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Implementing structural reforms in the Western Balkan countries

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Abstract

The paper focuses on three main objectives. First, it assesses the progress of structural reforms implemented in six Western Balkan transition economies, i.e. Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro and Serbia. Second, it outlines the major economic and institutional weaknesses of these countries. Third, using the conceptual framework of new institutional economics it suggests a non-standard general approach to the reform process and provides guidelines for the design and sequencing of the most needed structural reforms which may enhance the international competitiveness and improve the macroeconomic performance of the Western Balkan countries in the future.

Key words: Western Balkans, structural reforms, economic performance, institutions.

I Introductory remarks

The aim of this paper is three-fold. First, it strives to assess the progress of structural reforms implemented in the past 24 years in six Western Balkan transition economies, i.e. Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro and Serbia. Second, against this background and based on a brief overview of macroeconomic performance, it seeks to outline the major economic and institutional weaknesses of these countries. Third, using the conceptual framework of new institutional economics it suggests a non-standard general approach to the reform process and lists the most needed structural reforms which may enhance the international competitiveness and improve the macroeconomic performance of the Western Balkan countries in the future.

Apart of their own merit, the goals outlined above gain in importance in view of the fact that most of the Western Balkan countries aspire for the EU membership as soon as they meet the institutional convergence criteria. That is why we decided to include to our sample two other countries of the region, Croatia and Slovenia (who were granted the EU full membership status in 2004 and 2013 respectively); they will serve as reference points in our exercise.

The focus of our study will be both backward- and forward-looking; on the one hand, we will contrast the progress in structural or institutional reforms made so far with the starting point of systemic transformation while on the other hand, we will attempt to show the present size of structural or institutional gaps in the Western Balkan countries (WBCs) vis-à-vis the benchmark or the level of institutional development in particular areas in the 'old' member countries of the European Union (EU15).

The paper is organized as follows. Section 2 provides a brief overview of macroeconomic performance in Western Balkan countries pointing out to their major flaws and challenges ahead. In Section 3 we embark on a tentative assessment of the progress of structural reforms in the WBCs so far. Section 4 complements the picture of institutional quality of the WBCs and discusses the institutional underpinnings of structural reforms. Section 5 concludes with main suggestions regarding the broader institutional foundations of a viable strategy of implementing structural reforms in the Western Balkan countries and the guidelines for their design and sequencing.

II Macroeconomic performance

Poor economic growth record ranks among the biggest weaknesses of macroeconomic performance of Western Balkan countries between 1990 and 2012, the only spectacular exception being Albania. Table 1 gives account..

Table 1. Economic growth performance in Western Balkan countries, 1990-2012

Country	Real GDP average annual growth rate (%)	Real GDP index in 2012	Development gap (GDP per capita in PPP, EU15 = 100)	
	1990-2012	1989=100	1989	2012
Albania	2.6	182	19	28
Bosnia & Herzegovina	-0.7	84	11 ^a	27
Kosovo	15 ^c	27
FYR Macedonia	0.2	105	41	32
Montenegro	-0.4	91	21 ^b	38
Serbia	-1.2	69	21 ^b	33
WBCs average	0.1 (0.0) ^d	106 (99) ^d	21	31
Croatia	0.0	101	51	56
Slovenia	1.6	143	74	77
CE average	2.3	167	58	67
CIS average	0.9	122	27	18 ^a
EU15	1.6	145	100	100

a - 1990, b - 1997 (Serbia and Montenegro jointly), c - 2000,
d - calculated as a weighted average.

Source: Eurostat (ec.europa.eu/eurostat); EBRD (www.ebrd.com); IMF, *World Economic Outlook Database*, October 2012; Rapacki (2009); own calculations.

If a weighted average is used for calculation, the combined GDP in Western Balkans in 2012 was still below its pre-transition level, with Serbia and Bosnia & Herzegovina being the worst performers. This result remains in a sharp contrast with the average growth record in Central European (or new EU members) or even the CIS countries. At the level of individual peer economies, Croatia recorded a similar, disappointing growth trajectory while Slovenia substantially outperformed the WB countries.

As a result, the process of real economic convergence or catching up in WBCs towards the EU15 levels has been very slow and in some cases (Macedonia) has shown symptoms of reversal. By 2012 the average GDP per capita in the Western Balkan countries represented some 31% of the average for the EU15 compared to 21% in 1989 (due to incomplete data for 1989 this latter figure should be treated with caution). The size of the present WBCs' development gap unfavorably compares with that reported by eight Central European

transition economies (including Slovenia) at the time of their EU accession in 2004 (55% in terms of unweighted average).

The short list of other major weaknesses in WBCs' macroeconomic performance includes the following (the pertinent data come from IMF 2013 and EBRD 2012):

- very high, double-digit unemployment ranging between 12.3% in Albania and 31.3% in Macedonia in 2012,
- huge current account deficits relative to GDP, reaching double-digit levels in Kosovo (-20.4%), Montenegro (-17.7%) and Albania (-12%),
- excessive external debts in some WBCs, and in particular in Montenegro (94.6% of GDP in 2012) and Serbia (85%),
- relatively high income disparities, with Gini coefficient exceeding 30 (the only exception being Serbia) or even 40 (Macedonia - 43.2).

III The progress of structural reforms - a tentative assessment

The most important structural changes to be implemented in the Western Balkan countries (as in all transition economies), on their road from central planning to the market system, included privatization, liberalization of markets and broadening the scope of economic freedom. The latter encompassed steps such as stifling corruption and removing bureaucratic barriers impeding the development of private entrepreneurship. Other key structural changes were to comprise support for the development of markets and competition; upgrading infrastructure; a public finance reform, combined with a comprehensive government reform designed to increase its effectiveness and strengthen functions stimulating economic development (through measures such as creating positive externalities for private entrepreneurship); an expansion of financial intermediation and the development of financial markets (Rapacki, Matkowski and Prochniak, 2013).

Generally, structural reforms in the Western Balkan countries - in terms of their scope and depth - deserve a mixed evaluation. As a group, these countries have made some progress in liberalizing and opening their economies, pushing through with small- and (to a lesser extent) large-scale privatization, creating some market mechanisms and taking a number of important steps aimed at building the institutional infrastructure of the market.

On the other hand however, in a number of key institutional areas the results of implementing structural reforms are far from being satisfactory. This claim refers in particular to enterprise restructuring and corporate governance, government regulation and competition policy, infrastructure and the development of financial markets and the scope of financial intermediation. Table 2 provides a list of indicators used by the EBRD, showing the advancement of structural reforms in WB countries as of 2013.

At the individual country level, Macedonia and Albania have made a relatively biggest progress in structural reforms whereas Kosovo and Bosnia & Herzegovina have lagged behind. However, compared to their peers - Croatia and Slovenia - even the top reformer WBCs exhibited a substantial gap in terms of quality of their institutional market infrastructure. The gap in question was much more pronounced vis-à-vis Central European transition economies or the current EU members.

Still another way of assessing the progress of structural reforms in WB countries (and all transition economies in general) is to express the scores shown in Table 2 as a percentage distance covered since 1990 to date on the way to fully catch up with the benchmark level or 4.3. In these terms a score of 2.7 translates into a 50% (half-way) progress or - equivalently - a 50% gap to reach the benchmark. Data in the parentheses shown in the last column of Table 2 indicate how much distance in the process of implementing structural reforms is still ahead in individual Western Balkan countries and their group combined. The longest way to go is in Kosovo (51% to the target) whereas the top reformer country in this group - Macedonia - has yet to cover some 33% of the distance. These indicators unfavourably compare both with the respective figures for Croatia and Slovenia and even more so - with new EU members from Central Europe.

Table 2. Progress in structural reforms in the Western Balkan countries, 2013

Country	Enterprise sector			Development of markets and competition			Financial institutions		Infra-structure	Average score
	Large scale privatization	Small scale privatization	Governance and enterprise restructuring	Price liberalization	Trade and exchange rate regime	Competition policy	Banking reform and liberalization of interest rates	Securities markets and non-bank financial institutions	Infra-structure reform	
Albania	3.7	4	2.3	4.3	4.3	2.3	2.7	2.3	2.3	3.13 (64)
Bosnia & Herzegovina	3	3	2	4	4	2.3	2.7	2	2.7	2.84 (56)
Kosovo	1.7	3.3	2	4	4	2.3	2.3	1.7	2.3	2.62 (49)
FYR Macedonia	3.3	4	2.7	4.3	4.3	2.7	2.7	2.3	2.7	3.22 (67)
Montenegro	3.3	3.7	2.3	4	4.3	2	2.7	2.3	2.3	2.99 (60)
Serbia	2.7	3.7	2.3	4	4	2.3	2.7	2.7	2.7	3.01 (61)
Average	2.95	3.62	2.27	4.10	4.17	2.33	2.63	2.22	2.5	2.97 (60)
Croatia	3.7	4.3	3.3	4	4.3	3	3.3	3.3	3.3	3.62 (79)
Slovenia	3	4.3	3	4	4.3	2.7	3	3	3.3	3.40 (73)
Average for CE countries ^a										3.76 (84)
Average for CIS countries ^a										2.67 (50)

a – scores for 2012.

Note: Scale from 1 to 4.3; the higher the score, the greater is the progress in structural reform and the smaller the gap towards the benchmark or advanced market economies.

Source: EBRD, *Transition Report 2013*, London 2013; EBRD, *Transition Report Database*: <http://www.ebrd.com/pages/research/analysis/forecasts.shtml>; own calculations.

At the institutional areas cross-section, the WBCs exhibited an unbalanced pattern of structural reform implementation. On the one hand, they made a remarkable progress in two areas: price liberalization and trade and exchange rate policy; they were also much advanced in small-scale privatization. On the other hand however, in five other areas (governance and enterprise restructuring, competition policy, banking sector reform, securities markets and non-bank financial institutions, and infrastructure) WBCs as a group has not even reached half of the road leading to the benchmark level of institutional development.

This kind of government failure in implementing much needed structural reforms in WBCs can be further confirmed if we look at some other indicators of 'institutional quality' provided in the next section (Table 3). The countries involved displayed in particular serious institutional weaknesses in the area of product market regulation ('ease of doing business' or the strength of bureaucratic hurdles to private entrepreneurship), the quality of governance and the incidence of corruption.

As a concluding remark in this part of the discussion it is worth mentioning that a wide body of empirical evidence suggests a strong effect of the quality and complexity of market institutions (or progress of structural reforms as a proxy) on economic growth and macroeconomic performance of a country. For example, a regression analysis carried out in another study co-authored by the present author (Rapacki, Matkowski, Prochniak 2013) revealed that transition economies, most advanced in structural reforms, achieved on average a faster GDP growth in 1990-2012 than those lagging behind in this process. The positive correlation between these two variables was especially clear in Central Europe. By contrast, in countries such as e.g. Bosnia & Herzegovina, Montenegro and Serbia the lack of major structural reforms contributed to negative GDP growth rates throughout the analyzed period.

IV Institutional underpinnings of structural reforms

As a complement to the foregoing account of the progress in structural reforms in the Western Balkan countries, in this section we embark on a tentative, more complex assessment of the outcomes of past reforms, i.e. the kinds of institutional architecture that seem to have been emerging in these countries. To this end, we will refer to the conceptual framework offered by the new institutional economics and in particular to two approaches: the 'Varieties of Capitalism' (or VoC) and the 'Diversity of Capitalism' (or DoC). The VoC typology developed by Hall and Soskice (2001) and based on the prevailing mode of coordination of economic agents' actions, makes a distinction between: (i) liberal market economies (LME) and (ii) coordinated market economies (CME). In turn, the DoC classification put forward by Amable (2003) and further developed by Sapir (2007), singles out five models of capitalism co-existing in the contemporary Western world: (i) Anglo-Saxon or market-based capitalism, (ii) Continental European capitalism, (iii) Nordic or social-democratic capitalism, (iv) Mediterranean or South European capitalism and (v) Asian capitalism.

According to many authors, the former socialist countries entered the road from plan to market without a clear *explicit* vision of the end point or the target kind of capitalism they were aiming to build. Following a distinction made by Myant and Drahekoupil (2011) and similarly by Heiduk and Rapacki (2009), it can be claimed that the overwhelming majority of these countries have undergone the process of 'systemic transformation,' i.e. a process of change without a clear end result, rather than 'transition' or a movement toward a defined end result. Hence, after twenty four years of systemic transformation, there emerged no single post-Communist variety of capitalism in the Western Balkans, similar to the rest of post-

communist world. Simultaneously, the results achieved so far on the road from plan to market are very diverse in particular countries in terms of prevailing institutional setups that determine the dominant mode of coordination in these countries.

The data compiled in Table 3 seem to clearly corroborate this claim. Three out of five Western Balkan countries shown in the table displayed characteristics akin to a coordinated market economy while two other WBCs (Serbia and Montenegro) exhibited features of a LME category. This categorization clearly differentiates our sample - while in the former group of WBCs (Albania, Bosnia & Herzegovina and Macedonia) a non-market, strategic type of coordination is prevalent, in the latter group it is the market that dominates as a coordination mechanism. Interestingly, under the former institutional environment there is a relatively large room for government intervention and administrative discretion, extended public sector, and high incidence of bureaucratic hurdles for private entrepreneurship.

Table 3. Development level and selected indicators of ‘institutional quality,’ selected EU15 and transition countries, 2005–2011

Country	pcGNI	EoDB	Gov	CPI	Social cohesion	Labour market	Business regulation	Coordination index
Selected EU15 countries								
Greece	63.1	100	16.3	35	1.4	6.5	3.7	11.6
France	74.4	29	50.8	68	4.5	3.2	0.2	8.0
Germany	80.7	19	57.5	79	2.4	3.3	-0.9	4.8
Spain	69.0	44	35.5	61	2.9	4.9	-3.1	4.7
Sweden	83.4	14	70.8	92	5.6	0	-4.7	0.9
Denmark	85.0	5	72.7	91	1.6	-2.9	-0.3	-1.6
Ireland	72.4	10	58.2	80	-1.0	-0.9	-3.0	-4.8
UK	78.6	7	55.1	76	1.4	-2.9	-4.3	-5.8
Selected transition economies								
Belarus	27.9	69	-38.8	25	1.6	1.5	5.9	8.9
Slovenia	58.0	37	36.5	64	3	2.1	1.3	6.3
Croatia	42.1	80	16.5	41	1.3	2.9	1.5	5.6
Bosnia-Herzegovina	19.2	125	-15.3	32	0.5	1.1	3.2	4.8
Albania	18.9	82	-6.6	33	-1.8	-0.6	3.3	0.9
Macedonia	23.8	22	-7.9	41	-1.9	-0.2	2.7	0.6
Serbia	25.6	92	-5.7	35	-3.7 ^a	-2.6 ^a	2.1 ^a	-4.3 ^a
Montenegro	29.2	56	2.5	37	-3.7 ^a	-2.6 ^a	2.1 ^a	-4.3 ^a
Estonia	41.9	24	43.3	65	-4.4	0.4	-1.7	-5.7

^a – a joint score for Serbia and Montenegro.

Notes: **pcGNI** = per capita gross national income in international dollars at purchasing power parity, 2009, U.S. = 100.

EoDB = country ranking on 'ease of doing business', including 183 countries; measures for 2011.

Gov = sum of governance scores (voice and accountability, political stability, effectiveness of government, regulatory quality, rule of law, control of corruption), converted into % of maximum possible score; possible range from +100 to -100. Refers to 2010.

CPI'10 = corruption perception index (CPI) by Transparency International for 2010, expressed as a percentage (100 = no corruption at all).

Social cohesion = the Knell-Srholec score computed for 2005; the four sub-components include the Gini coefficient, top marginal personal income and corporate tax rates, and government final consumption expenditure as % of GDP.

Labour market = Knell and Srholec index for 2005 based on four sub-components: difficulty of hiring and firing workers, the cost of firing workers and rigidity of working hours.

Business regulation = Knell and Srholec index for 2005 based on four sub-indices: number of start-up procedures to register a business, time to resolve insolvency, number of procedures to register property and the role of stock market relative to banking sector.

Coordn = score (based on multiple indicators) on strategic coordination versus competition; + tending towards coordination; - tending towards competition.

Sources: Hanson, P., 2006, *The European Union's Influence on the Development of Capitalism in Central Europe*, mimeo, London 2006; Knell, M., M. Srholec, *Emerging Varieties of Capitalism in Central and Eastern Europe*, paper presented at the conference on Varieties of Capitalism, University of Paisley, 23–24 September 2005; www.doingbusiness.org/EconomyRankings; http://info.worldbank.org/governance/kkz2004/year_report.asp?yearid=1; World Bank, *World Development Indicators 2011*; www.transparency.org/cpi/2005/cpi2005.en.html; author's calculations.

A more refined and versatile framework which appears to be particularly useful for assessing the 'institutional quality' of individual countries and their groups as well as for designing and implementing necessary structural reforms may be found in the DoC approach (Amable 2003; Sapir 2006). The classification criteria used to distinguish five co-existing models of capitalism are based on the prevailing institutional architecture in five key areas:

- Product market competition/regulation.
- Wage-labour nexus and labour market institutions.
- Financial intermediation and corporate governance.
- Social protection sector.
- Education and knowledge sector.

The key in the DoC approach is the factor of institutional complementarities. It links together the five institutional areas and may give rise to positive synergies thus triggering the comparative advantage of a country and enhancing its international institutional competitiveness.

In general, institutions are said to be complementary when the presence of one institution increases the efficiency of another. More precisely, institutional complementarities imply that the existence of or the particular form taken by an institution in one area reinforces the presence, functioning, or efficiency of another institution in another area [Amable 2003].

As a matter of illustration, the Anglo-Saxon (sometimes also dubbed a 'shareholder') capitalism relies heavily on competitive, unregulated product market and is biased towards a short-run perspective. This is compatible with a highly fluid labor market, easy fire and hire,

high work force mobility, decentralized wage bargaining and low employment protection. In turn, the financial system is based on sophisticated capital (stock) markets, important role of M&As and active market for corporate control. These features combined imply a weak social protection policy and low involvement of the state - mostly focused on poverty alleviation. Finally, the education system features highly competitive higher-education and weak vocational training, and puts an emphasis on acquiring general skills (which can be used in different occupations and easily switched between jobs; this again can be explained as a function of short-term horizon of both the product, labor and financial markets, and low job security).

In contrast, the Continental European model of capitalism (or 'stakeholder capitalism') operates with a great deal of strategic cooperation, both between firms, banks and firms, and between trade unions, employer associations and firms. The product market is subject to regulation and a substantial involvement of public authorities. There is a high employment protection and greater job security on the labor market; wage-bargaining tends to be coordinated at a national level. Investment depends more heavily on long-term financing from banks whereas financial markets play a secondary role. These characteristics are compatible with a high degree of social (employment-based) protection, involvement of the state, and more progressive personal and income taxes. In the education sector, the institutional complementarities with the remaining four areas can be seen, inter alia, in high level of public expenditures on education, high enrollment rates in secondary education, developed vocational training, and strong emphasis on specific skills (Amable 2003).

Against this conceptual background it can be argued that the emerging diversity of post-communist capitalism in the Western Balkan countries (much similar to the entire group of transition economies) shares a number of peculiarities of their institutional setups, compared to their benchmark or developed Western economies. This claim has gained support in a number of empirical studies applying the DoC approach in the conditions of transition economies (e.g. Mykhnenko 2005). Two such peculiarities are worth highlighting in particular:

- 'institutional ambiguity' or a 'hybrid' nature of the nascent capitalism. This implies that while in some institutional areas a country may resemble one model of capitalism, in some other areas it tends to converge to quite a different model.¹ This outcome may be due to the uncompleted process of building the 'post-Communist capitalism' in transition economies that makes their institutional infrastructure still a 'work in progress'.
- missing or incomplete institutional complementarities between the five areas concerned; as a result, some parts of institutional structures prevailing in WB countries are not compatible with other parts, as is usually the case in advanced Western countries representing different models of capitalism. This may give rise to negative synergies and adversely affect the efficiency of existing institutions.

Having outlined the conceptual framework and its institutional underpinnings, below we briefly sketch the key elements of the recommended approach to the much needed structural reforms in the Western Balkan countries.

¹ To be more specific, whereas in one case involved in Mykhnenko's study (Poland) the mix of institutional characteristics in most areas (four out of five) point out to a similarity of the emerging variant of capitalism to the Mediterranean model, the dominant features of the fifth area, i.e. the social protection system are more akin to the Continental model. In turn in the second case (Ukraine), while the nascent capitalism appears to resemble in most respects the Continental European model, the most salient properties of its social protection sector seem to exhibit much more similarity to the Anglo-Saxon model of capitalism (Mykhnenko 2005).

V Concluding remarks

The underlying objective of this section is to lay the broad institutional foundations for a viable strategy of implementing structural reforms in the Western Balkan countries and to suggest some useful guidelines for their design and sequence.

A. General foundations

- as a starting premise it ought to be stressed that, while designing the reform strategy, a systemic perspective is strongly recommended rather than a piece-meal approach focused on particular reforms;
- carry out an in-depth and comprehensive diagnostic study aimed at describing and understanding the nature of institutional architecture prevailing in five institutional areas in each of the WBCs involved;
- if appropriate, add the sixth area to the exercise, i.e. the housing market which is closely interconnected with the remaining five areas and may be a critical factor in triggering potential bubbles and adverse economic shocks in the country;
- conduct a 'peer review', i.e. compare the results with four models of capitalism singled out in the DoC approach², with a view to establish the pattern prevailing in each of the five (six) institutional areas in a particular WBC;
- based on the above steps, find possible 'institutional ambiguities' in a country concerned, to eventually arrive at the aggregate definition of the nature of 'hybrid capitalism' emerging in a WBC;
- screen the results against possible inconsistencies or lack of institutional complementarities between the five (six) areas involved;
- based on the foregoing results and on a necessary political consensus, make a decision regarding the end point on the road from plan to market, i.e. the choice of target model of capitalism to be built in a country; the choice in question should take account, inter alia, of the 'path dependence' factor and country-specific determinants.

B. Design and implementation of the reform program

- capitalizing on the assessment offered in Sections II and III, make a ranking of the most pressing structural reforms to be implemented in WBCs; they should address in particular the following areas/problems: (i) securities markets and non-bank financial institutions, (ii) corporate governance and enterprise restructuring, (iii) competition policy, (iv) infrastructure, (v) banking sector, (vi) corruption, (vii) governance, (viii) excessively high unemployment, (ix) external imbalances, (x) consolidation of public finance, and (xi) income disparities;
- allocate each intended structural reform to one of the five (six) institutional areas; some of them may have a more complex nature and be interconnected with more than one area (e.g. corruption); for example, securities markets and non-bank financial institutions, and the banking sector should be allocated to the financial intermediation and corporate governance area while income disparities - to social protection sector;

² The fifth model, i.e. Asian capitalism does not seem applicable for the Western Balkan countries or elsewhere in Europe.

- design a 'consistency test' or an appraisal system (procedure) aimed at checking the potential impact of a particular structural reform or their sets on institutional complementarities between the five (six) institutional areas (e.g. between product market regulation and labor market condition including unemployment),
- while planning the sequence of the reform program, give priority to those reforms that contribute most to increase (build) institutional complementarities of the whole institutional architecture or to remove (weaken) barriers inhibiting such complementarities;
- in sequencing the reforms bear in mind that institutional complementarities entail complexity or systemic perspective; in other words, if an institution in one area - which determines the efficiency of another institution in a different area(s) - is to be changed or restructured, the prerequisite for the reform to be successful is to take a 'bundling' approach;
- design and implement a system of monitoring the progress of structural reforms including the 'early warning' component that would allow to signal emerging loopholes in the institutional system and to anticipate the threats and challenges ahead.

It sounds like a plausible expectation that adopting this broad institutional or systemic approach and designing and implementing structural reforms in the Western Balkan countries along the lines outlined above is likely to become a key driver of their improved economic performance and a success factor on their road to a fully-fledged capitalist market economy. In particular it may bring about a boost in WBCs' competitiveness and productivity, be conducive to improved labor market conditions including a sharp reduction in unemployment, may result in an ameliorated investment climate, and lead to an improved fiscal stance including consolidation of their public finance.

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