WESTERN BALKANS:
Regional Economic Integration Issues Notes

WORLD BANK GROUP

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WESTERN BALKANS: Regional Economic Integration Issues Notes

World Bank Group Input in WB6 Regional Economic Area Action Plan

Contents

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Overview: Benefits of Economic Integration for the Western Balkans

Towards regional actions to ensure macroeconomic stability, effective structural transformation, and deep economic integration to boost productivity and rekindle income growth[1]

Background: Slow Income Convergence

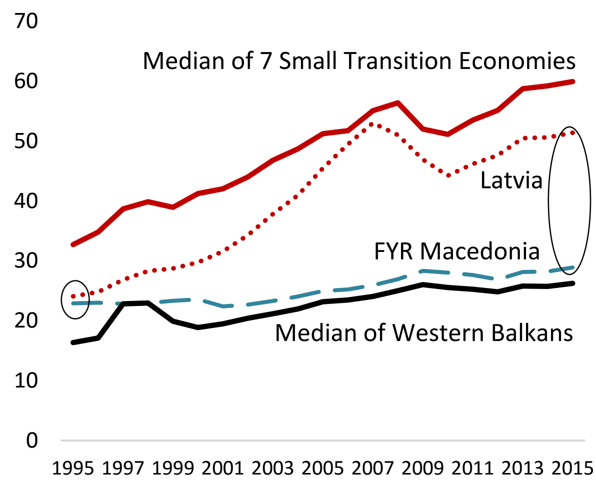
The Western Balkan countries—Albania, Bosnia and Herzegovina, Kosovo, the former Yugoslav Republic (FYR) of Macedonia, Montenegro, and Serbia—achieved strong growth and poverty reduction since the start of the transition to market economies. Beginning from a low level, living standards[1] increased almost six-fold in Bosnia and Herzegovina, nearly tripled in Albania, and almost doubled in Serbia between 1995 and 2015. At 5 percent annual average growth during 2000-2008, living standards in the Western Balkans expanded faster than world and EU averages. During this period, job creation helped decrease somewhat the high rates of structural unemployment, driving down poverty in most countries in the region. In the early 2000s, roughly one in three people in the region lived on less than US$5 per day.[2] By 2008, this figure had fallen to only one in five. Other human development indicators such as life expectancy, literacy, and access to services also improved during this period.

Despite progress, today the six Western Balkan countries remain among the poorest in Europe, overtaken by the more successful neighboring countries in terms of convergence to EU standards of living. Prior to the 2008-2009 global financial crisis, the average pace of convergence with the EU of Western Balkan incomes was slower than in other small transition economies in Europe (Figure 1). A comparison between Latvia and FYR Macedonia helps to highlight this difference. In 1995, Latvia and FYR Macedonia had similar income levels, about 30 percent of the EU's income per capita. By 2015, Latvia had caught up to more than 60 percent of the EU's income per capita, while FYR Macedonia's income remained at around 35 percent.

The average pace of convergence with the EU slowed down significantly in the aftermath of the global financial crisis. In the post-crisis period, growth stagnated in the Western Balkans. By contrast, early accession countries caught up with the rest of the EU even more quickly after the crisis (Figure 2). Indeed, at current speed, it would take over half a century for the Western Balkans to converge to the EU standards of living, where on average, people enjoy incomes that are three times higher.[3] With slower growth, unemployment remained persistently high. As of 2015, the unemployment rate ranged between 17 and 35 percent in the Western Balkans, with youth unemployment almost doubled the national average. Many families depend more on transfers for their daily income (from government or from abroad) than on their own labor.

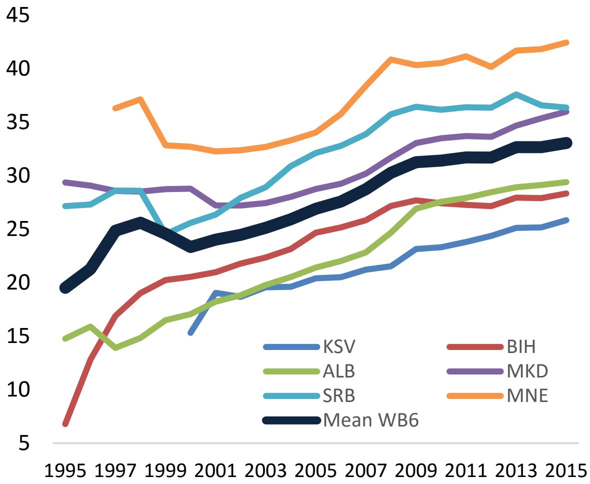
[1] This note draws on the forthcoming World Bank (2017) report *"The Western Balkans: Revving Up the Engines of Growth and Prosperity"* Western Balkans Regional Systematic Country Diagnostics Synthesis Report.
[2] Measured by GDP per capita in 2011 international purchasing power parity terms (World Development Indicators).
[3] In 2005 purchasing power parity, excluding Bosnia and Herzegovina and Kosovo due to quality of PPP measures.
[4] According to the World Bank's World Development Indicators, the median income in the Western Balkans is 32.7 percent of the EU's median income, measured by per capita GDP in 2011 international purchasing power parity terms.

Figure 1. Starting from a similar level of per capita income as FYR Macedonia, Latvia was able to grow much faster.
(GDP per capita as share of EU's, international 2011 PPP US$, percent)



Source: World Bank (2017).

Figure 2. Slower convergence in living standards in the Western Balkans after the global financial crisis
(GDP per capita as a share of EU GDP per capita, international 2011 PPP US$)



Source: World Bank (2017).

How to Catch Up? Macroeconomic Stability, Structural Reforms, and Economic Integration

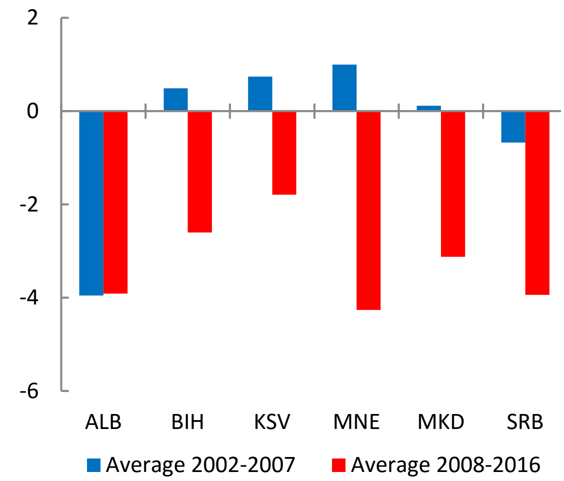
Three mutually-reinforcing factors highlight the differences in the pace of convergence between the Western Balkans and its neighbors in the EU: macroeconomic stability, progress on structural transformation of the economies, and economic integration.

Macroeconomic stability is a precondition for economic growth and integration as it guards against external shocks, helps reduce uncertainty for consumers and investors, thereby promoting trade, investment, and capital market development.

Macroeconomic stability has been hard to maintain in the Western Balkans, especially since 2008. The global financial crisis strained fiscal positions in all six countries by significantly eroding fiscal buffers (Figure 3) and increasing public debt (Figure 4). On average, countercyclical policies led to a doubling of primary deficits in the region, from 1.7 percent of GDP in 2008 to 3.8 percent in 2009, remaining above 2 percent until 2016. As a result, the region's average general government gross debt increased from about 30 percent of GDP in 2008 to over 50 percent by 2016. The crisis also exposed structural weaknesses in public finances, including the presence of sizeable contingent liabilities of state-owned enterprises (SOEs) and other public entities. Furthermore, there is a need to improve the efficiency, equity, and transparency of fiscal policy to mobilize resources more effectively and improve public service delivery. Public spending remains heavily concentrated on public wages and weakly-targeted social benefits, leaving little space for productive investments. On the revenue side, the labor tax wedge remains high and creates disincentives to hire people. There is room for improving tax collection and the progressivity of tax policies.

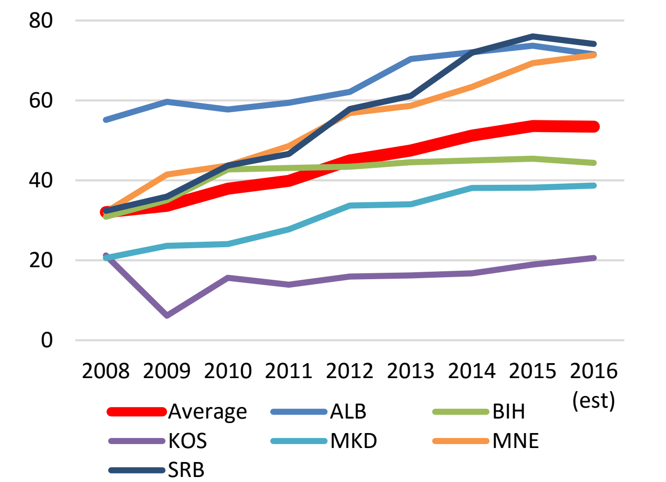
Having weathered the global financial crisis, there is a common need in the Western Balkans to ensure macroeconomic stability by consolidating public finances, reducing debt levels, and enhancing the quality and equity of public spending. Fiscal sustainability is particularly important in small open economies like the Western Balkans that have limited monetary policy flexibility and that are highly exposed to external shocks. Strong commitment to macroeconomic stability can help improve consumer and investor confidence, thereby promoting trade, investment, and financial market development. And while some countries in the Western Balkans have strengthened their fiscal positions in the last few years, achieving fiscal sustainability would require improvements in fiscal transparency, revenue mobilization, as well as public financial (including investment and debt) management to better prioritize and target spending based on economic and social returns, clear public arrears and better monitor and limit fiscal risks.

Figure 3. Fiscal balances deteriorated after the global financial crisis...
(Fiscal balances as a share of GDP)



Source: National authorities and World Bank staff.

Figure 4. ...leading to a significant increase in public debt.
(General Government gross debt as a share of GDP)



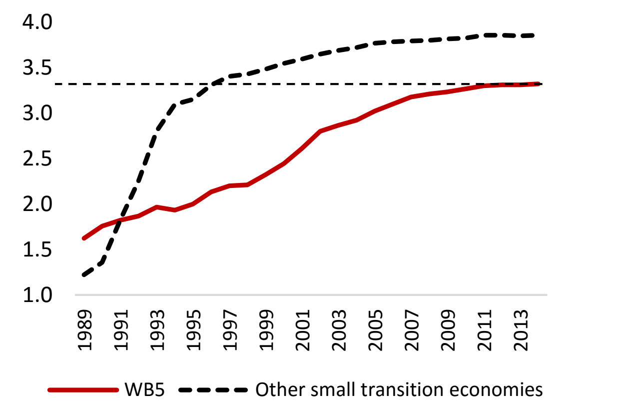
Source: World Bank (2017).

Addressing structural bottlenecks to private sector development and job creation would improve productivity and help countries reap the benefits of economic integration to sustain higher levels of economic growth.

The transition to a market economy remains incomplete in the Western Balkans. While the region has achieved substantial progress on price liberalization, trade, foreign exchange management, and small scale privatization, structural transformation lags behind other small transition economies in Europe (Figure 5). Notably, today, the average "transition score" for the Western Balkans is similar to the one that other small transition economies had in 1996. Reform progress in the Western Balkans has been particularly slow in the areas of competition policy, governance, SOE restructuring, and large scale privatization (World Bank, 2017). For example, government spending as a share of GDP is well above thafor countries with similar income levels, in Bosnia and Herzegovina, Montenegro, and Serbia (Figure 6). In these countries, a large and inefficient public sector often serves to block the entry and dynamism of private firms, distorts investment decisions, and indirectly nurtures the region's large informal sector. Roughly one-third of all formal jobs in Serbia and Montenegro are in the public sector, almost half in Bosnia and Herzegovina, and more than half in Kosovo.

The prospect of EU membership continues to provide a strong anchor for reform, but implementation has been slow. Accelerating the pace of structural reforms would help exploit the potential of Western Balkan countries by supporting the efficient allocation of factors of production, which would transpire into higher productivity levels, stronger competitiveness, and more and better jobs for their populations. To this end, Western Balkan countries need to act quickly to restructure inefficient and state-heavy economies, and enhance links to regional and global markets. Speeding up reforms to improve the business environment (e.g., investment and competition policies, property and contract rights protection), enhance public service delivery (e.g., health, water), improve the quality of human capital and remove barriers to employment (e.g., education and labor market policies), and improve regional connectivity (e.g., trade, logistics, transport and energy infrastructure) would promote stronger private sector in the region (World Bank, 2017). The Western Balkans are facing high levels of emigration—as young and educated people look for opportunities elsewhere— and also aging populations. In this context, implementation of bolder reforms would not only allow for a faster transition to a market economy, where human, capital, and natural endowments are reallocated efficiently, but also help Western Balkan countries reap the benefits of economic integration.

Figure 5. Structural reforms in Western Balkans lag other countries in Europe by at least two decades.
(Average EBRD transition score, between 1 and 4, higher score indicates more advanced reforms)



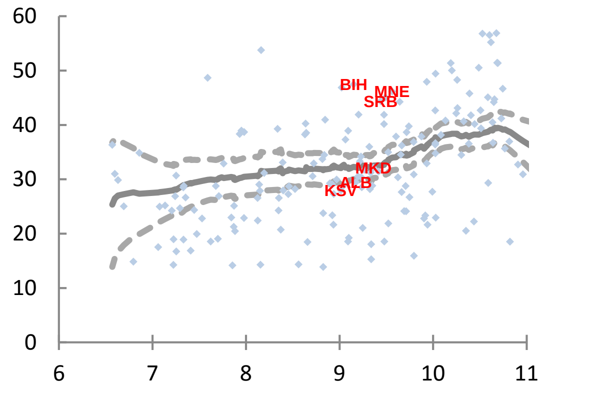
Source: World Bank (2017).

Economic integration would facilitate a transition to an accelerated and sustainable growth model.

Economic integration can reduce the costs of trade, thereby improving the availability and selection of goods and services in the economy and leading to greater purchasing power for citizens. For instance, economic integration may allow firms in one country to learn about the goods, technologies, and business relationships of firms in other countries, thus boosting productivity (Bown et al. 2017).

The Western Balkans are located next door to the EU market and have already taken steps to integrate their economies into world markets, particularly in trade and finance. But there is still ample room for improvement. For instance, on trade, Western Balkan countries could raise their degree of openness as measured by the share of exports in GDP, from less than 40 percent to at least 80 percent, as in other small transition economies in Europe (Figure 7). Notably, only three of the six countries are currently WTO members; and trade logistics lags behind (Figure 8). Similarly, in the area of finance, domestic financial markets currently do not offer the necessary diversification of investment

Figure 6. There is an oversized state footprint in some Western Balkan countries.
(Expenditures as percent of GDP, average 2011-2014, vs ln(GDP) per capita 2011 in international PPP US dollars)



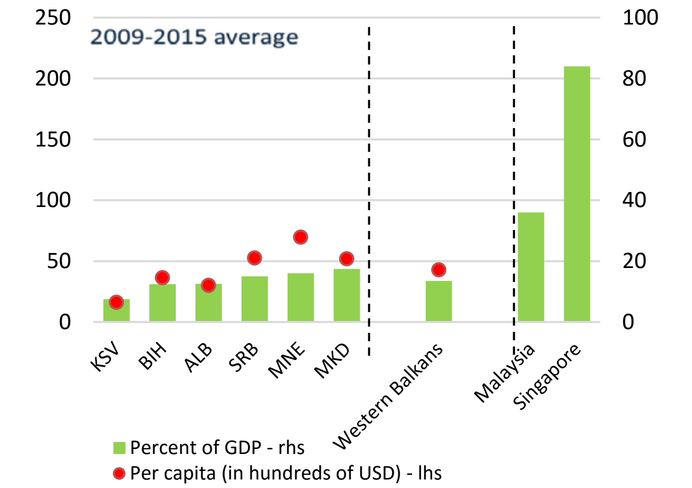
Source: World Bank (2017).

opportunities to investors or of funding sources to companies (World Bank, 2016). In this area, Western Balkan countries could develop regional financial products to better link investors and savers with companies (e.g., indexes, regional investment funds), as a preamble to the development of a regional capital market. Furthermore, regional integration within the Western Balkans can help build a "strong neighborhood". An interconnected region would support an easier exchange of goods and services like electricity, telecommunications, and land transportation, among others, for which policy-related barriers to trade stem mainly from differences in regulatory schemes rather than from tariffs. A similar argument can be made regarding labor markets. In particular, pooling resources to develop skills can help improve the quality of products sold abroad, outside the Western Balkans neighborhood, and enhancing intraregional mobility of labor can facilitate a more efficient allocation of workers across countries (World Bank, 2017).

Central European Free Trade Agreement (CEFTA), which has the objective ofgenerating economic growth by promoting trade facilitation, trade in services, investment, and capacity building and transparency among member countries, including the six Western Balkan countries.

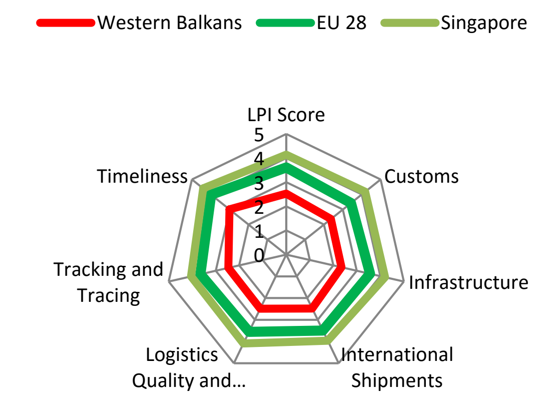
Indeed, Western Balkan countries have comparative advantages in many products that are in demand in the EU and globally. Current export industries use relatively low skills and technology, meaning they can raise export growth by upgrading the products sold abroad. And considerable upgrading has occurred. For example, Serbia and FYR Macedonia raised their share in high- and medium-skill products, as well as technology-intensive ones, to 60-70 percent

Figure 7. Exports remain relatively low in the Western Balkans...
(Exports as a share of GDP)



Source: National authorities and World Bank staff.

Figure 8. ...and there is significant room for facilitating trade.
(Logistics performance index, 2016)



Source: World Bank.

Advancing economic integration in the Western Balkans would require joint policy efforts going beyond tariff liberalization and focusing on a number of areas including the harmonization of rules and procedures in order to promote the exchange of goods, services, and factors of production, including labor, cooperation to strengthen investment policies and develop skills, and joint efforts to address infrastructure bottlenecks. The goal of leveraging integration to boost growth is evident in the regional efforts currently in place in the Western Balkans. These efforts include, for example, the

of manufactured exports and Bosnia and Herzegovina to about 40 percent. This is due, in part, to their rising participation in European value chains, as manifested in their expanding share of parts and components in machinery and transport exports. As participation in the European value chains helped to increase market size, the region has more than doubled its share of exports to the EU since 2005 (albeit, from a low base).

While a slower global economy complicates the task of increasing exports, it also creates opportunities because international firms that have markets, technology, and capital are looking even more carefully to relocate to improve their competitiveness or find new niches. The countries with increasing working-age populations, can also harness a demographic dividend which can spur growth and incomes through higher proportions of people working.

In summary, to converge faster to EU living standards, the Western Balkan countries need to continue to pursue a 'three-pronged' effort by implementing in parallel prudent macroeconomic policies, bold structural reforms, and measures to advance economic integration. Macroeconomic and fiscal stability, accompanied by decisive structural reforms are two necessary conditions to promote a sustainable and strong growth model, one that is based on private sector growth, investment, and higher exports. Structural reforms are key to unlocking the benefits of regional integration including productivity gains, investments, and job creation, all of which would support convergence to EU living standards. Indeed, economic integration is linked to productivity, as productivity is inherent in achieving economies of scale. And the speed and depth of reforms that rekindle income convergence will help advance the pace of economic integration.

When implementing the 'three-pronged approach', it is imperative that policymakers assess the economic, poverty and social impacts of public policies. International evidence suggests that economic integration has the potential to reduce wage inequality if accompanied by effective social policies (see Lopez-Calva and Lustig, 2010). However, impacts vary depending on the country context, and there could be winners and losers of reforms (Winters et al. 2004). Understanding the potential impacts on poverty and equity would help design more effective policies, as well as help communicate policy efforts to ensure broad consensus.

World Bank Group Issues Notes: Input for the Regional Economic Area Action Plan

To support the Western Balkan countries in the preparation of a Regional Economic Area Action Plan, the World Bank Group (WBG) has prepared a set of notes that assess the benefits of economic integration and provide policy options along several of its dimensions—e.g., trade, investment, financial markets, institutions, equity, skills and labor mobility, digital markets, and infrastructure. These notes argue that the Western Balkans have significant economic potential, and that economic integration can play a fundamental and catalytic role in supporting growth and income convergence with the EU. The Western Balkan authorities understand the need to create opportunities at home for the poor and for the middle class, in order to broadly improve living standards. But, in the absence of maintaining macro stability and pursuing vigorous structural reforms, the region faces a vicious cycle of low growth and high emigration.

These "issues notes" detail the policy agenda to support faster income convergence and better living standards in the region through economic integration. The notes are organized around four pillars: (1) Trade, Investment, and Capital Markets, (2) Skills and Labor Market Mobility, (3) Digital Market, and (4) Infrastructure for Regional Integration.

Each note describes (1) how a regional approach to a particular topic (e.g., investment policy, research and innovation, or broadband infrastructure) can support economic integration in the Western Balkans, (2) what are the key challenges that Western Balkan countries face, and (3) what are the policy options. Next, we provide a brief summary of each of the notes.

Pillar I: Trade, Investment, and Capital Markets

1. **Productivity.** Greater efficiency in the use of the factors of production is essential for, and can be accelerated by, economic integration. A reform agenda that combines prudent macroeconomic policies with reforms to remove barriers to entrepreneurship, enhance the effectiveness of the state, develop human capital, improve connectivity, and build resilience to climate change and natural hazards would support economic integration. Economic integration would allow the region to benefit from entering larger and higher value added markets, and generally benefit from the spillovers from international trade.

2. **Trade.** Regional collaboration to reduce trade costs, improve the transparency of barriers and regulations, and increase market access for goods and services would make the Western Balkans a more desirable trading partner to the rest of the world, as well as support integration efforts with the EU.

3. **Investment Policy.** Greater convergence of regional investment policies—e.g., investment promotion and attraction, entry and establishment, and protection and retention—and their alignment with international good practice standards is a key conduit for economic integration and the attraction of more and higher quality investment.

4. **Competition Policy.** International experience shows that implementation of competition policies are an effective way to deepen economic integration, especially in the non-tradable sectors. Convergence in antitrust law and enforcement as well as better regulation of services market, along the lines of the EU Directive in Services are important components of broadly understood competition policies.

5. **Financial Markets.** Regional integration of capital markets would complement bank-centric financing and (1) promote domestic investment, especially from small and medium-sized enterprises (SMEs), (2) attract foreign investment, and (3) improve the stability of the financial system by opening up a wider range of funding sources.

6. **Financial Reporting.** Effective financial reporting frameworks based on international standards generate reliable and transparent information needed for integration of regional financial markets and growth.

7. **Institutions.** Joint efforts to strengthen governance systems to improve service delivery and enhance transparency and accountability in the execution of public policy—e.g., harmonization of revenue policies, effective cooperation in tax administration, and efficient deployment of limited public resources to strategic priorities that can boost growth and equity—are critical in facilitating private investment and developing regional markets.

8. **Justice.** Regional coordination and collaboration to improve court performance—by reducing barriers to information, improving efficiency in cross-border cases, and developing a common approach to justice system performance—would foster greater trust in government and improve the business climate.

9. **Agriculture.** Regional cooperation aimed at modernizing agriculture systems by exploring comparative advantages in agricultural production and enhancing forward and backward linkages of the agri-food industry can play an important role in economic integration and support the development of the rural sector.

Pillar II: Skills, Innovation, and Labor Market Mobility

10. **Skills Development and Employment Policies.** Developing a regional Labor Market Observatory that assesses skill demand and supply would help Western Balkan countries (1) prepare for free mobility of people across countries, (2)

maximize the benefits of economic integration through reform of national labor market policies, and (3) manage unintended consequences of integration in national labor markets.

11. Higher Education. Pooling resources strategically at the regional level to improve the governance of universities, the efficient and transparent use of funds and financing instruments, and the transparency of higher education systems (e.g., through joint organization of quality assurance) would help improve learning outcomes and promote research and innovation.

12. Research and Innovation. A Regional Research and Innovation Area can help expand the scientific research base, support research-industry collaboration and technological transfer, and promote the creation of start-ups by (1) strengthening research and innovation systems through the adoption of EU-type programs, policies, and institutions, (2) enabling better use of available human, capital, and financial resources by avoiding fragmentation and redundancy, and (3) creating a platform for continued promotion of policy reforms in the research sector. Fostering a region wide-entrepreneurial eco-system would also foster innovation.

13. Gender and Equity. A regional approach to improving equity in access to assets and opportunities to all groups in society, including women and the youth, is essential so that individuals can engage productively in society and reap the benefits of economic integration. Going beyond country-level efforts can support Western Balkan countries' common objective in the process of EU accession, including gender equality and obligations related to non-discrimination.

Pillar III: Digital Market

14. Broadband Infrastructure. The commercialization at a regional scale of already deployed and spare fiber optic assets along electricity transmission operators' (TSOs) can boost productivity through reduced costs of telecom services, improved cross-border exchanges of goods and services, and improved access to job marketplaces, particularly for those facing constraints in finding jobs.

15. Women in Online Work. Regional training and employability programs that support the inclusion of un/underemployed women into the fast-growing information and communication technology (ICT) industry would promote access to jobs already created, and at the same time strengthen the supply of digital skills that can benefit firms in the Western Balkans facing ICT skills shortages.

Pillar IV: Infrastructure for Regional Economic Integration

16. Energy. A regional energy market would improve the reliability and affordability of energy service provision. Furthermore, the emerging regional energy market creates opportunities to increase energy trade and investments, which are at the core of economic integration and development across the region. To achieve these benefits and create an integrated and competitive regional energy market, Western Balkan countries should reinvigorate the reform agenda and accelerate the implementation of EU compliant laws and regulations.

17. Transport. Improving regional transport systems, in particular their efficiency (e.g., railway market opening), reliability (e.g., asset management and road safety), and environmental sustainability (e.g., resilience to natural hazards) can significantly reduce costs to trade and labor mobility.

18. Industrial Waste. Regional infrastructure and systems solutions to manage industrial and hazardous waste—underpinned by shared regulatory, policy, and tariff measures—can help reduce fiscal costs and improve the business environment for heavy industry and tourism, thereby attracting private investment and facilitating a new service sector.

19. Water. Developing the Sava River Basin—focusing on enhancing the river's navigability, strengthening flood management, protecting the environment, and promoting nautical tourism—would support economic integration and social development through improved hydropower and irrigation and reduced risks associated to recurrent floods.

The World Bank Group stands ready to support the Western Balkan countries in their efforts to accelerate economic integration, achieve macroeconomic stability, and implement structural reforms. To succeed in advancing the regional agenda for economic integration, Western Balkan countries would need a strong degree of technical and political cooperation, combined with a transparent communication strategy to ensure broad policy consensus. To this end, we hope that the attached notes support the development of a Western Balkans Economic Area Action Plan.

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WESTERN BALKANS: Regional Economic Integration Issues Note No. 1

Productivity and Economic Integration

Total factor productivity growth — efficiency of use of the factors of production is both essential for and can be accelerated by economic integration.

OVERVIEW:

Productivity in the Western Balkans is low by international standards. It grows slowly and, most recently, has been subtracting from growth. Productivity in the region is hampered by an often unfriendly business environment and the dominance of state-owned enterprises (SOEs). Unfair competition from informal enterprises and lack of access to finance are the only obstacles to businesses that rank in the top five in all six countries. The broad frontier of reforms is needed to unleash the private sector and improve formalization of firms. Improving the quality of micro-level data is also important for evidence-based policy making.

Benefits of Economic Integration – Evidence and Global Experience

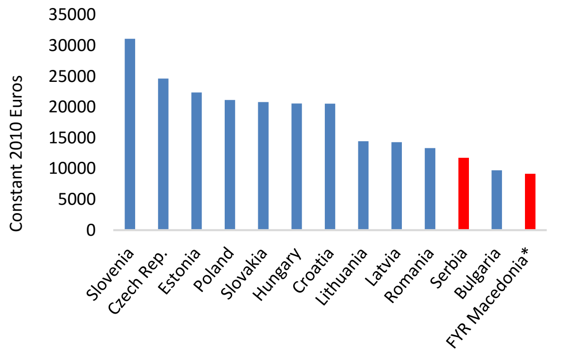
Productivity within the Western Balkans is low and slow-growing. Labor productivity is lagging behind comparator countries. A decomposition of growth shows that total factor productivity levels have dwindled since the global financial crisis, and also have evolved less uniformly across the region. Productivity is essential for competitiveness of the economy and therefore successful integration into world and regional markets. Weak productivity, should it persist, will make it very difficult to propel growth within the Western Balkans.

Key Challenges for Western Balkans Regional Economic Integration

Productivity in the region is hampered by an often unfriendly business environment and the dominance of state-owned enterprises (SOEs). Reallocation of resources to more productive uses does not occur automatically, but it can be facilitated by improving the environment businesses operate. Generally, the Western Balkans countries still lag behind other European transition economies in terms of efficiency of the business environment. In addition, the relatively slow pace of privatization and restructuring of legacy SOEs often means obsolete technology and equipment and unproductive labor, leading to inefficient allocation of resources in the economy.

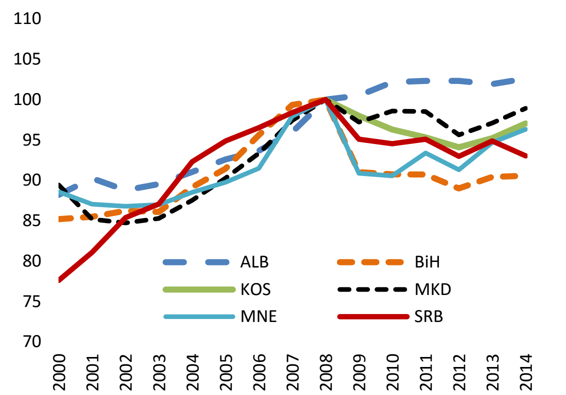
Unfair competition from informal enterprises and lack of access to finance are the only obstacles to businesses that rank in the top five in all six countries. Albania, Kosovo, and FYR Macedonia are particularly weighed down by informality and need to address it. The competitiveness of private enterprises is also curtailed by the generally high cost and low quality of infrastructure - including electricity, logistics, transport, and telecommunications, especially in Kosovo and Montenegro. All six Western Balkans countries lag behind the EU on the logistics performance index and broadband penetration.

Figure 1: Real labor productivity levels in 2014 were low compared to other transition economies
(Constant 2010 euros)



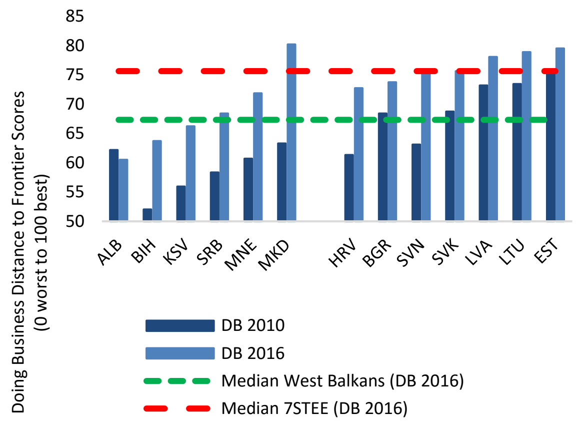
Source: World Bank staff calculations. Real labor productivity is measured as value added (at factor cost) per person employed

Figure 2: In most Western Balkan countries, productivity levels have dwindled since the global financial crisis
(Total factor productivity, 2008 = 100)



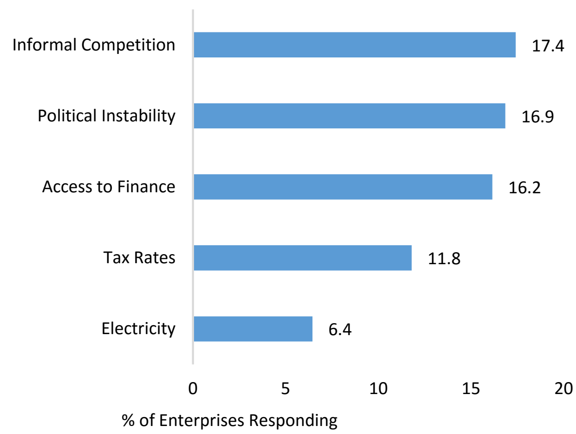
Source: World Bank staff calculations.

Figure 3: Western Balkans remain at a fair distance from the business environment frontier



Source: World Bank's Doing Business Report 2016.

Figure 4: Top five constraints to enterprises



Source: World Bank's BEEPs Survey 2016.

Priority Areas for Medium-Term Action

To reignite economic growth, and fast-track convergence to promote economic integration, governments in the region **must focus on boosting productivity for gains in competitiveness**. Aside from maintaining macroeconomic stability, a battery of reforms is necessary.

Priority Area 1: Removing barriers to private sector and entrepreneurship, which involves making it easier to do business notably by allowing new entrants that are facing high barriers to operate and grow, and enabling the reallocation of productive resources.

Priority Area 2: Privatization and restructuring of the legacy SOEs, which are inherently inefficient and poorly governed, to level the playing field and allow more efficient allocation of labor and capital.

Priority Area 3: **Investment in improving the quality of human capital and in access to quality education**, as well as boosting innovation and research and development, in order to create new skills and adapt existing ones. Countries will need to address disincentives for work and barriers to employment that exist in their labor, tax, and social protection systems.

Priority Area 4: **Improving energy, logistics and trade, and ICT infrastructure** to increase competitiveness and help domestic firms upgrade and expand exports, a benefit from digitalization. Better roads, rail, and air connectivity across the region is important.

Priority Area 5: **Removing barriers to intra-regional trade and investment** and participation in global value chains, which is essential for knowledge spillovers and productivity enhancement.

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Regional Trade Integration

Achieving Economic Prosperity through Regional Trade Integration

OVERVIEW:

Economic integration is an essential element in many success stories of countries that have achieved high income and economic prosperity. Exports have expanded significantly in recent years, but the Western Balkan countries remain poorly integrated into world trade. Removing market barriers and reducing the cost of trade will make the region a more desirable trading partner to the rest of the world, and support integration efforts with the EU.

Benefits of Economic Integration – Evidence and Global Experience

Economic integration is an essential element in many success stories of countries that have achieved high income and economic prosperity. Integration can bring productivity gains via increased competition, greater exposure to frontier technologies, and, for small economies, the possibilities of achieving economies of scale. While the Western Balkan countries experienced fast economic growth in the 2000s, progress has slowed after the 2008 financial crisis. Improvements in living standards and poverty reduction came to an abrupt stop, revealing the limits of their pre-crisis model that was driven by domestic consumption and capital inflows. The pathway to prosperity for the Western Balkans hinges on furthering regional and international economic integration by connecting to global markets through trade, transport, and investment.

The benefits of trade integration are well documented and discussed among policymakers. Trade liberalization is strongly related to economic growth, especially through the channels of boosting aggregate and firm productivity (see for example, Winters 2004 and Panagariya 2004). The European Union is one of the most successful stories of trade integration, and the benefits of trade integration are evident in the income convergence of EU members.

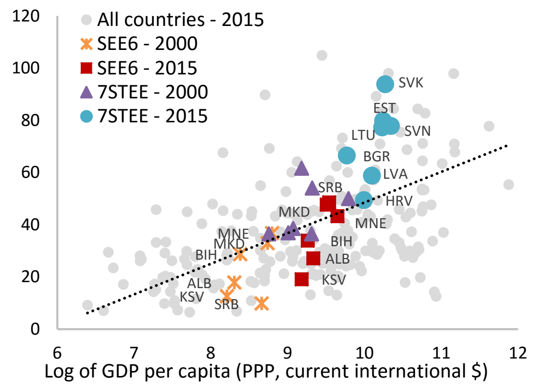
Key Challenges for Western Balkans Regional Economic Integration

Exports have expanded significantly in recent years, but the Western Balkan countries remain poorly integrated into world trade. FYR Macedonia, Montenegro, and Serbia are the most integrated, with exports of goods and services close to 40 percent of GDP, followed by Albania and Bosnia and Herzegovina (just over 30 percent), and Kosovo (19 percent) (Figure 1). But comparator countries in the region such as Slovakia, Estonia, Lithuania, and Slovenia have larger shares that equal or exceed 80 percent of GDP.

Efforts towards economic integration through the Central European Free Trade Agreement (CEFTA) have not increased the shares of trade with the Western Balkans. The share of trade with the Western Balkans remains small despite the proximity, and the EU has remained the dominant export market for all Western Balkan countries. Albania, Bosnia and Herzegovina, FYR Macedonia, and Serbia depend on the EU for 60-70 percent of their exports, compared to only 10 percent on CEFTA (Figure 2). Montenegro and Kosovo export about 30 percent to CEFTA countries and 40 percent to the EU.

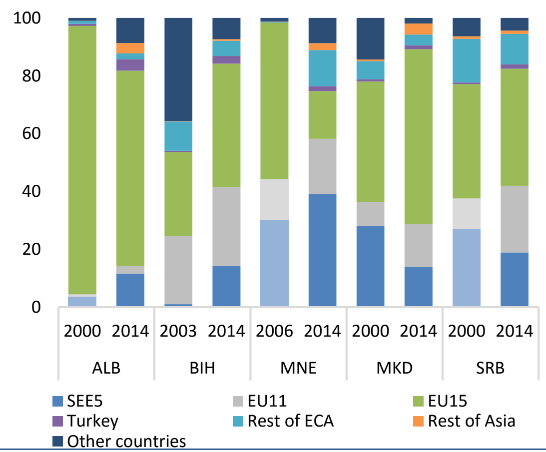
The proportions of exporters, however, is small. Many firms in the Western Balkans are not exporters, choosing instead to sell domestically. If they do export, the firms tend to sell to the EU market than to other Western Balkans countries. A large proportion of Albanian firms (87 percent) sell to the local market, 10 percent export to the EU market, and only 3 percent sell to other Western Balkans countries. Among the Western Balkans countries, only Serbia and Kosovo have a larger share of firms that are selling to the Western Balkan region than to the EU.

Figure 1: There is huge room for further growth in exports
(Exports of goods and services, percent of GDP)



Source: World Bank (2017) based on World Development Indicators and World Bank staff estimates.
Note: SEE6 denotes the six Western Balkans countries.

Figure 2: The EU is the dominant export destination
(percent)



Source: World Bank (2017) based on Comtrade.
Note: SEE5 denotes the five Western Balkans countries with trade data: Albania, Bosnia and Herzegovina, Montenegro, FYR Macedonia and Serbia.

There are constraints that undermine the ability of firms in the Western Balkans to take further advantage of economic opportunities in neighboring markets and the EU. Firms continue to face significant trade costs mainly related to border crossing, compliance and regulatory burden in export markets. Among the Western Balkans countries, firms in Kosovo face the highest exporting costs. The Kosovan exporter takes almost two days (42 hours) for border compliance and another 1.5 days (38 hours) for documentary compliance, compared to the average of 7 hours and 3.8 hours in the other five Western Balkans states. In addition, the Kosovan firm will have to pay US$264 to export, compared to an average of US$72 in the other five countries. Conversely, the firms in Montenegro pay the highest costs to import, which also exceed the costs of exporting. The Montenegrin firm takes 33 hours and pays US$406 to import its goods, whereas the Serbian firm takes only 7 hours and pays US$87.

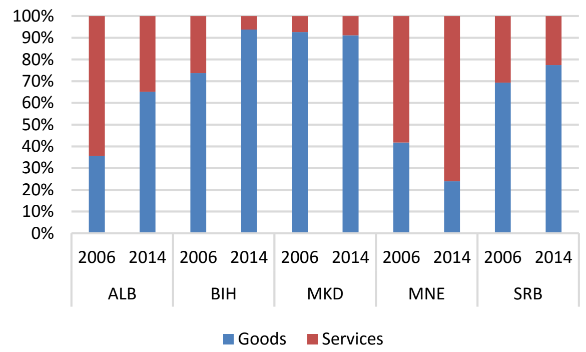
Nonetheless, merchandise exports enter CEFTA countries and the EU tariff free, but services exports still face barriers. Among CEFTA countries, there are no tariffs on industrial goods and tariff rates have declined substantially on agricultural goods. Exports from the Western Balkan countries can enter the EU tariff free, with the exception of quota restrictions on certain agricultural products. Thus, the crucial actions for trade in goods are not market access, but reduction in the non-tariff measures and costs to trade – trade facilitation. In contrast, the CEFTA and the EU Stabilization and Association Agreement do not cover market access for trade in services.

The growth of services exports of Western Balkan countries has been stymied. With the exception of Montenegro, services account for a small share of total exports of goods and services (Figure 3). Services account for about 30 percent of total exports of goods and services in

Albania and Serbia and less than 10 percent in Bosnia and Herzegovina and FYR Macedonia. The shares of services in total exports has also been declining over the years. Albania and Bosnia and Herzegovina suffered the largest fall in the share of services between 2006 and 2014, with a reduction of more than 20 percentage points.

Services exports are dominated by tourism and transport sectors. Both sectors account for over 40 percent of services exports in FYR Macedonia and Serbia, about 70 percent in Albania and Bosnia and Herzegovina, and 84 percent in Montenegro in 2015 (Figure 4). High productivity services sector such as professional and ICT services are a small proportion, and there is considerable potential to expand their share. Serbia, Kosovo, and FYR Macedonia have a head start because they have a significant nucleus of firms and skilled workers that are already providing communication, information, and computer services for the domestic market as well as export, albeit at a low level. In 2012-14 these services averaged about 15 percent of total service exports for each of the three countries. Such services contribute to value added in global value chain (GVC) exports and are thus exported indirectly too. Enhancing the efficiency of these services can contribute to expanding GVCs.

Figure 3: Decreasing Share of Services Exports in Western Balkans, except Montenegro



Source: World Development Indicators.
Note: Goods and Services share of Total exports.

Figure 4: Tourism and Transport services account for a large share of Services exports

Source: UNCTAD.
Notes: Goods-related services include manufacturing services on physical inputs owned by others and maintenance and repair services.

The Western Balkans countries have been improving the market access for services sectors, but more efforts are needed. The countries are currently negotiating an Additional Protocol (AP6) to the CEFTA agreement, which covers the liberalization of trade in services. The AP6 includes the typical provisions on trade in services: National Treatment (where each country accords the same treatment to domestic firms and firms from other CEFTA parties), Most Favored Nation (where each country accords CEFTA parties at least the same treatment as it does to non-CEFTA parties) and market access commitments that will cover all modes of services. However, negotiations on the AP6 are completed but the protocol is not signed and effective, and market access commitments are not public so there is no proper analysis of the AP6. Nonetheless, the AP6 represents a pledge towards a free market in trade in services and a movement towards the reforms needed for EU accession. When the Western Balkans countries become an EU member, they will need to adopt the Services Directive that requires each country to remove all legal and administrative barriers to services trade to facilitate the establishment of firms, cross-border provision of services and simplier procedures. By first liberalizing the services sectors among the Western Balkans countries, the AP6 is a good initial step towards introducing market discipline in the services sectors before a full liberalization to the EU market.

Priority Areas for Medium-Term Action

Priority Area 1: Reducing trade costs

Action 1.1: Start the implementation of the Additional Protocol 5 (on Trade Facilitation)

Action 1.2: Harmonize National Authorized Economic Operator (AEO) frameworks

Action 1.3: Ensure mutual recognition of Authorized Economic Operators (AEOs) in the region

Action 1.4: Implement Risk Management systems for all border agencies (beyond customs)

Action 1.5: Launch the preparation for the establishment of a National Single Window

Priority Area 2: Improving transparency of barriers and regulations

Action 2.1: Conduct surveys of exporters and importers to better understand their experiences with regulatory and procedural obstacles to trade (Non-Tariff Measures)

Action 2.2: Improve intra-regional cooperation between regulatory bodies and governmental agencies to harmonize customs and trade regulations for exporters and importers

Action 2.3: Prepare inclusion of Western Balkan countries in relevant international data collection exercises (e.g. OECD Product Market Regulations, Services Trade Restrictiveness Index, Trade in Value Added – TiVA)

Action 2.4: Conduct surveys of regulations and barriers in services sectors

Priority Area 3: Increasing market acess for goods and services

Action 3.1: Adopt and start the implementation of the Additional Protocol 6 (trade in services)

Action 3.2: Improve intra-regional cooperation between regulatory bodies, governmental agencies, and professional associations in charge of services

Action 3.3: Achieve mutual recognition of professional services, starting with a selected subset of professions

Action 3.4: Improve business and regulatory environment to increase the participation of firms in exporting and importing activities and foreign firms in the local economy

There is consensus among the countries of the Western Balkans that trade and transport facilitation issues are critical to deepen economic integration in the region and the EU. The strong regional impetus is followed with different levels of commitment and technical capacity to implement reforms at the country level. The World Bank is supporting countries' efforts, including through the ongoing technical assistance program and an envisaged regional operation. The support aims to promote deeper economic integration between Western Balkan countries and with the EU through improving the efficiency and capacity for cross-border movement of goods, improving transparency and predictability of trade and transport regimes, and enhancing market access for goods and services.

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WESTERN BALKANS: Regional Economic Integration Issues Note No. 3

Investment Policy

Towards a regional agenda to attract higher quality investments to the Western Balkans

OVERVIEW:

Greater convergence of regional investment policies and alignment with international good practice standards is a key conduit for economic integration and the attraction of more and higher quality investment to the Western Balkans. To make greater regional harmonization of investment policies a reality, advances at different levels are required. The economies of the region need to develop and agree upon a regional agenda, draft relevant regional frameworks, and implement them de jure and de facto in all of them so that regional integration and better alignment with EC standards becomes a reality in practice. They need to increasingly cover different technical areas of sophisticated regulation and synchronize integration of policies in different fields, including in particular in investment promotion and attraction, entry and establishment, as well as protection and retention.

Benefits of Economic Integration – Evidence and Global Experience

Multinational firms and investors increasingly operate and invest regionally, based on strategic decisions about market size, regional production networks, and infrastructure links. Empirical evidence suggests that the existence of larger and more sophisticated markets as constituted by regions allows investors to benefit from economies of scale and organize their production processes more efficiently.

Economies can better meet the strategic needs of corporate investors by thinking regionally. Greater regional harmonization of investment policies holds significant potential for the economies of the Western Balkans to increase the attractiveness of the region for market-seeking and efficiency-seeking foreign direct investment (FDI). Despite an unquestionable competition among the economies of the region in their attempts to create a more competitive business environment, it is of utmost importance for the region to join forces in removing existing barriers to regional investment. Investors look at the region and the potential of its markets as a whole. The region therefore needs to improve and harmonize its investment policies and promote itself as a unique investment destination.

The removal of barriers to regional investment offers the opportunity for economies of scale, geographically diversified businesses, and an overall more efficient allocation of resources within a regional market. At the firm level, this means the potential for investor subsidiary networks, as firms seek efficiency gains through a fragmentation of their production process allocating individual segments of value addition in places of comparative economic advantage. Increased coherence of regional investment policies reduces the time and cost to invest within a region. It fosters development of regional value chains and leads to increased diversification and sustainability of economic growth.

A regional investment and trade agenda for the Western Balkans can be mutually supporting. The deepening of trade integration and trade flows among the economies of the region, as well as with its neighbors, provides a strong signal to investors and helps boost the attractiveness of the region for market-seeking and efficiency-seeking FDI. Equally, the increasing presence of multinational enterprises (MNEs) and other foreign investors has the potential to support and increase trade flows through regional production networks and value chains.

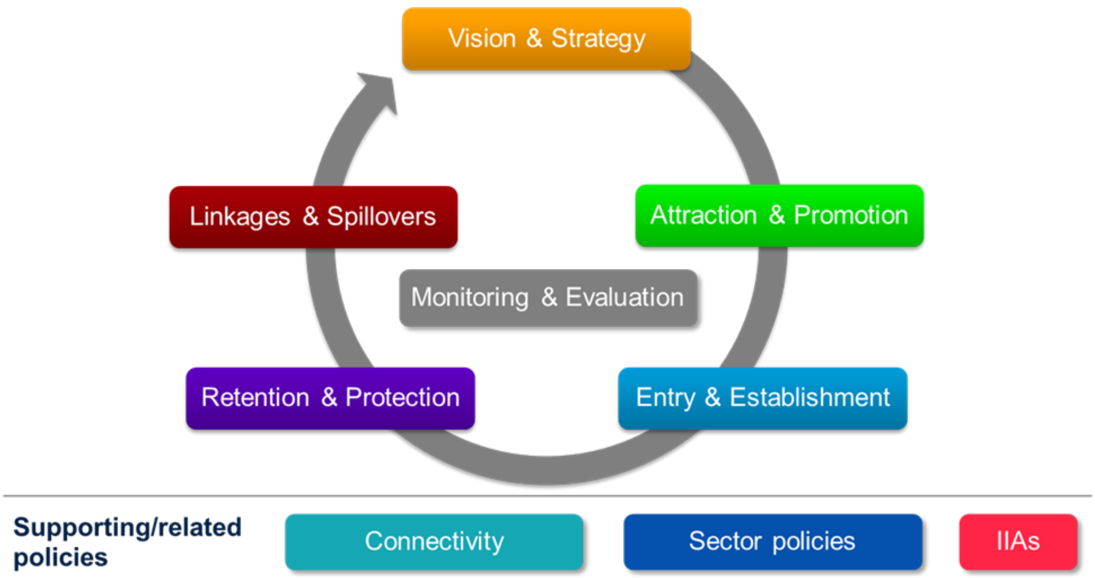
Key Challenges for Western Balkans Regional Economic Integration

To make greater convergence of regional investment policies a reality, advances at different levels are required. While some basic elements of a regional investment agenda are existent in the Western Balkans, a comprehensive framework effectively aligning key policies for investment is still missing.

The economies of the Western Balkans need to develop and agree upon a regional investment agenda, draft relevant regional frameworks, and implement them de jure and de facto in all of them so that regional convergence and better alignment with EC standards becomes a reality in practice. This will entail addressing increasingly different technical areas of sophisticated regulation and synchronizing the harmonization of policies in different fields.

The regional investment agenda will need to focus on core areas of investment policy as well as related policies that matter most for the private sector in the Western Balkans. For the benefits of regional cooperation in investment policy to materialize, convergence of policies along the different stages of the investment lifecycle is required. This begins with setting an investment vision and priorities, proceeds with policies for investment attraction and promotion, entry and establishment, retention through adequate levels of protection, and ends with the development of sustained linkages with the local economy and contribution to the development of its value chains.

Figure 1: Core areas of investment policy



Additional policy areas that need to be considered include sectoral policies, issues of connectivity and the framework of international investment agreements. Policies governing non-equity modes (NEMs) of investment also hold great potential as a powerful conduit for fostering intraregional knowledge transfer within the region.

The regional investment agenda will add value to the existing efforts of each of the

individual economies of the region in their own investment-related reforms. The removal of barriers to regional investment and increased coherence of regional investment policies reduces the time and cost to invest within a region. It fosters the development of regional value chains and leads to increased diversification and sustainability of economic growth.

Priority Areas for Medium-Term Action

The economies of the region need to develop and implement a regional investment agenda, draft relevant regional frameworks, and implement them de jure and de facto in all of them so that regional integration becomes a reality in practice. This will entail the implementation of a series of steps in order to achieve greater harmonization of regional investment policies and alignment with EU standards:

Priority Area 1: Identification and stocktaking of key investment policy barriers in the region

Action 1.1: Identify and map key policy barriers and inhibitors to intra-regional investment and new investment to the region through in-depth consultations with the private sector, leveraging existing business and investors associations in the region, such as the regional Foreign Investor Councils (FIC) and WB Chamber Investment Forum (CIF)

Action 1.2: Triangulate information on issues obtained through private sector consultations through a review of existing analysis on investment barriers undertaken by various international and regional organizations including that of OECD (Competitiveness Outlook) and UNCTAD (regional investment policy review)

Action 1.3: Compile a comprehensive inventory of existing barriers to regional policy harmonization addressing the policy and regulatory framework pertinent to investments as outlined above (investment lifecycle) in a comprehensive manner

Action 1.4: Compile a mapping of foreign direct investment and major investors in the region to develop an in-depth understanding of the amounts and main patterns of FDI flows in the region, as well as major investors

Priority Area 2: Categorization and rationalization of the issues to be addressed in a regional investment reform agenda

Action 2.1: Classify and categorize the list of identified issues in order to distinguish between horizontal and sectoral measures; recognize measures affecting the different investment policy dimensions such as investment attraction or entry; determine legal, procedural or de facto measures

Action 2.2: Conduct a consultative process involving the key stakeholders in the region with the aim of establishing a solid and shared understanding of the pertinent issues preventing regional harmonization

Action 2.3: Design and implement an ongoing mechanism to address implementation challenges and assist regional stakeholders to review progress with the implementation of the reform agenda building on the categorized list of issues and reform proposals

Priority Area 3: Formulation of a regional investment reform agenda aimed at harmonizing regional investment policies and aligning them with international good practices

Action 3.1: Formulate a regional reform agenda through a consultative process involving the member economies of the region—the reform agenda would be aimed at fostering greater convergence of regional investment policies and at aligning them more closely with good practice standards such as the OECD's Policy Framework for Investment (PFI), UNCTAD's Investment Policy Framework for Sustainable Development (IPFSD), and pertinent EU standards

Action 3.2: Develop and agree upon a set of short, medium and long-term reform measures constituting the regional reform agenda based on the desirability for the region's value proposition and the feasibility of implementation from an economy level perspective

Action 3.3: Develop and agree upon individual investment policy action plans, formulated by the relevant authorities of each of the member economies that will underpin the implementation of regional reform agenda in the economies of the region—these action plans will specify the concrete measures that each member economy would undertake to address or remove the identified barriers, including a specific implementation schedule

Priority Area 4: Monitoring of the implementation of the regional investment reform agenda and impact assessment through a regular regional reform dialogue

Action 4.1: Strengthen the existing regional dialogue mechanism under the South East Europe Investment Committee (SEEIC) to become the major instrument to support and monitor the implementation of the regional reform agenda—while the operational details of this mechanism can be adopted at the start of the regional reform dialogue, it is expected that it would include the relevant authorities from each of the participating economies that work on the identification and implementation of reforms; these are primarily ministries of economies, investments or trade, as well as investment promotion agencies (IPAs) from each of the participating economies

Action 4.2: Develop and prepare regular agendas for monitoring and supporting the reform implementation in a working group format under the SEEIC—the appointed working level representatives of the above mentioned institutions will be in charge of preparing the operational level agendas, while ministers from each of the participating economies will meet on a regular basis to approve key decisions; the updated list of common reforms and issues will become a regular agenda item for repeated review of progress

Action 4.3: Invite private sector stakeholders and representatives from the business community to join the meetings to monitor progress and engage pro-actively with the implementation of the regional reform agenda—private sector should include both, the domestic and the foreign investor base in the Western Balkans economies, for example through the network of the regional Foreign Investor Councils (FIC) and WB Chamber Investment Forum (CIF)

Priority Area 5: Joint regional investment promotion initiative

Action 5.1: Explore possibilities for joint action in investment promotion including the development of a joint investment promotion initiative for the Western Balkans region to complement the policy reform approach; the approach should be focused on the joint regional priority sectors identified in the SEE 2020 strategy

Action 5.2: Implement a small set of targeted investment promotion efforts that hold potential for regional cooperation and for increasing the region's visibility—this initiative should be focused on selected priority regional value chains within the target sectors of the SEE 2020 to help maximize complementarities and minimize the competition between the economies of the region in attracting investors in those sectors

Action 5.3: Establish an operational platform based on a range of contemporary investment promotion tools and techniques, as well as institutional mechanisms that could be progressively built upon to help catalyze investment attraction, growth and regional cooperation

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WESTERN BALKANS: Regional Economic Integration Issues Note No. 4

Fostering Economic Integration through Effective Competition Policies

Levering the synergies of domestic competition policies to build regional markets

OVERVIEW:

While all Western Balkan countries have competition regulatory frameworks in place, implementation remains weak. Effective competition policies would offer a tool to complement and support governments' efforts to promote economic integration in the Western Balkans. Regional trade reinforces competition in national markets by increasing contestability, entry, and rivalry through increased presence of foreign products, services, and investments. Implementing an effective competition policy at the regional level would be key to promote economic integration in the Western Balkans and embed competition principles in sectoral policies. Competition in domestic markets is also critical to foster integration with the EU.

Benefits of Economic Integration – Evidence and Global Experience

Strengthening competition policies would support governments' efforts to promote economic integration in the Western Balkans. Active competition among market players has the potential to mitigate vested interests and facilitate the opening of markets to trade and investment. Greater competition within national markets reinforces international competitiveness of potential exporters through increased incentives to foster productivity, innovation, and efficiency. Restrictions to competition are many times permitted, supported, or even created by public bodies themselves. Those restrictions not only affect the dynamics of internal markets but also the ability of these countries to compete internationally and reap the benefits of enhanced economic integration.

Enhanced regional trade in the context of economic integration at the same time reinforces competition in national markets by increasing contestability, entry, and rivalry through increased presence of foreign products, services, and investments. Empirical evidence suggests, for example, that: (i) the elimination of entry barriers, increased rivalry, and leveling the playing field in upstream sectors contribute to export competitiveness in downstream manufacturing sectors, (ii) pro-competition market regulation that reduces restrictions and promotes competition is an important determinant for trade, (iii) competition law enforcement can be traced to export performance and is complementary to trade reforms, and (iv) industries with more intense domestic competition will export more.[1]

Competition in domestic markets would also be critical to foster further regional

[1] *See,* Goodwin, Tanja; Pierola, Martha Denisse (2015). *"Export Competitiveness. Why Domestic Market Competition Matters"*. Viewpoint, Public Policy for the Private Sector. The World Bank Group, Trade and competitiveness Global Practice, Note n. 348. Available at: http://documents.worldbank.org/curated/en/432141468189538318/pdf/97914-REPLACEMENT-FILE-VP-348-Export-Competitiveness-WEB.pdf

integration with the European Union. As part of the EU policy for gradual integration of the Western Balkans in the framework of the Stabilization and Association Process (SAP), competition policy has been identified as a key element within the 2016 criteria for enlargement.[2]

Key Challenges for Western Balkans Regional Economic Integration

While all Western Balkan countries have competition regulatory frameworks in place, implementation remains weak. Competition laws were approved in Albania in 2003,[3] in Kosovo in 2004,[4] in Serbia[5], Bosnia and Herzegovina[6], and FYR Macedonia[7] in 2005, and in Montenegro in 2006[8] However, the Global Competitiveness Report 2016-2017 ranks all the countries low[9] in all competition-related indicators, especially in relation to the effectiveness of their antimonopoly policy and extent of market dominance.

Limited enforcement against anticompetitive conducts impacts the effectiveness of the competition policy and misaligns the incentives of market operators to comply. For instance, in Kosovo the authority issued no decisions between 2013-2016 due to lack of appropriate internal procedures and limited budget.[10] During the same period, Albania,[11] Serbia, and Montenegro took between 5-10 decisions with limited amount of associated fines, e.g. in Montenegro the single decision resulting in a fine amounted to a sanction of only EUR36,000.[12] Other jurisdictions have stronger levels of enforcement: in FYR Macedonia for the period of 2013-2015, there were a total of 18 decisions adopted on cartels and abuses of dominance with fines amounting to EUR4.5 million and in Bosnia and Herzegovina there were 16 decisions concerning anticompetitive practices which imposed fines amounting to EUR650,000.[13]

[2] *See*, European Commission Communication on EU Enlargement Policy, 2016.
Available at: https://ec.europa.eu/neighbourhood-enlargement/sites/near/files/pdf/key_documents/2016/20161109_strategy_paper_en.pdf
See also, Commission Staff Working Documents and Reports Accompanying the European Commission Communication on EU Enlargement Policy for Montenegro, Serbia, the former Yugoslav Republic of Macedonia, Albania, Bosnia and Herzegovina, and Kosovo, for 2016. Available at: https://ec.europa.eu/neighbourhood-enlargement/countries/package_en

[3] *See*, Albania, Law No. 9121 of July 28 2003 on Competition Protection.

[4] *See,* Kosovo, Law No.2004/36 on Competition of September 8, 2004.
Available at: https://ak.rks-gov.net/repository/docs/Law-onCompetition.pdf and Law No.03/L –229 of October 7, 2010 on the Protection of Competition.
Available at: https://ak.rks-gov.net/repository/docs/2010-229-eng.pdf

[5] *See* UNCTAD, *Peer review of Serbian competition law and policy,* 2011, p.1
http://unctad.org/en/Docs/ditcclp2011d2overview_en.pdf
Serbia, Law on Protection of Competition published in the Official Gazette of the RS, no. 51/2009 and 95/2013.
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[6] *See*, Bosnia and Herzegovina, Act on Competition on the bases of the Article IV (4) a) of the Constitution of Bosnia and Herzegovina, the Parliamentary Assembly of the Bosnia and Herzegovina, at the session of the House of Peoples, held in June 29, 2005 and at the session of the House of Representatives, held in June 29, 2005.
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[9] There is no data for Kosovo in the WEF Global Competitiveness Report 2016-2017.

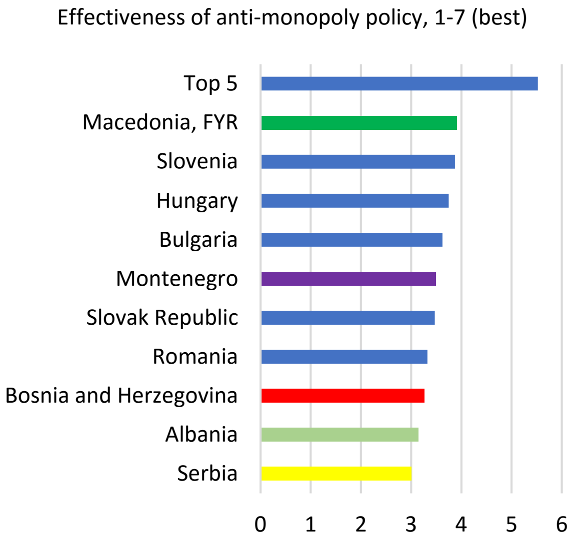
[10] *See,* Kosovo 2016 Report at p. 47.

[11] *See,* Albania 2016 Report at p. 45.

[12] *See,* Serbia 2016 Report at. P.39 and Montenegro 2016 Report at p.38,

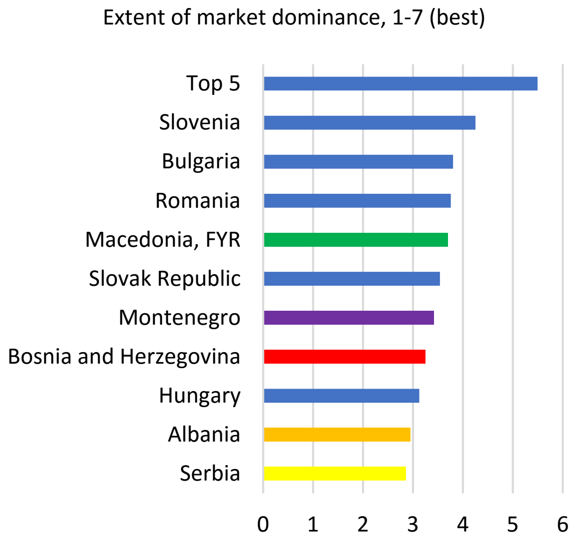
[13] *See* the FYR Macedonia 2016 Report at P.39. and Bosnia and Herzegovina 2016 Report at p.45

Figure 1: Effectiveness of Anti-Monopoly Policy



Source: WEF, Global Competitiveness Report (2016-2017)

Figure 2: Extent of Market Dominance



Source: WEF, Global Competitiveness Report (2016-2017).

Figure 3: Effectiveness of Anti-Monopoly Policy and GDP (in logs)

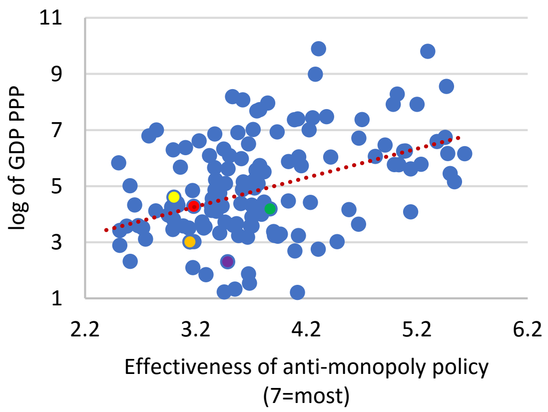
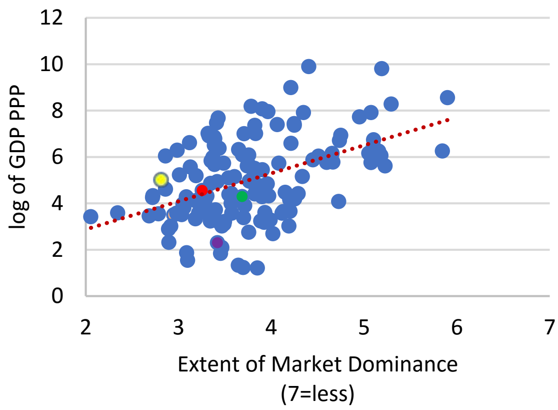


Figure 4: Extent of Market Dominance and GDP (in logs)



Source: WEF, Global Competitiveness Report (2016-2017), World Bank Development Indicators, and World Bank staff estimates.
Note: Albania (orange), Bosnia and Herzegovina (red), FYR Macedonia (green), Montenegro (violet), Serbia (yellow). Kosovo is not included in the GCR.

The effectiveness of anti-cartel policies is hindered by suboptimal use of key tools to detect and prosecute cartels.[14] All Western Balkan countries have legislation in place aligned to EU standards, i.e. Articles 101 and 102 of the TFEU. However, their ability to collect direct evidence of the anticompetitive conducts remains limited. While most countries have established leniency programs in the past few years, starting with Bosnia and Herzegovina in 2006,[15] no cases brought under leniency

[14] Cartels and horizontal agreements result in a welfare loss for the economy as a whole; for instance, price-fixing agreements among competitors impose significant costs on society. Connor (2010) examined studies and judicial decisions on 381 cartelized markets worldwide and estimated a long-run median overcharge of 23% of prices above competitive levels.

[15] See, Bosnia and Herzegovina, Regulation On The Procedure For Granting Immunity From Fines, available at: http://bihkonk.gov.ba/datoteka/regulation_leniency_policy.pdf

applications have been reported so far.[16] Similarly, on-site inspections have been rare and to some extent ineffective. [17]

All countries have implemented *ex ante* control of mergers in line with EU Merger Regulation, but the authorities tend to approve all decisions without ever issuing remedies to mitigate the anticompetitive effect of the transaction. This is the case of Albania which had no prohibition decision during 2013-2014, Bosnia and Herzegovina that had very few conditional clearances during that same period, Serbia which had four conditional clearances and no prohibition decisions to date, and Montenegro which had its first in depth investigation of a merger in 2015.[18] The proactive use of remedies, either structural and behavioral, is key to minimize anticompetitive effects of market concentration for the benefit of consumers.

While EU-based state aid frameworks exist in all Western Balkan countries, implementation remains challenging. Albania, FYR Macedonia, Kosovo, Montenegro, and Serbia have implemented a state aid system largely aligned with the EU state aid rules, while Bosnia-Herzegovina still lacks clear criteria and conditions for granting state aid. However, significant gaps exist in relation the secondary legislation on State aid. Moreover, from an institutional perspective, the resources to implement these frameworks appear to be inadequate. Most state aid agencies need to increase their staff and budget, as is the case of the Albanian State Aid Unit, a technical secretariat to the State Aid Commission (SAC) which only has two experts, or Kosovo's State Aid Commission (SAC) which only has one staff member employed out of six planned. Moreover, the authorities in charge of state aid scrutiny in Albania, Montenegro, and Serbia are not operationally independent.[19] Finally, there is evidence from Kosovo, Montenegro, Serbia, and Bosnia and Herzegovina of aid being granted and either not being notified or not investigated, as in the case of Kosovo in the telecommunications sector. [20] Regarding enforcement of their state aid mandate, the most active in the region were Montenegro's SACC with 31 decisions in 2015 including two declaring illegal aid and Serbia's CSAC, which in the period between 2013 and 2015 issued 53 decisions, albeit none prohibiting the aid. Other authorities in the region had a much more discrete level of enforcement, such as Albanian's (SAC) which adopted seven decisions in 2014 and nine in 2015 and has issued no decisions ordering recovery of unlawful aid and Kosovo's SAC, which has been limited to distributing notification forms to potential aid granters.

Finally, most competition authorities in the Western Balkans lack the necessary resources and expertise to effectively eliminate anticompetitive conducts and promote competition in key sectors of the economy. In some instances, the authorities lack political support to implement their mandate. For instance, the Kosovo Competition Commission (KCC), a collegial decision making body that governs the Kosovo Competition Authority (KCA), was unable to take any decision for more than three years until 5 of its members were appointed in 2016. Even now, KCA's operational budget has decreased, and it still lacks the capacity to conduct investigations.[21] Along similar lines, the Agency for the Protection of Competition (APC) of Montenegro lacks the power to impose fines as these are decided by the misdemeanor courts.[22] Agencies' staff ranges from 39 employees in Serbia's CPC to 13 in Montenegro's APC and Kosovo's KCC.

Given this set of challenges, developing the necessary tools to implement an effective competition policy at the

[16] *See*, Albania 2016 Report at p. 41, Bosnia and Herzegovina 2016 Report at p.45, Kosovo 2016 Report at p.47, Montenegro 2016 Report at p.38, Serbia 2016 Report at P.39 and, the former Yugoslav Republic of Macedonia 2016 Report at. P.39.

[17] *Idem.*

[18] *See*, Albania 2016 Report at p. 41, Bosnia and Herzegovina 2016 Report at p.45; Montenegro 2016 Report at p.38,

[19] Albania State Aid Commission (SAC), Montenegro's State Aid Control Commission (SACC) and Serbia's Commission for State Aid Control (CSAC).

[20] *See*, Kosovo 2016 Report at p.47, Montenegro 2016 Report at p.38, Serbia 2016 Report at. P.40 and, Bosnia and Herzegovina 2016 Report at p.45.

[21] *See*, Kosovo 2016 Report at p.47.

[22] *See,* Montenegro 2016 Report at p.38,

regional level would be key to promote economic integration in the Western Balkans and embed competition principles in sectoral policies. The WBG provides technical assistance on the implementation of pro-competition reforms to more than 60 countries and several regional integration. organizations/processes across all regions of the world. This assistance is provided under close partnerships with Competition Authorities, state aid bodies, and line ministries, and through regular consultations with key stakeholders from the private sector.

Priority Areas for Medium-Term Action

Priority Area 1: Design a mechanism for the identification and elimination of anticompetitive regulations at the national level that entail barriers for regional integration. This mechanism would build on Markets and Competition Policy Assessment Tool (MCPAT) developed by the WBG, as well as complemented by instruments developed in the framework of other projects such as BR4C (including PMR indicators built by the WBG in partnership with the OECD for the Western Balkans) and the sectoral competition check lists applied to key markets for interregional competition, especially in the areas of transport, energy, professional services and retail commerce.

Priority Area 2: Develop and implement effective anti-cartel enforcement tools at the regional level. These could include the issuance of unified leniency guidelines to encourage applications across countries and ensure timely cooperation among the competition authorities of the Western Balkans. A well-functioning leniency program can destabilize and deter cartels by creating a permanent threat that any of its members may come forward to the authority in order to avoid the fine.[1] Moreover, unified dawn raid instructions could promote more effective inspections to collect both physical and electronic evidence of cartels in order to build solid investigations.

Priority Area 3: Implement a regional inventory of state aid to monitor notified aid and assess its ex post impact.

Priority Area 4: Enhance cooperation among competition authorities by supporting the establishment of a structured network to exchange experiences and foster peer learning.

[23] Miller (2009) found that the leniency program in the US reduced the rate of cartel formation by 59% and increased the rate of cartel detection by 62%.

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WESTERN BALKANS: Regional Economic Integration Issues Note No. 5

Diversification of Financial Markets

Developing regional capital markets for better economic integration

OVERVIEW:

Global financial integration has increased substantially over the last two decades, including in the Western Balkans. However, financial deepening has been uneven across countries and sectors and lacks diversification. Given that the countries in the Western Balkans are relatively small in terms of economic size and population base, there is a compelling case for regional integration of capital markets. Capital markets can play a key role in complementing bank-centric financing. In this context, a regional capital market in the Western Balkans can help (i) unlock more investment for all companies, especially SMEs, and for infrastructure projects, (ii) attract more investment into the region from the rest of the world, and (iii) make the financial system more stable by opening up a wider range of funding sources.

Benefits of Economic Integration – Evidence and Global Experience

Regional integration is an attractive proposition particularly for small countries whose domestic financial markets do not offer the necessary diversification of investment opportunities to investors or of funding sources to companies. In addition to the EU, there are projects of integration in all other regions, including the *America Central* (AMERCA) and *Mercado Integrado Latinoamericano* (MILA) initiatives in Central and South America respectively, the East Africa Community initiative in Africa, and the *ASEAN* initiative in Asia. However, only the EU has achieved a relative degree of capital markets integration. Yet, the proposal for a capital markets union[1] highlights that more needs to be done to efficiently link investors and savers with companies and to unlock the potential of capital markets for long term investment. In all other regions, projects of regional integration are at a much earlier stage (see Annex 1 for further information on global experiences in developing regional capital markets).

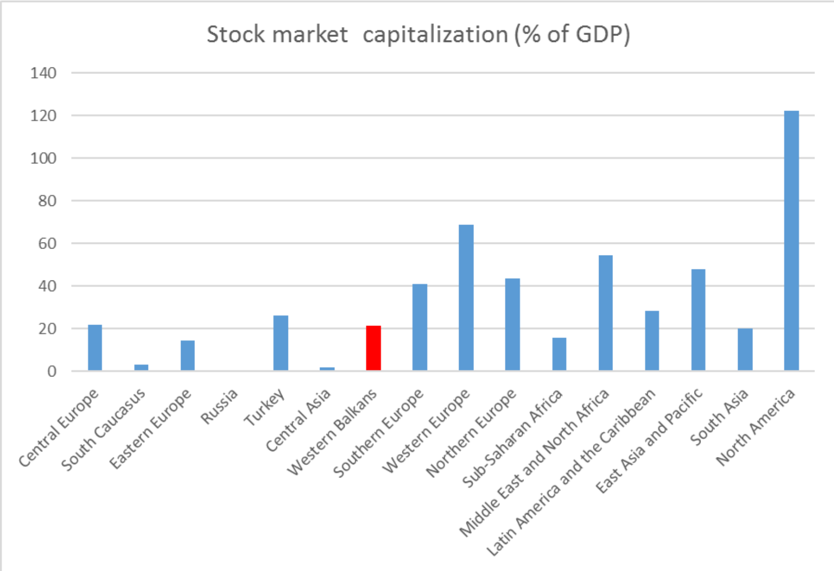
Key Challenges for Western Balkans Regional Economic Integration

Nonbank financial intermediaries and capital markets in the Western Balkan countries are shallow and sometimes nonexistent. Stock markets exist in four out of the six Western Balkan countries, with the exception of Albania and Kosovo, but the value traded is small. Equity markets remain underdeveloped with only a limited number of companies listed, and there is no liquidity of the secondary markets. On the debt side, in general, government bond markets exhibit more development, with corporate bond markets still being negligible in size. As to the demand side, the investor base across countries is still narrow. In general, direct retail investor participation is very limited, unlike in Albania where their share in the government securities market is quite significant (>10%). Institutional investors (mutual funds, pension funds and insurance companies) while growing, have not reached

[1] On 30 September 2015, the European Commission adopted an action plan setting out 20 key measures to achieve a true single market for capital in Europe. See at http://ec.europa.eu/finance/capital-markets-union/index_en.htm

significant size, neither in terms of assets under management nor relative to the economy. Finally, there is no single currency in place. However, the experience of capital markets in Europe shows that the process of integration can start even with multiple currencies; but in that case, the availability of hedging mechanisms is critical.

Figure 1: Stock market capitalizations in the Western Balkans and other regions



Source: World Bank Global Financial Development Database.

Priority Areas for Medium-Term Action

Priority Area 1: Enhancing coordination and cooperation among key stakeholders to promote the diversification of financial markets

Action 1.1: Form a regional 'Capital Market Development Task Force' comprising policymakers and regulators to spearhead capital market development matters and enhance coordination on regulatory and supervisory regimes in the region and beyond (including coordination with the Vienna Initiative Working Group on Capital Markets Union)

Action 1.2: Conduct country level assessments on capital markets development aimed at identifying gaps and opportunities on a country by country basis under coordinated approach of the Task Force (Task Force to set template of the assessment)

Action 1.3: Based on the results of the assessments and building upon existing analysis respectively, Task Force to develop a regional strategy for capital markets development. Regional integration should complement the Western Balkan countries' efforts aimed at strengthening the role of capital markets at the domestic level. Where integration makes sense, domestic plans should be fully integrated into this broader strategy

Priority Area 2: Develop and implement a strategy for the development of a regional capital market

Action 2.1: Encourage development of regional products (e.g. indices, regional investment funds)

Action 2.2: Take measures to strengthen the regional institutional investor base

Action 2.3: Harmonize regulatory and supervisory standards to facilitate investor protection and avoid regulatory arbitrage. Countries should aim to base their (domestic/regional) regulatory approaches on the EU framework, in order to facilitate future integration with the regulatory framework for capital markets at the European Union level

Action 2.4: Develop solutions to regional integration of market infrastructure, e.g. electronically linking domestic stock exchanges, electronic trading platforms for debt securities, and central securities depositories (CSDs)

Action 2.5: Create an EU-style 'passporting' regime covering issuers, investors and market intermediaries. Consideration could be given to an EU-style model, where efforts were made to linkup national exchanges and harmonize legislation and regulation across the entire region, but without requiring any country to give up their national stock exchanges or their rights to regulate their home markets. Instead, a so-called 'passporting' framework has been put in place that allows for issuers, investors and market intermediaries to operate in each other's national market, thereby creating a vastly larger 'common' market, without sacrificing any institutions or independence

Priority Area 3: Improving the availability, transparency and integrity of capital market data

Action 3.1: Publish all capital market related laws, regulations and rulebooks, data, and other relevant information, in both the local and English languages

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For more information about the Capital Markets Union, see the European Commission's website at http://ec.europa.eu/finance/capital-markets-union/index_en.htm.

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Annex 1: Selected experiences with capital markets integration

European Union

Integration of capital markets in Europe is part of a broader process of political, social and economic integration imbedded in regional treaties.

Integration of financial markets in general, and capital markets in particular is anchored on a passport regime, whereby products authorized in one jurisdiction can be offered across all jurisdictions and intermediaries licensed in one jurisdiction can provide services in all jurisdictions without the need to obtain additional authorizations or licenses, and in the case of intermediaries without the need to establish subsidiaries.

The passport regime is supported by a series of EU directives and in some cases EU regulations that seek to harmonize the requirements applicable to products, market infrastructure providers and intermediaries. Initially the approach relied more on minimum harmonization (whereby countries have the possibility to add requirements, commonly known as gold plating). Increasingly the approach relies more on maximum harmonization (whereby the domestic authorities cannot add requirements to those agreed at the European level). This maximum harmonization approach has aimed to minimize the potential for regulatory arbitrage. Overall the existing directives and/or regulations cover all key areas of the capital markets framework (perhaps the main "gap" is corporate governance of listed companies). However, key components of the enabling environment are not yet harmonized, including for example the insolvency framework and the tax regime.

Initially supervision and enforcement were left to the domestic authorities, although provisions exist in the directives and regulations that require countries to cooperate and coordinate with each other. Overtime regional bodies emerged. Initially, the domestic securities regulators created the Committee of European Securities Regulators (CESR), to facilitate cooperation and coordination. More recently regional authorities were created for the financial sector. On the securities market side, this authority is the European Securities and Markets Authority (ESMA). Currently ESMA has direct supervisory authorities in limited areas (mainly supervision of credit rating agencies and trade repositories); however, it has a key role in fostering supervisory convergence (via for example peer reviews) and assisting the authorities in the identification of emerging and systemic risks.

In terms of the market infrastructure, multiple trading platforms coexist at the regional level and the same instrument can potentially be traded in different platforms. At the exchange level, it is possible to refer to a process of consolidation/integration of exchanges that has taken place mainly via mergers and acquisitions. That is the case for example of Euronext, which currently integrates the markets of Belgium, France, the Netherlands, and Portugal and a listing venue from UK. At the same time, with the implementation of MiFID 1, other types of trading platforms appeared. In general, it is recognized that the plurality of trading venues brought trading costs down, however there has been a recognition that the high degree of market fragmentation poses challenges vis-à-vis market transparency, price formation and investor protection. A key objective of MiFID 2 has been to address these concerns. In the same vein, several CSDs coexist across the region. However, lack of interoperability, which is particularly important for post-trading, remains an important issue to address.

Canada

The 10 provinces and 3 territories in Canada are responsible for securities regulations. Securities regulators from each province and territory have teamed up to form the Canadian Securities Administrators, or CSA for short. The CSA is primarily responsible for developing a harmonized approach to securities regulation across the country.

The CSA brings provincial and territorial securities regulators together to share ideas and work at designing policies and regulations that are consistent across the country and ensure the smooth operation of Canada's securities industry. By collaborating on rules, regulations and other programs, the CSA helps avoid duplication of work and streamlines the regulatory process for companies seeking to raise investment capital and others working in the investment industry. In recent years, the CSA has developed the "passport system" through which a market participant has access to markets in all passport jurisdictions by dealing only with its principal regulator and complying with one set of harmonized laws. It is a major step forward in improving Canada's securities regulatory system by providing market participants with streamlined access to Canada's capital markets. The CSA's impact on most Canadians comes through its efforts to help educate Canadians about the securities industry, the stock markets and how to protect investors from investment fraud and market abuse generally.
As an informal body, the CSA functions through meetings, conference calls and day to day cooperation among the securities regulatory authorities. The CSA Chairs meet quarterly in person and by-weekly by conference call through meetings of the Policy Coordination Committee. Source: CSA website (www.securities-administrators.ca)

Latin America: MILA

MILA is a cross border initiative that currently focuses on the integration of the equities markets of Chile, Colombia, Mexico and Peru. In its origins, around 2008, it covered only the exchanges of Chile, Colombia and Peru, while Mexico joined the MILA in 2014. The initiative originated in the exchanges, but has had the support of the regulatory authorities of the region. Further, in its 2014 Summit, the Ministers of the region on its Pacific Alliance Summit expressed their support to the MILA, as a key component of a broader policy for free trade among these countries.

The MILA has covered only the equity markets and has been mostly geared towards secondary market trading, and in particular the development of a single trading platform whereby the companies listed in one of the exchanges in the region can be easily traded in the remaining exchanges. Such single trading platform is achieved via technological tools, rather than via mergers and acquisitions of one exchange by another. However, it is expected that under the umbrella of the Pacific Alliance this initiative will expand beyond equity markets.

As per its initial focus (i.e. equity markets) the initiative was developed under a two-step approach: (i) on a first stage the virtual single market takes place through the routing of orders to local intermediaries. Transactions take place in the market in which the securities are listed, in accordance with the rules of that exchange, in the local currency, and with book-entry though the local brokers; (ii) on a second stage integration would allow for remote participation of brokers from each country in all the remaining jurisdictions.

The initiative is currently in its first stage. The implementation of the first phase required legal and regulatory changes, as well as technological changes. From an issuers' perspective the project required changes in the regulatory framework of the home country to facilitate the offering of securities in the remaining host countries; however, there are still differences in the "ease" by which securities from each country can be offered and listed in the others. On the intermediaries' side, the implementation of the first phase did not require substantive changes to the legal and regulatory framework, given that remote participation is not yet allowed. But it did require the establishment of cooperation arrangements between brokerage houses for the routing of orders. On the exchanges side, important technological changes were needed to arrive to a virtual single platform, which are also backed by cooperation arrangements between the exchanges. On the CSD side, the MILA required changes in custody rules, to allow for omnibus accounts and facilitate cross border custody, as well as cooperative arrangements among the CSDs. Finally, some legal changes were made to eliminate some tax distortions; however, there is not yet a fully harmonized tax regime.

The MILA has been supported by MoUs signed by the corresponding supervisory authorities. A first MoU signed in 2009 committed the regulatory authorities to take all necessary actions to implement the MILA. A MoU signed in 2010 provided the basis for cooperation, coordination and exchange of information in regard to the activities that take place in the MILA. An addendum to the MoU was signed in 2012 to deepen the level of coordination and cooperation via the creation of a supervisory committee with a mandate to foster the transparency and integrity of the MILA market, determine the technological and process requirements for exchanges, CSDs and intermediaries, review counterparty, exchange risk and liquidity risks, and information mechanisms.

Central America: AMERCA

AMERCA aimed at integrating the capital markets of Costa Rica, El Salvador and Panama. It originated in the late 1990s as an initiative of the exchanges. Since its inception the project faced significant challenges both from the private sector and the public sector perspective. While in principle the three exchanges had agreed that integration was the best way to move forward, in practice they failed to agree on the terms of a cooperative agreement among them. At the regulatory level, the project was not backed by the supervisory authority of the Costa Rica securities market, the SUGEVAL, mainly due to concerns over the existence of material differences in the legal and regulatory framework, and over the intensity of the supervisory program of the three authorities. In August of 2015 the regulatory authorities of El Salvador and Panama announced their intention to move forward with the project of integration, on a bilateral basis.

Africa: The capital markets of the East African Community

Similar to the case of Europe, the integration of the capital markets of the East African Community is part of a broader project of political, social and economic integration among Burundi, Kenya, Rwanda, Tanzania, and Uganda. The Treaty for Establishment of the East African Community was signed on 30 November 1999 and entered into force on 7 July 2000 following its ratification by the original three Partner States – Kenya, Tanzania and Uganda. The Republic of Rwanda and the Republic of Burundi acceded to the EAC Treaty on 18 June 2007 and became full Members of the Community with effect from 1 July 2007.

The strategy toward integration is largely inspired by the experience of the European Union. It is anchored on the development of a passport regime for issuers and intermediaries. Such regime is supported by directives approved by the Council of Ministers, which prescribe the minimum requirements that issuers, intermediaries and market infrastructure providers would need to fulfil. A key set of directives involving issuers, CIS and intermediaries was approved by the EAC Council of Ministers in 2014. In practice, important issues are not being fully detailed in the directives. To a large extent this has been a reflection of the difficulties of agreeing on a framework that would need to be applied to markets that are at different levels of development. A key example relates to the requirements for the licensing of securities intermediaries, and in particular the minimum capital and solvency required. Currently those requirements vary significantly among these jurisdictions and coming up to one unified framework has been a key source of concern. Thus, the trial with fire of this approach will come in the transposition of the directives, and the extent to which concerns about regulatory arbitrage and potential risks to investor protection and financial stability could be properly addressed.

The securities supervisory authorities sought to increase coordination and cooperation through the creation of an association, the East African Securities Regulatory Authorities (EARSA) in 1997. In addition, the Capital Markets Development Committee (CMDC), consisting of chief executives of the regulatory authorities and security exchanges, was established in 2001. It is a standing committee of the EAC, making policy recommendations on regulation and integration of the capital markets. More recently, discussions have started on the potential creation of a regional supervisory authority.

The trading and clearing and settlement infrastructure in East Africa is still highly fragmented with four exchanges and seven CSD systems that are not yet interconnected. The goal is to make them interoperable.

Harmonizing Financial Reporting to Promote Regional Integration and Growth

Effective financial reporting frameworks based on international standards generate reliable and transparent information needed for integration of regional financial markets and growth.

OVERVIEW:

Transparent, reliable, and comparable financial reporting enables investors and lenders to identify viable opportunities to offer financing, and also helps companies obtain financing on reasonable terms. Improving the quality of financial information and increasing its acceptance and use are key to addressing one of the greatest impediments to growth for small and medium sized enterprises (SMEs) in the region, namely the lack of affordable financing without excessive collateral requirements. Effective implementation of international accounting standards will help broaden financial markets and improve access to finance from regional and global sources. It will also help assure reliable information for financial market supervisors, bank regulators, and tax authorities, and support insolvency mechanisms and creditors' rights. In addition to promoting financial transparency, accountants can become skilled business advisors to help SMEs overcome common challenges to growth. Regional cooperation and knowledge-sharing can help countries address these common challenges.

Benefits of Economic Integration – Evidence and Global Experience

Financial reporting based on international standards and requirements – including the EU Accounting Directive, IFRS and IFRS for SMEs – is critical for regional integration, access to finance and growth.[1] Adopting shared and internationally recognized financial reporting frameworks across the Western Balkans will enhance transparency and comparability of corporate financial information, making it easier for businesses to expand their operations across the region and to the wider European markets. The credibility provided by sound financial reporting gives banks and other providers of external finance the confidence to move beyond purely collateral-based lending toward reliance on reported financial performance and cash flows, thus widening access to finance and reducing its burdens. For SMEs seeking venture capital finance, reliable financial reporting standards can reduce the barriers to investment.

Alignment with EU and international good practices will improve the investment climate and promote economic integration and financial stability. For businesses from the Western Balkan countries, alignment of financial reporting frameworks with EU requirements set forth in the EU *acquis communautaire* and good international practice is critical for legal approximation with EU norms. Alignment with

[1] International Financial Reporting Standards (IFRS) guide how particular types of transactions and other events should be reported in financial statements. IFRS were established in order to have a common accounting language, so business and accounts can be understood from company to company and country to country, and are applied in around 140 countries; they are primarily designed for listed companies and other public interest entities. IFRS for SMEs covers the accounting of all small and medium-sized companies' transactions.

international standards also creates preconditions for improved financial reporting at the corporate level to meet the needs of investors, lenders, trade creditors, and business owners. Furthermore, alignment leads to more effective regulation, including improved banking regulation for financial stability, as well as regulatory simplification, including a reduction in the burden of tax compliance.

A regionally integrated accountancy profession plays a key role in improving SMEs' financial management and access to finance. To manage finances successfully, make sound business decisions, and engage with investors and lenders, SMEs need solid financial information, analysis, and a seasoned perspective. The accountancy profession can provide assistance to SMEs both for compliance-related issues and for financial management challenges and beyond. Trained at the university level, licensed by the profession based on international requirements, obligated to continuous professional development, and overseen by a public oversight system, accountants can provide services to SMEs that support enterprise performance, profitability, and growth. Regional cooperation, mutual recognition of qualifications, a regionally harmonized university curricula and university programs with international recognition, as well as a continuous professional development in line with international best practices can help build the profession's capacity and create opportunities to support business clients across the region.

Key Challenges for Western Balkans Regional Economic Integration

SMEs do not always provide reliable financial information, which hinders their prospects for borrowing and attracting investors. SMEs are traditionally viewed by investors and banks as opaque[2] and have a high level of informality in the Western Balkans. SME owners sometimes do not trust banks and tax authorities, which may impede their commitment to transparency. This sometimes leads to financial statements that do not capture all activities of the company and limits access to finance, other than from family investors. Banks and investors are left to rely on heavy collateralization and extensive due diligence, among other burdensome means to assess financing prospects, which reduce availability of financing. During the financial crisis, banks seized collateral provided by business owners, and the trauma from that period continues, creating reluctance for some business owners to disclose all of their business activities.

Legal alignment with EU norms and international good practice is underway but requires continued efforts. All countries still need to further align their accounting and auditing frameworks with the new EU *acquis.* The new Accounting Directive (2013 – implemented in the EU in 2015) and the new Audit Directive and related Regulation (2014 – implemented in the EU in 2016) present significant challenges for effective implementation. Inspections of audit quality and quality assurance for auditors of Public Interest Entities (mainly banks, insurance companies, and listed companies) must be shifted from professional accountancy organizations that were already reviewing audits to other entities – audit public oversight bodies – that typically have little or no capacity. The new Regulation enhances independence of audit oversight but requires major efforts to build appropriate institutions and capacity.

Financial supervisors often lack sufficient capacity to monitor, probe, and respond to financial information provided by regulated entities. Financial supervisors in the region often lack necessary skills to review the quality of financial statements of supervised entities in the banking sector, the insurance sector, and on equity markets. Efforts are underway to

[2] Global Financial Development Report 2014: Financial Inclusion

strengthen supervisors' skills and enhance the necessary cooperation between auditors and supervisors, but more work remains. Regional cooperation and knowledge-sharing can help raise capacity.

Significant investments are needed to raise the quality of education systems and the capacity of the accounting profession. Universities and professional accountancy organizations (PAOs) need to cooperate more and move away from a classic education framework to a competency framework to ensure students move smoothly from a tertiary education program to professional education and on to the labor market. A broader and deeper integration with the countries of the European Higher Education Area would also help recognition of national education systems.

Priority Areas for Medium-Term Action

Priority Area 1: Adoption and implementation of international standards in accounting and auditing

Action 1.1: **Amend legal framework:** Harmonizing the reporting frameworks is a common objective of the Western Balkan countries, which will lead to regulatory simplification in line with the acquis and supports the business climate of the region. In particular, a harmonized approach for SME accounting frameworks that follows international good practice is encouraged; it will help reduce the regulatory burden on SMEs and improve the quality and reliability of reporting.

Action 1.2: **Build capacity:** Implementation challenges remain in terms of availability of standards in local language, application by the accounting and auditing profession, and enforcement by regulators. To address these shortcomings, capacity building activities organized at the region level help take advantage of economies of scale and boost harmonized approaches.

Action 1.3: **Enhance monitoring and enforcement mechanisms:** Monitoring and enforcement mechanisms in the region are still weak. Given the rather small size of the region's economies, collaboration frameworks for more effective monitoring and enforcement mechanisms should be explored to share capacity and expertise, ultimately leading to increased trust in financial reporting systems across the Western Balkans.

Priority Area 2: Raise capacity of the accountancy profession to support SMEs in financial management and compliance

Action 2.1: **Establish strong accounting education and continuous professional development**. The accounting profession transitions from a focus on basic bookkeeping services and audits to more advisory work in support of SMEs. Professional accountancy organizations (PAOs) across the region are encouraged to develop together specialized education and deliver it on a regional level as appropriate.

Action 2.2: **Support recognition of the profession to the benefit of SMEs.** The profession of the region is encouraged to adopt international good practice and seek recognition through membership in international associations, as appropriate. Regional business forums and other networking initiatives may support the establishment of functioning networks between the business community and the accounting profession leading to improved availability of business support services for SMEs.

Priority Area 3: Align financial reporting frameworks with EU requirements and international good practice

Action 3.1: **Align legislative framework with EU requirements.** All countries of the region aim to meet the requirements of the EU acquis communautaire. Working jointly through experience sharing and joint activities facilitates harmonized actions and policies.

Action 3.2: **Reduce regulatory burden for businesses and align financial reporting and tax reporting requirements.** The countries are encouraged to aim at taking all simplification options offered under the new accounting and auditing Directives.

Action 3.3: **Raise capacity of financial sector supervisors to use information of financial statements.** Sharing experiences, and building expertise across the Western Balkans for financial supervisors contributes to enhanced financial stability through better supervision processes.

Priority Area 4: Promote Regional Cooperation

Action 4.1: Promote Regional Cooperation and Knowledge Sharing. Working towards the common objective of EU integration, government representatives on both the senior and working level, the profession and other stakeholders are encouraged to seek opportunities such as conferences and learning events to share experiences and identify harmonized approaches.

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Strengthening Institutions for Regional Integration

Sound governance as a foundation for economic integration and growth and equity

***OVERVIEW**:*

Governance is key to effective economic integration in the Western Balkans as it underpins harmonization of revenue policies, effective cooperation in tax administration, and efficient deployment of limited public resource to strategic priorities that can boost growth and equity. Fiscal responsibility and transparency can support coordination of macro-economic policies. Joint efforts to strengthen the rule of law can play a critical role in facilitating private investment and development of regional markets. Converging around EU governance standards and policies in the economic integration would facilitate access to, and eventual absorption of, EU pre-accession funds. Improving governance systems, especially systems that facilitate improvements in service delivery—such as cross border exchange of skills—and those that enhance transparency and accountability in the execution of public policy—such as tax administration and public financial management—are important foundational actions with potential for system wide improvements.

Benefits of Economic Integration – Evidence and Global Experience

The empirical link between governance—the process through which state and nonstate actors interact to design and implement policies within a given set of formal and informal rules that shape and are shaped by power—and development has long been established (World Bank, 2017). A fundamental element of governance is the role of institutions—the "rules of the game"— in conditioning how these relations are organized. Indeed, most empirical studies have found that the quality of institutions is an important predictor of increased growth. While the direction of causality may vary at the country level, a foundational level of institutional quality is necessary for sustained economic growth. Realizing the promise of regional integration requires a region wide approach for strengthening these and policies around tax, fiscal transparency and regulatory frameworks.

A coordinated revenue policy is an important outcome of economic integration. It controls harmful competition caused by discretionary incentives and market distortions resulting from the shadow economy. Economic integration is important for coordinated efforts in combating the shadow economy through rationalization of tax policies, streamlining of revenue administration requirements to reduce cost of compliance, and regional cooperation of revenue authorities. Coordinated policy on incentives ensures that investment decisions are made purely on economic considerations and not on the basis of the tax inducements that can be obtained from one partner country over another. In addition, cooperation between the tax authorities helps address tax base erosion and profit shifting and enables effective information exchange and often joint efforts in mitigating revenue risks in cross-border transactions.

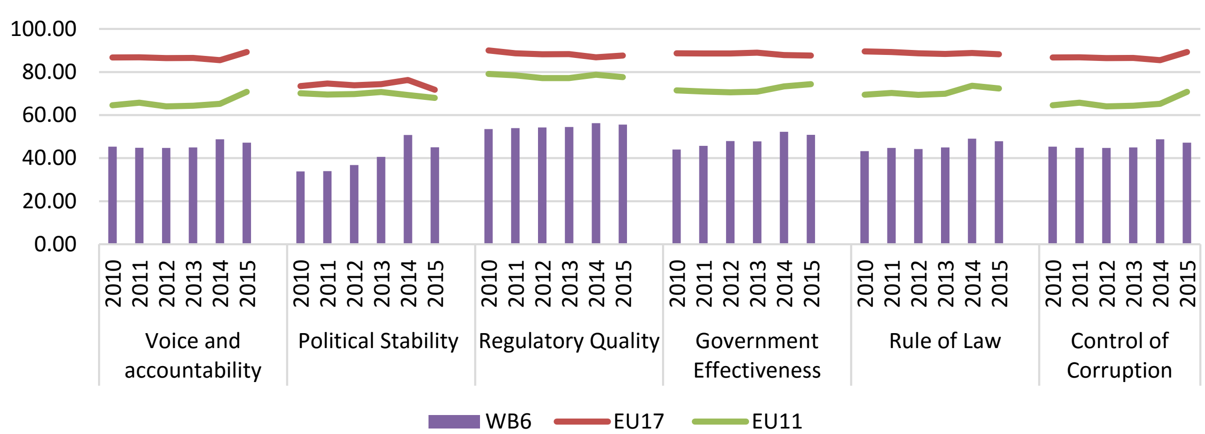
Standards for fiscal transparency and cooperation among ministries of finance is another favorable outcome of economic integration. A coordinated approach to fiscal transparency standards facilitates coordination of macro-economic policies and contributes to more comprehensive fiscal transparency which helps countries to improve credit ratings and provide better access to financing in international markets. The latter is particularly important for attracting private investment to support growth. Cooperation between the ministries of finance enables effective peer-to-peer learning and transfer of technological know-how, and thus often enables to achieve better and faster results in strengthening public financial management systems in partner countries. It also helps to effectively plan and implement public investments in projects that improve regional trade and transport infrastructure.

Focusing on governance as a centerpiece of regional integration would have positive spillover effects. The African Peer Review Mechanism, supported by the African Union, for instance, has empathized the development of region-wide governance targets and a system for reviewing progress towards these indicators. While there has been slow progress towards convergence, the very existence of such a system suggests that governance is thought to be critical to regional economic integration. An important feature of EU accession is the improvement of the governance environment. Recent emphasis on the "fundamentals first" approach implicitly calls for a focus on state building and strengthening the "infrastructure of the state" to perform its core functions. In this respect, the Western Balkan countries lag behind their EU counterparts in several governance indicators (Fig.1).

Key Challenges for Western Balkans Regional Economic Integration

The structure of institutions in Western Balkan countries is different. Countries have different traditions of public sector management; disparate bodies of laws governing business practices, including contract enforcement and insolvency procedures. Customs practices, tax regimes, and rules and regulations involving market accessibility for goods and services from neighboring countries are not harmonized. Across the region, administrative capacity is hampered by the lack of capacity, absence of merit based recruitment systems, and poor remuneration. Inadequate systems for policy planning and coordination and weak systems for performance management have hampered the monitoring and delivery of government commitments. In this context, integrating regional markets, developing a shared regional economic narrative and the visioning of a joint Western Balkan institutional structure to provide the foundation for a regional economic structure is an important challenge. Addressing these governance and institutional challenges are critical for the attainment of the vision of an integrated regional economic bloc.

Figure 1: Countries in the Western Balkan regions lag behind their EU counterparts in key governance indicators



Source: World Bank. 2016. World Wide Governance Indicators, 2016.

Economic integration will require cooperation on revenue policies to avoid competition. Cooperation on tax administration could provide a uniform environment for businesses, tackle the shadow economy, tax base erosion and profit shifting through cross-border transactions**.** The Western Balkan countries could harmonize tax systems and duties, including developing a coordinated policy of tax incentives and creating a level playing field for small and medium-sized enterprises in the regional market. Albania, Bosnia and Herzegovina and Kosovo would also benefit from aligning VAT regimes with the EU Six Directive which Macedonia, Montenegro, and Serbia have adopted as a foundation for their VAT systems. Modernization of the respective country tax administrations will be a prerequisite for a successful tax cooperation.

The challenge for economic integration lies on the ability of regional governments to efficiently marshal public resources to support regional strategic priorities and establish fiscal transparency standards that can facilitate private investment. This will require strengthening public financial management systems in the six Western Balkan countries. Efforts are required to tackle weaknesses in budget planning which result in poor links between policies and budgets. Moreover, public investment management remains disconnected from medium-term fiscal planning and budgeting. The countries also lack capacity for strategic planning thereby hindering proper estimation of public spending in support of regional integration and the Europe 2020 agenda. Weak commitment and expenditure controls are inadequate to support efficient and transparent budget execution. As a result, the quality of reporting is poor, treasury systems are fragmented and, in some countries, important elements such as unified budget classifications are still missing.

Individual countries in the region have improved the business environment through streamlining regulatory procedures and reducing burdens. The most ambitious efforts have taken place in the FYR Macedonia, Montenegro, and Serbia (OECD/EU/EBRD/ETF/SEECEL, 2016). However, a broader set of governance tools must be applied at the regional level to sustain a favorable regulatory environment, as well as to ensure accountability, predictability, and transparency in policy-making over time. The sub-region has made progress in the use of some regulatory governance tools, including regulatory consultation. Most countries also have provisions for mandatory Regulatory Impact Assessment (RIA), although Albania and BiH lack detailed RIA methodology and quality standards. Montenegro, FYR Macedonia, and Serbia all have dedicated regulatory oversight units, yet their opinions on RIAs are not binding (Vági and Kasemets, 2017). To improve competitiveness and ensure a well-functioning government, the countries should further strengthen their regulatory governance system, not only through legal and quality provisions, but also through measures such as performance agreements at ministry level. RIA could also be better integrated with strategic planning processes, not least in the context of the large implementation backlogs related to strategic documents, notably in regards to new laws.

Priority Areas for Medium-Term Action

Priority Area 1: Strengthening administrative systems to support economic integration

Action 1.1: Building on the Regional School of Public Administration, develop standard training programs and certification of public sector employees to facilitate the exchange of personnel to augment shortage of skills or expertise in neighboring countries

Action 1.2: Develop a list of binding region wide measures to be reviewed annually by peer countries to encourage collective absorption and implementation of agreed governance practices

Priority Area 2: Facilitating cooperation in revenue policy and administration

Action 2.1: Establish a regional peer-to-peer learning group and cooperation on cross-border transactions and combatting the shadow economy

Action 2.2: Support reforms to align revenue policies with EU, rationalize tax incentives, make revenue administration more efficient, and streamline administration processes to reduce compliance costs

Action 2.3: Establish an intergovernmental revenue policy coordination mechanism to address unhealthy tax competition, tax incentives, and smuggling activities

Priority Area 3: Enhancing fiscal transparency and cooperation in public financial management

Action 3.1: Establish a regional peer-to-peer learning group of ministries of finance to share knowledge

Action 3.2: Establish an intergovernmental fiscal transparency council to develop standards for fiscal transparency

Priority Area 4: Strengthening Regulatory Governance

Action 4.1: Deepen and accelerate knowledge exchanges and peer-learning on regulatory governance issues provided by institutions such as the Regional School of Public Administration as well as through informal networks of reformers

Action 4.2: Ensure regional regulatory cooperation in areas that can provide private sector with improved policy predictability across the region, such as the regional standards for public consultations on policies and legislation being promoted by the Regional Cooperation Council

Action 4.3: Develop a regional scorecard for Good Regulatory Practices, including proposed actions, to be reviewed annually by peer countries to encourage collective absorption and implementation of agreed good regulatory practices

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WESTERN BALKANS: Regional Economic Integration Issues Note No. 8

Justice Reform for Economic Integration

Improvements in court performance can improve the regional business climate

OVERVIEW:

Fostering a coherent regional approach to justice system performance could significantly improve the business climate across the Western Balkans. The countries of the Western Balkans are taking measures to improve the justice system, but their efforts are fragmented and citizens and businesses are yet to feel the results. Through coordination and collaboration, and with a regional commitment for the medium term, these countries could present themselves globally as region that is open for business, deserving of its place among EU member states as a place of trusted government and rule of law.

Benefits of Economic Integration – Evidence and Global Experience

The economic benefits for regions with effective justice systems are immense. Economies with effective justice systems – where courts can enforce contractual obligations and resolve disputes in a fast and fairly – demonstrate a higher level of economic development overall. Such economies generally have more developed credit markets, more rapid growth of small firms, higher levels of foreign direct investment, and more secure tax revenues. The firms operating in these economies are less likely to be informal and more likely to innovate, employ staff, engage in cross-border deals, and achieve economies of scale. Improving justice system performance at a regional scale can help to foster innovation, deepen regional integration, and improve the business climate for an entire region.

In the Baltic States, for example, a coherent regional approach to rule of law has fostered greater trust in government and a more conducive business climate. National judiciaries have collaborated with their neighbours to strengthen their respective justice systems. They have increased transparency, coordinated in cross-border matters, simplified processes to become more user-friendly, and harnessed ICT tools to deliver services to citizens and businesses across the region, including businesses that operate in multiple countries. Within a decade of sustained reform, the Baltic States now present a positive picture of a region that is open for business, with fast and fair courts that resolve disputes and uphold rights and obligations. From 2005 to 2016, the average Doing Business ranking for ease of contract enforcement in the Baltics jumped more than 15 places, and the gap between the best and worst performing economies narrowed, suggesting significant convergence. Across all rule of law indices, Baltic performance has been strong, particularly compared with Balkan averages.

In each of the Western Balkans countries, justice reform is a high priority, driven largely by the prospect of EU accession. Improving justice performance is a key pillar of each country's EU accession strategy. However, this external driver is not itself sufficient, and degrees of ownership vary among fragmented local stakeholders. There remains a tendency for policymakers in each country to check boxes and adopt the form of accession requirements, with less focus on how to make the system more user-friendly for citizens and businesses, so as to increase trust and satisfaction in institutions.

Western Balkans countries can exploit their common legal tradition to improve regional integration and the business climate. By improving justice, including in cross-border disputes, these regional synergies could open up more regional trade, improve diversification of financial markets and foster economic convergence. Through coordination, collaboration, and a coherent approach, it is possible to improve the business climate for the whole region, improve trust in government, and increase economic opportunities.

Key Challenges for Western Balkans Regional Economic Integration

Across the Western Balkans, justice systems perform at a far lower standard than their EU neighbours. While each country has its own legal system, but all of the countries in the region face common challenges in court performance, and share common legal and cultural traditions. Each of them is looking for ways to improve justice performance in line with EU benchmarks.

Challenge #1: Courts across the region are slow and inefficient. Arcane processes and procedures cause unnecessary adjournments and delays. Parties struggle to navigate a system that is both non-transparent and complex. In the resulting ambiguity, the more powerful parties commit procedural abuses that go largely unchecked. Old cases often go unattended—the resulting backlogs causing frustration for parties and courts alike. There are few mechanisms to fast-track small cases for micro and small businesses (MSMEs).

Challenge #2: The quality and integrity of justice is also a concern. The judiciary remains marred by perceptions of corruption and undue influence, and while performance in this area is improving, it lags far behind EU Member States and regional neighbors. Citizens and businesses complain of unpredictability in decision-making, which leaves them unable to make reasonable assumptions in business. Many courthouses across the region perform well and meet EU averages, but pockets of under-performing courts mar the perception of the rest. Rudimentary tools to standardize quality in service delivery, such as templates and checklists for routine procedures, do not exist. There are no regional professional organizations or structured training opportunities. There are isolated sites of innovation, often in courts outside of the capitals. Such innovations have been driven by personal initiatives or with donor support. Innovators have rarely been recognized and lessons from have not been shared in a systemic way or replicated in other courts or in other countries. As a result, gains have been fragile and have yet to instill systematic change in the region. The heterogeneity highlights the need for a more consistent and measured approach to strengthening the rule of law in the region.

Challenge #3: There are significant barriers to access to justice. Legal information such as consolidated legislation and court decisions is hard for lay people to find. There are few lay formats or guides that citizens and businesses can use to inform themselves of their rights and obligations, or represent themselves in negotiations or disputes, in or out of court. Online tools for accessing information or services are limited, which prevents people and businesses from engaging with the courts remotely. This acts as a barrier for cross-border businesses and discourages cross-border deals.

All this dampens the business climate of the region. For businesses that have cases before the courts, delays and inconsistencies in decision-making cause uncertainty, which directly affects their business operations. For businesses without cases before the courts, their fear of the courts deters them from doing deals or expanding operations. Fear also deters them from seeking justice when they have a dispute. Many businesses remain a small target – small or informal and unable to grow. When they have a dispute, they avoid the courts and negotiate as best they can with any information at their disposal in the shadows of the law. Ultimately, MSMEs suffer the most, as they are likely to have less power in any negotiation, and are vulnerable to abusive litigation by bigger players.

In recent years, Western Balkan countries have embarked on successive reforms which have caused much upheaval but produced limited improvements for citizens and businesses. In these reforms, countries have tended to repeat the mistakes of their neighbours, as there have been few opportunities for substantive peer exchange, structured dialogue and lesson learning. Meanwhile, simpler user-centric reforms such as business process simplification, basic ICT investments, rollout of online tools, closure of procedural loopholes, backlog reduction, and modernization of management and administration. Such innovations, which have been successful adopted by advanced judiciaries, and emerging regions, could generate a much higher impact for citizens and businesses.

Priority Areas for Medium-Term Action

Priority Area 1: Reduce barriers to information and empower citizens and businesses to know their rights and navigate the justice system (including remotely)

Action 1.1: Provide more and better information online, including access to laws, court decisions, and information on court procedure and court fees (including translations in English)

Action 1.2: Increase availability of online tools and services to support parties to navigate the justice system (including remotely), including electronic filing of claims, court fee calculators, online updates on the status of the case and video conferencing for hearings.

Action 1.3: Offer guides to self-represented parties to better enable them to know their rights and navigate the justice system, including checklists, video materials, and self-representation handbooks

Priority Area 2: Improve court efficiency in cross-border cases

Action 2.1: Improve mechanisms for the delivery of service of process and summons for hearings across countries in the region, to increase hearing predictability and reduce delays

Action 2.2: Tighten internal pre-trial and scheduling processes in courts to reduce the number of adjournments, and ensure the presence of witnesses, including expert witnesses to reduce delays

Action 2.3: Strengthen fast-track mechanisms for small claims cases, including cross-border small claims as required under EU law, so that small businesses can resolve minor disputes quickly and fairly through the courts

Priority Area 3: Develop a common approach to justice system performance improvement across the sub-region

Action 3.1: Engage in structured dialogue to share results of recent reform efforts, analyze lessons from previous reform failures, and cross-fertilize ideas and reform proposals

Action 3.2: Agree to a core set of indicators for justice system performance for the purpose of benchmarking and for presentation to the international/regional business community

Action 3.3: Foster positive competition, for example through a regional rewards program whereby judiciaries compete to reduce red tape, simplify processes, and offer user-centric services to improve the business climate

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Agriculture and Regional Economic Integration

Advance economic integration by transforming agriculture on and off farm

OVERVIEW:

Agriculture can play an important role in the economic integration of the Western Balkans both directly (as a primary sector) and through its forward and backward linkages to the rural economy (through the agri-food system). Economic integration can drive the modernization and competitiveness of the sector by exploring comparative advantages in the output base, the natural resource endowments, value addition, and human capital of the countries. However, the potential benefits of integration are not immediate and careful actions would need to be taken to enable them across the agri-food system and the rural economy.

Benefits of Economic Integration – Evidence and Global Experience

Economic integration can support the development of economies of scale in the region that each country can not provide alone given its size and the size of the majority of the productive units in rural areas. To capitalize on this regional economy of scale, countries will need to develop a set of necessary conditions, such as institutional coordination to ensure continuous volumes of production, uniformity of food quality standards, and monitoring mechanisms to be able to respond to market demand, hence developing a complex delivery mechanism of agricultural products.

Economic integration can stimulate comparative advantages in agricultural production and can support the modernization of the sector by improving specialization and focus on delivery of quality and volume. Integration can also redefine the spatial composition of agricultural production and contribute to the development of supporting services off farm, such a processing and value addition, hence strengthening the underlying value chains and the rural economy. This is important for the overall competitiveness of the sector on and off farm.

Economic integration can change the patterns of labor mobility currently observed in the region. Instead of migrating out of rural areas and into urban areas, agricultural producers can move to other rural areas motivated by specialization and demand for specific skills. Retraining and the development of specific skills will be necessary to respond to demand on, but mostly off farm, along the agri-food value chains that can benefit from increasing tourism in the region and cross-border trade. Different jobs can be created across the continuum of the region and the continuum of the agri-food system, where some remain on farm, while others develop off farm to cater to the supply chain. These processes could lead to shifts in labor market composition with more women exiting informality and engaging in the formal agri-food sector.

Economic integration can facilitate information flows that improve resilience and competitiveness of the productive sector and drive innovation. Regional information systems for tracking agricultural production, traceability and food safety, weather, commodity prices, and other important variables can improve the decision-making capacity of producers and enhance their competitiveness and resilience to external shocks. A common information system, as a public good, can benefit all producers and develop an exchange platform to support the modernization of the traditional extension systems and promote innovation on and off farm.

Key Challenges for Western Balkans Regional Economic Integration

Economic integration will inevitably lead to the formulation of comparative advantages in agricultural production that can shift production (and trade) patterns away from some areas/countries to others and can cause social discontent, despite aggregate efficiency gains. When the countries share similar geographic conditions, produce generally the same products, are small in size and have similar rural labor force dynamics, comparative advantages within the region, although economically beneficial, can be socially and politically difficult to reconcile. Preferences for local production can drive local protectionism within a regional economy.

Economic integration brings together a large number of heterogeneous production units, as well as producer knowledge and skills, **making it difficult to develop common policies that benefit all**. A transition period where incentive frameworks are provided for retraining, assessment of production potential vis-à-vis market demand, can reduce the limitations that the process can have in the rural space.

Effective mobility of rural labor, to align with comparative advantages in production across the region, **may be limited due to cultural and language differences**. The high average age of agricultural producers can also be a limiting factor of labor mobility within and across rural areas. Hence, mobility may be more system-wide, along the value chain, and less spatial.

Priority Areas for Medium-Term Action

Priority Area 1: Improving the competitiveness of the agri-food system

Action 1.1: Bringing knowledge to agricultural producers, using ICT, and incentivizing innovation, through the development of common, regional information systems

Action 1.2: Linking farmers to markets through public-private partnerships (productive alliances), including the financial sector

Action 1.3: The development of uniform food safety standards and mechanisms for monitoring their compliance

Priority Area 2: Improving the resilience of the agri-food system

Action 2.1: Develop country-specific climate smart agriculture profiles as means for identifying steps to reduce vulnerabilities to climate while improving production outcomes and supporting countries in their NDC processes

Action 2.2: Development and adoption of risk mitigating instruments, such as agricultural insurance, early warning systems, to response to exogenous shocks (weather, prices)

Priority Area 3: Reaping the job creating potential of the agri-food system

Action 3.1: Develop incentives for job creation along the value chain (retraining, support agri-food investments), benefitting rural employment but also creating linkages with urban labor markets, while reducing informality

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WESTERN BALKANS: Regional Economic Integration Issues Note No. 10

Regional Cooperation on Skill Development and Employment Policies

Developing a Regional Labor Market Observatory to inform labor market policies for enhanced economic integration

OVERVIEW:

The governments of the six Western Balkan (WB6) countries seek to increase competitiveness and employment levels of their national economies, while preparing for eventual integration with the European Union. Free mobility of people, or labor, is at the core of the latter. Given high unemployment rates across the region, governments want to tread slowly and should first build mechanisms to assess skill demand and supply—through a regional labor market observatory—and reform labor market policies, gradually removing constraints to labor mobility within and eventually beyond the region.

Benefits of Economic Integration – Evidence and Global Experience

Free mobility of labor across countries is a distinctive and desired outcome of economic blocs. The most successful cases of economic integration do not only have free trade of products and services, but also free mobility of productive inputs: labor and capital.

As the production of goods and services moves across space, the free movement of labor is needed to maximize the returns of new investments. Countries attract FDI to take advantage of local resources—including natural resources and labor/skills. These new investments may shift the demand of skills by firms. On one hand, some local skills may be demanded in higher proportions. On the other hand, there may be a need for skills that are not yet available in the country. For new firms to maximize productivity and thus the return on new investments, it is critical that the right skills for the technology available are both available and well used.

Free mobility of people is also important to avoid aggravating the problem of local unemployment. As the demand for skills shifts as a result of economic integration and the reallocation of production of goods and services across space, unemployment among those with skills that are no longer in demand will increase. In the short term, the impact of economic integration on unemployment will be cushioned if people are allowed to take up work in places where their skills are in demand, giving local skills some time to adjust to the new labor demand.

A regional labor market observatory could be the solution to reform labor market policies for enhanced economic integration, i.e., balancing the reality of high unemployment while preparing for increased mobility of people. The labor market observatory would include a body of researchers and policy makers that identify data needs, perform analysis, and communicate evidence to policy makers in each of the countries and in the economic bloc. This body could help coordinate country labor market policies to (i) prepare for free mobility of people across countries, (ii) maximize the benefits of economic integration, and (iii) manage unintended consequences of integration in national local labor markets (see priority areas for action).

Key Challenges for Western Balkans Regional Economic Integration

Labor markets in the WB6 countries are characterized by low employment rates and high unemployment. Governments are concerned that removing constraints to mobility of people will aggravate labor market challenges. Inactivity (40 percent in 2015) is especially high among women, youth, and people with low-education, and it varies from over 60 percent in Kosovo to 36 percent in FYR Macedonia and Albania. Unemployment (21 percent in 2015) ranges from over 25 percent in Bosnia and Herzegovina to 17 percent in Serbia, but all countries suffer from a high proportion of long-term unemployment – more than 70 percent of the unemployed are out of work for more than one year (World Bank and WIIW, 2017). Thus, mobility of people needs to be gradual to avoid generating shocks, and evidence on possible impacts needs to be built.

To date, there is no good measurement of the skills available in each country or the demand of skills by firms. The knowledge of the skills stock or the demand of skills in these countries is low (the World Bank has contributed to filling the knowledge gap in a number of WB6 countries through household and employer surveys, called Skills Towards Employment and Productivity (STEP) surveys). Western Balkan countries used to conduct occupational employment and wage structure surveys in the past, but they were discontinued. Some countries have recently restarted efforts to collect such data.

Also, there is no monitoring of migration flows or characteristics. Evidence of numbers and characteristics of migration flows is important for policy making and responding to mis- or uninformed statements about the benefits of mobility (e.g. the emotional debate on 'brain drain', or high-skilled migration). Establishing migration monitoring systems and conducting household surveys that transcend the frontiers in order to understand migration dynamics and characteristics become important. These structures take time to develop and to analyze, and thus countries should start developing them ahead of increased mobility.

To reduce unemployment, all WB6 countries are working on strengthening their public employment services (PES) and active labor market programs (ALMPs). Increasing coverage and effectiveness of labor market policies are national priorities in all WB6 countries, including focusing on key target groups, reducing disincentives to formal employment, and re-orienting training towards employer needs. While these policies are national at their core, inter-regional cooperation would support peer learning and possibly raise the bar. In addition, the countries in the region vary in their level of efficiency of PES and ALMPs. More consistent achievements will also contribute to reducing country unemployment.

Priority Areas for Medium-Term Action

While these actions are important for the regional integration of Western Balkan countries, they are also needed for integration with the EU.

Priority Area 1: Prepare for free mobility of people across countries

Action 1.1: Establish a regional labor market observatory composed of regional experts working on data collection, labor market analysis, and forecasting

Action 1.2: Support evidence-based policy making by collecting sound and harmonized data on local and regional skill needs

Action 1.3: Support evidence-based policy making by collecting sound and harmonized data on migration flows and characteristics (e.g. through the establishment of migration registries and expanding household and labor force surveys)

Action 1.4: Support regional coordination of national qualification frameworks/mutual recognition of qualifications

Action 1.5: Establish a high-level working group (including line ministries – interior, labor, education, etc.) that defines intended scope of mobility, level of liberalization, target group (e.g. sectoral approach based on qualifications/skills), and other relevant criteria (IOM and RCC, 2015)

Action 1.6: Develop mechanisms / instruments to alleviate the procedure of obtaining work permits and visas. Unrestricted mobility could be prioritized initially for certain professions/occupations where migration is of biggest need (e.g., health, construction, researchers) (IOM and RCC, 2015)

Priority Area 2: Maximize the benefits of economic integration through reform of national labor market policies

Action 2.1: Support employer-driven demand for life-long learning (e.g. through sector-wide training institutes, work based learning)

Action 2.2: Provide career guidance to youth and develop skill needs list to be used to prioritize work permits with help of data on local and regional skill needs (see action 1.2)

Action 2.3: Increase speed of filling job vacancies and quality of match by collecting data on local skill needs (see priority area 1.2) and by coordinating between public and private employment services across borders (see priority action 2.4)

Action 2.4: Rethink level of minimum wage with regard to WB6 and EU countries (e.g. minimum wage in Bosnia 70 percent of value added/worker) to reduce informality and increase job creation among low-skilled workers

Action 2.5: Improve the business climate to promote job creation and attract business. In particular, continue deregulating the labor market to reduce the cost of hiring and firing, and promote job churning

Priority Area 3: Manage unintended consequences of integration in national labor markets

Action 3.1: Target key group for support (youth, women, disability, and other minority groups) to reduce unemployment and inactivity

Action 3.2: Reduce disincentives to formal and informal work (e.g. delink unemployment and health insurance, improve design of social assistance programs)

Action 3.3: Increase use and improve efficiency of Active Labor Market Policies to increase the skill level of the workforce and employment, especially among hard-to-employ groups. This can also be achieved through increased knowledge sharing and coordination among Public Employment Services

Action 3.4: Introduce or improve portability of social benefits and pensions to allow returned migration

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WESTERN BALKANS: Regional Economic Integration Issues Note No. 11

Higher Education for Advanced Skills and Competitiveness

Using higher education to promote competitiveness through improved outcomes in teaching and research

OVERVIEW:

Countries of the WB6[1] share a range of challenges, which urgently need to be addressed in order to enable higher education and research to fuel the development of advanced skills, competitiveness, and growth of the countries of the region. Issues which require immediate attention include the governance of universities, the efficient use of funds and financing instruments, and transparency as a basis for productive steering of the sectors towards high quality teaching, learning, research, and innovation. Pooling resources strategically at the regional level—for example, through joint organization of quality assurance—will enable countries to find solutions to these challenges.

Benefits of Economic Integration – Evidence and Global Experience

"First...education increases the human capital inherent in the labor force, which increases labor productivity and thus transitional growth towards a higher equilibrium level of output... Second, education may increase the innovative capacity of the economy, and the new knowledge on new technologies, products and processes promotes growth... Third, education may facilitate the diffusion and transmission of knowledge needed to understand and process new information and to implement successfully new technologies devised by others, which again promotes economic growth."

Hanushek and Woessmann (2008)

Working together to lower costs and increase capacity: Today, higher education in the WB6 is delivered by a multitude of providers, including state and private institutions. Recent expansion, however, was primarily driven across low-cost/low-return subjects like social sciences and law. Fields like medicine and engineering remain cost-intensive, and financing high quality provision in all areas poses a significant challenge, especially for small countries. Regional cooperation and a smart specialization, including in teaching and learning, is of paramount importance to ensure high-quality higher education provision in the WB6.

Pooling talent and resources to maximize outcomes: There are significant advantages in pooling talent and resources in order to maximize outcomes in efficiently delivered

[1] "WB6 "or "Western Balkans 6" includes the following countries: Albania, Bosnia and Herzegovina, FYR Macedonia, Kosovo, Montenegro and Serbia. The "Berlin Process" launched in 2014 aims at enhancing regional economic cooperation and laying the foundation for sustainable economic growth across these countries. With a view to a shared history and current challenges in the sector, Croatia, as one of the key partner countries of the WB6, would be particularly well placed to be included in the proposed regional activities concerning higher education cooperation.

formats. Innovation can only be fueled if a critical mass of devoted academics and students, funding, and equipment is in place, which demands efforts going beyond the national level in the WB6.

Learning from the experiences of peer nations with a shared past: The countries of the region face a range of challenges in the higher education sector, including, but not limited to, governance of institutions, transparency, and efficient use of funds. Regional cooperation could promote a vital exchange of good practices, allowing countries to learn from different experiences (while taking a shared past and existing collaboration, for example in the context of the Bologna Process as a starting point) and find solutions to persistent problems.

Key Challenges for Western Balkans Regional Economic Integration

According to a recent IMF report, "The Western Balkans: 15 Years of Economic Transition", the priority areas for reform in the Western Balkans are: Improving the quality of governance, Increasing the efficiency of goods market, Labor market reform, Strengthening human capital, (emphasis added), and Deepening financial systems.

The Economist (2015)

Service industries are the main drivers of GDP improvement, but attention to provision of related skills has been inconsistent. As service industries gain prominence in the region, education and research must adapt to provide the skills necessary for all workers to fare well in the labor market. Generic (or 'transferable') skills have been identified as a key weakness among new graduates and the unemployed in the region, and post-secondary institutions can play a vital role in training youth in developing these skills (in addition to subject-specific knowledge and skills) and in providing lifelong learning opportunities for the re- and up-skilling of adult workers. The lack of advanced generic and technical skills affects the countries' competitiveness directly (via labor supply) as well as indirectly, as advanced skills are also needed to promote research and innovation.

Table 1: Western Balkans: value added by main sector of the economy, 2014 (% of GDP)

	Services	Agriculture	Industry
Albania	52.4	22.9	24.6
BiH	65.9	7.2	26.8
Kosovo	66.3	14.3	19.4
Macedonia	63.1	11.6	25.2
Montenegro	72.3	10.0	17.7
Serbia	60.5	9.3	30.2

Source: World Bank (The Economist, 14 March 2017).

The provision of advanced skills at the tertiary education level is hampered by quality issues and a lack of institutional efficiency. While enrollment rates have significantly increased during the last two decades, timely graduation remains a challenge and multiple employment of teaching staff and a lack of incentives for quality teaching and research negatively impact the quality of provision.

Underlying reasons for observed quality and efficiency issues lie in the current approach to higher education governance, financing and quality assurance. Fragmented universities with independent academic faculties lack the basic preconditions for institutional steering towards results (Linden and Arnhold, 2008). In many cases, there is a lack of quality data on the institutional and system level, resulting in little transparency concerning institutional performance and a related lack of incentives.

Priority Areas for Medium-Term Action

Priority Area 1: Sector and institutional steering

Action 1.1: Regional exchange on development of sector strategies and related legislative change. Many higher education sectors in the region suffer from a lack of strategic direction. Clear and focused sector strategies need to be developed and related legislative change introduced. WB6 countries need regional exchange and technical assistance to succeed in this process

Action 1.2: Regional exchange and technical assistance focusing on institutional governance reforms, in particular with a view on the functional integration of institutions (to be supported by financing reforms – see Priority Area 3)

Priority Area 2: Quality and transparency of provision

Action 2.1: A set of regional activities needs to be defined to help increase the quality of provision. This could include increased academic and student mobility and development of Centers of Excellence in teaching and learning (in coordination with related initiatives focusing of research and innovation, possibly within the framework of a regional Excellence Initiative which could be funded through the EC)

Action 2.2: Benchmarking of institutional performance through a set of regionally developed Key Performance Indicators (KPIs) – which could potentially be integrated with the EC-supported U-Multirank Project

Action 2.3: A regional initiative in support of external quality assurance (QA) – ideally resulting in a regional facility for QA. WB6 countries tend to be too small for an independent organization of external QA (accreditation, evaluations), which could thus be moved to the regional level. At a minimum, an increased exchange of information and experience in QA as well as capacity building of QA experts – in accordance with the European Standards and Guidelines for Quality Assurance (ESG) – could be supported

Priority Area 3: Setting incentives through performance-based financing

Action 3.1: Knowledge sharing and Technical Assistance for higher education financing (HEF) reforms: As recent initiatives of the World Bank have shown (e.g. a related regional high-level event on HEF in Kotor, Montenegro in April 2017), there is an enormous need for information and knowledge sharing on HEF topics. This should be facilitated at the regional level

Action 3.2: The KPIs to be developed under 2.2 could serve as a basis for piloting performance-based financing (PBF) in countries advancing with related reforms. While HEF will continue to be driven by national agendas, comparing the experience of countries advancing with related reforms will create clear benefits

Action 3.3: Either alternatively or in addition to 3.2, EC funds could support the creation of a regional pool of competitive funds, supporting activities as those mapped out under 2.1 as well as 1.2, as financing incentives might leverage for institutional integration

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Developing an Open and Integrated Research and Innovation Area

Towards a more efficient regional innovation system for growth and job creation

OVERVIEW:

Promoting economic growth and job creation in the Western Balkans requires a shift toward a more productivity-based, export-oriented growth model in which research and innovation are essential components. Yet, research and innovation systems in the region – characterized by weak research performance, poor collaboration between science and industry, and an inadequate governance regime – are essentially dysfunctional. Working towards a Western Balkans Regional and Innovation Area would contribute to changing this situation by (1) strengthening the overall governance through the adoption of EU type of progams, policies, and institutions, (2) enabling better use of available human, capital, and financial resources by avoiding fragmentation and redundancy – including through smart specialization, and (3) creating a platform for continued promotion of policy reform at national level.

Benefits of Economic Integration – Evidence and Global Experience

There is growing awareness worldwide about the role of innovation for economic development. The EU has been at the forefront of this approach, promoting the development of the European Research Area and urging member-countries to spend more and better on research and innovation as a way to foster economic growth and create job opportunities.[1] As Western Balkan countries seek to shift their growth pattern to a more productivity driven and export-oriented approach and generate employment opportunities, especially for the youth, focusing on improving the impact of research and innovation can pay important dividends. For example, innovative firms in the Western Balkans have been found to grow 15 percent faster (in sales) and 8 percent faster in labor productivity than non-innovative firms.[2]

Open regional integration in the area of science and innovation can generate important efficiency gains. As with trade specialization, specialization of research on areas with scientific comparative advantages can increase research productivity and promote a better allocation of resources – from human capital to research infrastructure. An open regional approach to research and innovation is particularly important to enable economies of scale to happen, avoid duplication of investments, and fragmentation of resources. It is also more consistent with the region's smart specialization – as comparative advantages are not bounded by political frontiers.

A common legacy of unfinished reforms and a common strategic goal – integration with the EU – facilitate the development of an open research and innovation area in the Western Balkans. As national reform agendas tend to be similar, peer to peer learning and peer

[1] See for instance, the innovation strategy for the European Union set in the policy plan "Innovation Union", an initiative within the Europe 2020 Strategy.

[2] Seker (2013). Firm R&D expenditures significantly contribute to sales (by 14 percent) and labor productivity growth (by 7 percent).

pressure may help to advance the national reforms. Supranational agreements around this common agenda can help to mitigate the risk of reform reversal. Built around the regulatory and institutional reforms framed by the EU accession process, a **'Western Balkans Research and Innovation Area'** would foster regional economic integration while at the same time deepening the integration to the European Research Area (ERA) and the EU Innovation Union.

Key Challenges for Western Balkans Regional Economic Integration

Recent efforts integrating research and innovation in the Western Balkans

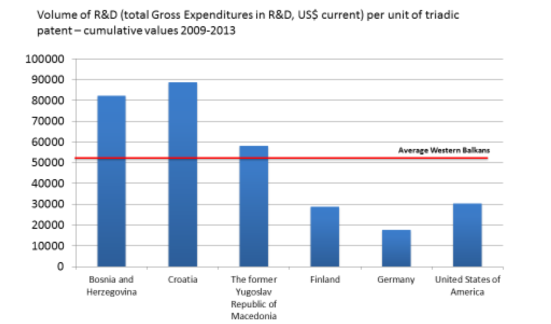
Western Balkans' efforts to integrate into the ERA and build strong cooperation in research and innovation are not new, and several of them have been funded by the EU.[1] Among those, the Joint Statement of the Ministerial Conference of Sarajevo in 2009 was particularly relevant because countries committed to developing a regional strategy on research and innovation.[2] This strategy was then prepared between 2011-13 and subsequently endorsed by all Western Balkan ministers of science and education in October 2013.[3] The *Strategy* – a combination of detailed common policy actions and selected joint regional programs (investments) – is currently struggling to be implemented, due to pending ratification from some of the participating countries and lack of funding.[4]

The legacy of unfinished reforms[5]

Transition to market-economies during the 1990s led to the deterioration of the research systems, which in several cases was extremely severe. Research and innovation systems in the region (i) generally lag behind in terms of research-excellence, (ii) show weak 'linkages' with the economy – both in terms of technology transfer and broader collaboration with the enterprise sector, and (iii) suffer from inadequate mechanisms for policy coordination, monitoring, and evaluation. In short, research and innovation systems are relatively inefficient, unfit to promote growth and job creation. Figure 1 illustrates the low productivity of the region's research and innovation system in terms of amount of R&D investment required per patent obtained.

Input and incentive-related factors help explain such performance. On the one hand, funding for research has declined and became unstable in most countries. A large number of qualified researchers emigrated since the mid-90s and research infrastructure deteriorated. Linkages between research institutes and state-owned enterprises were eliminated after the market reforms, eliminating an important

Figure 1: Low R&D Efficiency in the Western Balkans



[3] Those experiences include the *FP6 Southern European Research Area (SEE-ERA.NET)* and the *FP7 WBC-INCO.NET* projects. The Western Balkan Enterprise and Innovation Facility (EDIF), the European Investment Bank and the European Bank for Reconstruction and Development, among others, are funding regional initiatives on innovation.

[4] Regional Cooperation Council (2009).

[5] The technical assistance was implemented by the World Bank and funded by the European Commission in coordination with E.C., the Regional Cooperation Council and government officials from Albania, Bosnia and Herzegovina, Croatia, Kosovo, Macedonia, Montenegro, and Serbia (the Project Steering Committee). This team was joined by representatives of leading universities, research institutes, and the business sector (the Advisory Body).

[6] So far Albania, Croatia, Bosnia and Herzegovina, and Montenegro had the initiative ratified.

[7] This section is based on diagnostic studies prepared under the Western Balkans Regional R&D Strategy for Innovation Technical Assistance (TF0716310). For more details see World Bank (2013).

source of funding and demand for services in those public research organizations. On the other hand, the lack of prioritization further fragmented the use of already scarce resources. The inadequate application of meritocratic rules to access to research funding, research infrastructure, and opportunities for career development further encouraged emigration of young and talented researchers. Policy disincentives, such as the predominance of block/institutional (as opposed to competitive) funding coupled with limited autonomy of public research organizations, severely discourage research excellence and collaboration with the enterprise sector.

The way forward: Sustaining national reforms, while building a well-functioning open regional innovation system

The proposed way forward consists of a 'two-pronged' approach. It combines the promotion of policy reforms at national level and joint investments in selected regional initiatives. *Policy reforms* must improve the impact of research and innovation on economic growth and job creation in the long run. *Regional investments* must finance regional programs and institutions that could help create a well-functioning, open regional innovation system – including a platform for coordination and advancement of the Western Balkans Research and Innovation Area.

Priority Areas for Medium-Term Action

In order to advance the creation of a Western Balkan Research and Innovation Area, a first step could be to have the existing *Strategy* ratified or revised by the countries from the region. This includes ratifying or reviewing (i) the established priorities in terms of common policy reforms and joint regional programs, and (ii) the mechanism for coordinating its implementation – currently a platform called WISE (Western Balkan Research and Innovation Strategy Exercise).

Those regional initiatives should not replace the national reforms agenda nor underestimate the regulatory changes necessary for the development of a regional research and innovation area. Yet, a regional agreement can serve as credible commitment mechanism for the development and sustainability of reforms at national level. Moreover, by introducing stability of funding and meritocratic allocation of resources – while enabling economies of scale and a results-orientated focus – the regional programs would be a pragmatic, albeit limited, way to jump-start innovation and improve the impact of research investments in the Western Balkans.

Those policy reforms have been detailed in World Bank (2013) based on a consensus building exercise and an analysis of the research and innovation systems in the region. In World Bank (2013), a series of concept notes for each of the regional programs is presented, describing the governance structure of the programs, proposed operational procedures, eligibility criteria, as well as expected outcomes, outputs, and costs. The next section illustrates some of those actions which, subject to the renewed consent of government authorities and inevitable update for the development of the last three years, provides a good starting point for the development of the Western Balkans Research and Innovation Area.

Priority Area 1: Improve the Research Base and Conditions for Research Excellence

Action 1.1: Advertise all new research positions in the EU portal EURAXESS

Action 1.2: Further facilitate the issuing of visas for researchers from the regions

Action 1.3: Strengthen merit-based recruitment and career progression in line with the European Charter for Researchers and the Code of Conduct for the Recruitment of Researchers

Action 1.4: Develop a **Regional Research Fund** as a stable and meritocratic source of competitive grants for collaborative research within the Western Balkans, possibly emphasizing collaboration with the scientific diaspora in key scientific domains and participation in the EU Framework Programs

Priority Area 2: Promote Research-Industry Collaboration and Technology Transfer

Action 2.1: Define a common regional infrastructure roadmap

Action 2.2: Adopt the principles of the European Strategy Forum on Research Infrastructures (ESFRI) for management, funding, and access policies of research facilities

Action 2.3: Reform the intellectual property regime of publicly funded research to improve certainty

Action 2.4: Reform career progression rules to encourage science-industry collaboration and academic entrepreneurship

Action 2.5: Establish a program for the development of **Regional Centers of Excellence/Research Networks** with the participation of the private sector, when possible, and focused on priorities associated to the region's strategies for smart specialization

Action 2.6: Establish a **Regional Technology Transfer Program** composed of technical assistance for technology transfer organizations and a regional fund dedicated to proof of concept and prototype development for regional ventures

Priority Area 3: Enable Business Investments in Research and Innovation and in the Creation of Start-Ups

Action 3.1: Review and harmonize the regulation of early-stage funding (venture capital) according to EU regulations

Action 3.2: Adopt a **Regional Investment Readiness Program** to help generate 'investment-ready' projects for early stage investors

Priority Area 4: Strengthen the Governance of Research and Innovation Policies, including for regional cooperation

Action 4.1: Improve the quality and availability of R&D statistical system in the countries

Action 4.2: Coordinate donor funding for research and innovation activities

Action 4.3: Establish a regional program with clear goals, outcomes and motioning indicators to be implemented

Action 4.4: Establish a routine of peer-to-peer learning for policy authorities of both research and innovation areas to reduce fragmentation and sylos-like approach

Action 4.5: Establish and fund a **Regional Platform** to foster regional integration

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Gender and Equity in the Western Balkans

Integrating for effectiveness through enhancing equity in the Western Balkans

OVERVIEW:

Making opportunities available to all groups in society, including women and the youth, requires an equitable provision of services and access to markets so that individuals can engage productively in society. Going beyond country-level efforts, the challenges governments face in achieving equity goals can be tackled more effectively if policies are designed in an integrated way following a regional approach. Integration allows economies of scale to materialize and takes advantage of strategic complementarities in helping people build their human capital, access to assets, resilience, and economic opportunites. For example, labor markets can work more effectively and make investments more attractive, potentially boosting employment. Credit and insurance markets are more efficient at larger scale. Education policies can promote regional learning and knowledge sharing. Investment in public goods yields higher social and economic returns.

Benefits of Economic Integration – Evidence and Global Experience

Promoting equity in access to economic opportunities is important to improve regional social cohesion and enhance economic growth prospects for the Western Balkans.[1] A **regional approach to the equity agenda** can enhance policy effectiveness, providing gains beyond the country-specific agendas by allowing economies of scale to materialize and taking advantage of strategic complementarities. For the Western Balkan countries in particular, given relatively small domestic markets, economic integration and integrated policy design can help create stronger and more sustainable economic opportunities for the region and its people.

Specifically, more integration can generate synergies by helping countries coordinate the right investments to create a capable and healthy workforce, maximize the use of their human capital, increase the scale for credit and insurance markets, and attract investment to the region that can increase economic production and job opportunities. A regional approach can also support these countries' common objective of EU accession: in particular, gender equality, including in employment, is a core principle for Member States, and obligations related to non-discrimination need to be fulfilled by accession countries.[2]

The benefits of regional integration for an equity agenda can materialize in very concrete ways:

- **By boosting growth prospects, job creation and entrepreneurship through economies of scale** from greater integration of factor and product markets. The experience of countries of Central and Eastern Europe (CEE) region in the European Union highlights the benefits of integration for growth and convergence.[3]

- **By promoting diffusion of ideas as well as regional learning and knowledge sharing** for promoting entrepreneurship, research and innovation, and on good practices and successful interventions to

[1] World Bank (2005), Bussolo and Lopez-Calva (2014).
[2] Burri, Susanne and Sacha Prechal (2010).
[3] Rapacki and Prochniak (2009).

address inequalities in access to opportunities – given the commonalities in the underlying drivers of these gaps. For instance, the OECD Regional Programme for Latin America and the Caribbean, launched in 2016, is a good example of a regional initiative that aims to promote strategic policy dialogue, and diffusion of knowledge and good practices in areas of increasing productivity, advancing social inclusion, and strengthening institutions and governance.[4]

- **By promoting regional coordination and investment in public goods** to tackle common challenges in areas such as regional connectivity, skills, migration, health and climate risks, that can yield benefits for all countries and that can benefit excluded groups in particular. Regional coordination in policy and institutional frameworks can also signal stronger commitment and credibility to foreign investors. The Master Plan on ASEAN Connectivity (with a regional financing scheme), the Strategic Action Plan for SME Development (including business regulations, regional benchmark for SME credit rating methodology), the ASEAN Qualifications Reference Framework and agenda for free flow of skilled labor are examples of such regional policy coordination and investment.[5]

Key Challenges for Western Balkans Regional Economic Integration

While countries in the Western Balkans have made progress in promoting equity, certain groups, in particular women, remain disadvantaged in accessing basic services, assets or labor market opportunities. Important gender gaps in favor of men remain in labor force participation, employment, entrepreneurship, and land/property ownership,[1] and nearly every third young person in the Western Balkans is detached from jobs or education (every sixth in the EU).[2] Furthermore, low-income households and ethnic minorities lag behind considerably on indicators such as preschool attendance, literacy, and access to jobs. [3]

Inequity can be costly: it can substantially impair certain groups' upward economic mobility prospects, as well as the economic growth potential of the region. Specifically, differences in labor market activity rates between men and women are estimated to lead to potential economic losses of around 18 percent of GDP on average in the countries of the Western Balkans, and as high as 28 percent in Kosovo.[4] Similarly, prevalent unemployment of youth across the Western Balkans can have long-lasting effects since joblessness at a young age tends to delay or prevent the accumulation of valuable on-the-job skills, translating into lower productivity and human capital accumulation for young workers later in life.[5] Population aging in most of the region adds further urgency to the need for more participation of all groups in the workforce.

Priority Areas for Medium-Term Action

An agenda for promoting equity in access to economic opportunities in the Western Balkans region, alongside efforts to boost job creation, needs to focus on removing the barriers and disincentives that certain groups face. Some countries in the Western Balkans are updating their legal frameworks to promote gender equality, and taking measures to improve monitoring systems related to gender. In addition, the

[4] For details, see https://www.oecd.org/latin-america/regionalprogramme/

[5] ASEAN Integration Report 2015. http://www.asean.org/wp-content/uploads/images/2015/November/media-summary-ABIS/ASEAN%20Integration%20Report%202015.pdf

[1] World Bank Policy Notes for the Western Balkan countries on Women's Access to Economic Opportunities (forthcoming).

[2] World Bank (2016).

[3] According to the Roma Survey, Roma women in Serbia, have a much higher unemployment rate (67 percent) than their non-Roma female counterparts (37 percent), the gap between Roma and non-Roma men is smaller, but still significant (39 and 21, respectively).

[4] Cuberes and Teignier (2015).

[5] World Bank (2016)

Western Balkans countries are committed to a *Positive Agenda for Youth* inclusively through the Regional Youth Cooperation Office (RYCO). Yet, this effort needs to be expanded to include an agenda for providing equal economic opportunities for women, ethnic minorities, and other disadvantaged groups.

Priority Area 1: More inclusive labor markets

Action 1.1: Improving access to assets and productive inputs, such as land and credit, for excluded groups, including women, so as to boost the entrepreneurship potential of the region

Action 1.2: Improving access to child and elder care, particularly relevant for young women

Action 1.3: Removing disincentives and barriers embedded in labor taxation and regulation that can limit job opportunities for some groups, particularly low-wage and part-time workers, women, and youth

Action 1.4: Increasing employability of women and the youth through effective active labor market policies and adequate education and training [6]

Priority Area 2: Cross-sectoral policy efforts to improve information and knowledge sharing

Action 2.1: Establishing regional mechanisms for knowledge sharing to promote entrepreneurship, research and innovation, and cross-country learning of good practices and successful interventions to address inequalities in access to opportunities

Action 2.2: Improving regional monitoring and evaluation across the dimensions of access to economic opportunities, and disaggregated by group, to assess progress and identify areas in which policy efforts at the country and regional levels should be increased. For example, increased access to information that help inform schooling and labor market decisions, and monitoring of compliance with current legislation against discrimination can improve the functioning and inclusiveness of the region's labor market

Action 2.3: Coordinating policies to tackle discrimination and influence social norms that limit opportunities for some groups, particularly women

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[6] Arias et al (2015); World Bank (2016).

Regional Broadband Infrastructure

Utilizing existing assets versus constructing new ones

OVERVIEW*:*

WB6 countries agree that regional broadband connectivity is patchy and needs to be developed further. Rather than constructing new broadband infrastructure, commercialization at a regional scale of already deployed and spare fiber optic assets along electricity transmission operators' (TSOs) grids in the Western Balkans (WB6) provides a unique opportunity for economic integration within the region and with the global digital economy. This is a real opportunity for beneficial collaboration for national TSOs and the WB6 Governments, but implementation requires a truly regional dialogue and agreements.

Benefits of Economic Integration – Evidence and Global Experience

Regional integration is one of the instruments to overcome socioeconomic challenges facing the WB6. Because of their significant size, integrated regional markets create economies of scale, thus more easily attracting Foreign Direct Investment (FDI). Regional cooperation is also important because it can help create regional supply chains (or more easily gain access to global supply chains), reduce vulnerability, and increase resilience to external shocks of each economy involved.

As it was documented by the *World Development Report* (WDR) 2016 *on Digital Dividends,* the internet is both a subject of cooperation and a new tool to facilitate cooperation in other realms. Unlike any other infrastructure, the internet is a truly global network connecting all of the nations and continents into a seamless global digital economy, offering vastness of new opportunities for governments, private companies, and individuals. If there is one infrastructure that has the potential to interconnect those three groups of stakeholders in and between WB6, it is definitely the internet. Digital cooperation opportunities offered by internet connectivity are tremendous. For example:

a. The internet facilitates more cross-border exchanges of goods and services, allowing consumers and businesses to bypass national borders. Moreover, the internet intensifies trade by enabling more products to be exported to more markets, often by newer and younger firms. Overall, a 10-percent increase in internet use in the exporting country is found to increase the number of products traded between two countries by 0.4 percent. A similar increase in internet use of a country pair increases the average bilateral trade value per product by 0.6 percent.

b. The rise of online job marketplaces is accelerating the integration of developing countries into world markets, by supporting job creation and increasing worker productivity. The ability of internet to reduce transaction costs increases opportunities for those who face constraints in finding jobs or productive inputs. This promotes inclusion of women, people with disabilities, and those living in geographically remote areas. Impact outsourcing brings internet-based jobs to the poor and vulnerable.

Broadband internet infrastructure in WB6 does not reach all households, businesses, and public institutions. Regional interconnectivity is patchy.

Average penetration of broadband in the region stands at ~60 percent (v. near universal coverage in EU-28)[1], and its growth is stagnating from 2011.[2] High investments for broadband deployment, consisting at 70-80 percent of costly civil works and lengthy permit granting procedures, present the main constraints to the development of national or regional broadband connectivity. This is a conclusion echoed by private and public telecom sector stakeholders in WB6.[3] To "develop regional broadband infrastructure to provide high-speed internet access" is thus one of the goals set forth by the South East Europe 2020 (SEE2020) strategy.[4] Delivering on this goal means looking into the opportunities to set up a new regional backbone network.

There is a strong opportunity to capitalize on investments already made via the extensive (~14000 km) fiber optic network laid out in the region by TSOs. The vast majority of newly-constructed and some legacy energy infrastructures in WB6 have fiber optic cables installed in parallel to electricity transmission grids.[5] Those cables are interconnected within WB6 and with all the neighbouring countries (Greece, Croatia, Bulgaria, Hungary, and Romania). These fiber optics assets, when not opened for sharing, are usually used for only 5-10 percent of their existing capacity, mainly for internal energy distribution network control and monitoring purposes. Because these assets are underutilized, part of the capital and operational expenditure related to their installation and maintenance is transferred to end users. This capacity could be utilized regionally and offered jointly by WB6 TSOs to telecom operators on a commercial basis, generating additional revenues for TSOs.

Sharing of infrastructure between energy and telecommunications sectors will reduce the costs of telecom services, benefitting the greater public and the environment. By reducing the necessity for costly civil works and lengthy permit granting procedures, telecom operators

would be able to deliver their broadband services at lower costs and considerably faster. At current state of play, high costs and delayed broadband service provision is assumed by the regular broadband subscriber. By reducing the number and scope of civil works projects, infrastructure sharing mitigates potential disruption or displacement of economic and social activities, population relocation or displacement, health and safety risks, and negative environmental impact.

Infrastructure sharing would provide TSOs with new sources of revenues and new business opportunities for growth. Utilization of existing or spare assets would allow for avoiding unnecessary and costly investments and duplication of infrastructure. It is clear that such an economic integration opportunity needs to be carefully assessed. The World Bank is conducting a preliminary analysis that scopes out the demand, estimates supply, and identifies actionable recommendations on whether and how such regional infrastructure could be commercialized jointly by WB6 Governments. The particular advantage of the regional approach is the scale – a big enough pool of capacity and coverage would attract more clients and create bigger business opportunities that would be otherwise unreachable for separate countries.

Key Challenges for Western Balkans Regional Economic Integration

Achieving collaboration and agreements among TSOs on the conditions of infrastructure commercialization are perhaps the most challenging aspects for such an economic cooperation. The only truly regional fiber optic infrastructure in WB6 belongs to the energy sector and its

[1] European Digital Progress report, European Commission, 2016
[2] Telegeography, 2016
[3] Conclusions from World Bank meetings with ISPs in all WB6 countries, April 2016
[4] http://www.rcc.int/files/user/docs/reports/SEE2020-Strategy.pdf
[5] Containing from 12 to 96 fibers; part of existing and/or planned optical groundwire (OPGW) installations

commercialization, for the purposes of the telecom sector needs lies within the hands of TSOs – national energy sector incumbents. Regulatory frameworks will need to be reformed to permit such asset sharing, and TSOs' concerns about the grid security and revenue accounting have to be addressed. In addition, organizational structures of TSOs may need to undergo changes to facilitate the commercialization of the excess fiber optic assets. Informing the decision-making process and securing political support for such an initiative within the energy sectors in WB6 would be key to enabling establishment of a regional broadband backbone network over energy transmission grids.

Beyond reaching commercial agreements, WB6 TSOs would need to collaborate on technical day-to-day maintenance and compliance with service level agreements. Once access to this fibre infrastructure is granted, TSOs will have to commit to their clients on a service level on a regional scale. Reaching agreements and enforcing collaboration between technical teams of TSOs will be key to attracting, sustaining, and increasing the potential client base.

Priority Areas for Medium-Term Action

Priority Area 1: Regional dialogue on commercialization of spare fiber optic capacity

Action 1.1: Decide on the existing regional platform (e.g. Energy Community, Regional Cooperation Council) to be used for the dialogue on viability and agreements on scenarios for potential commercialization of spare fiber optic capacity on a regional scale among TSOs and other energy sector stakeholders

Action 1.2: Develop the plan and terms of reference for the dialogue

Action 1.3: Reach agreements on scenario and *modus operandi* for regional infrastructure sharing approach

Priority Area 2: Regulatory and legal reform to enable commercialization of spare fiber optic capacity in WB6

Action 2.1: Identify specific regulatory and legal constrains in each WB6 country

Action 2.2: Plan and implement required regulatory and legal reforms to enable commercialization of spare fiber optic capacity across WB6

Priority Area 3: Implementation of agreed upon model of commercialization of spare fiber optic capacity in WB6

Action 3.1: Identify fiber optic infrastructure and equipment needs, if any, required for commercialization of spare fiber optic capacity in WB6 TSOs[6]

Action 3.2: Plan and implement required upgrades/expansion of the infrastructure per Action 3.1 above

Action 3.3: Secure the resources for transactional support and impement commercialization of spare fiber optics capacity across WB6 TSOs

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[6] Additional capacities, links, interconnections, Dense Wavelength Division Multiplexing (DWDM) equipment, etc.

Regional Women in Online Work (WoW)[1] Initiative

Digital inclusion of un/underemployed women through online work

***OVERVIEW**:*

The WB6 suffers from low labor force participation of women and their high level of unemployment. Women across WB6 face similar barriers to jobs, e.g. lack of opportunities, lack of relevant skills, inability to attend to a traditional employment schedule due to family responsibilities, etc. Small economies of WB6 cannot create many convenient employment opportunities for its women, but the rapidly expanding global online work industry can. Un/underemployed women stand to particularly benefit from ICT-enabled online work because of the flexibility of location and work schedules that it provides. The regional training and employability program aiming to mobilize and upskill un/underemployed women in the WB6 to work online is both a modern and a pragmatic action to tap into the global online employment marketplace and strengthen access to the jobs already created. Furthermore, this program will strengthen the supply of digital skills for the local economies and benefit IT companies in WB6 that are facing ICT skills shortage.

Benefits of Economic Integration – Evidence and Global Experience

Emerging evidence posits that the rise of online marketplaces, such as online work platforms, has potential to accelerate the integration of developing countries into world markets, by supporting job creation and increasing worker productivity. The reason for this is the ability of the internet to reduce transaction costs, which, in turn, increases opportunities for those who face constraints in finding jobs or productive inputs. **Un/underemployed women stand to particularly benefit from ICT-enabled online work because of the flexibility of location and work schedules that it provides**. Through over 50 online job marketplaces, online work industry is rapidly expanding across developed and developing countries, and increasingly more analyses are proving its positive impact on women.*

For example, the impact assessment of the WoW pilot conducted in two municipalities of Kosovo throughout 2016-early 2017 resulted in over half of the beneficiaries gaining online employment, with some of them becoming self-sustaining.** The demonstrated development impact convinced the Governments of Albania and Montenegro to follow suit by expressing their interest in a technical assistance for a similar pilot intervention. Donor agencies (Swiss-EYE Project by Helvetas Swiss Intercooperation and USAID-Empower Private Sector Project) have similarly taken note of the emerging success by financing the WoW scale-up in new municipalities of Kosovo.**

Benefits of activating un/underemployed women into online work on a regional scale are likely to be far-reaching. Currently misallocated talent significantly constrains overall economic development in

[1] Named after Women in Online Work (WoW) pilots conducted by the World Bank in 5 municipalities of Kosovo throughout 2016 and early 2017; Two objectives of the WoW pilots were helping female beneficiaries to generate incomes while testing the possibility of overcoming traditional barriers to labor force participation and economic inclusion through online work;

WB6. It has been estimated that, on average, GDP of the region could be 20 percent higher if women participated in the labor market on par with men, with 5 percent of this GDP loss being driven by the existing gap in the levels of entrepreneurship between women and men. Tackling this gender inequality through online work will thus result in higher levels of employment and higher productivity.***

Designing and implementing a regional WoW initiative will allow countries to join efforts across WB6 in addressing typical barriers for female labor force inclusion and employment online. A joint effort to tackle issues of lower digital literacy between women and men, women's lower access to digital infrastructure and digital skill training programs will spur cross fertilization of relevant experiences and solutions between countries. For instance, Kosovo has a tremendous implementation experience to share from the recently conducted WoW pilots, and Kosovar beneficiaries could become role models to other women in the region by sharing their knowledge of participation in this innovative training. A regional approach will also increase the scale and visibility of online work across the region and of local online workers internationally. Global ICT and ITES (especially business process outsourcing) companies might be more prone to setting operations in the region seeing increased supply of qualified digital labor, which shares languages, work culture, and similar demographic patterns.

From the implementation standpoint, a regional approach to rolling out the WoW across WB6 seems to be more efficient, as it will significantly decrease costs for participating countries and increase efficiency of the task execution through resource-sharing and positive knowledge spillovers. Over time, a fragmented approach to program implementation could lead to increased costs (especially overheads), inconsistent approaches to monitoring and evaluation, and administrative delays due to complex procurement associated with ICT projects, among others. A consistent and highly collaborative multi-country approach would realize efficiencies through the economies of scale, creating a virtuous cycle that would promote greater participation of a larger number of beneficiaries in online work and the regional digital economy.

Key Challenges for Western Balkans Regional Economic Integration

WB6 governments will have to decide on a regional collaboration mode to promote regional economic integration through online work oriented at un/underemployed women. The majority of the countries in the region do not have sufficient experience in the design and implementation of national-level ICT training programs, not to mention regional undertakings. Despite a strong political momentum and understanding of the need to spur initiatives promoting female digital inclusion, establishment of a modus operandi for such an initiative may present the first challenge.

If conceived as a joint initiative among all WB6 countries, regional WoW might be able to attract considerable donor funding, however pulling these resources together will require a significant coordination effort for governments, on one hand, and the donor community, on the other. There are many active donor programs in each country. While some donors are glad to support WoW in separate countries through smaller initiatives, bringing WoW to scale on a regional level will require a significant effort in donor program coordination. Other than setting up parameters for the donor program collaboration and coordination, reaching a consensus over an appropriate financing vehicle may become another issue impeding the start or implementation of the entire program.

Finally, the ultimate success of a regional WoW might be affected by infrastructure and affordability constraints (inability to work online from a household without a fixed broadband connection/without computer) or insufficient competitiveness of local female labor, compared to global competitors (e.g. poor command of the English language).

Priority Areas for Medium-Term Action

Priority Area 1: Regional dialogue on WoW initiative in WB6

Action 1.1: Decide on the existing regional platform (e.g. Regional Cooperation Council) to be used for the dialogue on viability and agreements on scenarios for potential implementation of WoW initiative

Action 1.2: Develop the plan and terms of reference for the dialogue

Action 1.3: Reach agreements on scenario and *modus operandi* for regional WoW initiative

Priority Area 2: Create enabling environment for online work in WB6

Action 2.1: Review regulatory framework for self-employment and identify specific barriers to online freelancing

Action 2.2: Plan and implement required regulatory and legal reforms to facilitate online freelancing in WB6

Priority Area 3: Implementation of regional WoW initiative

Action 3.1: Raise awareness of the opportunities in online work on a national scale through partnerships with a local ICT ecosystem: ICT firms and academia

Action 3.2: Assess competitiveness of local un/underemployed female labor based on its access to digital infrastructure, basic literacy/numeracy, English language command, and levels of educational attainment

Action 3.3: Find a qualified training provider to implement regional training program on a set of marketable technical and soft skills, in demand by the global online work market

Action 3.4: Provide continued support to the most successful program graduates through additional regional workshops and trainings on self-employment and digital entrepreneurship

Action 3.5: Raise awareness of the locally trained online labor among global online work platforms through the establishment of a continued dialogue, organization of joint events, competitions, and rapid training programs

Action 3.6: Design and implement an impact evaluation program of the conducted training, relying on a rigorous quantitative-qualitative methodology

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WESTERN BALKANS: Regional Economic Integration Issues Note No. 16

Towards a Regional Energy Market

Scaling-up Efficiency, Trade, and Investments in Sustainable Energy

OVERVIEW:

Development of a regional energy market strengthens energy security, improves reliability, and increases affordability of energy supply. Furthermore, the emerging regional energy market creates opportunities to increase energy trade and investments which are at the core of economic integration and development across the region. To achieve these benefits and create an integrated and competitive regional energy market, WB6 countries should reinvigorate the reform agenda and accelerate the implementation of EU compliant laws and regulations.

Benefits of Economic Integration – Evidence and Global Experience

Enhancing security and reliability of energy supply by exploiting diversity in energy resource endowments across WB6 countries is a major driver of regional integration. All Western Balkan countries (WB6) are net energy importers. Overall, energy imports (mainly oil, petroleum products, and natural gas) account for about 30 percent of the total primary energy supply in the region. BiH has the lowest dependence on energy imports (about 22 percent), and FYR Macedonia has the highest dependence (about 53 percent). However, significant indigenous energy resources, primarily lignite[1] and hydropower – which are geographically spread across the region – enable the WB6 countries to cover their electricity needs practically without fuel imports. This provides strong incentives for regional economic integration in order to improve energy security and enhance reliability of energy supply in all WB6 countries.

Cost savings from regionally optimized investments and enhanced competition in the regional market[2] benefit consumers through lower prices and better services. A well-functioning regional market would enable economy of scale and investments in regionally optimal energy solutions, compared to more costly energy projects serving smaller country markets. Furthermore, an integrated energy market would lower the system capital costs by lowering reserves margins for a given level of system reliability. All WB6 countries have significant potential to attract investments in regionally optimal energy projects which would help drive down the long-run marginal cost of energy supply across the region. In particular, scaling-up investments in renewable energy, including hydropower and natural gas infrastructure, would significantly support regional economic integration which helps reduce market risks and, therefore, enables cheaper financing, including from International Financial Institutions (IFIs) and EU funds supporting regional energy infrastructure.

Regional energy trade and power market integration lower the system operating costs and emissions creating strong incentives for regional economic integration. Electricity trade among WB6 countries is already significant, due to a natural complementarity between their power systems (i.e. complementarity between coal-fired and hydropower generation in meeting electricity demand). With the exception of BiH, which is a net electricity exporter, all other WB6 countries have seasonal surpluses and deficits of electricity generation, which are best

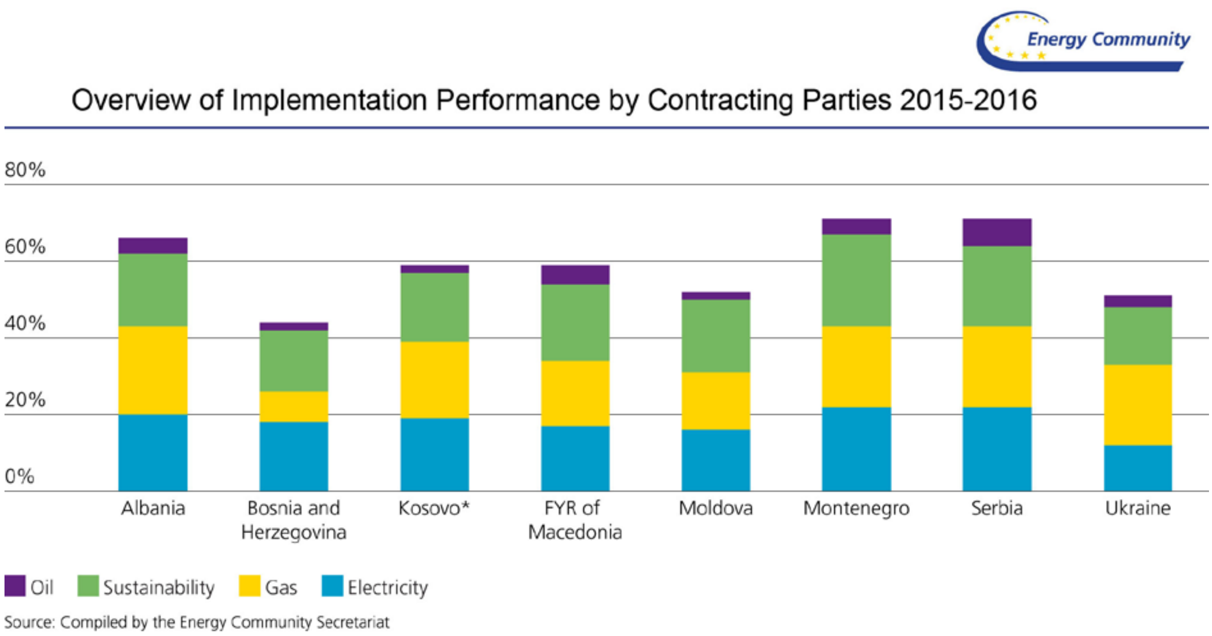
[1] Lignite accounts for about 50 percent of the primary energy supply in the region.

[2] The WB6 electricity market accounted for about 72 TWh, valued around Euro 3 billion in 2015.

matched through an integrated electricity market. Subject to adoption of environmental pricing mechanisms (such as carbon pricing), the power market can also lower emissions[3] by prioritizing generating units with lower environmental costs. Therefore, a well-functioning regional electricity market drives down operating costs and emissions across the energy sector and stimulates regional economic integration.

Creating an open and competitive regional energy market, in line with the country's commitments under the Energy Community Treaty, supports the EU integration process. Following the signing and ratification of the Energy Community Treaty in 2006, and establishment of the regional Energy Community (EnC), all WB6 countries made significant progress in harmonizing their legal and regulatory environment with the EU Internal Energy Market. As shown in the chart below, the rate of compliance with the Third Energy Package is relatively high across all WB6 countries, although significant further work is needed particularly in BiH, Kosovo, and FYR Macedonia. Continued progress in creating a functioning regional energy market will help all WB6 countries advance their integration process with the EU.

Figure 1: EnC progress in harmonization of energy laws with the Third Energy Package



Key Challenges for Western Balkans Regional Economic Integration

Building institutional capacity, improving corporate governance, and accelerating reforms in the energy sector require strong commitment and persistent support from the Governments. Despite significant progress over the past few years, a fully competitive regional electricity market is yet to be established. Recently, WB6 countries committed to an Action Plan to foster development of Spot Markets and other "soft measures" for power market integration. The establishment of Southeast European Power Exchange (SEEPEX) in Serbia (2016) was an important step in implementing the agreed Action Plan. However, WB6 countries are still relatively slow in implementing the agreed measures (including cross-border balancing and regional transmission capacity allocation), mainly due to weak

[3] Due to a high share of coal in the primary energy supply, the CO2 emissions in the region are around 2.8 tons of CO2 per toe, similar to Greece, but significantly higher than 1.9 tons of CO2 per toe in Austria and Slovenia.

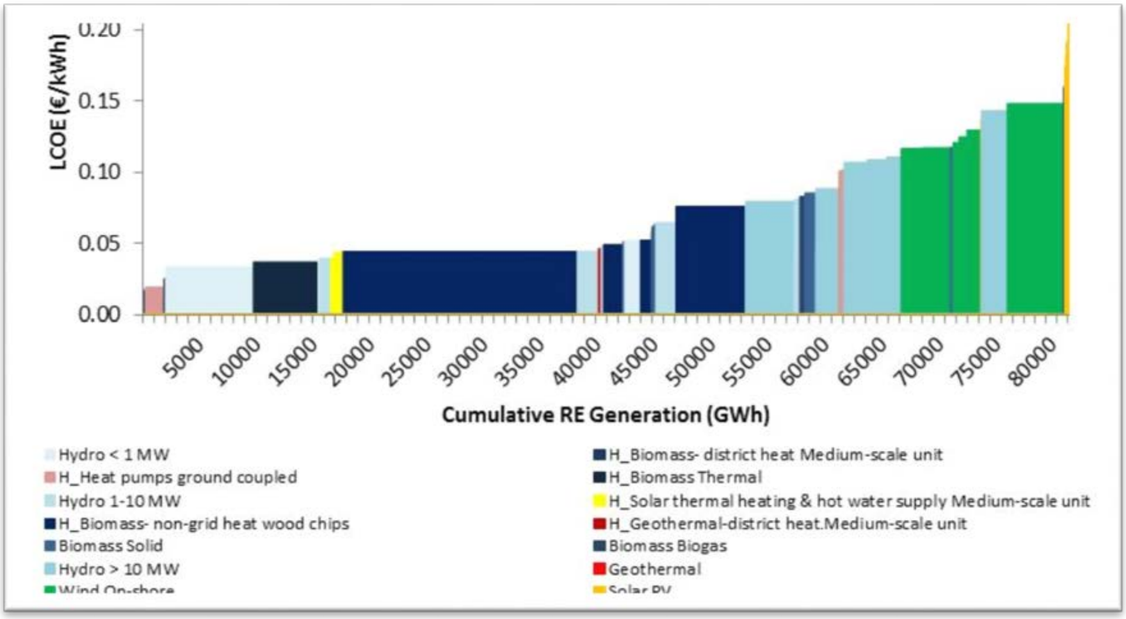
institutional capacity and slow reform of monopolistic (majority) state-owned enterprises (SOEs), which dominate the energy sector. Furthermore, the lack of corporate governance and SOE oversight often lead to poor financial discipline, commercial losses, and soft budget constraints, which are major challenges for transformation of energy utilities to effective market players.

Twin challenges of energy poverty and high energy intensity require a strong focus on scaling up energy efficiency across all categories of consumers. Average energy consumption in WB6 countries (about 1.6 toe per capita) is less than a half of consumption in the EU countries (e.g. Slovenia consumes 3.2 toe per capita, and Austria consumes 3.8 toe per capita). Albania has the lowest energy consumption of about 0.8 toe per capita, and BiH consumes around 2.0 toe per capita. On the other hand, energy intensity of economy (toe per $ of GDP) in WB6 countries is three times higher than in the EU. The lowest energy intensity is in Albania (0.2) and the highest in BiH (0.4). All WB6 countries aim to overcome energy poverty and improve energy efficiency starting from a relatively low base. Under the EnC Treaty, all WB6 countries committed to 9 percent energy savings target (by 2018, based on 2010 levels) and adopted National Energy Efficiency Plans. While increasing energy efficiency is essential in order to save energy and modernize the economy (e.g. structural shift towards services and modern technologies), the energy demand in WB6 countries will continue to grow as incomes rise and energy poverty reduces.

Aging, obsolete and inefficient energy infrastructure undermines security and reliability of energy supply across the region and slows down power market integration. Due to a chronic underinvestment in energy infrastructure over the last 30 years, WB6 countries are facing a risk of rapid decline of security and reliability of power supply. More than 90 percent of the existing energy infrastructure in WB6 countries has been developed before 1990. About 2,600 MW of thermal power generation is scheduled for decommissioning by 2025, accounting for about 15 percent of the installed capacity in the region. Some of these capacities are already significantly de-rated (e.g. available capacity in Kosovo A is only about 300 MW out of the 630 MW nominal capacity). The EC-supported Generation Investment Study (GIS, 2007) identified a regional least-cost generation expansion plan, including rehabilitation and/or replacement of existing capacities with modern, energy efficient technologies in compliance with the EU environmental standards. However, very little progress has been made over the last ten years in implementing regionally optimal power projects. Recently, the Energy Community and Contracting parties have identified "Projects of Common Interest" (gas, oil and electricity PCIs) in the amount of EUR 15 billion which are considered to be a priority from the point of view of security of supply, generation adequacy, and renewable energy targets.

Renewable energy potential, particularly hydropower, is significantly underutilized in the WB6 region. Currently, the share of renewable energy in the WB6 regional energy mix is around 25 percent, mainly due to a significant share of hydropower. About 92 percent of the present hydropower capacity (8,432 MW) has been constructed before 1990 and many of these plants are in need of rehabilitation to increase their capacity and efficiency, as well as to strengthen dam safety. The existing capacity utilizes only about 40 percent of the regional hydropower potential, and all WB6 countries have plans for further hydropower development, as outlined in the EC-supported Regional Hydropower Strategy (2017). Also, all WB6 countries put in place incentives to promote the use of wind and solar energy through "Feed-in-Tariffs" (FIT). As shown in the graph below, there is significant potential to scale-up the use of hydropower, as well as biomass and solar for heating in a cost-effective way. Given that more than 40 percent of heat demand is supplied through inefficient stoves and building-level heat-only boilers (HOBs) using solid wood, it is estimated that around one million household stoves and tens of thousands of HOBs throughout the region can be replaced with efficient biomass solutions which would boost economic activity, save energy, improve environment, and reduce dependence on electricity for heating. There is also potential to switch existing DH boilers from fossil fuels to biomass. On the other hand, it is important that the WB6 countries follow the principles of least cost development of energy resources and tap into the low-cost RE options first. Regional cooperation and power market integration would go a long way in enabling the least cost RE potential to be developed, including cross-border projects.

Figure 2: Regional least-cost RE supply curve for electricity and heating



Low affordability, inefficient subsidies, and slow pace of tariff reform pose major risks for the modernization and development of energy sector in the WB6 region. In most WB6 countries, energy expenditures account for a large share of the household total expenditure. The highest share (13 percent) is in Serbia and the lowest share (7 percent) in FYR Macedonia. The bottom 20 percent of poorest households are particularly vulnerable and more than a third of them are considered energy poor. The low affordability and inefficient subsidies (which provide blanket coverage) are the main reason for slow tariff reform and accumulation of "quasi-fiscal deficit" (QFD) in the energy sector due to tariffs below cost recovery, as well as poor collections and significant "commercial" (non-technical) losses. For example, in 2014, QFD in the electricity sector was around 6 percent in Albania and 2 percent of GDP in Serbia. As a result, state-owned utilities across the region lack financial viability and have poor creditworthiness, which is major barrier for investments needed to improve efficiency and modernize energy infrastructure.

Priority Areas for Medium-Term Action

Priority Area 1: Improving corporate governance and financial viability of energy utilities

Action 1.1: Strengthen financial discipline, eliminate commercial losses, and non-payments

Action 1.2: Improve governance, oversight, and corporate planning in SOEs

Action 1.3: Bring tariffs to the cost recovery level, while protecting poor and vulnerable consumers with well targeted and fiscally affordable subsidies

Priority Area 2: Modernization and strengthening of energy infrastructure

Action 2.1: Prioritize investments and improve predictability of public financing for key projects, and develop a strategy for public private partnership in energy development

Action 2.2: Operationalize the Regional Hydropower Strategy by developing (or updating) Sustainable Hydropower Development Plans for selected river basins

Action 2.3: Update the regional gas sector development plan

Priority Area 3: Development of regional electricity market compatible with ENTSO-E

Action 3.1: Establishment of Spot Market and continuous intra-day trading across the region

Action 3.2: Cross-border balancing and regional cooperation in maintaining system balances

Action 3.3: Regional capacity allocation of interconnection capacities among neighbors

Priority Area 4: Scale-up renewable energy resources

Action 4.1: Resource mapping and assessment of renewable energy (RE) potential

Action 4.2: Regulatory framework for the competitive development of least-cost RE potential

Action 4.3: Support for improvement of sustainability and efficiency of biomass use for heating

Priority Area 5: Improving energy efficiency (EE)

Action 5.1: Put in place national EE programs to scale-up energy efficiency

Action 5.2: Adopt regulations and develop institutions supporting implementation of NEEAPs

Action 5.3: Attract private sector and commercial financing using revolving EE funds and other financial solutions (e.g. ESCOs) to support EE investments

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Transport Connectivity

Better transport connectivity is key to further economic integration in the Western Balkans

OVERVIEW:

The lack of adequate and modern transport connectivity systems in the Western Balkans hinders the ability to trade and move people efficiently, as well as to unleash the potential of regional economic integration. Improving regional transport connectivity requires investment in physical infrastructure, but more importantly in addressing non-physical barriers. The main challenges to regional transport connectivity are to increase the SEETO Comprehensive Network's (i) efficiency, (ii) reliability, and (iii) environmental sustainability. Key interventions to improve network efficiency need to address railway market opening, Intelligent Transport Systems (ITS), and border crossings. Increasing the network's reliability requires more attention to asset management and road safety. Finally, strengthening sustainability requires increasing the network's resilience in responding to major climate events, as well as implementing climate change mitigation measures.

Benefits of Economic Integration – Evidence and Global Experience

Transport connectivity is essential for unlocking the power of economic integration. Greater economic integration among the Western Balkan countries, as well as between them and the EU, is essential for economic prosperity. Transport integration is one of the most direct pathways to such prosperity.

However, the lack of adequate and modern transport connectivity systems in the Western Balkans hinders the ability to export and move people efficiently. Despite investments in the SEETO Comprehensive Network[1] of about EUR12 billion since 2004 to create sustainable/reliable transport infrastructure and support connectivity, it is widely acknowledged that sustained and significant efforts are still needed to ensure that the Western Balkans' transport systems appropriately support the movement of goods and people, as well as the competitiveness of the region. The adjacent graph shows the performance of the transport and logistics sector in the Western Balkans relative to EU averages. The potential benefits of reducing the cost of connectivity are substantial with savings potentially exceeding EUR900 million or 1 percent of the region's GDP if logistics costs were brought in line with those of the EU.

Figure 1: Logistic Performance 2016

Source: World Bank, Connecting to Compete (2016).

[1] The South East Europe Transport Observatory (SEETO) was established by the Memorandum of Understanding (MoU) signed by the Governments of Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Montenegro and Serbia and the United Nations Mission in Kosovo and the European Commission in 2004. The Comprehensive Network is defined as a multimodal regional transport network in the South East Europe which is the base for the implementation of the transport investment program

Improving regional transport connectivity in the Western Balkans requires some investment in physical infrastructure, but more importantly in addressing non-physical barriers. For example, inventory carrying costs for trucks involving international movements in Western Balkan countries are more than ten times the comparable costs for trucks in the EU. Additionally, the number of trucks and drivers needed is approximately 5 times that of the average number in an efficient EU country, due to delays at the border crossings. A majority of the cost of exporting and importing is related to border compliance and time spent at the borders. For instance, the Kosovan exporter takes almost two days (42 hours) for border compliance and another 1.5 days (38 hours) for documentary compliance compared to the average of 7 hours and 3.8 hours in the other five Western Balkans states. In addition, the Kosovan firm will have to pay US$264 to export compared to an average of US$72 in the other five countries. Reducing these transport and logistics costs to more reasonable levels would enhance regional integration.

Key Challenges for Western Balkans Regional Economic Integration

The main challenges to regional transport connectivity are to increase the SEETO Comprehensive Network's (i) efficiency, (ii) reliability, and (iii) environmental sustainability.[1] Addressing these non-infrastructure barriers to trade and transport facilitation in the Western Balkans will increase the capacity and functionality of transport systems and institutions. A high priority needs to be given to these actions, due not only to their relatively low cost of implementation, but also to the high returns and synergies.

Enhancing network efficiency entails implementing railway reform actions to increase the utilization of the environmentally-friendly rail mode for long distances and heavy loads, developing and implementing ITS strategies to harmonize technologies, policies and procedures and reduce transportation cost, and enhancing border crossing modalities to reduce the large time and money costs incurred at the border. More specifically:

a. ***Railway sector challenges***: There is almost no competition in the railway markets in the Western Balkans. This is also accompanied by generally low labor productivity and traffic intensity in the region, which are less than the EU averages. Opening the railway markets to competition and building capacity in this area would be expected to increase the competitiveness of the sector and the efficiency of regional transport connectivity as the experience of the EU has indicated. Rough cost estimates for opening the railway market and building capacity were estimated in the REBIS Update to be about EUR45 million for the WB6 per annum over a period of 5 years, an average cost of less than EUR2 million per annum per regional participant. The returns to these investments, however, were estimated to be over 250 percent.

b. ***Intelligent Transport Systems utilization***: The use of information and communication technologies in the field of transport, be it related to infrastructure, vehicles, or users, is fast becoming one of the most important areas in the EU to deliver improvements in network capacity and traveler mobility and therefore enhance economic productivity. In the Western Balkan countries, ITS could support improvements in congestion management, incident detection and recovery, advice on diversion and rerouting, real time travel information, and better journey time estimate. Harmonization or interoperability of systems is also essential for seamless and

[1] As per the Western Balkan Joint Action Plan adopted during the Paris Summit in July 2016.

safe cross border transport movements and could improve energy efficiency.

Another important application for ITS is the European Rail Traffic Management System (ERTMS) to help ensure interoperability of train command systems.

c. ***Border crossing delays***: Critical to cross border trade and transport movements is the efficiency of border crossings. International experience consistently shows the large benefits generated by simplifying and harmonizing procedures at the borders and by ensuring sufficient capacity to handle border trade. Calculations[i] show that trucks spend collectively over 26 million hours at border crossing points (BCPs) in Western Balkans. The sum of inventory carrying costs, vehicle costs, and driver costs attributed to border crossings in a Western Balkan participant is more than 5 times the cost in an efficient EU country. Increasing the efficiency of border crossing entails cross border agreements in a number of areas including transport, customs, and border police and may require parliamentary ratification.

Improving the Network's reliability. Two important challenges to having a reliable Network are modern and sustainable asset management practices to safeguard the quality of the transport network, and transport safety policies to reduce fatalities and accidents, especially in the context of increased traffic.

a. ***Asset preservation*** should be a priority due to the large backlog in rehabilitation and the high economic rates of economic return that maintenance can yield. EUR1 spent on proper maintenance can save up to EUR3 in vehicle operating costs and reduce energy consumption and GHG emissions. Moreover, international experience has shown that if timely maintenance is ignored, road repair costs can reach multiples of the maintenance cost—6 times as much if the period of neglect is 3 years, and over 15 times if it is 5 years.[2] In the Western Balkans, the annual

needs for the rehabilitation of roads and railways, including the backlog, was estimated at around EUR1 billion for each of the next five years. This is particularly important for railway infrastructure, where track capacity is sufficient, but poor network condition impedes the efficient use of railways due to frequent speed restrictions.

b. ***Road Safety***: The average rate of fatalities per million people in the Western Balkans is about one third higher than the average of the EU28, and road fatalities and injuries have been estimated to cost as much as 2 percent of GDP. Traffic crashes and fatalities are expected to increase further as trade and transport flows increase if road safety improvements are not implemented. Prioritizing road safety is consistent with the objectives of the Trans European Transport Networks (TEN-T) that connect Europe and have as one of their objectives: "Ensuring safe, secure and high-quality standards, for both passenger and freight transport." Effective management of road safety involves addressing engineering designs, enforcement, education and emergency response.

Strengthening the resilience and environmental sustainability of the Comprehensive Network. The increasing importance of addressing climate change, particularly following the Paris Climate Agreement in 2015 and in light of the natural disasters that the region has faced recently[3], requires clear attention to climate change. The critical area for climate intervention in transport in the Western Balkans is network resilience, which will require a certain degree of redundancy in the network in the most cost effective way to cope with potential network disruptions. Climate change mitigation can be achieved by increasing the modal use of more environmentally-friendly modes of

[2] S Burningham and N Stankevich, 2005, Transport Note No. TRN-4: Why road maintenance is important and how to get it done. World Bank, Washington D.C.

[3] Bosnia Hercegovina, FYROM, Albania, Serbia and Montenegro have all been affected by floods of different severity over the last 3 years, including the largest ever recorded floods in Bosnia Hercegovina and Serbia. During 2014, Floods in Serbia triggered 4.7% of GDP in damages and losses and 15% of GDP in Bosnia Hercegovina for instance (WB, Serbia Floods , 2014; WB, Bosnia Herzegovina Recovery Needs Assessment, 2014)

transport such as rail and waterways, the better use of intermodal transport, and more efficient logistics that increase the intensity of use of transport vehicles.

Priority Areas for Medium-Term Action

Western Balkans countries are committed to further strengthening regional cooperation, increasing coherence, and deepening integration driven by a clear EU accession perspective and integration into a multilateral trading system that provides a framework for engagement around WTO, CEFTA and SEETO membership, as well as via the EU accession process. The medium-term actions below are based on the articulated challenges. They build on the Joint Action Plan that was adopted by the WB6 last June, which focused on short term goals.

Priority Area 1: Enhancing the efficiency of the SEETO Networks

Action 1.1: Gradual Rail market opening on the Orient/East Med and Mediterranean Corridors, with reciprocity between WB6 and EU countries

Action 1.2: Adoption of a strategic framework for the implementation of ITS on the Comprehensive Network, and start of implementation

Action 1.3: Implementation of border crossing agreements and IBM agreements on all border crossings on the Comprehensive Network

Priority Area 2: Improving the reliability and safety of the SEETO Networks

Action 2.1: Implementation of road safety interventions based on the completed inspections/audits of the SEETO Comprehensive Network

Action 2.2: Implementation of maintenance plans for the SEETO Core Network ongoing

Priority Area 3: Strengthening the environmental sustainability of the SEETO Networks

Action 3.1: Adoption of Comprehensive Network resilience plan and start of implementation

Action 3.2: Finalization of plans for adopting interventions for climate mitigation on the Comprehensive Network and increased network efficiency, and start of implementation

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Regional Infrastructure for Industrial Waste

Harnessing regional integration to eliminate legacy pollution

OVERVIEW:

The industrial and hazardous waste management sector across the Western Balkans demands serious reforms as a condition for investments in treatment and disposal infrastructure and for enabling private sector engagement. Single-country solutions are costly, resulting in the need for public sector subsidy or expensive export outside the region. Regional infrastructure solutions leverage volume and geography of waste, and create a shared regulatory, policy and tariff economic integration agenda across the region that could stabilize the business environment for heavy industry and tourism, attract private investment, and facilitate a new service sector.

Benefits of Economic Integration – Evidence and Global Experience

All Western Balkan countries have developed policies for solid waste management and have completed the process of transposing the key EU Directives and Regulations[1] into national legislation. Where the main share of investments today is focused on domestic waste management, most countries have also made efforts in dealing with industrial waste, albeit predominantly in controlling historic stockpiles and dumpsites for these materials.

Where domestic waste management requires solutions at the local level, the same is not true nor cost-effective for hazardous and industrial waste. Given the size of the Balkan countries, the volumes of waste, and the various disposal methods, it is often not cost-effective to develop dedicated infrastructure in each country to meet national demands for all waste categories. Nonetheless, as all countries in the region have now adopted the relevant EU acquis on waste management and shipment, a number of countries are already preparing for investments in national hazardous waste centers.

Regional waste management solutions will lower system operating costs and create viable markets to attract private sector engagement. National solutions are second-best options given the volumes of waste necessary to justify the capital necessary to finance costly infrastructure. As countries develop their national schemes for various types of waste treatment and disposal and seek to avoid costly long-distance shipments of hazardous materials outside the region, building regional infrastructure creates economies of scale and an environment conducive to attract commercial interest.

Regional hazardous waste infrastructure will support regional economic integration by turning a regional public bad into a vehicle for building trade relationships in a politically safe space (everyone wants rid of waste, and nobody wants to pay for the infrastructure to destroy it themselves). This will engender a shared policy framework to enable the import-export of waste, and a shared tariff regime that facilitates private sector investment. Moreover, managing waste – from legacy pollution and current industrial processes – will improve the business climate across the region, and the shared policy framework will create regulatory

[1] EU Waste Framework Directive (2008/98/EC), the Basel Convention (93/98/EC, 97/640/EC) and the Regulation for Waste Shipment (1013/2006)

certainty across the region, thereby reducing the cost and risk of doing business (including the cost of investing in one country only to have a tariff reduction in a second increase the relative cost of doing business). It will also improve the investability of the region from a tourism perspective, given that the reality or even the perception of hazardous waste in one country or its neighbor can damage an elastic sector such as tourism.

Key Challenges for Western Balkans Regional Economic Integration

In the absence of adequate management and infrastructure, too much hazardous and industrial waste is stored on site across the Balkans, often mixed with household waste or disposed of in an uncontrolled manner. Some countries have taken concrete steps to improve management of industrial and hazardous waste[2]. Some countries actively export to Western Europe, an expensive and transaction-heavy process that involves complex and lengthy trans-boundary transport arrangements. For example, all hazardous chemicals removed from the gasification site under the Kosovo Clean-up and Land Reclamation Project were exported to incinerators in Western-Europe in the absence of regional alternatives. Similar experiences have occurred in other cleanup operations, such as in Albania where all hazardous materials from Porto Romano area needed to be exported at high costs and with trans-boundary transport arrangements with large delays. Currently (2017) under tender procedure, large volumes of hazardous waste from a shipyard in Montenegro will need to be exported as well.

Development of industrial and hazardous waste policies, regulatory oversight and infrastructure vary widely across the Balkans, but most countries in this region need additional institutional and regulatory reforms to develop the sector in support of new legislation for waste management and shipments. Adequate and financially sustainable industrial and hazardous waste management requires strong legal arrangements, credible institutions to enforce those arrangements, well-developed infrastructure, incentives for private sector involvement in waste collection, handling and disposal, and tariffs that are sufficient to recover costs.

Cost savings from regionally optimized investments and enhanced private sector engagement in the industrial waste sector benefit public and private sector consumers through lower prices and better services. This will also foster regional cooperation and connectivity between countries. For purposes of time and cost, co-processing of hazardous waste in a licensed cement kiln[3] presents a viable option for some of the historic and ongoing hazardous waste production across the Balkans. Currently investment needs in the region are roughly estimated at Euro 200-300 million.

Priority Areas for Medium-Term Action

Identifying the necessary, most cost-effective regional infrastructure will require a regional hazardous waste sector development plan, differentiated to address specific issues at the national level, on the basis of which infrastructure investment and regional cooperation options can be decided. The focus countries of study would be: Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Montenegro, Serbia, and Kosovo. For Kosovo and Montenegro, there is already substantial information available about the amount and classification of hazardous waste and available treatment and disposal facilities – or lack thereof. It is estimated that also for the other countries, there is need for some amount of primary data collection with

[2] Croatia has developed a functioning hazardous waste management system, Montenegro has obtained financing from the World Bank for the planning and national permitting process for the infrastructure for management and disposal of hazardous waste and Albania has established a national center in Elbasan where special categories of waste, after repackaging, can be stored awaiting final processing. Kosovo has prepared itself with the support of WBIF with an inventory of hazardous waste, classification and national plan for hazardous waste management.

[3] According to the Integrated Pollution Prevention and Control Directive

industries about their quantities and types of hazardous waste.

Priority Area 1 (months 1-3): Develop ***a shared understanding on the need for regional infrastructure*** by building on existing dialogue in each country on waste management (with both Ministries of Environment and Ministries of Finance).

Priority Area 2 (months 3-12). Broker this shared understanding into a ***Regional Industrial and Hazardous Waste Management Strategy*** that will consider the differences in available data and current development across the countries, look at needs already identified or to be identified under the study and investigate options for cooperation across the Western Balkan countries. The study will also investigate mechanisms to implement regulatory systems at the national level, build management capacity, and involve the private sector in investments and operations.

Priority Area 3 (months 9-12): Use the Strategy to generate a costed-***Investment Plan for Regional Waste Management Infrastructure*** that will enable countries, waste generators and waste management operators to decide on costed options to export waste in-region, rather than develop treatment or duplicate disposal capacity within each country or explore the option to allow imports of certain categories of waste to enhance efficiency of waste management infrastructure. This plan will include financial and economic rates of return for different options.

Priority Area 4 (months 12-24): Use the Strategy and Investment Plan to ***establish a shared policy/regulatory environment and tariff schedule*** in the public sector across the region to enable the proposed infrastructure to ***attract capital financing***, particularly from the private sector.

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WESTERN BALKANS: Regional Economic Integration Issues Note No. 19

Sava Integrated River Basin Development

Cross-sectoral and regional water management in the Sava River Basin

***OVERVIEW**:*

This integrated river development program for the Sava River Basin will support the regional cooperation among the five Sava River Basin countries to accelerate economic integration and social development. A coordinated program of multipurpose and integrated interventions to enhance river's navigability, flood management, environmental protection, and nautical tourism will also contribute to the development of its hydropower and irrigation potential and reduce risks associated to recurrent floods and droughts while improving environmental outcomes.

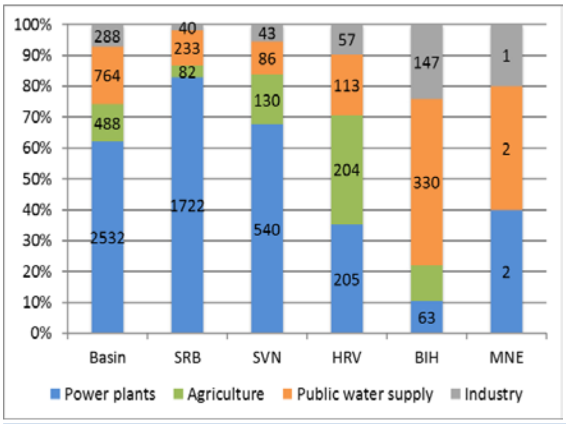
Benefits of Economic Integration – Evidence and Global Experience

Economic integration around the Sava river basin could be realized, capitalizing on its rich land and water resources endowments. The Sava River Basin, shared by Slovenia, Croatia, Bosnia and Herzegovina, Serbia and Montenegro, is home to 8.1 million people and is the largest tributary of the Danube river system. The Sava basin provides a considerable proportion of jobs in the region (e.g. 20.5 percent of employment in Serbia, 35.3 percent in Croatia and 54.4 percent in Slovenia). The May 2014 flood, the largest during the past century in the Sava River Basin, affected the entire region from Zagreb to Belgrade. Total damages amounted EUR1.3 billion in Serbia (4.7 percent of GDP), EUR2.0 billion (15 percent of GDP) in Bosnia and Herzegovina and EUR200 million in Croatia. The hardest hit economic sectors include agriculture, transport, productive activities, energy, mining, communication, and housing. In this context, an integrated approach to water management of the Sava River Basin, combining the potential of hydropower generation, agriculture, shipping, and flood protection sectors could be a large source of economic development.

Integration of different sectors in investment planning and in management can yield additional benefits. As the river's water resources connect all sectors and uses, the decisions regarding investments and water allocation must be based on a comprehensive analysis across countries and sectors. Country-level decision-making on water allocation and investment in infrastructure will necessarily fail to capture incremental benefits, lead to sub-optimal investment, and create risk of dispute and tension. On the other hand, regional integration of water management across national borders and water-dependent sectors will reduce investment costs and enhance benefits for each country thanks to win-win solutions, economies of scale, and synergies. The International Sava River Basin Commission (ISRBC) has developed plans and management tools and created the optimal conditions for the preparation of a new generation of interventions that will enhance the regulation of flows (reservoirs) during floods and droughts, improve navigability, and better buffer flood peaks by giving more room to the river in natural water retention areas. Furthermore, on it's 46th Session, held on June 15, 2017 in Bled, Slovenia, ISRBC and 5 riperian countries adopted Joint Statement on the Plan of Actions for the Sava River Basin as a Catalyst for Cooperation in the region.

Sustainable, integrated river management across the region will unlock productive investment. The energy sector dominates the current water use in the basin, but its future development to meet increasing demands of clean energy and to comply with reduced emissions targets depends on an active collaboration amongst countries and sectors. Hydropower generates 37 and 32 percent of the electricity in Serbia and Slovenia, 50 and 51 percent in BiH and in Serbia, and 76 percent of the energy in Montenegro. The Sava River Basin also provides cooling to 85 percent of the thermal plants in the region. River basin management interventions have to be planned jointly with the neighboring countries to better identify and negotiate financial, environmental and social costs and benefits, and to prevent any potential conflicts due to transboundary impacts. This approach will create more favorable economies of scale and accelerate the EU accession process.

Figure 1: Sectoral water demand in the Sava River Basin by country in 2005 (labels are expressed in Mm^3)



Multi-purpose integrated investments lead to multiple benefits. The physical works and hydraulic changes required to upgrade to a higher class of navigability and safety (such as dredging, canalization, works to regulate the river discharge and level, etc.) can be designed to mitigate flood risks as well. The Sava was navigable along the 683 km between Belgrade and Rugvica (Croatia). The total annual freight carried on the Sava has declined from 5.2 Million tons before the conflict (1990) to 0.250 Million ton in 2012. Restoration of the capacity of the Sava river waterway would have a major impact on reducing transport costs of mining and agriculture products and would enable the expansion of tourism coming from the Danube corridor.

The World Bank has been supporting the Sava River upstream-downstream coordination that is key to enhance the preparedness and resilience of all countries. A continued dialogue and incremental collaboration among countries has consolidated the ISRBC with the support of the World Bank and donors. These efforts enabled the establishment of the Sava Flood Forecasting, Warning and Alarm System, which is currently being operationalized, and resulted in the ongoing Flood Risk Management programs for the Sava and Drina River Basins. The ISRBC functions and development strategies build on Danube River Basin conventions and instruments regulating water protection and navigation. The International Commission for the Protection of the Danube River (ICPDR) assists with the implementation of the Water Framework Directive focused in water quality protection and flood management. [1]

[1] Another relevant international experience supported by the WB is the case of the Senegal River Basin that coordinates the development of plans and exploitation of common works benefitting riparian countries (Mali, Mauritania, Senegal and Guinea). In this case a Permanent Water Commission allocate water rights among Member States and sectors. On the sharing of cost and benefits of hydropower production and flood management facilities between upper and downstream riparian countries is the case of the Columbia River Basin Treaty signed by Canada and USA. Additional information about the economic benefits of transboundary water cooperation can be seen in Namara, R, and Giordano, M, "Economic Rationale for Cooperation in International Waters in Africa", CIWA, World Bank, 2017

Key Challenges for Western Balkans Regional Economic Integration

There will be limited progress in economic integration until a well-established system for joint planning and coordination of decisions on investments is in place to create appropriate incentives and to demonstrate the beneficial value of cooperation on a regional scale against, sometimes narrow, national interests. Countries must be more confident about the incremental benefits they will reap from regional cooperation. Past experience in the Sava basin, as in many other river basins around the world, has shown that unilateral and bilateral interventions undertaken in isolation are unable to significantly and sustainably boost economic growth. Investments and new economic development in this region will happen only if countries reach higher levels of cooperation and integrated planning.

Decades of poor maintenance and management has affected the navigability of the Sava water way. The drastic decline of the waterway traffic affects the competiveness of the regional economy because of the high cost of transport of important commodities produced in the region and poor connectivity. A long-term agreement for the integrated development of the Sava waterway to increase the capacity on the corridor from Belgrade to Zagreb will promote investments in critical sectors, such as mining, agriculture, industry, and tourism.

Lack of effective collaboration and inadequate decision-making during hydrometeorological extreme events (floods and droughts) has caused considerable economic damages to critical sectors, such as agriculture, energy, tourism, and transport, among others. Mitigating flood risks requires sharing hydromet observation data and a reliable basin-wide rainfall and river flow forecast system. The information of the flood risks mapping is required for a proper land use planning and protection to be done by the riparian countries assisted by the ISRBC.

Enhancement of institutional capacity for preventing disputes based on sharing of data and knowledge around the ISRBC. Working groups and Bilateral Water Committees such as the existing in Sava, Neretva, and Drina have demonstrated to be very effective in creating confidence and trust amongst countries. This positive experience indicated the need to continue supporting further and expanding the ongoing dialogue to build consensus on potential solutions for sharing costs and benefits of hydropower production and flood management intervention between upper and downstream riparian countries.

Harmonization of the legal and institutional framework for coordinating the implementation of actions by different jurisdictions and entities (municipal, national, and regional level). A successful implementation of actions involving different countries, entities and ministries might need to better harmonize regulations and administrative requirements and processes to minimize conflicts during implementation.

Managing uneven financial and institutional capacity for implementing actions by the riparian countries required for a balanced economic development. The implementation of a plan of this nature will require enough budget allocations in the ministries and municipalities involved in the implementation which might not be that easy. Otherwise the plan might face delays in the implementation.

Limited resources and administrative experience for complying with water-related EU directives and policies in the EU accession process. Country members have a record of limited utilization of EU funds, in particular at local level. Measures to augment the financial and administrative capacity for using these resources available are recommendable.

Priority Areas for Medium-Term Action

Priority Area 1: Consolidating the Sava river basin planning and development system to accelerate economic integration and investments

Action 1.1: (by June 2018) Preparation of a new Sava River Basin Management Plan aimed at linking water resources and river basin management with the integrated and sustainable socioeconomic development of the riparian countries, to be prepared under the framework of the EU Water Framework Directive

Action 1.2: (by Feb 2019) Integrated water investments planning on a regional scale, in order to create socio-economic benefits, reduce the risks associated to periods of low flows and flood events, and ensure environmental protection and enhancement. The planning and implementation of these multi-purpose investment plans might include reservoirs for the development of hydropower and irrigated agriculture, flood management, and environmental restoration and protection

Action 1.3: (by Dec 2018) Implementation of the Program of Measures based on solid trade-offs and scenario analyses, public consultations, and environmental and social assessments to enable well-targeted investments in the hydropower, transport and agricultural sectors with the support of EU. This platform would facilitate the dialogue on critical investment decisions related to the sustainable expansion of the hydropower, transport, and agriculture sectors while enhancing and protecting the environment, as well as lower up-front resistance to large investments

Action 1.4: (by Jun 2019) Consolidation of the knowledge development and data sharing platform to mainstream transboundary collaboration and inform investments decisions and negotiations under the umbrella of the Sava River Commission (ISRBC)

Priority Area 2: Improving the navigability of the Sava water way

Action 2.1: (by July 2019) Development of integrated plan to enhance the navigability of the Sava Waterway as part of the EU's indicative extension of the TEN-T Rhine-Danube transport corridor to the Western Balkans. Enhancing navigability entails upgrading the section between Belgrade and Brčko to Class Va and the section between Brčko and Sisak to Class IV. This requires completion of (i) the detailed design, (ii) the associated environmental and social impact assessments, and (iii) the demining of the Banks of the Sava River

Action 2.2: (by Dec 2019) Development of an asset management strategy for the Sava River to ensure the desired navigability

Action 2.3: (by Dec 2019) Establishment of a system for collection, treatment and disposal of hazardous and ship waste on the Sava River

Priority Area 3: Flood monitoring and management

Action 3.1: (by July 2019) Preparation of a Flood Management Program including structural and non-structural measures to mitigate flood risks in the basin, especially along the Sava main river course. The flood management program will comprise works that will be coordinated with the Sava Waterway program to optimize investments and economic impacts on both transportation and flood protection

Action 3.2: (by Dec 2019) of a Flood and Drought Forecasting and Data Management Facility will be further developed, building on the existing programs, including an upgrade of Sava GIS

Action 3.3: (by Dec 2019) Assessment of current and potential reservoir capacity on the southern tributaries to mitigate floods and drought risks and to improve hydropower generation

Priority Area 4: Environmental development and protection

Action 4.1: (by July 2019) Monitoring and development of natural protected areas along the Sava Corridor to protect regional biodiversity, the health of the aquatic ecosystems, and water bodies

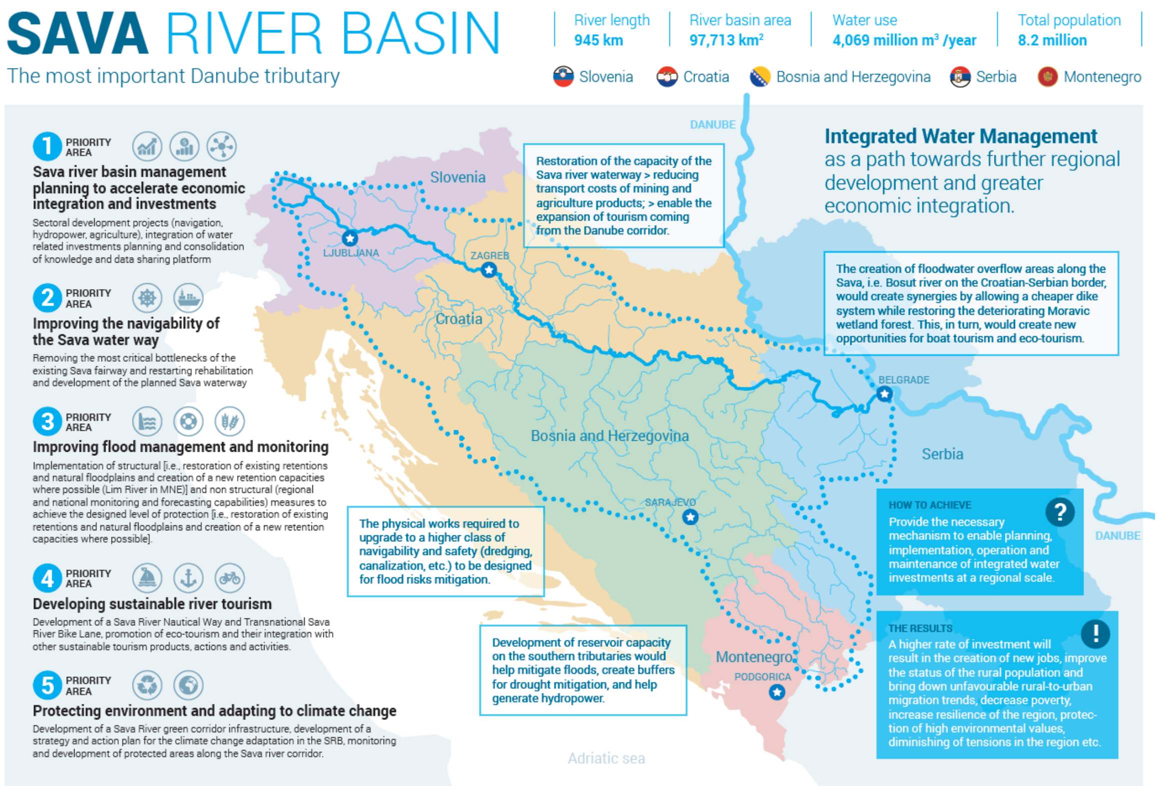
Action 4.2: (by Dec 2018) Mitigation of the impact of the rise of water demands associated to the growth of the economy and the need of enhancing environmental quality, as well as to meet the Water Framework Directive, Natura2000, and Habitat Directive guidelines

Action 4.3: (by July 2020) Development of floodwater overflow and retention areas along the Sava. Design specific interventions to protect, restore, and create retention areas and floodplains and hereby create the basis for increased river tourism and eco-tourism, such as near the mouth of the Bosut River on the Croatian-Serbian border, which would create synergies by allowing a cheaper dike system while restoring the deteriorating Moravic wetland forest

Priority Area 5: Development of a master plan for nautical and eco-tourism in the Sava River

Action 5.1: (by July 2019) Improvement of touristic infrastructure capacity, such as the installation of a pontoon network for touristic vessels along the Sava River, development of bike lanes along the Sava River, etc

Figure 2: 'The Sava River Basin' Map



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