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Conference Paper

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46th Congress of the European Regional Science Association: "Enlargement, Southern Europe and the Mediterranean", August 30th - September 3rd, 2006, Volos, Greece

Provided in Cooperation with:
European Regional Science Association (ERSA)

Suggested Citation: Filipovic, Milorad (2006) : Importance of Institutional Development for Western Balkan Countries, 46th Congress of the European Regional Science Association: "Enlargement, Southern Europe and the Mediterranean", August 30th - September 3rd, 2006, Volos, Greece, European Regional Science Association (ERSA), Louvain-la-Neuve

This Version is available at:
https://hdl.handle.net/10419/118300

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REGIONAL SCIENCE ASSOCIATION
"ENLARGEMENT, SOUTHERN EUROPE & MEDITERRANEAN"
Volos, Aug. 30- Sep. 3 2006.

IMPORTANCE OF INSTITUTIONAL DEVELOPMENT FOR WESTERN BALKAN COUNTRIES

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Belgrade, April, 2006.

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Abstract

The main purpose of this paper is to research what are central obstacles for Western Balkan countries to become a part of integretad European Union territory. Are those obstacles in the sphere of economic underdevelopment of Western Balkan countries or not? We knows that one of the condition for EU accession is to attain 40% of average EU GDP, or to have low inflation rate and transparent and balanced public consumption (budget) policy. The fact is that all Western Balkan countries more or less do not fulfil those conditions. But the fact is also that most of 10 new EU member states do not fulfil same conditions and that fact do not limited their memebrship. So, it is something else that prevent Western Balkan's to become a full member of EU territory. It is **institutional framework development** that is missing in a great measure in this region and, what we want specially to stress, selective implementation of the laws and regulations or inefficient judicial and prosecuting system. Now we can realise how important was initial EU technical support in all Western Balkan countries through Institutional Capacity Building projects. Countries that most successfully implemented those reforms and establish more or less effective institutional framework, like Bulgaria and Romania, already becomes candidate countries and they are on their way to become a full memebers very soon. This example is a clear sign for other countries of the Region how to speed up thier process of EU Accession.

Key words: *Transition, Reforms, Institutional Development, EU Accession.*

Present position of Western Balkan countries

After a decade of transition process in the European countires it becomes obvious that the most succesfull ones are the countries that radicaly enter into structural transformation of theirs economies and societes. Every try to make new economic strucutres by implementing old institutional solutions sooner or later becomes useless and just time consuming activity. Changes that could be label as «make-up» ones do not touch the esential institutional arangements that exists before transition process started, so we have a new «variety» of organisational solutions based on old institutional framework.

Today it is modern to classified all transition economies into three main categories:

(a) The most successful economies in transition that provides stable economic growth rates, establish institutional framework comparable with developed economies and that already deeply enter into European integration (or become a full member states of the EU)[1];

(b) Relatively successful economies in transition that has temporary episodes of successes measured by economic and social performances - first of all

[1] In this group are Slovenia, Hungary, Poland, Czech Republic.

through low level of inflation, high rate of GDP growth and avoiding of mass unemployment, but also followed by short episodes of destabilisation and worsening of their performances[2];

(c) Third group of countries in transition are the most obsolete countries, with slow and not in depth institutional changes, countries that are still at the beginning of the transition process and that miss enough courage to cope with the changes transition must comprised.[3]

From the point of view of this paper the most interesting one are the countries of Western Balkan states – namely: Croatia, Serbia and Montenegro(including Kosovo and Metohija), Bosnia and Hercegovina, Macedonia and Albania. This group of countries represents entity that is quite large – by territory, by population and in every other mean to be attractive as the partner for the EU. When we add Romania and Bulgaria, as Balkan countries as well, but closer to the process of European integrations, we come to respectable territory of almost 55 million inhabitants and with strategic position as the connection between Europe and Asia. Prudent and sophisticated analysis predicts this Region as the "New New Emerging Market" area of the World economy, area that will replace most successful countries in transition and attract most FDI's in the near future. Reasons for that are obvious: the first above mentioned group of countries already becomes a full member of EU, accepting European standards, norms of behaviour, organisational structures and most important European institutional framework. Those countries liberalised their markets and open it to FDI inflow in early nineties so most attractive investments and lucrative opportunities for old EU investors are already diminished. Contrary to this, in Western Balkan countries there are still some obstacles for their faster integration in European institutional framework: most of them lack transparent and effective judicial system (including prosecution system), there is still selective implementation of laws, every new election are considered as potential change and turbulence in economic system and new distribution of "invisible forces"[4] that drives national socio-economic system.

The experience from the last enlargement of the EU by new 10 members shows that conditions for accession are relatively flexible: most of the new member states do not fill economic conditions (Maastricht Treaty), first of all 40% of GDP average of the EU, but they became members thanks to the fact that they successfully implemented institutional changes. Transparent and predictable political, economic and judicial systems are necessary to exist in those countries. That will disable high corruption, organised crime and other "characteristics" still presented in Western Balkan countries and enable transparent and effective property rights system, the Rule of Law and overall stability of macro economy.

Transition reforms

There is general agreement that systematic transformation implies fundamental reforms in a great many areas. Following reforms are regarded as unavoidable in transition economies (listed in order of priority):

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[2] Typical representatives in this group are some of Western Balkans countries, like Croatia, Serbia and Montenegro etc.

[3] In this group are most of the CIS countries (former Soviet Union members).

[4] Unfortunately, here we do not mean market forces!

- First in order of importance is the **creation of domestic markets**. It is necessary to provide macroeconomic stability as the prices could done their role in the market – to gives clear and accurate signals. A legal framework must be created so that contracts can be enforced; property rights must be reasonably secure, without difference between ownership type (private, state or mixed); and market institutions must be created, and in particular a properly regulated, financial viable and efficient commercial banking system must be created.
- Second reform is **liberalisation of the international trade**. Most transition economies (especially Western Balkans one) are rather small and have little alternative to relying on international markets to exploit their comparative advantages. That is the reason why European Union forces Western Balkan countries to enhance cooperation between them through Free trade Association.
- Third reform is **liberalisation and stimulating system for SME's development**, first of all in private sector. Administrative obstacles and control of the process must be removed so that private enterprise is not inhibited. New private sector activities have several features which make them especially attractive during the early stages of the transition: they usually are small in scale, widely dispersed and labour intensive, and hence the benefits of private sector activity contribute to employment creation and a relatively equal distribution of income.
- Next reform is to **remove existing state enterprises**. That becomes one of the most difficult task in most countries of Western Balkan as those companies has concentrated very high amount of capital, labour force and has been very important for national economy in previous system. Transformation of those enterprises has been a source of systematic corruption; "client's" privatisation, when over the night individuals become enormously wealthy thanks to their relations with political decision-makers, has been presented in all of these countries.
- Following reforms includes **changes in taxation system** where the main goal is to secure "hard budget constrain" and to eliminate permanent financial injections from public consumption to the state owned companies. Also, it is necessary to include as wide range of tax payers as it is possible simultaneously with decreasing of fiscal burden - to have effective, but stimulating system.
- The last reform should be **liberalisation of external capital account**. FDI can be particularly useful, but it is doubtful that short term foreign borrowing or portfolio investments should be liberalised until transition is completed, and particularly not until macroeconomic stability is achieved, the commercial banking system is reformed, markets are functioning well and the state owned enterprises have been reformed.[5]

[5] K.Griffin, 1999.

Many of above mentioned reforms already started in Western Balkan countries but had not been successfully implemented to the end. Reasons for those failures are different:

- in some cases it is missing political willingness to implement reforms (nominally all policy decision-makers are "pro" but in reality they do everything to preserve situation unchanged and to continue to rule in the same manner);
- in some cases lack of institutional framework and ineffective regulations limits possibilities to react and to influence to make reforms fasters;
- in some cases lack of knowledge and expertise among policy decision-makers is insurmountable difficult that could not be overcome except with foreign support.

Institutional reforms – theory

In development theory it is usual to define development as economic growth plus structural change. But in the framework of institutional economic theory development could be defined as "economic growth plus appropriate institutional change, meaning institutional changes which facilitate further economic growth. Appropriate institutional change has been elevated by the New Institutional Economics to the central place in the theory of development…".[6]

First of all we must make clear definition of institutions. [7]

Institutions are the "rule of the game" of a society, or, more formally, are the humanly devised constraints that structure human interaction. Institutions are composed of: *(i)* formal rules (statute law, common law and regulations, *(ii)* informal constraints (conventions, norms of behaviour and self-imposed codes of conduct) and *(iii)* the enforcement characteristics of both.

"While the formal rules can be changed overnight, the informal norms change only gradually. Since it is norms that provide the essential 'legitimacy' to any set of formal rules, revolutionary change is never as revolutionary as its supporters desire, and performance will be different than anticipated. More than that, societies that adopt formal rules of another society… will have very different performance characteristics than the original country because both the informal norms and the enforcement characteristics will be different. The implication is that ***transferring the formal political and economic rules of successful Western market economies to Third World and Eastern European economies is not a sufficient condition for good economic performance*** (Underline M.F.). Privatisation is not panacea for solving poor economic performance". [8]

[6] Harris, Hunter, Lewis, 2000.
[7] Apart institutions there are also organisations – defined as: groups of individuals bound by a common purpose to achieve objectives. They include political bodies, economic bodies, social bodies and educational bodies.
[8] Ibid.

As we can see from above citation effective institutional framework is not a question of adaptation of foreign rules and norms, but more the question of gradual and long time consuming process. Every society has its own norms and tradition, and existing formal rules are just the result based on informal one. Evolutionary way to implement reforms sometimes evolved to revolutionary one – first of all when organisations with different interests emerge and the fundamental conflict between organisations over institutional change cannot be mediated within the existing institutional framework. That is real potential danger in (some) Western Balkan countries if they missed to quickly implement effective changes in their institutional framework.

Institutional reforms in Western Balkan countries

The European Bank for Reconstruction and Development (EBRD) summed up, using transitional indicators, the advancement of structural and institutional reforms in the year 2004 for 27 countries in transition. Eleven transitional indicators encompass six main transitional areas: liberalization, privatization, companies, infrastructure, financial institutions, and the legal environment. Each indicator shows a synthesized assessment of improvement achieved in a certain area, based on various data, narrative information and analyses.

Countries in transition continued to advance in their structural and institutional reforms with various levels of success. Countries of South-East Europe advanced significantly, Baltic states and Central and East European countries achieved some advancement, while the advancement in Newly Independent States was modest.

Comparison of the average yearly transitional index (unpondered arithmetical middle value of 9 indicators) between economies in transition shows that in 2004 21 countries (scope 2,6-3,9) were more advanced than Serbia and Montenegro (and Bosnia and Herzegovina), while only Turkmenistan, Belarus, Uzbekisyan, and Tajikistan showed results that were lower. Hungary, with the highest index value (3,9), came closest to the level of developed market economies. The Czech Republic, Estonia, and Poland (3,7) were also listed as most advanced transitional economies. With regard to the level of implemented reforms, Serbia-Montenegro was surpassed by Azerbaijan (2,6), Moldova (2,7), Ukraine, and Albania (2,8).

EBRD transition indicator scores, 2004

Country	Average value-total	Enterprises			Markets and trade			Financial Institutions		Infrastructure
		Large-scale privati-sation.	Small-scale privati-sation	Gover-nance & enterprise restructu-ring	Price liberali-sation	Trade & foreign exchan. system	Competi-tion policy	Banking reform & interest rate liberalisa-tion	Securities markets & non-bank financial institutions	Infra-structure reform
Albania	**2,8**	2+	4	2	4+	4+	2↑	3-↑	2-	2
Armenia	**3,0**	3+	4↑	2+	4+	4+	2	2+	2	2+
Azerbaijan	**2,6**	2	4-	2+	4	4-	2	2+	2-	2
Belarus	**1,8**	1	2+	1	3-	2+	2	2-	2	1+
Bosnia & Herz	**2,5**	2+	3	2	4	4-	1	3-↑	2-	2+
Bulgaria	**3,4**	4↑	4-	3-	4+	4+	2+	4-↑	2+	3↑
Croatia	**3,4**	3+	4+	3↑	4	4+	2+	4↑	3-	3↑
Czech Rep.	**3,7**	4	4+	3+	4+	4+	3	4-	3+↑	3+
Estonia	**3,7**	4	4+	3+	4+	4+	3-	4↑	3+	3+
Macedonia	**3,0**	3+↑	4	2+	4	4+	2	3-	2↑	2
Georgia	**3,0**	3+	4	2	4+	4+	2	3-↑	2-	2+
Hungary	**3,9**	4	4+	3+	4+	4+	3	4	4-	4-
Kazakhstan	**2,9**	3	4	2	4	3+	2	3	2+	2+
Kyrgyz Rep.	**2,9**	4-↑↑	4	2	4+	4+	2	2+	2	2-↑
Latvia	**3,6**	4-	4+	3	4+	4+	3-	4-	3	3
Lithuania	**3,5**	4-	4+	3	4+	4+	3	3	3	3-
Moldova	**2,7**	3	3+	2-	4-	4+	2	3-↑	2	2
Poland	**3,7**	3+	4+	3+	4+	4+	3	3+	4-	3+
Romania	**3,2**	4-↑	4-	2	4+	4+	2+	3↑	2	3+↑
Russia	**3,0**	3+	4	2+	4	3+	2+	2	3-	3-↑
Slovak Rep,	**3,6**	4	4+	3	4+	4+	3	4-↑	3-	3-
Slovenia	**3,4**	3	4+	3	4	4+	3-	3+	3-	3
Tajikistan	**2,3**	2+	4-	2-	4-	3+	2-	2↑	1	1+
Turkmenistan	**1,3**	1	2	1	3-	1	1	1	1	1
Ukraine	**2,8**	3	4	2	4	3	2+	2+	2+↑	2
Uzbekistan	**2,1**	3-	3	2-	3-	2-	2-	2-	2	2-
Serbia & Mont	**2,5**	**2+**	**3+↑**	**2**	**4**	**3+**	**1**	**2+**	**2**	**2**

/Source: EBPD Transition Report 2004

Note: The value of transitional indicators has a scope of 1 to 4+. Value 1 represents a small or non-existing change from the rigid, centrally planned economy, while 4+ represents the standards of market economies. Values "+" or "-" represent addition or reduction by 0,33 of the entire value. The average value is obtained by rounding not up but down, for example, value 2,6 is marked as 2+, value 2,8 as 3-. Arrow ↑ shows a change of the transitional indicator in relation to the previous year. One arrow represents a change of one point (for example, from 4 to 4+), two arrows a change of two points. An upwards pointing arrow shows improvement, a downwards pointing arrow shows decline.

According to the EBRD assessment, in 2004 Serbia-Montenegro was among the countries that showed a certain move in the implementation of reforms. The analysis of individual EBRD indicators showed that Serbia-Montenegro received the highest mark (4) for price liberalization, 3+ for the foreign trade regime (trade liberalization and the foreign currency system), 3+ for the privatization of small companies, the area in which the transitional process advanced the most.

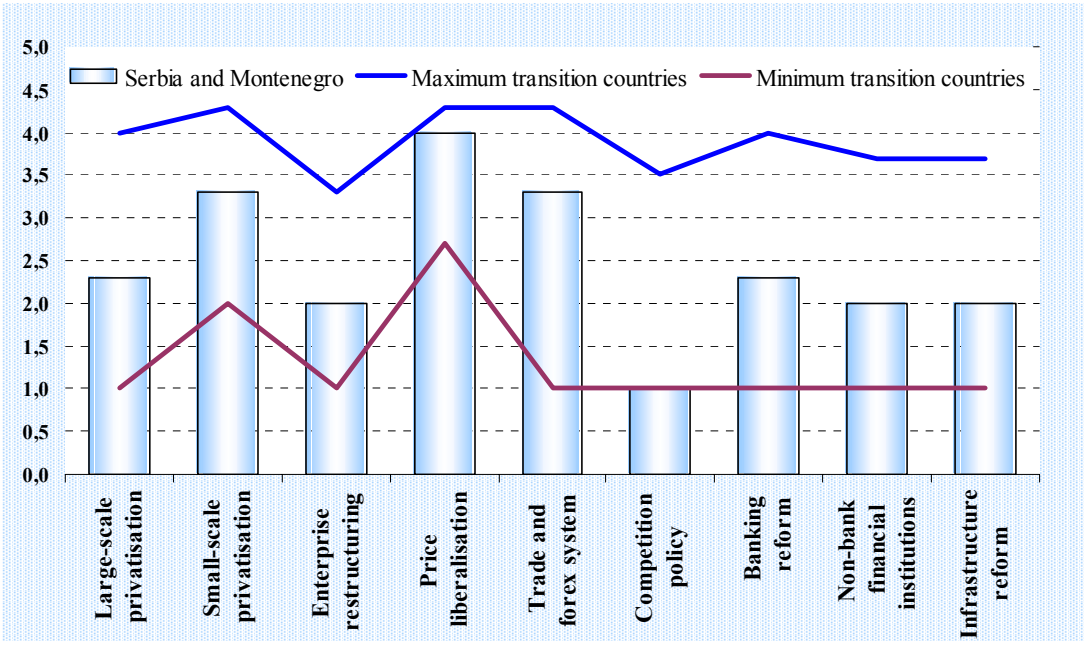
Average advancement was realized in the process of privatization of large companies (2+) and the restructuring of the banking sector (2+). The creation of the securities market, non-banking financial institutions, and infrastructural reforms received modest marks (2). No advancement was made in the area of anti-monopoly policy, the indicator showing the lowest value (1).

Values of annual EBRD indicators for Serbia-Montenegro

EBRD indicator	1998	1999	2000	2001	2002	2003	2004
Price liberalisation	2,3	2,3	2,3	4,0	4,0	4,0	4,0
Forex and trade liberalisation	1,0	1,0	1,0	3,0	3,3	3,3	3,3
Small-scale privatisation	3,0	3,0	3,0	3,0	3,0	3,0	3,3
Large-scale privatisation	1,0	1,0	1,0	1,0	2,0	2,3	2,3
Enterprise reform	1,0	1,0	1,0	1,0	2,0	2,0	2,0
Competition policy	1,0	1,0	1,0	1,0	1,0	1,0	1,0
Banking sector reform	1,0	1,0	1,0	1,0	2,3	2,3	2,3
Reform of non-bank financial institutions	1,0	1,0	1,0	1,0	1,7	2,0	2,0
Infrastructure reform	1,7	1,7	2,0	2,0	2,0	2,0	2,0
Average annual value of EBRD indicators	1,4	1,4	1,6	1,9	2,3	2,4	2,5

Source: EBRD Transition Report 2004

EBRD transitional indicators, 2004



During the past several years, **privatization** of companies was continually conducted through auctions and tenders - 1.249 companies changed owners (from 2002 to September 2005). According to data of the Agency for Privatization, 96 companies entered the restructuring process in 2005 (until 15 September).

During the year 2004 and the expired portion of 2005, a significant move was made towards the completion of a **stimulating business environment.** Accelerated economic reforms increased the legal security of economic subjects and improved business conditions that are of particular importance to foreign investors (laws were passed that provide for a better business environment, that is, protect property, contracts, creditors and investors: Law on Economic Subjects, Law on Bankruptcy Proceedings, Law on Registration of Economic Subjects, Law on Executive and Litigation Proceedings, Law on Electronic Signature, as well as the new labour legislature).

Corporate tax was lowered from 14% to 10% and it is one of the lowest among the countries in transition. Nevertheless, political instability, corruption, and inefficient functioning of the judiciary system are still present.

For its **competition policy,** Serbia-Montenegro was given the lowerst mark, showing that legal regulations and a defined policy were missing. The Parliament of Serbia adopted (on September 14, 2005) the Law on Protection of Competitors and the Law on Prices. The Law on Protection of Competitors regulates protection of competitors in the market, in order to establish the equality of participants, achieve economic efficiency and the rule of law, and create conditions needed for more rapid economic growth.

Reforms are under way in the **banking sector.** During the first half of 2005, the banking sector consisted of 14 banks whose majority owner was the Republic of Serbia, 13 banks whose majority owners were domestic physical and legal entities, and 14 banks whose majority owners were foreign shareholders. The banks' loan activity increased. The total value of loans increased from 1,1 billion EUR at the end of 2001 to 3,9 billion EUR towards the end of 2004. The dynamics of loan increase continued in the first half of 2005 (by 18,6%).

In **infrastructure sectors,** laws that regulate telecommunications, energy, railways and postal services were passed. In the function of restructuring of large economic systems and public companies, Law on Cessation of Validity of the Law on Eastablishment of the Public Company For Research, Production, Processing and Trading in Oil and Natural Gas was passed in August**,** creating proper conditions for the national oil company to start functioning according to the new organization scheme on October 1.

The economy of Serbia, according to the assessment of the EBRD expert team, has potential for strong mid-term advancement. Its perspecive, though, depends mostly on political stability and a favorable business environment. Performances of Serbian economy in 2005. shows that it is on a good way to continue further economic reforms, but with very slow down changes in other important sectors, like judicial system, anticorruption program etc.

Serbia and EU Relations

Serbia should closely connect the EU association and accession strategy with the reform policy directed to political, economic and social transformation. This implies the following and urgent activities:

- To overcome the internal political obstacles which hamper the establishment of a harmonised political will on objectives, directions and means of overall reform and systemic transformation. This is the most important internal conditions for realising the EU association and accession strategy.
- As a particular supplement to the previous request, Serbia should pass a new constitution as soon as possible. This constitution would, among other, contain a provision foreseeing the necessary assignments or a shared sovereignty i.e. legislative, executive and judicial power with the European Union institutions.
- Alongside the establishment of internal political concord on the new constitution, Serbia needs to intensify the initiated reforms. It has to reform the institutional skeleton of the system – democratic strengthening of political institutions, reform of public administration and judiciary – as well as macro- and microeconomic systems and sector policies. The reform of legislation has to go along with the reform of mechanisms for public policy enforcement.
- Within the reform process, Serbia has to immediately initiate the legal harmonisation with the European Union *acquits*. This harmonisation shall not be mechanical and formal, but in line with the concrete development needs of Serbia and with realistic enforcement possibilities of the new legislation. That is why the institutional alignment with this requirement is of special importance. Both legal and institutional harmonisation should serve the internal reform. This would enable the synchronization of two parallel courses: change of the social and state structure and the fulfilment of obligations arising from cooperation with the European Union (Stabilisation and Association Process).

Conclusion

Western Balkan countries comprises following entities: Bosnia and Hercegovina, Croatia, Serbia and Montenegro, Kosovo and Metohija, Albania and Macedonia. Even there are just five sovereign (internationally recognized) states among those entities, number of different names (9) shows to us all fragmentation and tendencies toward further dissolution of this region to increasing number of small states. Tendencies that are shown in WB region are quite different from those in other transition countries in Europe. Instead of cooperation in economic, financial and all other important fields, like Vise grad - group countries did in nineties and strengthen their negotiation position compared with the EU, WB countries try to flatter to EU member states and to build their better position through deterioration of the position of other region states!

On the internal plan, all WB countries are still rely on weak institutional capacity – mechanisms that enables governments non-transparent behavior, manipulation with judicial system and judges, selective implementation of the laws, very high and resistant level of corruption in all social and economic fields, surviving of organized crime structures which are very often related to government officials at all levels etc.

Integration of WB countries in the EU will be very long term and difficult process as the precondition for that will be building of effective institutional mechanisms that could provide governance comparative with other transition countries and in more distant future with European mature market economies. It is

important also to establish efficient regional cooperation and to increase the level of income and competitiveness to cope with the competition from EU. Experiences from other Balkan countries should be useful for WB region – Greek's as one old member state, and Romania's and Bulgaria's as candidate member states. WB countries expect to have greater understanding of EU officials for the very serious problems that have to be resolved and it is out of question that without important support from outside WB it will be impossible to do so.

Main problems of the Region remain: organized crime, trafficking, very high corruption in all segments of the society ("endemic" corruption at all level of governance), insecure and instable judicial system that is implemented selectively and "backwardness" of the Region that prevents any serious changes and reforms to be implement.

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