 160 countries along six different dimensions of trade. Chart 15 illustrates the gaps in Western Balkans countries in comparison to the EU-11 regarding all sub-indices. The efficiency of customs and border management, the quality of trade and infrastructure and the ease of arranging competitively priced shipments (here averaged as an indicator for cross-border transport) are below the EBRD average of 2.7 in all Western Balkan countries.

⁸³Krešić et al. (2017).

⁸⁴ See OECD (2013), "Trade in Intermediate Goods and International Supply Chains in CEFTA", CEFTA Issues Paper 6.

Chart 15: Logistic Performance Index



Access to electricity remains a major barrier to business development. Similar to transport, the energy sector in the Western Balkans has been plagued for many years by under-investment, poor management and a non-commercial approach to operations, and the gaps in quality relative to EU countries are large. Access to electricity emerges from an econometric analysis of the BEEPS as one of the top three obstacles for a representative firm in the region.⁸⁵ Energy market integration has stalled, despite the fact that the countries' infrastructure in the electricity sector is relatively well interconnected. Given the small size of national energy markets, the Western Balkans countries will not be able to develop liquid markets in isolation. Cross-border cooperation is therefore essential for achieving important cost savings for energy consumers through increased competition and more effective use of existing generation and transmission infrastructure in the region. However, with the exception of a common platform for coordinated allocation of electricity cross-border capacities, SEE CAO, there has been little progress in cross-border cooperation. For example, according to the Energy Community, with the exception of Serbia, the Western Balkans countries are yet to establish functioning power exchanges. Cross-border electricity trade is therefore below the region's potential, reflecting the high level of market fragmentation.⁸⁶ The lack of crossborder cooperation between the WB-6 and EU

⁸⁵ Krešić et al. (2017).

⁸⁶ Energy Community Secretariat (February 2018) Knocking on the EU's Door through the Energy Community: Integration of Western Balkans into the Pan-European Energy Market.

member states is also highlighted in the European Commission's Enlargement Strategy 2025 for the region as a key barrier to expanding the EU's Energy Union to the region. Chinese investment in the Western Balkans is growing in importance. China views the Western Balkans as an important component of its ambitious "Belt and Road" initiative. Major investments with Chinese sponsors have occurred or are under way in the transport and energy sectors in Bosnia and Herzegovina, FYR Macedonia, Montenegro and Serbia. This funding, combined with a streamlined approval process and speedy implementation, is proving attractive to Western Balkans countries because the region's major investment funding needs cannot be fully met by EU pre-accession grants and IFI lending.⁸⁷ In April 2017, the China-CEE Institute became the first think-tank independently registered in Europe by a Chinese institution to produce research related to the "16+1" cooperation between China and central and south-eastern Europe and the Belt and Road initiative.

8. Regional Economic Growth in the Western Balkans (Albania, FYR Macedonia and Serbia)

GDP growth in the Western Balkans slowed from 3.1 percent in 2016 to an estimated 2.4 percent in 2017. Regional growth in 2017 is less optimistic than the 2.6 percent expected when the Fall issue of this report⁸⁸ was published. It slowed in Serbia due to a harsh winter and stalled in FYR Macedonia, where the political crisis deterred both public and private investment. The dynamism of the smaller economy of Albania drove regional growth in 2017, with support from higher growth in trading partners, a pickup in commodity prices, and the execution of large investment projects.

⁸⁷ For further discussion, see O. Levitin, J. Milatovic and P. Sanfey, "China and South-Eastern Europe: Infrastructure, trade and investment links", EBRD focus piece, 2016, available at: www.ebrd.com/documents/comms-and-bis/see-china-investments.pdf.

See also J. Bastian, "The potential for growth through Chinese infrastructure investments in Central and South-Eastern Europe along the "Balkan Silk Road", independent report prepared for the EBRD, 2017, available at: www.ebrd.com/documents/policy/thebalkan-silk-road.pdf.

⁸⁸Western Balkans Regular Economic Report No.13. Vulnerabilities Slow Growth, Spring 2018.

Although job growth was slower than in 2016, in the first nine months of 2017 190,000 new jobs were created in the region. Labor force participation increased in most countries, as more people entered the labor market and found jobs. Over 80 percent of new jobs were in services, mostly retail and wholesale trade, supported by growth in consumption. Although unemployment fell in most countries, it still ranges from 13.5 percent in Serbia to 30.4 percent in Kosovo. Poverty continued to fall despite rising food and energy prices.

Even though revenues improved, not all countries took the opportunity to reduce fiscal deficits. Serbia recorded surpluses in 2017, but in the rest of the region, deficits continued, driven by the high amount of recurrent spending, often on poorly targeted social benefits and subsidies. Albania is now working to revive growth-enhancing capital investment. Careful financial, public investment and budgetary management will help ensure that fiscal risks associated with investments are minimized, which should relieve pressures on medium-term debt sustainability.

External vulnerabilities intensified in some countries. Current account deficits widened in several countries despite growth in exports because, except in FYR Macedonia, imports overwhelmed exports. A particularly cold winter necessitated more energy imports, and large infrastructure projects and higher consumption demanded more machinery, equipment, and goods from abroad. A current account sustainability analysis suggests that Western Balkan countries need to reduce external deficits in the medium term.

Bold structural reforms are necessary if the region is to grow sustainably over the medium term. Regional GDP growth is projected to rise from 2.4 percent in 2017 to 3.2 percent.

Because of weaker growth in FYR Macedonia and Serbia, real GDP growth in the Western Balkans slowed from 3.1 percent in 2016 to an estimated 2.4 percent in 2017. In Serbia, where GDP growth was 1.9 percent in 2017, a severe winter and a summer drought subtracted at least 1 percentage point (pp) from growth because of lower agriculture and energy slow. In FYR Macedonia, a fall in investment subtracted 1.1 pp from growth.

Although the external environment remained favorable, in 2017 net exports contributed less to growth, overwhelmed by higher imports for energy projects, consumption, and investment. Western Balkan countries where base metal and mineral commodities constitute an important share of the export basket benefitted from the rise in global commodity prices. However, the combination of rising oil prices and energy imports necessitated by the harsh winter reduced the contribution of net exports to growth; though that contribution was positive in Albania (0.4 pp), net exports subtracted from growth in Serbia (-1.9 pp) and FYR Macedonia (-0.7 pp). As demand rose in the Euro Area, Albania and FYR Macedonia benefitted from rising commodity prices and higher tourism-related exports.

In Serbia the moderately negative contribution of net exports to growth was due to higher imports of energy, intermediate, and capital goods.

Consumption continued to make a major contribution to growth, supported by higher employment and increasing consumer credit. Consumption accounted for around 90 percent of output in the Western Balkans. In Albania, a sustained recovery in employment, wages, and household credit boosted private consumption, and public consumption was also positive as public wages rose. Private consumption grew, buoyed by rising employment, growing credit to households, and higher wages in Serbia and FYR Macedonia. Consumption growth stimulated job creation in wholesale and retail trade (services). While consumption is important at this level of development in the Western Balkans, because its growth is adding to the pressure on the external account from rising imports, it might stunt future growth.

8.1 A positive, but clouded growth outlook

In the medium term real GDP growth in the Western Balkans is projected to recover, reaching 3.2 percent in 2018 and 3.4 percent in 2019. A slight slowdown in Albania is being more than counteracted by faster growth in other countries in the region. FYR Macedonia's economy is projected to gain momentum in 2018

and grow at 2.3 percent, from zero in 2017, as investment and consumption recover after resolution of the political crisis. In Serbia, a recovery in investment is projected to support growth of 3 percent in 2018 and 3.5 percent in 2019. On the other hand, growth in Albania is expected to moderate in during 2018–19 as large FDI projects wind down.

The growth outlook assumes favorable external conditions: an investment-supported economic recovery in the EU, higher growth in global trade flows, and favorable financing conditions with relatively low interest rates, even if there is further normalization of monetary policy in advanced economies. With a projected modest increase in prices, commodity exporters will get an additional growth boost, which should further build domestic demand. In general, growth relies on higher exports in Albania and FYR Macedonia and investment in FYR Macedonia and Serbia, tied to growth in the EU. While consumption is currently a major driver of growth throughout the region, its contribution is expected to strengthen even further in Albania and Serbia. As a result, risks could rise as growing demand for imports leads to higher external imbalances and subdues growth. Albania and Serbia will also rely on more public investment to support baseline growth, thus highlighting the importance of creating fiscal space for public investment, improving project management capacity, and exploring options for additional investment, such as PPPs.

Externally, the expected recovery in EU growth is a major impetus for growth in the Western Balkans. But should the fears of trade wars gain ground, there could be a decline in confidence that would affect medium-term growth. EU growth is projected to remain strong in 2018 (though somewhat constrained by the unwinding of the monetary stimulus and below-target inflation), supported by higher investments and consumption driven by improved labor market conditions. Yet trade protectionism and rising geopolitical tensions could disrupt progress. Imports to the EU are projected to moderate in the medium term with a slowing in trade growth and domestic demand. The proposed U.S. introduction of tariffs on imports of steel and aluminum would have negative impacts, both direct and indirect, on the outlook for the Western Balkans. For instance, the EU exports about US\$6 billion of steel to the U.S. While estimates suggest that the new tariffs

would depress U.S. demand for steel by not more than 10 percent, lower margins and volumes might have some impact on Western Balkan countries.

Furthermore, both weather-related shocks and country-specific vulnerabilities—such as low potential growth—could disrupt regional growth forecasts. Growth in 2017 was damaged by Serbia’s weather vulnerability, which could rise even further with climate change. In addition, in the absence of productivity gains there is a risk that growth in the Western Balkan countries may slow down even if global growth trends up. Also, with interest rates low and financial markets volatile, the possibility of a sudden adjustment cannot be ruled out; inflation expectations are edging up as labor markets in developed countries tighten, and the U.S. dollar could appreciate as monetary easing is withdrawn in the EU, raising risk to countries with a high share of US\$-denominated debt, like Serbia.

Domestically, political uncertainty may cloud the growth outlook if upcoming elections in several countries lead to a slower pace of structural reforms. Notably, the risk of fiscal loosening is compounded by the increasing reliance on consumption: Serbia has announced yet another increase in public wages and pensions and high spending on pensions in FYR Macedonia leaves little for public investment.

Downside risks to growth, challenges generated by fiscal consolidation, high rates of unemployment and inactivity, and exposure to natural disasters can only heighten vulnerability. Volatile domestic policy has previously affected growth in the Western Balkans.

Risks to the growth outlook can be mitigated by increasing fiscal space for growth enhancing reforms and investments. The current fiscal consolidations in Albania and Serbia have reduced fiscal risks and improved confidence. However, more profound and long-lasting reforms are needed to ensure that policy reversals do not jeopardize growth and confidence outcomes. Tax reforms to mobilize revenues and create the fiscal space to fund development priorities should be accompanied by rationalization of spending. Fiscal rules, medium-term expenditure frameworks, and close monitoring of fiscal risks and contingent liabilities can foster institutional credibility and help restore fiscal space. Reforms

to support growth include broadening the tax base, eliminating loopholes and excessive tax exemptions, and reinforcing tax administration and collection. To be prepared for shocks, countries in the Western Balkans need fiscal space in which to maneuver; the space is currently tightly bound by untargeted recurrent spending. Rationalizing spending must be emphasized, especially as several countries in the region prepare for elections. Reforms could enhance the quality of public spending.

But because the highest risk to the outlook is a low-growth trap, it is important to advance structural reforms to promote private sector development and reduce barriers to labor force participation. With high structural unemployment, low investment, low education outcomes that explains the inadequacy of human capital, and stagnating productivity growth, potential output in the Western Balkans is low. Investment rates are below the 25 percent of GDP recommended by the Growth Commission for sustainable long-term growth, even though countries with similar incomes have on average surpassed that.⁸⁹ Real labor productivity has been low and stagnating. Political concerns—such as coalition politics and repeated election cycles, which intensify the political cycle, so that even dominant elites are risk-averse—have been slowing essential structural reforms, which are the only engine that can increase growth potential. The cost of inaction on reforms is enormous; an outsized public sector encourages capture of state assets and income streams. Finalizing this part of the transition from a planned to a market economy would lower fiscal pressures, reduce crowding out, and promote market competition. Policies to lift physical and human capital encourage labor force participation, and improved market institutions will help raise growth potential and reduce inequality.

Low productivity, which is holding back the region's growth potential, is a consequence of years of under-investment, inadequate institutions, and a difficult business environment. In all Western Balkan countries, the private sector is the main contributor to economic output; yet in several countries the state is still dominant in important industries, and the privatization agenda is still extensive.

⁸⁹ Commission on Growth and Development. 2008. "The Growth Report: Strategies for Sustained Growth and Inclusive Development." World Bank: Washington, DC.

Small and medium-sized enterprises dominate the private sector and account on average for about two-thirds of value added. An econometric analysis of barriers to productivity and growth highlights the importance of numerous factors and qualities.⁹⁰ For instance, extreme corporate indebtedness and market concentration are two variables that help explain poor productivity, as does the low level of youth inclusion. Complementary evidence comes from a major survey of firm owners and senior managers, which reveals the difficulties caused by competitors operating informally. Small businesses in particular find this obstacle, as well as corruption, highly problematic. Other constraints cited frequently were cumbersome tax administration, difficulties in accessing a reliable supply of electricity, and limited access to financing.

9. Albania, FYR Macedonia and Serbia EU Accession: Is the 2025 target date realistic?⁹¹

Fifteen years after the Thessaloniki promise, most countries in the region are still stuck in the waiting room. FYR Macedonia has been a candidate since 2005 (but held back by a name dispute with Greece), Serbia since 2012 and Albania since 2014. Membership talks have started for Serbia, and the European Commission recommended recently that talks should also start with Albania and FYR Macedonia.

In 2014, European Commission President Jean-Claude Juncker said that no country would join the EU during the current parliament. However, this was accompanied not long after by a greater attention by some bigger EU member states on the region, emphasized most clearly by the Berlin process. This was followed in 2018 by an ambitious new strategy for the region accounted by the

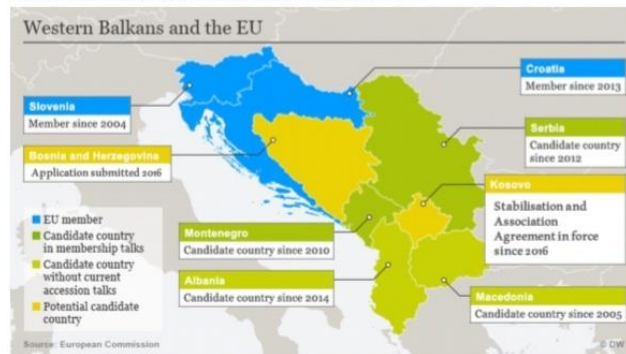
⁹⁰ Sanfey, P. and J. Milatovic (2018) The Western Balkans in transition: diagnosing the constraints on the path to a sustainable market economy. EBRD. <http://www.ebrd.com/documents/eapa/western-balkans-summit-2018-diagnostic-paper.pdf>;

Vostroknutova, E; TV Nguyen. 2017. Western Balkans - Revving up the engines of growth and prosperity. Washington, D.C.: World Bank Group. <http://documents.worldbank.org/curated/en/643211511855017188/Overview>.

⁹¹ Grieveson R., Grubler J., Holzner M. (May, 2018). Western Balkans EU Accession: Is the 2025 Target Date Realistic? Policy Notes and Reports 22.

European Commission, which set a target date of accession of 2025 for Serbia⁹² (with a note that others could also catch up).

Figure 1 / Status quo: 15 years after the Thessaloniki promise



Note: As of December 2017 – Serbia: 12 chapters out of 35 opened, of which 2 preliminarily closed, Montenegro: 30 chapters opened, of which 3 preliminarily closed.

Source: The Vienna Institute for International Economic Studies

The approach of the European Commission, Germany and France in particular reflect the acknowledgement that a lot is at stake. Now, there are four reasons for the renewed focus on the Western Balkans:

- First, the 2015 migration crisis drew attention to the importance of the Western Balkans for the EU in a security sense. From the perspective of governments in countries like Germany, such an inflow of people in such a short space of time, and the sense the national governments were not in control of their own borders, must not happen again. The migration has risen up the agenda since then in much of Western Europe. In Austria, the far right has ended power, while the hard-right Alternativ für Deutschland is now the biggest opposition party in Germany according to most opinion polls.
- Second, there was a concern that some of the intra-regional conflicts were heating up. Recent high profile incidents involving Kosovo and Serbia represent a key example of this.
- Third, there are growing concerns—loudly and regularly expressed in the media in Western Europe— about the growing influence of outside powers

⁹² https://ec.europa.eu/commission/news/strategy-western-balkans-2018-feb-06_en

in the region. This has included (but is not limited to) worries about Russia, Turkey and China.

- Fourth, there is a clear feeling in Brussels that ultimately the Western Balkans belongs in the EU. Geographically, the region is surrounded by EU member states. This sense of the EU being the Western Balkans' ultimate destination appears to be both stronger and more widespread than in the case of, say, Ukraine. The fact that Albania is a NATO member, while not directly connected to EU membership, also matters, in further reinforcing the region's tilt towards euro-Atlantic institutions.

The new Commission strategy notably puts a much bigger focus on taking a hands-on approach to solving political conflicts in the region. For two decades, the EU strategy for the Western Balkans has been characterized by a focus on economic connectivity as a way of driving political conciliation. In short: countries that trade with each other and that are well connected will not fight each other, and may eventually become friends. In addition, the EU has sought to open its markets to the Western Balkan countries to help develop the external sectors of the region. Western Balkan countries have enjoyed free trade with the EU since 2000. Regional trade integration was cemented by the Central European Free Trade Agreement (CEFTA) in 2007. The new Commission strategy, by contrast, acknowledged that often political tensions are themselves a barrier to greater connectivity and trade between countries.

The new target for accession is highly ambitious, even for Serbia, and probably deliberately so. The big question is how realistic the 2025 target date for accession is, and where the main barriers are to achieving this.

At least for some countries in the region, economic development per se is not a problem for EU accession. Or put another way, the economic problems of the Western Balkans are not necessarily explained by or encapsulated in GDP per capita income levels. Particularly in the cases of Serbia, GDP per capita levels as a share of the EU average are roughly in line of those with Romania and Bulgaria when they joined the EU in 2007. Even as of 2016, data on wage convergence

with Austria in PPP terms showed almost all countries in the region at a higher level than Bulgaria.

However, the economic challenges to accession are clearly significant and numerous. The most recent Commission progress reports, published in April⁹³, refer to various idiosyncratic obstacles to Western Balkans economies on their road to EU accession. However, looking across the reports, there are several common themes. A lack of competitiveness, big external deficits, high public debt, rigid labor markets (according to the Commission linked to high unemployment and large-scale outward migration), weak governance, a large informal economy, and infrastructure deficiencies appear in most if not all country reports.

Among these various factors, four things stand out as particularly problematic. Tackling and resolving political conflicts (which act as a barrier to economic development), infrastructure deficiencies, weak governance and the generally small industrial base are particularly pressing issues. This is not the whole story, but solving these four issues would provide help to solve the region's economic problems more generally, and improve its ability to meet the criteria for EU accession.

9.1 Solving political conflicts as a first step for economic development

Political conflicts are often a barrier to economic connectivity and development in the region. By taking a more active stance in the region, including via the “Brussels process”, the Commission could drive political reconciliation that delivers important economic benefits as well.

Admittedly, the Commission approach of the past two decades has produced positive results from an economic perspective. Since the EU opened its markets to the region in 2000, the overall shares of exports in GDP in the Western Balkans have doubled. FYR Macedonia and Serbia in particular have achieved relatively high levels even compared with many EU member states.

⁹³ https://ec.europa.eu/neighbourhood-enlargement/countries/package_en

However, efforts to stimulate intra-regional trade have been much less successful. While total exports have grown strongly over the past ten years, trade within the region has largely been flat over the period, and in almost all cases accounts for a fairly low share of the total.

An important reason for subdued regional trade, especially compared with exports outside the region over the past decade, is a shortage of demand. While Western Balkan exports to the EU are effectively supply-constrained (the region can sell as much as it can produce), those within the region are demand constrained. Even by European standards, most of the Western Balkans has had a tough post-crisis period. In Serbia, comfortably the region's biggest economy and therefore most important potential source of regional demand, real final consumption expenditure in 2016 (last year for which full comparable regional data are available) was still below 2008-09 levels.

However, a lack of demand is clearly not the only issue. Domestic demand in Albania has risen quite strongly since 2008, without any discernible impact on regional trade patterns. It is clear that political factors, and specifically multiple instances of bad bilateral relations between countries in the region (combined with related connectivity deficits), have held back intra-regional trade growth. In this sense, while we welcome attempts to further facilitate trade via, for example, a regional common market (as floated by Johannes Hahn, the European Commissioner for European Neighborhood Policy and Enlargement Negotiations), we believe breaking the political barriers to higher trade is a greater priority.

Finally on politics, the Commission believes that intra-regional disputes must be solved before countries join the EU. Most importantly here, the Commission has stated a legally-binding agreement between Kosovo and Serbia must be signed before either joins the EU⁹⁴. This makes sense, although it is clear that the challenges are enormous. Among other things, the legitimacy issues that leaders on both sides, will face in pushing through any possible agreement domestically⁹⁵.

⁹⁴<https://www.theguardian.com/world/2018/apr/26/now-chance-kosovo-deal-serbian-president-what-cost-aleksa-ndar-vucic>

⁹⁵ <https://wiiw.ac.at/serbia-and-kosovo-legitimacy-deficits-are-barrier-to-brussels-agreement-progress-n-296.html>

Here perhaps more than anywhere else under the new strategy, the involvement and role of the Commission, and the EU more generally, will be very important.

9.3 The challenge of bad governance

The quality of governance and institutions matters a lot for growth, including in the CESEE region. Moreover, upgrading governance standards to EU levels are a key part of meeting the accession criteria. The governance deficit in the Western Balkans is big, even compared with the laggards among current EU member states such as Romania and Bulgaria. On average, using the World Bank governance indicators, the six Western Balkans countries stand at around two thirds of the levels of Croatia, Bulgaria and Romania when they joined the EU.

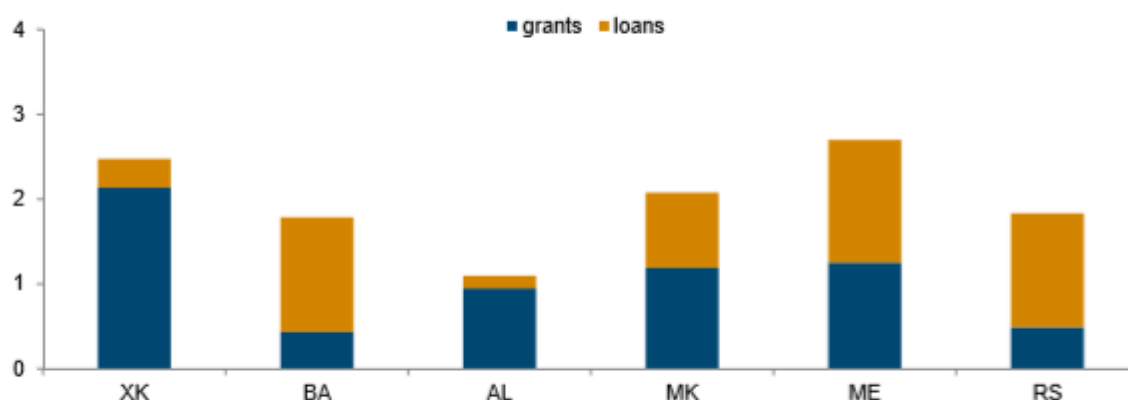
Based on current trends, meeting the EU accession criteria by 2025 looks very ambitious for even the frontrunners among the Western Balkan countries. A leap forward in governance standards is certainly not impossible, but will require a more concerted effort at the local level than we currently see. Political fragmentation and instability in some countries will make this even more challenging (and emphasizes the importance of a more active role for the EU). A strong improvement in democratic standards—as partly seen more recently for example in FYR Macedonia—could reduce the time needed for reform.

9.4 Connectivity and infrastructure development

The third major challenge is that the Western Balkans suffers from a major infrastructure deficit, which hampers economic development. This is hardly a new issue, and can be traced back at least 200 years. The historical division of the region between empires contributed to this. The region has long suffered from a lack of connectivity and poor infrastructure, in terms both of links within and outside of the region. Railways, for example, both arrived much later in the Western Balkans than in the rest of Europe, and once they did spread much more

slowly⁹⁶. This played an important role in holding back the economic development of the Western Balkans and its lack of convergence with Western Europe income levels, a challenge that the region is yet to overcome. This long-term historical deficit was then compounded by the wars of the 1990s, and the (linked) delayed accession to the EU. This had three important implications for connectivity in the region. First, physical infrastructure was destroyed in the wars, including infrastructure connecting what would become different countries in the former Yugoslavia. It is emblematic that so many bridges were destroyed. This ranges from the destruction of the historic Old Bridge in Mostar in Herzegovina to the NATO bombing of Serbian bridges across the Danube. Second, even after the wars ended, political relationships remained at best strained (if not outright non-existent), limiting the willingness of countries to develop physical transport connections between them.

IPA and WBIF grants and EIB loans, in % of GDP per annum



Note: IPA pre-accession funds are earmarked for the period 2007-2020. WBIF (Western Balkans Investment Framework) data is for the period 2009-2017. This is also the observation period for the loans of the European Investment Bank (EIB). Source: EC, wiiw Annual Database, wiiw calculations.

Third, the wars contributed heavily to the delay in the region joining the EU, which has meant the Western Balkan countries missed out a huge amount of funds available to their regional peers for infrastructure upgrading. Eight formerly Communist countries joined the EU in 2004, and another two in 2007, with Croatia arriving in 2013. Over this period, these countries have had access to full

⁹⁶Holzner, M., R. Stehrer, H. Vidovic (2015), 'Infrastructure Investment in the Western Balkans', wiiw Research Report No. 407 (September).

EU funds, something that remains largely unavailable to the Western Balkan countries. These factors have meant that the region's existing infrastructure deficit has, if anything, grown wider. Infrastructure investment needs in the Western Balkans are estimated by the EBRD to be between 8% (Serbia) and 12% (Bosnia) of GDP per year over the period 2018-2022, significantly higher than for most EU member states. Railway and motorway density in the region remains far below that of neighboring EU member states such as Bulgaria, Croatia, Hungary, Romania and Slovenia. In this context, the Berlin Process is a welcome development. Annual meetings with a focus on connectivity mean that the issue stays at least on the agenda. According to The Vienna Institute for International Economic Studies, announced projects in the Berlin Process, if realized, will add 1 percentage point per year to GDP in all Western Balkan countries over a 15-year time horizon. Moreover, around 200,000 jobs would be created, equivalent to around 4% of the region's workforce.⁹⁷ Given the low savings rates in the region, the funds for a bigger industrial base will have to come from FDI. FDI inflows into the Western Balkans relative to their GDP size was actually no lower than EU-CEE countries on average. However, this primarily reflects their small size (put together in nominal GDP terms they are roughly the size of Slovakia). Most have struggled to attract investment into higher value added sectors in the tradable sector. Weak governance and infrastructure deficiencies are key barriers to attracting a better quality of FDI.⁹⁸

To a certain extent, FYR Macedonia shows the way for the rest of the region. Along with (to a lesser extent) Serbia, FYR Macedonia has bucked the regional trend in developing a relatively big export-oriented manufacturing sector⁹⁹. Merchandise exports were equivalent to 50% of GDP in 2017 in FYR Macedonia, and 41% in Serbia. These levels were still far below those in the manufacturing powerhouses of central Europe (especially the Czech Republic, Slovakia and Hungary), but otherwise roughly in line with levels seen in the rest of CESEE. However, Albania lags significantly behind.

⁹⁷ <https://wiiw.ac.at/infrastructure-investment-in-the-western-balkans-p-3661.html>

⁹⁸ <https://wiiw.ac.at/wiiw-prepares-first-regional-investment-report-for-cefta-n-284.html>

⁹⁹ <https://wiiw.ac.at/macedonian-exports-p-4275.html>

Moreover, even in FYR Macedonia, the process is far from complete. My research on the Macedonian tradable sector finds that it is not sufficiently diversified and internationalized, with a dominance of larger firms, and not appropriately innovative. The policy should focus on supporting innovation, easier access to the product market in support of entrepreneurship, and support for the internationalization of economic activities. Both public policies and the financial system should be supportive of these improvements in the product market.

The four issues described above are not the whole story. However, addressing them would go a long way to helping to solve others, notably the lack of employment opportunities. Regional labor markets improved last year, but remain beset by high unemployment and low activity rates, especially among young people according to a major study undertaken by The Vienna Institute for International Economic Studies (wiiw) and the World Bank¹⁰⁰. Continued large-scale emigration reflects a lack of opportunities at home.

A previous wiiw study found that much better employment conditions could be achieved via several policy steps¹⁰¹. A more widespread use of collective bargaining would ensure cooperation between labor and industry in maintaining competitiveness. Better quality vocational training and stronger links between industry and the education system would also help.¹⁰² The region has generally been slow to adapt to changing circumstances in the labor market, owing to factors including resistance to reform, corruption in the education system, a lack of quality control in private institutions, and low incentives for new providers of vocational training.¹⁰³ Even in countries with relatively high levels of enrolment in vocational training (such as Serbia), this is not matched by professional skills acquisition.¹⁰⁴ One caveat here, however, is the point made recently by Ivan

¹⁰⁰ <https://wiiw.ac.at/further-improvement-in-western-balkan-labour-markets-last-year-n-292.html>

¹⁰¹ <https://wiiw.ac.at/infrastructure-investment-in-the-western-balkans-p-3661.html>

¹⁰² <https://wiiw.ac.at/2017-western-balkans-summit-in-trieste-the-quest-for-a-common-market-n-236.html>

¹⁰³ Arandarenko, M. and W. Bartlett (eds) (2012), *Labour Market Skills in the Western Balkans*, FREN and LSEE, Belgrade, November.

¹⁰⁴ <http://blogs.lse.ac.uk/lsee/2014/06/05/vet-balkans/>

Krastev at wiiw's Spring Seminar that improved education in CESEE simply leads to increased outward migration.¹⁰⁵

10. Policy recommendations

After a prolonged and difficult transition path, the WB countries still do not seem to be on a development path that would guarantee future socio-economic prosperity. Key long-term structural problems of the WB economies – limited competitiveness on world markets, “jobless” growth, increasing social problems, and extreme deindustrialization – have not been resolved, while growth based on excessive credit expansion has come to an end. Although the macroeconomic situation has recently improved, GDP growth rates are still subdued in comparison to the pre-crisis period, while fiscal and monetary policies have limited room of maneuver. Current economic and social problems are a serious constraint for future development of the WB economies. Rather than just strive for increased economic growth, the WB countries should aim at implementing *a more balanced model of development* that would take into account social, economic and ecological aspects. High inequality, unemployment and poverty ask for redistributive policies that would combat mounting social problems and secure decent living standards. The WB countries should enable its population to enjoy decent work and pursue the goal of social inclusion, envisioning a just transition to an economy that is also environmentally sustainable.¹⁰⁶

In order to pursue these goals, WB policy-makers need to elaborate and implement *a more efficient industrial policy*. Such industrial policies need to be country-specific, carefully prepared in each country on the basis of national priorities. Governments need to influence the quality of investment – both foreign and domestic – particularly its sectoral distribution. In order to diversify

¹⁰⁵ <https://wiiw.ac.at/exit-noise-and-disloyalty-n-302.html>

¹⁰⁶ International Labor Organization (ILO) (2015), “Guidelines For a Just Transition Towards Environmentally Sustainable Economies and Societies For All” p.4, available at http://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/documents/publication/wcms_432859.pdf.

and upgrade the production and export base, policy makers should not wait to see what international market forces bring to them; recent findings by Harding and Javorcik (2012)¹⁰⁷ show that sector targeting by investment promotion agencies – not simply opening the host economy to FDI – doubles FDI flows into the chosen sectors and results in higher unit-value exports.¹⁰⁸ The WB governments also need to devise such mechanisms for selecting industries and providing packages of public sector support to address coordination externalities, overcome imperfections in information markets, while providing investors with public goods such as a well-trained labor force. Such an approach is what Moran calls “light-form industrial policy” that could harness FDI to development and generate backward linkages as deep as possible into the host economy (Moran, 2014, pp. 32-33). Potential benefits of FDI for the host economy depend amongst other things on national infrastructure, market size, systems of education and training, institution quality, political stability and control of corruption.¹⁰⁹

Investment promotion policies directed towards potential foreign and domestic investors need to be linked to the *most important objectives of national economic development*. After more than eight years of economic crisis and feeble economic recovery, it seems risky for the WB governments to merely wait for the return of foreign investors and to continue relying on their capabilities to restructure their economies. An investment promotion strategy needs to aim at attracting not only more, but also better quality, investments that would facilitate faster restructuring and technological upgrading of key industries. Such an investment policy should also influence the sectoral distribution of domestic and foreign investments that should extend across sectors of agriculture, energy, R&D, education and innovation. More efficient policies promoting organic farming and

¹⁰⁷Harding, T. and B. S. Javorcik (2012), “Foreign Direct Investment and Export Upgrading”, *Review of Economics and Statistics*, 94 (4): 964-80.

¹⁰⁸Moran, T. H. (2014), “Foreign Investment and Supply Chains in Emerging Markets: Recurring Problems and Demonstrate Solutions”, *Working Paper Series*, WP 14-12, p. 32, Washington D.C., Peterson Institute for International Economics.

¹⁰⁹ Estrin, S. and M. Uvalic (2016), “Foreign Direct Investment in the Western Balkans: What Role Has it Played During Transition?”, *Comparative Economic Studies*, Vol. , June, pp. 1-29.

those connecting the agricultural sector with food industry should be implemented. The WB countries should reduce their dependence on highly polluting energy production (coal) and increase their energy sovereignty by reverting to renewable energy sources. FDI can be a welcome supplement to the still low domestic savings characterizing all WB countries, but it is unlikely to be sufficient to secure faster and sustained economic development. As elsewhere, FDI is influenced not only by government policies, such as institutional reforms and tax incentives, but by exogenous factors such as size, level of development and geographical position.¹¹⁰ Economic smallness and fragmentation of the WB region implies the lack of economies of scale, which remains a serious handicap of these countries.

One way to overcome this handicap and accelerate WB economic development is through *more intensive regional cooperation*¹¹¹. The current institutional crisis of the EU and the related bleak prospects of quick accession of the current candidates and potential candidates implies that they ought to devise new mechanisms to accelerate economic development in order to prepare for future competitive pressure within the EU. Coordinating national policies in some of the priority areas in order to implement regional initiatives jointly makes a lot of sense for small economies such as the WBs, particularly considering the legacies and economic linkages inherited from former Yugoslavia. Although the benefits of regional cooperation have been emphasized for long¹¹², its potentials have not been sufficiently utilized. More intensive regional cooperation in the area of R&D, energy, transport, agriculture or specific industries has the potential of accelerating growth in the WBs in the medium term. Industrial policy at the regional level through the creation of trans-national networks and supply chains

¹¹⁰ Estrin, S. and M. Uvalic (2014), "FDI into Transition Economies: Are the Balkans Different?", *The Economics of Transition*, Vol. 22 (2), pp. 281-312.

¹¹¹ The Regional Cooperation Council (previously the Stability Pact for South East Europe - SEE), has been promoting a series of objectives at the regional level, within the Southeast Europe-2020 Strategy that should reinforce cooperation among countries in the region (see: www.rcc.int).

¹¹² Uvalic, M. (2001), "Regional Co-Operation in Southeast Europe", *Southeast Europe and Black Sea Studies*, Special Issue – Balkan Reconstruction (eds. T. Veremis and D. Daianu), Vol. 1 (2001), no. 1, pp. 55-75.

could be mutually beneficial, since multinational companies created by enterprises from several WB countries are bound to be more competitive on EU markets than small national firms. The SEE 2020 Strategy adopted by the Regional Cooperation Council and the ministers of the respective SEE countries in Sarajevo in November 2013 is an attempt to implement desired regional cooperation initiatives. The Berlin process also represents a step forward in this regard. Whereas recently there has been some progress in initiating a Regional Economic Area in the WBs¹¹³, a lot more could be done in most areas of regional economic and political cooperation.

Regarding the *role of the EU*, the renewed EU enlargement policy based on three pillars – Public administration, Rule of Law and Economic governance – now gives major importance to problems of economic development. This is promising, since in the past and for too long economic problems were in the shadow of political issues. In particular, the new policy instrument recently introduced by the European Commission – the Economic Reform Program (ERP) – ought to contribute to improvements in WB's economic governance.¹¹⁴ Mirroring in part the European Semester, the new policy instrument, in addition to more efficient macroeconomic fiscal and monetary policies, imposes on the WB policy-makers the need to adopt a longer (three-year) planning framework, introduce prioritization of structural objectives and impact analysis of desired goals. However, only a few countries have for now had the administrative capacity to actually undertake this type of longer-term policy planning and assessment.¹¹⁵

Major constraints on the implementation of the desired reforms in the WBs are limited financial resources, especially for investment purposes. Even a radical reallocation of budgetary funds that would substantially increase public

¹¹³ European Commission (2017a), "Western Balkans Summit 2017: delivering for the region", available at http://europa.eu/rapid/press-release_IP-17-2007_en.htm.

¹¹⁴ Bonomi, M. (2016), "Economic Governance in the Balkans: Towards a More Sustainable Path of Economic Development?" European Policy Centre Policy Brief, November 2016, available at http://www.epc.eu/pub_details.php?cat_id=3&pub_id=7130&year=2016.

¹¹⁵ Arandarenko et al. (2017), *Regional Analysis of Employment and Social Measures in the Western Balkans 6*, Belgrade: Foundation for the Advancement of Economics (FREN), Report for the Regional Cooperation Council, February.

investment and reduce consumption-related expenditure would not be enough to provide the necessary resources for investment in those areas that have been singled out as crucial for faster economic development of the WBs. The finance provided by the EU through the IPA II to the WBs is still rather low and largely insufficient to provide for accelerated economic development. The WBs must be supported with additional financial resources from the EU and its institutions much before they actually fulfill the conditions to enter the EU. Flessenkemper and Reljić (2017)¹¹⁶ suggest that the WB accession countries “should be granted access to the EU’s structural funds, be permitted to participate in the EU’s financial stability mechanisms, and be treated in all other respects as part of the European integration project”. Major EU financial support could help the aspirant countries to boost their public investment and adopt a clearer developmental perspective. This would be beneficial both economically and geo-politically, not only for the Balkans but also for the EU itself (Bonomi and Reljić, 2017).¹¹⁷

Conclusions

The Western Balkans has witnessed dramatic changes over the past 25 years. Financial integration took off somewhat later than in the New Member States, but has increased rapidly, despite still much lower capital account openness. Capital inflows as a share of GDP are comparable to those observed in the New Member States, (perhaps surprisingly) diverse in terms of source countries and in both regions FDI and bank lending account for the bulk of inflows as well as outflows (though the latter are still small in the Western Balkans), while shares of equity assets in total external assets are much higher than they were in the New Member States at comparable levels of development.

¹¹⁶ Flessenkemper, T. and D. Reljić (2017), “EU Enlargement: A Six Percent Target for the Western Balkans”, available at <https://www.swp-berlin.org/en/point-of-view/eu-enlargement-a-six-percent-target-for-the-western-balkans/>.

¹¹⁷ Bonomi, M. and D. Reljić (2017), “Boosting growth in the Western Balkans to accelerate convergence with the EU”, forthcoming.

Similar to the experience of the New Member States, the region experienced booming inflows in 2003–07, driven by a combination of push and pull factors: a willing supply of funds from Western Europe and expectations of high growth in Emerging Europe. Booming inflows provided financing and supported private sector development and employment, however their sharp drop as a result of the global financial crisis and strong link with growth point to vulnerabilities. So far inflows have held up better than in the New Member States, however the similarities in terms of their determinants point to caution: capital inflows are pro-cyclical, thus potentially raising vulnerabilities by amplifying external shocks. The challenges facing the region on the road to accession are numerous. I believe that four are particularly pressing: resolving political disputes within the region, improving governance standards, upgrading infrastructure, and expanding the industrial base. Solving these in a comprehensive and timely manner will go a long way to helping countries in the region to meet their accession goals.

The Western Balkan countries will be able to join the European Union once the criteria of Article 49 of the Treaty on European Union, including the Copenhagen criteria, are met. While none meets these criteria today, the region has come a long way since the end of the 1990s.

Overall, significant progress has been made both on reforms and on overcoming the devastating legacy of war and conflict. But in order for the countries to meet all membership conditions and strengthen their democracies, comprehensive and convincing reforms are still required in crucial areas, notably on the rule of law, competitiveness, and regional cooperation and reconciliation.

First, the rule of law must be strengthened significantly. Today, the countries show clear elements of state capture, including links with organised crime and corruption at all levels of government and administration, as well as a strong entanglement of public and private interests. All this feeds a sentiment of impunity and inequality. There is also extensive political interference in and control of the media. A visibly empowered and independent judiciary and accountable governments and administrations are essential for bringing about the lasting societal change that is needed.

Second, critical parts of the region's economies are uncompetitive, with too much undue political interference and an underdeveloped private sector. None of the Western Balkans can currently be considered a functioning market economy nor to have the capacity to cope with the competitive pressure and market forces in the union. In spite of all progress on reforms, many structural issues remain, which in turn affect labour markets and notably employment opportunities for younger people.

Third, there are still important bilateral disputes between countries in the region which remain to be solved. The EU will not accept to import these disputes and the instability they could entail. Definitive and binding solutions must be found and implemented before a country accedes. Last but not least, joining the EU is a choice. It needs political and societal consensus and the support of the hearts and minds of the people. There can be no ambiguity by leaders about where the Western Balkans belong and the direction in which they are heading. This is necessary to secure and sustain the support of their own and of EU citizens, and must be reflected in leaders' communications and outreach to citizens.

The respective European paths of the Western Balkan countries are flanked by various initiatives, such as the Berlin Process, 3 sectoral platforms such as the Energy and Transport Communities, and regional actors, such as the Regional Cooperation Council. It is now up to the countries' authorities, with the support of their societies, to take ownership and deliver on the well-known conditions for accession. To make the ambitious best-case scenario a reality, action must be taken now. Ultimately, the region's citizens will judge their own governments on whether or not they are willing and able to deliver on their European ambitions.

Efforts should be intensified to **guide rule of law-related reforms** in the region, to support the ambitious steps to be taken by the countries themselves. The tools developed during the negotiations with Montenegro and Serbia under the rule of law chapters should also be used in other Western Balkan countries as a stimulus for early adoption of key reforms. This will include analysis of legislation and practice in this field, leading to the establishment of detailed action plans prioritising key issues, and close monitoring of implementation and delivery of

concrete results. There is great benefit in increased Member States' and experts' contributions to support and bring pressure to bear on reform implementation. More detailed rule of law assessments should be undertaken and advisory missions extended to the whole Western Balkans, building on the experience of the earlier advisory missions. Monitoring of implementation and enforcement should be enhanced including through more systematic, case-based peer-reviews organised by the Commission with the participation of Member State experts. Trial monitoring in the field of serious corruption and organised crime should be introduced. Work developing indicators of reform implementation should be undertaken. Progress in judicial reform needs to be measured by the effectiveness of justice that the system is able to provide to its citizens and businesses. The negotiating framework for Serbia place particular emphasis on the need for rule of law reforms to be addressed early in the negotiations. The Commission recommends that greater use is made of the leverage provided in the negotiating frameworks. Accordingly, a substantial improvement should be required on the rule of law and in particular concrete results in judicial reform and in the fight against corruption and organised crime before technical talks on other chapters of the accession negotiations can be provisionally closed.

An investment in the Western Balkans is an investment in Europe. Investments will only increase if economic governance is strengthened and structural reforms pursued to increase competitiveness. The measures below serve to support this goal and to enhance growth and job creation in particular for the region's youth. The Western Balkans Investment Framework financed through the Instrument for pre-Accession Assistance will be increasingly at the core of fostering investments in the region. To that effect, it will be expanded to further attract and coordinate bilateral donors' and International Financing Institutions' investment. Increased funding in the fields of transport, energy, the social sector, the environment, and private sector development, including the digital economy is foreseen. To link socio-economic development in the region to the Union's investment priorities, the Commission aims to significantly boost the provision of guarantees under the Western Balkans Investment Framework to crowd in private investment in the region, in full complementarity with existing initiatives. With a view to the next

Multi-annual Financial Framework, the Western Balkans should also be adequately covered in possible future external lending arrangements. The Regional Economic Area is an essential step for furthering economic integration between the EU and the Western Balkans and boosting the attractiveness of the regional market. The Commission will continue supporting the development of intraregional economic integration, including by mobilising its expertise to assist with the implementation of Regional Economic Area action plan, in particular in areas covered by the EU acquis. While trade between the EU and the Western Balkans was over EUR 43 billion in 2016, there is significant further growth potential. To realise this potential, the Commission will further facilitate EU-Western Balkans trade. This will include developing mutual recognition programmes on the basis of Central European Free Trade Area and Regional Economic Area (e.g. Authorised Economic Operators). Membership of the World Trade Organisation is a prerequisite for EU accession and can spur economic growth and foster significant investment for the region. The Commission will continue assisting Bosnia and Herzegovina and Serbia in their World Trade Organisation accession process. The development of a robust private sector led by entrepreneurs both from within the region and from the EU will better harness the dynamism of the region's youth and foster mutually beneficial economic integration. Links between the diaspora business community in the EU and entrepreneurs in the EU and the Western Balkans will continue to be encouraged, including through the EU programme for the Competitiveness of Enterprises and Small and Medium-sized Enterprises. Measures are needed to increase access to finance and harness the growth potential of small and medium-sized enterprises. In order to boost entrepreneurship and innovation, the Commission will roll out a scheme supporting technology transfer and start-ups across the region and support efforts aimed at smart specialisation as well as the circular economy. The EU's Framework Programmes are already open to the Western Balkans. To ensure their more effective participation, further integration into the existing knowledge networks in the EU should be foreseen, including research and innovation capacity building. Collaboration can be further developed under other initiatives, including EU macroregional strategies. The Commission will work on supporting the professionalism and independence of public procurement officials and on

strengthening oversight mechanisms to enable monitoring of the full tender cycle. For these efforts to be efficient, a firm political commitment is needed to address corruption. The annual economic reform programme exercise led by the Commission with all Western Balkan countries is a crucial tool for supporting the modernisation of their economies and achieving closer economic coordination with the EU. The Commission will strengthen this exercise, bring it even closer in line with the existing European semester for EU Member States and provide more advanced technical assistance. The European Pillar of Social Rights reflects principles and rights that are essential for fair and well-functioning labour markets and welfare systems. Through a new reinforced social dimension for the Western Balkans, the Commission will work to support employment and social policy in the region, encouraging appropriate engagement from all levels of government, social partners and civil society. This will include an increased focus on employment and social reforms through greater monitoring of relevant policies, including in the context of the economic reform programmes. The Commission proposes an annual EU-Western Balkans Ministerial meeting on social and employment issues to exchange views. More financial assistance should be foreseen in the social sector, notably investment in education and health to support social inclusion. Enhanced support should be provided to education, in particular vocational education and training and skills as well teacher training and pre-school education. Funding under the Erasmus+ programme will be doubled to help even more young citizens of the Western Balkans to study and gain experience in the EU thereby furthering economic development and promoting common values. A pilot mobility scheme for learners and trainers in vocational education and training will be established in close cooperation with stakeholders including the European Training Foundation.

Enhancing connectivity within the Western Balkans represents a strategic interest for both sides. Increasing transport and energy connections will allow for increased competitiveness, economic growth and security of supply, and is at the same time an important prerequisite for economic integration within the Western Balkans. The Energy Community Treaty and the Transport Community Treaty as

well as the European Common Aviation Area provide for advanced regulatory frameworks that can – combined with strong political cooperation in the region – largely facilitate intra-regional connectivity. The Western Balkans are surrounded geographically by EU Member States and it is a political priority to connect infrastructure also between the EU and the Western Balkans and to accelerate the development of interconnected trans-European networks in the fields of transport, energy and digital services. Investment in infrastructure networks brings tangible benefits clearly recognised by citizens and business in the EU and Western Balkans alike. In addition to increased funding of these networks and the creation of a new guarantee scheme for private investment, the Commission will work to ensure more effective use of existing provisions of the Connecting Europe Facility for the Western Balkans countries. The Commission will explore possibilities for 14 simplifying their participation in the next Multi-annual Financial Framework.

An energy union with the Western Balkans: To strengthen the EU's Energy Union, all of its dimensions should be expanded to the Western Balkans: supporting energy security, market integration and energy transition, including energy efficiency and renewable energies. In this context, each country should complete all necessary reforms and streamline their policies fully in line with the five pillars of the Energy Union. Capacity building of energy regulators and transmission system operators in the Western Balkans should be supported so that they can participate fully in EU-level networks. Work to complete the Regional Electricity Market in the Western Balkans should be pursued and its integration into the EU Internal Electricity Market assured. Towards a true transport union with the Western Balkans: Implementation of the Transport Community Treaty which entered into force in 2017 will be the key step leading to progressive integration of the region into the EU transport market. Agreements on priority transport corridors between the EU and the Western Balkans as part of the trans-European transport network are already in place. These now need to be made a reality to ensure their contribution to increasing the competitiveness of the continent as a whole.

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