THE WESTERN BALKANS

REVVING UP THE ENGINES
OF GROWTH AND PROSPERITY
THE WESTERN BALKANS:
REVVING UP THE ENGINES OF GROWTH AND PROSPERITY
Abbreviations and Acronyms

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<tr>
<td>7STEEs</td>
<td>Seven Small Transition Economies of Europe</td>
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<td>ALB</td>
<td>Albania</td>
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<tr>
<td>BEEPS</td>
<td>Business Environment and Enterprise Performance Survey</td>
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<tr>
<td>BIH</td>
<td>Bosnia and Herzegovina</td>
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<td>BIS</td>
<td>Bank for International Settlements</td>
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<tr>
<td>CAGR</td>
<td>Compound Annual Growth Rate</td>
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<td>CEE</td>
<td>Central and Eastern Europe</td>
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<td>CEFTA</td>
<td>Central European Free Trade Agreement</td>
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<td>CEQ</td>
<td>Commitment to Equity</td>
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<tr>
<td>CIT</td>
<td>Corporate Income Tax</td>
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<td>CMT</td>
<td>Cut, Make, and Trim</td>
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<td>CPI</td>
<td>Consumer Price Index</td>
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<td>CSC</td>
<td>Citizen Service Center</td>
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<td>DB</td>
<td>Doing Business</td>
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<td>DVA</td>
<td>Domestic Value Added</td>
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<td>EAP</td>
<td>East Asia and the Pacific</td>
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<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
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<td>ECA</td>
<td>Eastern Europe and Central Asia</td>
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<td>ECAPoV</td>
<td>Eastern Europe and Central Asia Poverty database</td>
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<td>ECFIN</td>
<td>Directorate-General for Economic and Financial Affairs of the European Commission</td>
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<td>EU</td>
<td>European Union</td>
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<td>EXPY</td>
<td>A measure of export sophistication</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<tr>
<td>GCR</td>
<td>Global Competitiveness Report</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GFS</td>
<td>Government Finance Statistics</td>
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<td>GVA</td>
<td>Gross Value Added</td>
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<td>GVC</td>
<td>Global Value Chain</td>
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<td>HBS</td>
<td>Household Budget Survey</td>
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<td>ICT</td>
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<td>IFS</td>
<td>International Financial Statistics</td>
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<td>ILO</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>KSV</td>
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<td>LAC</td>
<td>Latin America and The Caribbean</td>
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<td>LCU</td>
<td>Local currency unit</td>
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<td>MICS</td>
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<td>MKD</td>
<td>FYR Macedonia</td>
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<td>MNE</td>
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<td>NACE</td>
<td>Statistical classification of economic activities in the European Community (abbreviation of French name)</td>
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<td>NPL</td>
<td>Non-Performing Loan</td>
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<td>OECD</td>
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<td>PAR</td>
<td>Public Administration Reform</td>
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<td>PEFA</td>
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<td>PPP</td>
<td>Purchasing Power Parity</td>
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<td>RER</td>
<td>Regular Economic Report</td>
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<td>SBS</td>
<td>Structural Business Survey</td>
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<td>SCD</td>
<td>Systematic Country Diagnostic</td>
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<td>SEE</td>
<td>South East Europe</td>
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<td>SEETO</td>
<td>South East Europe Transport Observatory</td>
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<td>SILC</td>
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<td>Sub-Saharan Africa</td>
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<td>WB6</td>
<td>The six countries of the Western Balkans</td>
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<td>WEF-GCR</td>
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Acknowledgements

The team was led by Ekaterina Vostroknutova and Trang Van Nguyen, and included Ashley Taylor, Jennifer Keller, Monica Robayo, Kazi Matin, Bojan Shimbov, Olasupo Olusi, Michelle Tejada, Suzana Petrovic, Georgia Harley, Sandra Hlivnjak, Alena Kantarovich, and Johanna Jaeger. Inputs from Lazar Sestovic, Sanja Madzarevic-Sujster, Dusko Vasiljevic, Hilda Shijaku, Agim Demukaj, Barbara Cunha, and other team members working on the Western Balkans are appreciated. The team is grateful for comments, at different stages of the report’s preparation, from Ron Hood, Andrew Dabalen, Edgardo Favaro, Jorge Araujo, Gonzalo Varela, Lada Strelkova, Maria Davalos, Cesar Cancho, Alexandru Cojocaru, Johannes Koettl, Timothy Johnston, Josefina Posadas, Zahid Hasnain, Tony Verheijen, Raymond Muhula, Srdjan Svircev, and Jonas Arp Fallov. Editing by John Burgess and administrative support from Mismake Galatis are appreciated. The team was guided by Ellen Goldstein, Linda Van Gelder, Gallina Vincelette, Ivailo Izvorski, Luis-Felipe Lopez-Calva, Carolina Sanchez-Paramo, and John Panzer.
The Western Balkans: Revving Up the Engines of Growth and Prosperity
The six countries of the Western Balkans region today have a second chance for sustained growth and prosperity. Albania, Bosnia and Herzegovina, Kosovo, the Former Yugoslav Republic (FYR) of Macedonia, Montenegro, and Serbia largely missed their first. In the 1990s, as other small countries of Eastern Europe pressed forward with reforms and began a rise toward affluence, parts of the Western Balkans became embroiled in armed conflict. After peace returned, the countries lagged in making structural changes to their legacy socialist systems and thus were vulnerable when the global financial crisis struck in 2008. Today their economies have high unemployment and low growth. Poverty reduction has stagnated. Per capita incomes stand on average at about a quarter of Germany’s. The region’s 18 million people are yearning to restart convergence with the living standards of their neighbors in the European Union.

They can do that with a comprehensive set of reforms. The fundamental challenges are to modify the role of government in the economy, unleash the potential of private enterprise, make better use of labor and human capital, and integrate deeply with the EU and global economy, all the while maintaining macroeconomic stability. Demand needs to rebalance away from inward and toward outward. With proper reforms, the region can raise productivity, improve infrastructure, and foster an environment in which more people work (currently less than half of working-age people actually do). At the same time, the region needs to pay special attention to the welfare of groups that suffer particular hardships—the poor, women, youths, older workers, and ethnic minorities—so that growth is inclusive and pro-poor.

As the countries chart their future, they can draw inspiration and practical guidance from the so-called 7STEE group—Bulgaria, Croatia, Estonia, Latvia, Lithuania, Slovak Republic, and Slovenia—the seven small transition countries of Eastern Europe that are already members of the European Union. After starting at income levels that were comparable, and sometimes even lower than those in the Western Balkans, they have achieved about 60 percent of Germany’s.

The task ahead requires achieving the following broad goals:

1. Government that is more efficient and (in some countries) smaller.

The state retains an outsized role in Serbia, Montenegro, and Bosnia and Herzegovina, both in spending and employment, a legacy of the old socialist order. The private sector in the Western Balkans is smaller than that in the 7STEE countries. Operating behind protective walls, state-owned enterprises crowd out private initiative. They pay wages that are higher than in the private sector, yet operate with lower productivity, distorting labor markets, rewarding subpar performance, and indirectly strengthening the region’s large informal economy. Privatizations have turned some of these plants into successful companies—Fiat’s revival of Serbia’s Zastava car maker is a prime example—but more such conversions are needed.

But most important, the state needs to become a more efficient and reliable provider of services. In Albanian hospitals, for instance, about 35 percent of staff are non-medical personnel. Social spending
has remained at unsustainable levels. Better targeting would allow gross spending to come down while protecting segments of society that are most in need. In countries where state spending is large, reductions in it would relieve pressure on strained fiscal accounts and reduce debt.

This would help governments provide a stable macroeconomic environment for the private sector to grow. The global financial crisis precipitated GDP contractions in several countries in the region, with Serbia experiencing three separate recessions. As a result, fiscal accounts destabilized, deficits grew, and debt levels increased. While in most countries stability has returned, continuing high levels of debt and often depleted buffers leave countries more vulnerable to external shocks.

2. Greater employment and opportunities for increasing people’s well-being.

Better job opportunities, rather than reliance on the state for support, is paramount for creating greater affluence overall. It is especially important in a region whose population is aging rapidly, creating a progressively larger class of older citizens who are supported by the productive ventures of younger ones. Yet labor income in the Western Balkans accounts for only about half of total household income, reflecting low labor market engagement. Therefore, reforms need to remove a number of labor market barriers. The region’s extensive social security programs often undermine formal employment, with its long-term better wages and greater productivity. High payroll taxes, disproportionately affecting low-wage low-skill workers, may cause employers and employees alike to prefer informal arrangements where those taxes go unpaid. Pension systems that allow early retirement and unemployment programs that come with free health insurance are among the region’s many potential disincentives to work. Skill gaps and mismatches also hold back employment.

Specific social groups suffer disproportionate hardship. Women consistently have higher rates of unemployment than men. Members of the Roma community rank far below populations at large in such measures as income, education, and access to health care. The poor have lower access to education than the well-off. Going forward, ensuring equitable access to education, health care, and public services is critical if the poor and vulnerable are to improve their livelihoods. Better coverage of poverty-targeted social assistance would help more of them meet basic needs and cope with shocks. Policies that could remove women’s barriers to employment include greater child and elderly care, flexible work arrangements, and stronger labor market programs.

3. A friendly atmosphere for private enterprise.

Government in the Western Balkans should be an enabler, not a driver of economic growth. It can achieve this new role by overhauling the many legacy policies and institutions that discourage private enterprise.

A key constraint to operating a private firm in the Western Balkans is finding the right employees. The allure of the higher wages and security of public employment keeps qualified applicants away from private companies—surveys show that a government job is the preferred kind of employment for most people. The region’s schools and technical colleges often teach outdated skills, while people who do get a good education often emigrate due to the dim prospects at home. The region needs to pay added attention to creating an education system that equips graduates with the modern skills that today’s employers are looking for.

Poor services are another important drag on development. Power failures are common in the Western Balkans countries; the region’s roads and bridges need upgrading. Broadband Internet access, increasingly an underpinning of economic efficiency, remains well behind levels in the EU in many parts of the region. A sluggish and often unpredictable court system makes many business people wary—in Serbia it takes about 635 days to enforce a contract. Overall, the region needs to shake up a bloated administrative system that impedes such basic economic activities as registering a business and clearing a shipment through customs.


The experience of the SEE countries has confirmed that the best route to prosperity for small countries is to integrate with the global economy. It is not only a question of selling into overseas mar-
kets, but tapping into overseas investment, expertise, and economies of scale.

The Western Balkans states have made brisk progress on integration in the financial sector. But in other sectors the region has a long way to go. This is especially true for trade in goods and services, which would thrive with deeper integration into global value chains. While four countries in the region now have trade equal to about 100 percent of GDP, that remains well below the 140 percent average rates among the 7STEEs. Western Balkans exports tend to be heavy on agriculture, minerals, and metals. The region could increase the total value of goods and services sent abroad by increasing export sophistication. Becoming a more important part of global value chains would take them well along that path.

A key challenge in the region is that aggregate labor productivity is stuck at less than half the levels in the 7STEEs. Foreign partners’ technology and expertise can help drive these figures up. In addition to higher skill levels in the labor force, productivity could also be enhanced by reforms that make it easier for workers to move between firms, sectors, and geographic regions where economic activity is more efficient and remunerative.

All told, a rebalancing away from domestic consumption and towards an increased role for investment and exports would create a more sustainable growth model. But key to making any of these reforms work will be improvements in the quality of public administration. It is not only low efficiency that is the barrier. Corruption and malfeasance are common in the Western Balkans and are rarely punished in court. Public opinion polls show consistent worry over the “capture” of state institutions by private or political interests. Government must find the political will to build trust, both with the region’s own people and with those abroad who are eager to take part in an historic advance of prosperity.
How can the countries of the Western Balkans resume high growth and ensure sustained improvement in welfare for all citizens?

Answering this question is crucial to the future of the 18 million people who live in the six countries of the Western Balkans (the WB6)—Albania, Bosnia and Herzegovina, Kosovo, the Former Yugoslav Republic (FYR) of Macedonia, Montenegro, and Serbia. They have achieved major gains in growth, poverty reduction, and structural reform since socialism ended in the 1990s, yet now find this progress has stagnated. They live on incomes that are roughly 25 percent of what people enjoy in Germany. They have far higher rates of unemployment, and lower quality of health care and education. Electric power and Internet connections are often haphazard. Corruption and inefficiency in government are common. Economic crises are frequent. All of these conditions have helped build in Western Balkans society a yearning for a new path that would restore convergence toward the higher living standards of the EU.

Following the armed conflicts of the 1990s, the countries achieved a burst of economic growth that outstripped rates of neighboring countries. The expansion was pro-poor, with people in the bottom 40 percent of the income distribution rising faster than the average. But the financial crisis that hit the globe in 2008 exposed the vulnerabilities of that growth model. It depended too much on inward-oriented consumption and not enough on global and regional integration. Too often, foreign investment financed apartment blocks and shopping centers, not export factories and their attendant higher productivity. Growth stagnated; large numbers of people who had climbed out of poverty fell back into it. Nine years after the global crisis, unemployment holds stubbornly to rates between 17 and 35 percent, with youth unemployment nearly double the average.

The countries continue to lag on key reforms to create durable, outward-looking growth and substitute private enterprise for the socialist legacy of government as the key driver of the economy. State-owned enterprises retain an outsized footprint in the economy. Bureaucracy and high social taxes discourage formal employment and the launch of private companies. Skill sets that served workers well in socialist days have not been upgraded to fit today’s demands; broad social assistance programs and early pensions often encourage dropping out of the labor force. Millions of people, among them some of the best-educated, have chosen to emigrate in search of better fortunes abroad.

In charting their future, the Western Balkan countries can look to the experience of seven of their neighbors, the so-called 7STEEs (seven small transition economies of Europe): Bulgaria, Croatia, Estonia, Latvia, Lithuania, Slovak Republic, and Slovenia. Several of these countries
started their transitions at roughly the same time as the Western Balkans but today are well ahead in the convergence process. They have sustained strong gains in GDP and employment through efficient integration into the world economy—vibrant trade in goods and services and wise use of foreign capital. Using favorable external conditions to their advantage, the seven made strides in combining West European technology and investment with their own capable workers. They adopted policies and developed institutions that promoted economic integration and outward-oriented growth.

This report explores the mix of policies that will allow the Western Balkans states to follow in their neighbors’ path.¹ The region has major potential that can bloom with the right reforms. Reducing the size of the state in several countries, to bolster fiscal sustainability, increasing the quality of public services, and restructuring state-owned enterprises to end the crowding out of the private sector will be the most difficult tasks. Reforming labor markets, which are saddled with high inactivity rates, widespread informality, and limited job mobility, will help raise productivity growth. Improving governance and transparency in public institutions, particularly the courts, will make foreign investors more willing to risk their funds in the region. A friendlier business climate for private enterprise accompanied by deeper integration with EU and global markets will shrink unemployment and raise incomes.

Overall, the goal is to rebalance growth from consumption to investment, from domestic demand to international, and from public to private. Action is required on multiple fronts and in many cases will be politically challenging. But each reform will hold the potential to build on the others and after delays that have extended too long put the Western Balkans back on the path to convergence.

Needed: A new, sustainable model to restore economic expansion

For small countries like the Western Balkans six, finding a place in global or regional production chains is fundamental for future growth and prosperity. Serbian car maker Zastava offers an example of what’s possible.

Known in the ‘80s and ‘90s for the breakdown-prone Yugo sedan, Zastava was bought by the Fiat group in 2008. The new owner poured more than a billion euros of investment into the aging production lines destroyed by war, provided vital technical expertise, and hooked the company into its global network of supply and sales. Zastava is today producing more than 200,000 modern, reliable vehicles a year, and exporting to the European Union and United States.

The impact extends far beyond Zastava. Bosch and other international companies set up in Serbia to supply parts to the factory and look set to expand and export to the rest of Europe and other foreign markets as well. Exports of the Serbian automotive industry have already increased almost tenfold since the 1990s.

Openness to the outside world is driving this expansion, also indicating the upgrading of the sources of growth. Cumulative foreign direct investment in Serbia had reached 13.5 billion euros over 2009-16, helping accelerate GDP growth rates that had stagnated for a decade following the global financial crisis. Serbia can present challenges to foreign investors such as formidable paperwork. But the Zastava/Fiat experience shows that these can be overcome to reap major economic success.
1. How fast have Western Balkan countries converged to higher levels of income, and how has this performance compared to countries with similar backgrounds?

The Western Balkans achieved fast GDP and exports growth before the global financial crisis, starting from very low levels. While this drove some convergence in income per capita, the levels have now stagnated at around 25 percent of Germany’s. This compares to about 60 percent in the seven small transition economies in Europe.

2. What progress have the six countries made to date in abandoning the legacies of the past and becoming efficient and modern open economies?

The region’s growth model before the global financial crisis was based on consumption fueled by capital inflows. Rebalancing toward a more outward- and private investment-oriented growth model is necessary to speed up convergence in income. Structural reforms in that direction remain incomplete.

3. What are the key directions of further reform that could close the income and policy gaps with countries of the European Union?

Reforms to support sustainable rebalancing concern governance, labor markets, business environment, and integration with the global and regional economies. Together these steps can reduce the importance of the state and harness the dynamism of the private sector to bring higher standards of living to the region.
The Western Balkans have come a long way since the start of transition. Beginning from a low level in 1995, living standards had by 2015 increased almost six-fold in Bosnia and Herzegovina, nearly tripled in Albania, and almost doubled in Serbia (Figure 1). Before the global financial crisis, the region’s countries grew faster than world and EU averages and lagged only slightly behind the 7STEE countries, leveraging favorable external conditions to advance at a median 5.6 percent per year (Figure 2).

Despite past success, the six countries remain among the poorest in Europe and have grown more slowly after the global financial crisis.

Median growth in the region slowed to 2.4 percent on average in 2009-15. Though they remain among the poorest countries in Europe, the Western Balkans aspire to membership in the European Union.

Overall, the Western Balkan region has been converging to higher standards of living slower than some of its neighbors. While the region’s countries impressively raised their per capita income from 17 percent of Germany’s in 1995 to 27 percent in 2015 (Figure 3), other transition countries did better: in 1995 Latvia and FYR Macedonia both stood at about 24 percent of Germany’s income per capita. In 2015, Latvia’s had caught up to more than 50 percent of Germany’s level while FYR Macedonia’s remained at around 30 percent. Generally, the 7STEEs have been more successful than the Western Balkans in converging to higher standards of living.

Convergence to higher income is slowed by incomplete structural reforms.

In transition economies, the pace of implementation of the structural reform agenda has been a key determinant of the speed of income convergence. Across Eastern Europe, the transition to a market economy has led to a smaller footprint for the state and to economic liberalization. But in the Western Balkans, the necessary reforms have come into force later and at much slower speeds. In several countries, armed conflict and the subsequent struggle toward recovery delayed these important changes. In general, the Western Balkan states are now at the same place in transition reforms as the 7STEEs were in 1996 (Figure 4). This has held them back: overall, structural reforms and growth have had a strong association during post-communist transitions.

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Figure 1: Living standards increased two-to-six fold in 1995-2015, but they remain among the lowest in Europe.

Figure 2: The economy grew fast, especially before the global crisis.

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2 Measured by per capita GDP in 2011 international purchasing power parity terms, as shown in World Development Indicators.

3 Falcetti et al. 2006.
Today the Western Balkans have mostly completed reforms in price and trade liberalization, but continue to drag in privatization, governance, enterprise restructuring, and competition policy. In addition to slowing income convergence, the incomplete state of reforms took another toll during the financial crisis of 2008. Countries that had implemented advanced structural reforms and prudent fiscal management suffered shorter and less severe currency depreciations and stock market crises.

Factors of production are underutilized. The stock of capital is low and investment is below benchmarks. The wars and mismanagement of resources destroyed a significant portion of the region’s productive capital. Indirect measures suggest the quality of capital stock is also low, placing the former Yugoslav republics in the lower-left quadrant of Figure 8. The rate of buildup of this depleted capital stock has lagged behind countries with comparable income per capita. Average investment ratios in 2009–15 ran the range from 18 percent of GDP in Bosnia and Herzegovina to 28 percent in Albania. On average, this was below the 25 percent of GDP minimum threshold recommended for sustained high growth by the World Bank’s Commission on Growth and Development, and well below similar-income country averages of above 31 percent (Figure 9). These inefficiencies hamper the usual positive correla-

4 Commission on Growth and Development. 2008.

Growth is volatile and vulnerable to external conditions.

While growth has been high on average, it has also been volatile and vulnerable to external conditions. The structural component of growth has been declining or stagnating in most Western Balkan countries, a trend that started long before the global financial crisis (Figure 5). Kosovo and Montenegro’s potential output has become flat, with the crisis having had only minor role. Among the other four countries, the decline in potential output since the early 2000s has only tentatively reversed itself in Bosnia and Herzegovina and Serbia. The deceleration has impacted the middle-income countries of Europe more heavily than those in other regions (Figure 6). But while this dynamic has not been unique to the Western Balkans, unfavorable external conditions are adding to the already weak domestic growth drivers in their economies, which are more prone to external shocks than their neighbors (Figure 7). This puts the Western Balkan states at a disadvantage that is bound to affect their income convergence in the longer term. Continued anemic growth in the European Union and globally will make it harder for economic activity to pick up in the Western Balkans.
In 1996, Latvia, a strong performer in the 7STEE group, had an income per capita close to that of FYR Macedonia (their GDP per capita in PPP terms was at around 30 percent of European Union's). But unlike FYR Macedonia or other countries in the Western Balkans, Latvia front-loaded the critical mass of the most difficult reforms, allowing it to quickly unlock its growth potential. The reform package spanning over two decades included macroeconomic stabilization, trade and prices liberalization, and privatization. The first generation reforms included land restitution and enterprise reforms, to set up stage for a private-sector driven economy. Second generation reforms dealt with social security system, and were followed by legislative harmonization with the EU. The currency peg worked well in stabilizing inflation, maintaining monetary credibility, and facilitating trade with the EU. At the micro level, the authorities eliminated a number of enterprise and price subsidies and introduced a simplified tax system that consisted only of a value added tax, flat personal income and corporate taxes, and social security contributions. The investment climate improved significantly. Latvia harmonized many of its laws with EU legislation, streamlined business registration and construction permits, and improved business inspections.

Year after year, the Doing Business report shows newly implemented reforms improving Latvia’s its business environment. In 2017, the country occupied 14th overall place in the ranking of 189 countries assessed, and 22nd on the ease of starting a business. As a result, Latvia doubled its GDP per capita between 2000 and 2015 as it became an open economy able to boost exports to achieve growth, and allowing it to catch up with EU levels of income faster than the average of the 7STEEs. Latvia is now continuing to make progress on reforms under the “Europe 2020” strategy.

Two decades later, Latvia’s income per capita is 65 percent of EU’s, while that of FYR Macedonia is at 35 percent. In the Western Balkans, the pace of reforms has been much slower. The reforms have followed similar patterns as in the 7STEEs, but were not front-loaded and continued at a much slower pace. The biggest gains on price liberalization, trade, foreign exchange management, and small-scale privatization took place in the 1990s. However, the critical mass of reforms in competition policy, governance and enterprise restructuring, and large-scale privatization—which are more difficult to achieve—came later and are still incomplete. The privatization process was uneven across countries and while sectors such as telecommunications, banking, and energy moved faster, large public enterprises have been problematic to restructure. Progress was limited by unclear ownership rights, selling to insiders, weak governance, and price controls. While great strides have been made (notably, by FYR Macedonia), greater effort is needed to make the economies more business-friendly, with Doing Business ranking ranging between 10th (FYR Macedonia) and 81st place (Bosnia and Herzegovina).

Sources: World Development Indicators, EBRD, and World Bank staff calculations.

Note: The score ranges from 1 to 4+, where 1 represents a large transition gap (or challenge ahead), and 4 a negligible gap. The indicator is calculated as the average of six sub-indicators: large-scale privatization, small-scale privatization, governance and enterprise restructuring, price liberalization, trade and foreign exchange system, and competition policy. Improvement in the indicator is measured as the difference in the score between two points in time.
tion between investment and economic growth. Consequently, even in countries with relatively high investment ratios, there is a need for strong public investment to improve business-related and connectivity infrastructure. But given the strain on the region’s national budgets, public investment will grow slowly. It is all further evidence that the private sector will need to play a bigger role in the region’s economies.

Domestic savings have been growing in the Western Balkans, but reliance on foreign financing has been exceptionally high. Average savings in the region have been broadly consistent with the countries’ level of income per capita (Figure 10). There has been growth in domestic savings, with private savings playing an increasingly important role. Where domestic savings were not sufficient, foreign savings helped to fill the investment gap (Figure 11).
Large capital inflows in the pre-crisis period financed investment that was substantially in excess of national savings to generate higher growth, but this also meant high external borrowing, both by the private sector and governments.

Labor force participation levels and demography have worked against growth. Labor is a key factor in production, with labor outcomes largely determining improvements of household per capita income and standards of living. The ability of an economy to provide good, well-paying jobs for its people is a key measure of overall development performance. In order to accelerate per capita income convergence, the Western Balkans need well-functioning labor markets that make efficient use of labor and enable all citizens to participate in the growth process. Yet today only half of the
working-age population in the Western Balkans on average participates in the labor market, and a quarter of people seeking jobs fail to find them. Most of the unemployed are idle long-term. Strict employment rules protect insiders, make the labor market less competitive overall, and disproportionately hurt younger people and new entrants. The social benefit systems may discourage people from seeking low-wage and part-time work. A high labor tax “wedge” discourages creation of formal sector jobs. Early access to pensions, meanwhile, reduces employment among older workers. All of these constraints have considerable costs in efficiency and equity, holding back economic growth, and are discussed in more detail in the Labor chapter.

Low productivity is a key impediment to faster growth.

Productivity is determined by the quality of the factors of production and efficiency of their use. We can think of productivity—output per worker—as growing from three elements: quality of human capital (the skills and health of workers), quality of physical capital (the tools and facilities of production), and the efficiency in harnessing the two forms of capital. Efficiency, or total factor productivity, reflects how well a country harnesses the physical and human capital it has, through such processes as technology adoption, product innovation, the sharing of knowledge between firms and sectors, and the mobility of workers. If efficiency is slow, returns on capital are low as well, reducing incentives to invest in new equipment, infrastructure, and schooling. Lower returns in turn slow capital accumulation. In contrast, higher efficiency can raise productivity by improving returns on existing investments and motivating investors to put increased capital into new factors of production.

Aggregate labor productivity in the Western Balkans is less than half that in other small transition countries of Europe. Output per worker (a proxy for labor productivity at the economy-wide level) is substantially lower than in most 7STEE countries (Figure 12). Low quality of human capital is one factor contributing to this: PISA scores are 20 percent lower than those in the OECD. Investment quality is also low, by some indirect measures, such as under-representation of consumption goods in imports (Figure 13).

To achieve high growth, the region would need to overcome not only government capital constraints and high labor inactivity, but also rising total factor productivity (TFP). It would take a long time and vigorous reforms to tackle the region’s high structural unemployment. Improvements in the capital stock will also take time to bear fruit. It is clear that without improvements in the efficiency with which the factors of production are utilized, high growth will be very hard to achieve in the Western Balkans. After the global financial crisis, the TFP dynamic actually subtracted from growth on average in the region (Figure 14 and 15).

The region needs to shift to a more sustainable growth model.

The current economic model in the Western Balkans relies heavily on consumption. Consumption represents close to 100 percent of GDP in the Western Balkan states, compared to 78 percent in both the 7STEEs and the European Union as a whole. At the same time, exports are lower than what they could have been, as the experience of neighboring countries shows (Figure 16). While consumption will continue to play an important role in the Western Balkans, given their level of economic development and their growing middle class, overreliance on consumption limits incentives to move up in the production chain and become competitive in international markets. Many factors have combined to create the current situation: the often unfriendly business environment, fiscal limitations, fragile macro stability, paternalist government, and reliance on social and foreign transfers. Prolonged periods of high external deficits that are financed by capital inflows tend to undermine future growth by changing the incentive structure in the private sector. For instance, overly large shares of pre-crisis foreign direct investment went to less productive sectors, such as real estate (Figure 17).

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5 The growth accounting exercise is based on the Solow model and covers data for 2000–14. Despite its many well established caveats, this simple exercise can provide some intuition about the main drivers of GDP growth during the last 15 years. Annual GDP is assumed to be a function of the aggregate physical capital stock (K) and labor (L), following a Cobb-Douglas technology. In the absence of consistent employment data for all countries, the working-age population (age 15–64) is used as a proxy for labor. In the absence of data on capital stocks, physical capital is estimated through a highly simplified perpetual inventory method. In this simple growth accounting exercise, TFP includes the main component—efficiency with which the economy uses the main factors of production—but likely also hides the impact from a combination of factors including skills and labor under-utilization (i.e., converting the working-age population into employed human capital). This enables factors that affect the overall efficiency of the economy, as well as technological progress.
A rebalancing towards an increased role for investment and exports in the economy would create a more sustainable growth model. The global crisis forced a rebalancing of the sources of growth. As happened in many European countries, it led to a sudden stop in the flows of capital from abroad. A subsequent waning of optimism led to slower growth and a reduction in domestic demand and imports, which raised net exports (Figure 18). As a result of these shifts, labor costs moved more in line with productivity, improving competitiveness (Figure 19).

But rather than by stronger export performance, the rebalancing has been often driven by a reduction in economic activity, imports,
Only the manufacturing exporters were able to increase exports, especially in Serbia (by more than 20 percent over eight years). Serbia was also the only country to also increase imports, indicating a rebalancing in the right direction. In the other countries, higher net exports were due to a fall in imports, most likely driven by lower consumption. Moreover, the fall in domestic demand reflected, to a large degree, a fall in investment, except in FYR Macedonia. The evidence of a shift towards a more private-sector driven economy has been even more mixed (Figure 21).

Internal imbalances also worsened after the crisis, suggesting that the countries have yet to implement proper policies to sustain the adjustment. In a sustainable rebalancing towards higher exports, domestic imbalances such as high unemployment and fiscal deficits should also fall as private firms grow, demand-side constraints in the labor market decline, and more revenues flow in. But in the Western Balkans, unemployment either grew or stagnated at high levels, undermining the durability of the potential rebalancing of the sources of growth towards exports and the private sector.
As output slumped and governments applied fiscal stimuli, fiscal deficits widened, social spending increased, and public investment fell (Figure 23 and 24). FYR Macedonia was an exception, with unemployment declining. But the costs of the active labor market policies that helped bring this about may prove to have been too high and the labor market results unlikely to carry into the long term.

The prolonged deterioration in the fiscal accounts suggests that governments have been acting to maintain high consumption in a less favorable external environment. After the global crisis, the average current account deficit in the Western Balkans declined dramatically from 21.6 percent in 2008 to 7.6 percent in 2015, mainly reflecting the change in the capital inflows, but in some countries aided by currency depreciation and improvement in domestic savings levels. Most countries experienced a fall in FDI and other investments. Keeping spending levels unchanged as the adjustment on the external side continues has added to the pressures dating to the pre-crisis period and led to soaring debt levels as percentage of GDP. Instead of embracing adjustment...
and passing reforms to steer the region toward a more export- and private sector-driven economy, governments have tended to contract more debt. For example, PPG debt went up by almost 20 percent of GDP in just six years to reach 55 percent of GDP on average in 2016.

The Western Balkans need faster structural change to rekindle growth.

Sustainable rebalancing that can generate strong growth for the long term in GDP and employment will require a significant reallocation of labor, credit, and investment (including FDI) to the tradable sectors. Currently, the non-tradable sectors take the bulk of employment and production, but their labor productivity is low. The rebalancing must promote a more export- and private-sector driven growth model. However, with-
Most Western Balkan countries have completed the bulk of the transition from agriculture to industry that naturally accompanies growth of income per capita. Overall, workers who are shed from the agriculture and industry sectors move to jobs in the slowly growing services sector, in line with countries’ income per capita. As a result, growth has been mostly driven by industry, with structural labor movements playing a marginal role (see figure below). Albania and Montenegro are two exceptions from this pattern. Albania still has a high share of agriculture in GDP and a manufacturing sector that is growing its share in the economy from a low base. Montenegro already has a high share of services in GDP due to its tourism sector.

An analysis of sub-sectoral reallocation of labor using labor force surveys (LFS) versus administrative data yields somewhat different labor shifts across sub-sectors in the Western Balkans. These differences are the results of data collection methodologies and especially the inclusion of informal employment in LFS data. Then, although quantifying labor shedding and labor productivity shifts are challenged by these data shortcomings, common trends can be identified. Labor shed from agriculture and manufacturing finds its way into wholesale and retail, food, recreation, and to a lesser extent professional services. The decline of employment in the manufacturing industry is also common in 7STEE countries, but the expansion of employment is more focused in professional and other higher-productivity services. Moreover, government employment in the Western Balkans tends to compensate for lack of opportunities in other sectors at a larger proportion than in 7STEE countries.

In the long term, labor movement from manufacturing to less productive services could be accounted for by increased openness and a rise of the middle class. However, in the Western Balkans this shift means less productive use of labor and slower growth. For that reason, increasing labor productivity in the services sector becomes crucial to overall growth.
out a decline in the price of non-tradables, the reallocation may stall, and without a fall in the unit labor cost (ULC) of tradables to enhance competitiveness, export performance may not improve. Further structural reforms are needed to enhance the competitiveness of tradables and increase investment in them.

This is the type of sustainable rebalancing that many 7STEE countries accomplished in the post-crisis period through structural reforms, fiscal consolidation, and real devaluation. The external adjustment of the 7STEEs was aided both by import reduction and export expansion, but exports were particularly aided by wage adjustment in the tradable sector. While the emphasis and content of actions differed among these countries, and some acted more rapidly than others, they all aimed at four objectives: large improvements in competitiveness (ULCs fell); sizeable fiscal consolidation; maintenance of macro-financial stability; and repair of private corporate and household balance sheets. As a result, the countries enjoyed sustained increases in export growth despite an often adverse external environment in the 2009-15 period.

On the financing side, speeding up convergence will require putting the macro house in order. Despite the higher growth that the Western Balkans countries achieved in 2000-08, they were unable to converge in income per capita to the levels the 7STEE countries achieved. This was partly because the Western Balkans were starting from a much lower base, having fallen behind during the conflicts of the 1990s. Today, to raise growth and investment, especially private investment, they must not only improve the investment climate but increase domestic savings rates. If the investment climate improves substantially, a quickening of FDI inflows, especially to export sectors, could help finance higher investment without undermining debt sustainability.

In addition, output volatility and political cycles result in lower average medium-term growth in the region. They affect resource allocation and private sector activity and hinder the development of productive investment needed to raise output. Volatility has also been heightened by environmental shocks, which can derail improvements in structural performance, and disproportionately harm the bottom 40 percent of the income distribution. The floods of 2014, which hit growth hard in Serbia and Bosnia and Herzegovina, are proof of these shocks’ power.

Rekindling growth dynamics will require addressing deep-seated structural issues left unfinished during the transition to a market economy. Structural issues are slowing progress towards convergence and EU accession. Faster convergence will be achieved only when countries put in place a coherent reform plan that addresses the key bottlenecks holding back productivity improvements, a more conducive business environment, and well-functioning labor markets. Commitment towards EU accession provides a clear path for the difficult reforms needed to join the EU aspirational group, instead of those that are easier to implement but bring smaller gains.

Subsequent chapters of this report focus on steps that are fundamental for establishing higher structural growth in the Western Balkans. Reducing the footprint of the state, putting the fiscal house in order, increasing quality of public services, and reducing the dominance of inefficient SOEs in the economy (thus reducing their crowding out of the private sector) are the most difficult tasks. Eliminating disincentives and barriers to formal employment in labor markets, which are saddled with high inactivity rates, widespread informality and inflexible regulations is the first key step to higher productivity growth. Alongside these, reforms to improve the business climate for the private sector and deepen regional integration are necessary to sustain productivity growth. A cross-cutting theme is ensuring sustainable use of energy and natural resources and stewardship of the environment. Policies to support sustainable rebalancing would also close gaps to comparator countries in the key areas that this report looks at in more detail: governance and the role of the state, labor markets, the environment for business, trade, and financial integration, and migration (Figure 25).

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Figure 25: New policies are needed in these four areas.

**Labor**
(% of working age population not working)

**Integration**
(Exports as % of GDP)

**Enterprise**
(Doing Business indicators distance to frontier, 0 worst to 100 best)

**The State**
(Average of the six WGI governance indicators, 2014, between -2.5, weak to 2.5, strong)

Source: World Development Indicators, World Governance Indicators, Doing Business, and World Bank staff calculations.
The Western Balkans: Revving Up the Engines of Growth and Prosperity
Greater affluence through more jobs, less dependence on state transfers

In the early 2000s, the people of the northern Kosovo town of Drenas had scant hopes for a better standard of living, whether for themselves or their children. With few jobs, their community seemed stuck in permanent economic lethargy. Then in 2004, a group of foreign investors stepped in with capital and technical know-how for an abandoned mining and metals complex. Reborn as NewCo Ferronikeli, the facility today employs close to 1,000 people.

Now accounting for close to 40 percent of the country’s exports, Ferronikeli has raised welfare in other struggling communities of Kosovo as well by placing orders with suppliers there and raising general skill levels. The privatization has met some rough waters along the way. The company faced complaints of pollution, and in 2015, a collapse of world nickel prices pushed it into financial crisis. But it has bounced back more healthy, and few people in Drenas miss its former derelict, neglected state.
How far have the Western Balkans states come in raising their people’s welfare?

The Western Balkan countries have achieved laudable gains in living standards since the turmoil of the 1990s. The biggest advances came in the first years of the new millennium, as the region enjoyed boom conditions fueled by a favorable world economy. Poverty declined; living conditions rose overall, particularly for the less well-off. However, minorities and poor and rural people still lag considerably in both monetary and non-monetary dimensions of welfare. They are vulnerable to economic and weather shocks. Compared to other parts of Europe, citizens of the Western Balkan countries still have limited employment opportunities to make their livings.

What impact did the global financial crisis have on welfare?

Progress in welfare generally stalled. Poverty headcounts remained stagnant or edged up marginally. Only two countries—Kosovo and FYR Macedonia—continued to reduce poverty. The region remains well behind the former transition economies now in the EU on this measure.

What are the key steps toward future gains in welfare?

For sustainable improvement, the people of the Western Balkans need greater opportunities for employment rather than reliance on transfers from the state. Equitable access to education, health care, and public services is critical if the poor and vulnerable are to improve their livelihoods. Improved coverage of poverty-targeted social assistance would help more of them meet basic needs and cope with shocks.
Surrounded by wealthier neighbors in the European Union, the people of the Western Balkans aspire to better living standards. They have enjoyed notable welfare improvements since the end of the Yugoslav wars in the 1990s, as the Growth chapter has noted. The Human Development Index—which aggregates such dimensions of the human experience as living a long and healthy life, having a decent standard of living, and being educated—is higher than in other countries with similar income levels. The average life expectancy in the Western Balkans has increased from around 71 to 75 in the last 25 years. Poverty is in decline. In 2003, one in three people lived on less than $5 a day; that ratio has now narrowed to one in four. All in all, surveys show, satisfaction with life has trended upward in the last decade.

Despite these gains, income per capita in the Western Balkans remains among the lowest in Europe. Life satisfaction remains below levels in the post-transition EU neighbors. But these countries’ experience suggests that faster gains in living standard are possible in the Western Balkans. This chapter examines steps that would encourage an acceleration.

Economic growth before the global financial crisis was generally inclusive, but poverty reduction slowed post-crisis.

A spurt of economic growth in 2000-08 improved welfare and drove down poverty in the societies of the Western Balkans. Average household consumption increased by 1-6 percent per year in the years leading up to 2008 (Figure 27). Poverty reduction mirrored economic growth, with progress prior to the financial crisis, but since then poverty levels have held roughly steady (Figure 26). The share of the population living on under $5 a day in 2005 purchasing power parity fell steadily starting in the early 2000s, reaching its lowest level in 2008. Bosnia and Herzegovina and Kosovo—the two countries where this international poverty rate is not available—also reduced poverty as measured by the countries’ own definitions of it. Bosnia and Herzegovina reported a decline from 17.7 percent in 2004 to 15 percent in 2011. In Kosovo, the rate dropped from 50 percent in 2000 to 45.1 percent in 2006, and continued falling to 34.5 percent in 2009 and 29.7 percent in 2011. FYR Macedonia was an exception among the region’s six countries: its economic growth before the crisis was not pro-poor, for reasons related to lack of employment creation discussed below. Poverty measured at $5 a day in 2005 PPP increased from 29.2 percent in 2002 to 35.1 percent in 2008, though it has been declining since.

During the boom years, growth rather than distribution effects was often the main contributor to poverty reduction. Pre-crisis poverty reduction in Albania, Montenegro, and Bosnia and Herzegovina was in large part due to growth (Figure 28). Consumption growth accounted for more than 90 percent of the reduction in Montenegro in 2006-08 and Albania in 2002-08 of the fraction of the population living on under $5 a day. In Bosnia and Herzegovina, consumption growth accounted for three quarters of the downward trend in 2004-07. In Serbia, consumption growth and changes in the welfare distribution both played a role in lowering poverty before 2008.

Pre-crisis growth was not only pro-poor but also inclusive, that is, it improved welfare for the bottom parts of the distribution. Their improvement was actually faster than for the population as a whole (Figure 27). In Montenegro, for example, strong economic growth in 2005-08 created low-skill jobs in such fields as construction, mining, and retail trade that helped lower poverty and promote welfare gains for the bottom 40. In Albania, construction and services were important drivers of economic and employment growth in 2000-08, contributing to rising real wages, poverty reduction, and household income growth including for the bottom two quintiles. In Bosnia and Herzegovina, the bottom 40’s consumption grew a bit more than the average during the country’s growth years. This reflected job creation and growth in sectors requiring low-skill employment (mostly in services, wholesale and retail trade, real estate, construction, and transportation, with lesser growth in manufacturing and agriculture) and a large expansion of public and private transfers. In Serbia in 2006-08, household welfare improved especially among people employed in agri-

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7 UNDP: http://hdr.undp.org/en/content/human-development-index-hdi
8 Excluding Kosovo and Bosnia and Herzegovina due to issues with PPP measures.
culture, mining and construction, and services, but also among the unemployed through social transfers. Inequality, as measured by the Gini index, remained stable during this period in most of the countries except for a notable increase in FYR Macedonia (Figure 29). The reason is related to the lack of overall job creation in the economy prior to 2009, with labor re-allocation to low-productivity jobs. The sector with the most net job creation in 2002-06, agriculture, had minimal or negative contribution to value added growth. That tended to slow improvements of the welfare of the poor and the bottom 40.

However, living standards improvement and poverty reduction have stalled since the crisis. Real per capita income today, measured as GDP per capita in purchasing power parity, is not far from its 2008 level. Between 2008 and 2013, household consumption declined by 1-2 percent on average per year in Albania, Bosnia and Herzegovina, Montenegro, and Serbia (Figure 27). Poverty headcounts in these four countries circa 2013 all appear to have remained close to 2008 levels or edged up slightly. Overall, the growth slowdown in the Western Balkans has kept the $5 per day poverty rate roughly level, estimated at 25 percent in 2013 (Figure 26), but ending the reductions experienced during the boom years. Depending on the country, the economic downturn and rising unemployment hurt the bottom 40’s consumption a bit less or the same as the rate of the rest of the population (in Bosnia and Herzegovina and Albania) or more (in Montenegro and Serbia). In post-crisis Bosnia and Herzegovina, the average decline in consumption explained the overall increase in poverty, with the change in welfare distribution slightly counteracting this increase. In Serbia between 2008 and 2010, average consumption decline and distribution effects both contributed significantly to that country’s rise in poverty.

Only FYR Macedonia and Kosovo managed to make progress during the post-crisis period. In Kosovo, the poverty rate as measured by the national indicators continued falling from 45.1 percent in 2006 to 34.5 percent in 2009 and 29.7 percent in 2011, thanks to continued economic growth. The bottom 40 percent of the consumption distribution in Kosovo enjoyed consumption growth of 3.9 percent per year in 2006-11, higher than the 2.4 percent rate among the top 60 percent of the distribution. This inclusiveness was mainly due to increases in labor earnings, particularly among the bottom groups. Movement of workers out of agriculture and into construction, trade, and manufacturing was particularly visible in the two lowest quintiles. Similarly, the economy of FYR Macedonia continued to grow through the crisis, and contrary to the earlier period, growth in 2009-13 was

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employment-generating and pro-poor—income of the bottom 40 increased much more than average and absolute poverty fell. Net job creation in services, followed by industry, particularly construction, contributed to this progress. While there was growth in employment, a large share of employment creation was related to government efforts through public investment (construction), subsidies to industries (manufacturing) or costly active labor market programs.

Living standards in the Western Balkans remain below comparator countries. Real per-capita income is today about half of that in the 7STEE states. Figure 30 shows that the share of people living on below $5 per day is higher in the Western Balkans than the 7STEE. This comparison comes with a caveat, however, because of different welfare measures that are not strictly comparable: 7STEE countries and FYR Macedonia use the EUSILC income aggregates while most of the Western Balkans use consumption aggregates. But other measures commonly applied in EU countries for monitoring welfare and social inclusion also confirm the lower living standards in the Western Balkans. The share of population living in relative poverty (below 60 percent of median income) stands at around 25 percent in FYR Macedonia and Serbia. Rates of material deprivation (financial inability of a household to afford some level of material conditions including housing items, durable goods, and meals) in the two countries are also higher than in all of the transition economies that have joined the European Union.

The people of the Western Balkans desire better health and quality of life. The 2016 Life in Transition Survey found that people in the Western Balkan countries report lower life satisfaction than in the 7STEE countries and among transition countries in general, even though all did enjoy an increase in life satisfaction between 2006 and 2016 (Figure 31). The large numbers of people who pass their days in cafes and public squares give evidence of chronic low employment. While air quality has improved in Bosnia and Herzegovina and Serbia, certain environmental practices such as waste management remain behind EU standards.

Life expectancy and infant and maternal mortality rates in the Western Balkans are better than in other countries with similar per-capita income, but non-communicable diseases are a rising risk to health, compromising quality of life and productivity. Lifestyle-related risk factors—such as smoking and alcohol consumption—compound the impact of non-communicable diseases that are already common due to aging populations. Bosnia and Herzegovina, for instance, has one of the highest rates of smoking in the world, with nine out of ten adults lighting up daily. Almost all of the country’s premature deaths are attributable to major non-communicable diseases.

Figure 28: Growth was often the main contributor to poverty reduction prior to the crisis. (Contribution to poverty reduction measured at $5/day 2005 PPP, %)

Source: World Bank staff estimates based on the harmonized ECAPOV dataset.
Note: Figures for Bosnia and Herzegovina are based on its own definition of poverty.

Figure 29: Inequality remained stable in most Western Balkan countries. (Gini index, using ECAPOV harmonized aggregate)

Source: ECAPOV database.
More than 20 percent of Montenegrins, meanwhile, report health problems lasting 10 years or longer. The incidence of chronic diseases—such as depression, diabetes, high cholesterol, and hypertension—in Serbia showed a steady and significant increase from 2000 to 2013. Not surprisingly, the 2016 Life in Transition Survey data found that citizens of the Western Balkan countries consider investments in health or education, sometimes both, as the top two priorities for government spending.

Household welfare in many Western Balkan countries is vulnerable to macroeconomic volatility and weather shocks. The concentration of people around the poverty line indicates not only that they have the potential to break out of poverty during economic upturns but also that they risk falling back into it when the economy goes sour. Two percent of the population in Bosnia and Herzegovina and Serbia live right above the respective national poverty lines (within a 5 percent increase over the line) and another 2 percent right under. Nine percent live between the line and 1.2 times the line, while 7 percent live within the same range below the line. The poor and the less well-off are often more vulnerable to setbacks than better-off populations because they typically have fewer assets to help them cope with shocks. Therefore, some households that have escaped poverty may become poor again during downturns, as has happened not only in the Western Balkans but also in a number of countries in the Europe and Central Asia region (Figure 32).

In the years following the onset of the global financial crisis, more than 5 percent of non-poor households in Montenegro and close to 4 percent in Serbia fell back to living below $5 per day, reversing earlier upward mobility out of poverty. As a small state, Montenegro experienced a particular boom and bust with significant swings in the poverty rate in just a few years. During the boom, the rate declined from 11.3 percent in 2006 to 4.9 percent in 2008, but climbed back up to 11.3 percent in 2012 as growth slowed and some low-skill jobs disappeared. Vulnerability increased even more: the share of households with consumption below 1.5 times the poverty line increased from 16 percent in 2008 to 26 percent in 2012.

In addition, countries in the region are exposed to extreme weather events. Heat, drought, and flooding undermine agricultural production, energy efficiency, and the general welfare of people. For example, simulations show that the floods of May 2014 in Serbia increased the at-risk-of-poverty rate (people living below 60 percent of median income) by 1.7 percentage points, from a baseline of 24.6 percent. The simulated impacts were higher in the less well-off regions of the countries (Table 2.1).
Table 2.1: 2014 Floods in Serbia increased poverty.

<table>
<thead>
<tr>
<th>Region</th>
<th># Employees affected</th>
<th># Farmers affected</th>
<th>Baseline poverty % (2013)</th>
<th>Simulated increase in poverty (% pts)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgrade</td>
<td>4,879</td>
<td>4,492</td>
<td>11.4</td>
<td>0.7</td>
</tr>
<tr>
<td>Vojvodina</td>
<td>1,139</td>
<td>1,066</td>
<td>26.8</td>
<td>0.1</td>
</tr>
<tr>
<td>Šumadija and Western Serbia</td>
<td>41,817</td>
<td>21,641</td>
<td>28.4</td>
<td>4.1</td>
</tr>
<tr>
<td>Southern and Eastern Serbia</td>
<td>3,968</td>
<td>5,295</td>
<td>31.2</td>
<td>1.9</td>
</tr>
<tr>
<td>National</td>
<td>51,803</td>
<td>32,495</td>
<td>24.6</td>
<td>1.7</td>
</tr>
</tbody>
</table>

People in the Western Balkans need greater employment to drive sustainable welfare improvement, instead of relying on help from the state.

Labor earnings drive income growth of the less well-off and, as a result, the dynamics of poverty itself. Decompositions of per-capita household income growth and of changes in poverty can isolate the role played by different income sources. This analysis, conducted for the Western Balkans except for Kosovo due to data concerns, illustrates the significant contributions that employment makes. Specifically, unpacking per-capita household income growth by income source (Figure 33 and Figure 34) shows that labor earnings—from both wage and self-employment— were important for all groups in Bosnia and Herzegovina and for the bottom two income quintiles in FYR Macedonia. In Bosnia and Herzegovina, about a third of the overall growth in incomes of the bottom 40 percent over 2004-07 came from wage income growth, and about a quarter from self-employment income growth. In FYR Macedonia as well, increases in labor income at the bottom contributed the most to total income growth and helped lift people out of poverty in 2009-13. In Albania, wages and labor earnings accounted for about half of the poverty decline in 2005-08—2.9 percentage points of the 5.9 percentage-point reduction (Figure 35). In Bosnia and Herzegovina, almost half of the income growth of the bottom 40 in 2004-07 was attributable to increases in social assistance. However, throughout the crisis, pensions in that country played a larger role in mitigating the adverse impact of labor income losses. Similarly, in Montenegro, public transfers played a bigger role than employment in offsetting the rise of poverty in the post-crisis period. In Serbia during the same period, it was changes in pensions that countered the upward pressure on poverty (Figure 36).

Public transfers helped bring down poverty during good times and cushioned the pain during bad times. The cushioning effect was often due to the pensions that are common and generous in most of the region. In Albania, pensions accounted for close to half of the poverty decline in 2005-08, 2.8 percentage points of the 5.9 percentage-point reduction (Figure 35). In Bosnia and Herzegovina, almost half of the income growth of the bottom 40 in 2004-07 was attributable to increases in social assistance. However, throughout the crisis, pensions in that country played a larger role in mitigating the adverse impact of labor income losses. Similarly, in Montenegro, public transfers played a bigger role than employment in offsetting the rise of poverty in the post-crisis period. In Serbia during the same period, it was changes in pensions that countered the upward pressure on poverty (Figure 36).

Employment prospects worsened overall after the global financial crisis, including for the poor and low-income earners. Between 2008 and 2012, the unemployment rates in four of the six countries went up from already high levels, by 11 percentage points in Montenegro, where employment accounted for most of the decline in poverty in 2007-08. In Serbia, loss of employment accounted for 71 percent of the increase in poverty after the crisis. Declining wages accounted for 47 percent, while pensions largely counteracted this impact (Figure 36).
points in Serbia and 5 percentages points in Bosnia and Herzegovina. In Serbia, the unemployed and self-employed endured the greatest increases in poverty between 2008 and 2010, while data from 2012-13 indicate that informal workers in Serbia were more likely to move into unemployment or inactivity than the formally employed. In Montenegro, the percentage of poor households with two or more income earners decreased from an average of 55 percent in 2007-08 to 40 percent in 2009-12. While labor market performance has slowly returned to pre-crisis levels, weaker employment persists among the bottom income and consumption quintiles. Individuals in the bottom 40 percent of households are more likely to be unemployed or, if working, to hold informal jobs.

Figure 35: Wages and pensions reduced poverty in Albania. (Contribution of income sources to poverty change 2005-08, percentage points)

<table>
<thead>
<tr>
<th>Income Source</th>
<th>Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>-5.9</td>
</tr>
<tr>
<td>Income from properties</td>
<td>-0.3</td>
</tr>
<tr>
<td>Unemployment benefit</td>
<td>-0.5</td>
</tr>
<tr>
<td>Pensions</td>
<td>-2.8</td>
</tr>
<tr>
<td>Private transfers</td>
<td>-0.2</td>
</tr>
<tr>
<td>Social Assistance</td>
<td>-0.1</td>
</tr>
<tr>
<td>Wage &amp; Earnings</td>
<td>-2.9</td>
</tr>
<tr>
<td>Other</td>
<td>1.1</td>
</tr>
</tbody>
</table>


For sustainable welfare improvements going forward, the Western Balkans will need stronger role for employment and labor income. Citizens of Western Balkan countries say that the most important problem facing their economies is lack of jobs—that was the view of 68 percent of respondents in the 2016 Balkan Barometer. Labor income in the Western Balkans accounts for only about half of total household income on average. In many EU countries, the figure stands at around 60 percent, while in Latin America and East Asia Pacific, it averages 70-80 percent (Figure 37). The Western Balkans’ low figure for labor income reflects low labor-force participation and high unemployment, partly linked to disincentives to work, as discussed in a later chapter on labor. Labor and human capital are often the poor’s most important assets, so maximizing them is important for long-term poverty reduction.

Figure 36: Loss of employment and labor income drove poverty increase in Serbia. (Contribution of income sources to poverty change 2008-2010, percent)

<table>
<thead>
<tr>
<th>Income Source</th>
<th>Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>40%</td>
</tr>
<tr>
<td>HiS size factor</td>
<td>3%</td>
</tr>
<tr>
<td>Prop. Adult</td>
<td>6%</td>
</tr>
<tr>
<td>Prop. Employed adults</td>
<td>71%</td>
</tr>
<tr>
<td>Prop. Adult</td>
<td>47%</td>
</tr>
<tr>
<td>Wages</td>
<td>7%</td>
</tr>
<tr>
<td>Pensions</td>
<td>-80%</td>
</tr>
<tr>
<td>Social Assistance</td>
<td>1%</td>
</tr>
<tr>
<td>Assistance</td>
<td>4%</td>
</tr>
<tr>
<td>Agr. Income</td>
<td>8%</td>
</tr>
<tr>
<td>Other</td>
<td>100%</td>
</tr>
</tbody>
</table>


Here we use the “firm size and occupation” definition for informality. A worker is considered informal if he/she works in a firm with five or fewer employees and works as self-employed. For the general concept of informality, we mean the “enterprise-based” concept defined by the ILO which is defined as jobs in unregistered and/or small unincorporated private enterprises.

12 Serbia and FYR Macedonia calculations are based on the SILC, and Montenegro and Kosovo calculations on the Household Budget Survey.

13 Balkan Barometer 2016.
Reliance on public transfers, particularly pensions and categorical transfers not targeted to the poor, is difficult to sustain. Pensions together with social assistance represent a significant share of household income across all segments of the welfare distribution (Figure 38). Serbia and Montenegro, in particular, have preserved many social entitlements from Yugoslavia times, and today they have the highest proportion of public transfers and lowest proportion of labor earnings in household income. Bosnia and Herzegovina also has high government spending as a share of GDP. Households’ reliance on state benefits for their income is high in that country, similar to the level in Albania. Among the Western Balkan countries, Kosovo and FYR Macedonia have relatively lower shares of government spending both at the aggregate and household level. The region’s generally high reliance on public transfers is difficult to sustain because public debt in many countries is reaching critically high levels and the societies are rapidly aging.

Spending on social assistance should be geared more toward reaching the poor and vulnerable. Social assistance income is important for those in need: it makes up a larger share of income among the bottom 40 than among the top 60 percent. However, social assistance overall and last-resort (poverty-targeted) assistance in the Western Balkans have relatively limited coverage of the poor. The share of the poorest quintile that receives any form of social assistance ranges between 15 and 35 percent (Figure 39), which is low compared to countries in Europe and Central Asia in general and the post-transition EU members in particular. While these programs have respectable targeting (Figure 40), with more than half of spending reaching the poorest quintile in all countries but Bosnia and Herzegovina, their poverty impact is limited by the low coverage. Improving coverage while maintaining good targeting of social assistance would help the poor and vulnerable protect basic needs and cope with shocks.

Large numbers of households also get help in the form of remittances from family members.
who have moved abroad, income that bolster welfare but can also lower the incentive to work. Remittances as a share of GDP in the Western Balkans averaged around 9 percent in 2014, with the highest levels in Kosovo and Bosnia and Herzegovina (Figure 41). Remittances reach 20-25 percent of households in Kosovo and are estimated to amount to more than 15 percent of GDP. Remittances as a share of household income vary by country, with the highest levels in Kosovo, followed by Albania (Figure 38). While these flows can raise income, support small business development, and alleviate poverty, their regular arrival may undermine the incentive to work. Remittances together with the already sizeable public transfers to households and individuals in the Western Balkans push up non-labor income and reservation wages. The current study’s chapter on labor discusses further the impacts of outmigration and remittances on the level of human capital at home.

The poor and vulnerable need better access to health, education, and basic services if they are to improve their livelihoods.

While economic growth is necessary, improving the welfare of the poor and less well-off also requires equitable opportunities to build critical endowments and generate income. Access to basic education, health, and public services is not only a dimension of welfare in broad terms but also key to building human capital. Equitable opportunities to acquire human capital and other productive assets such as land and financial and social capital would further enable people to access employment and earn income as workers, farmers, and entrepreneurs.

Yet disparities persist across geographical regions, income groups, and ethnic groups in Western Balkan countries. Overall access to basic health and education and services such as sanitation and electricity is generally high in the Western Balkans and in line with countries of similar income levels. However, access is weaker in rural areas and for the Roma and RAE (Roma, Ashkalia, and Egyptians) minorities, where poverty is also more concentrated. Poverty rates among Roma populations are estimated to be two to four times those of non-Roma living in similar neighborhoods in Western Balkan countries (Figure 42). Poverty rates are also higher in rural than urban areas. The share of the population living in urban areas has been steadily increasing in some countries, notably Albania and Montenegro, over the past decade. In Bosnia and Herzegovina, however, 60 percent of the population is still rural, making it among the least urbanized country in Europe. The cost of living in cities is high while access to public services in rural areas is at reasonable levels. Migration, especially after the wars, tended to be cross-border rather than toward the cities.

Inequities start early for Roma people. From birth and early childhood, children in Roma families in all of the Western Balkan countries are more likely to be stunted, a sign of chronic malnutrition,
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with serious implications for their cognitive development and lifelong earning potential (Figure 43). They also have a significantly lower chance of receiving early childhood education and attending secondary school (Figure 44 and Figure 45).

Income and location also determine inequalities during childhood, a stage of life in which investments are most critical for future success. Global evidence shows that delays in cognitive and overall development from birth to age six have long-lasting consequences that are difficult to make up for later in life. Therefore, early childhood development is critical for addressing socio-economic disparities. Yet, rural children in Albania are twice as likely to die before age one compared to children born in urban areas, and the chance is four times higher for children in mountainous regions. Stunting is more common among the poorest quintile in FYR Macedonia and Serbia, while in Bosnia and Herzegovina and Montenegro, the relatively higher stunting among children in wealthy families is likely due to a decline in breastfeeding among mothers in this group rather than food insecurity. Preschool attendance is low overall, particularly for Roma and children from poor families (Figure 44). Preschool net enrollment can be three to eight times as high among the richest quintile as among the poorest. Fewer than one in ten children from households in the poorest quintile attend preschool while four in five children from the richest quintile do. Similar gaps exist in secondary school attendance and in educational attainment across all the Western Balkan countries (Figure 46).

Disparities carry over into adulthood, work and family life. Access to productive assets such as finance is unequal, affecting income-generating opportunities (Figure 47). Labor force participation, already low in the region, is worse for the poor, for Roma, and for women. For example, Bosnia and Herzegovina has the second-lowest labor force par-

**Figure 41:** The Western Balkans have outstandingly high remittances compared to other regions. (Percent of GDP, 2015)

[Graph showing remittances by country]

Source: World Bank staff calculations based on World Development Indicators.

**Figure 42:** Roma people have particularly high levels of poverty. (Percent with income below the absolute poverty line of $4.30 PPP)

[Graph showing poverty rates by country, with Roma and non-Roma comparison]

Source: Based on data from 2011 UNDP survey of Roma and non-Roma households living in similar neighborhoods, using smaller sample and shorter consumption and income modules than typical household surveys. The estimates are not strictly comparable with official national poverty measures.

**Figure 43:** Stunting incidence is high among the Roma. (Height for age stunted under 2 standard deviations below median, children under age 5, percent)

[Graph showing stunting rates by country, with Roma and non-Roma comparison]

participation among the Western Balkans. Furthermore, the employment rate among its bottom two consumption quintiles, at 40 percent, is even worse than the 50 percent employment rate among the top 60. The unemployment rate is 44 percent among the country’s Roma, compared to 27 percent among non-Roma neighbors living in the same community. The poor who do manage to find work are more likely to be farmers and unskilled professionals. Gender gaps in labor force participation are particularly large in Kosovo and Bosnia and Herzegovina.

**Similar gaps exist in access to health services.** In child bearing, poor women and Roma in Serbia are less likely to have four antenatal care visits. In Albania, only one third of poor women were informed by health providers of signs of pregnancy complications, compared to 73 percent among more well-off women. Lower-income groups in Serbia tend to have slightly higher unmet medical needs and lower insurance coverage even though 94 percent of the population has health insurance. The poor are more likely to forego care: among the poorest quintile, 11 percent reported that they had skipped health services in the past year for financial reasons, compared to 1.5 percent of the richest quintile. In 2010, about 4 percent of poor households spent more than a

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**Figure 44:** Early childhood education attendance is low, particularly among the poor and Roma. (Early childhood education attendance, age 36 - 59 months, percent)

**Source:** MICS for Bosnia and Herzegovina (2012), FYR Macedonia (2011), Montenegro (2013), and Serbia (2014).

**Figure 45:** Secondary education attendance is also low among the poor and Roma. (Secondary school attendance, percent)

**Source:** MICS for Bosnia and Herzegovina (2012), FYR Macedonia (2011), Montenegro (2013), and Serbia (2014).

**Figure 46:** The poorer the person, the lower the education. (Share of individuals aged 15+ with at most a primary education)

**Source:** World Bank staff estimates based on the harmonized ECAPOV dataset.

**Figure 47:** Poorer individuals also save less. (Share of individuals aged 15+ who saved any money in the past year; bottom 40 and top 60, 2011)

**Source:** Findex.
Demographic trends add new challenges for economic growth and maintaining the welfare of older people in the Western Balkan states. Populations are rapidly aging, and in some countries even shrinking. The median age in the Western Balkans is 8.7 years higher than in the world at large, and projections show this increasing even further. The population was already shrinking in Albania, Bosnia and Herzegovina, and Serbia between 2005 and 2010, due to low or negative natural population growth and net outmigration. The UN World Population Prospects projects that population numbers in the Western Balkans will decline further. Aging and stagnant populations will lead to a doubling of the old-age dependency ratio in the Western Balkans (excluding Kosovo) between 2015 and 2050. This would pose a serious obstacle to growth (Box 2.1) and the size of the labor force, already burdened with employment challenges for youth and the elderly (the chapter on labor discusses this issue in more detail). With the working age population declining over time, maintaining GDP expansion would require increasing labor productivity and keeping workers working until retirement age and beyond.

Aside from impacts on growth and labor force size and composition, aging puts pressure on the pension, health, and social care systems. A significant number of the elderly are poor, as shown in the age poverty pyramid (Figure 49). Ensuring sufficient income for them is important for avoiding poverty and hardship in old age. Improved preventive and long-term care can support healthier aging. Yet the projected demographics strain the ability of the pension and health care systems to deliver this support. For example, in Serbia, the pension beneficiary-to-contributor ratio is projected to jump from the current 0.6:1 to 1:1. This implies that today’s workers’ average 24 percent rate of contribution to the pension system would translate into a benefit of just 24 percent of average wage (assuming fiscal affordability of the system), far lower than the current benefit of about 60 percent of the wage. Mobilizing more resources for pensions and long-term care to support an aging population is especially challenging with the shrinking working-age population.

For the countries of the Western Balkans, speeding up poverty reduction and convergence of living standards toward the EU would require a growth rebound, an enhanced role for labor, and equal opportunities. Sustained economic growth would help resume the poverty reduction that the region enjoyed before the global financial crisis. The key role of labor in ensuring welfare improvements points to a need to improve labor market outcomes. Ensuring equitable access to schooling, healthcare, other basic services, and employment opportunities would empower those at the bottom of the welfare distribution to improve their livelihoods. Yet the current inequality of opportunities in access to basic endowments holds back this potential, and the low coverage of poverty-targeted social assistance limits the support that those in greatest hardship receive. Subsequent chapters on labor and on the state will elaborate on what can be done to improve employment outcomes, health, education, and other public services. Aging and, in some cases, shrinking populations add urgency to the reform agenda that will allow the Western Balkans to resume their catch-up with the EU in growth and living standards.
Box 2.1: Populations that are aging—and in some cases shrinking—mean challenges for economic growth.

The Western Balkan region is aging fast, with its population projected to continue declining. This trend is due to low fertility rates coupled with external migration. The regional fertility rate fell from 3.9 to 1.6 children per woman during 1965-2015. Emigration is projected to continue reducing the region’s population, though not by as much as in the past. Bosnia and Herzegovina, which has the highest median age among the six countries, expects to see its median age increase from 41.5 in 2015 to 53.9 in 2065—the second highest in the world. If there are no policy or behavioral responses or changes in labor productivity, simulations show that aging in the region will lower labor force participation and reduce average annual per-capita income growth by 0.4 percentage points over the next 50 years.

As a result, the window of opportunity to grow based on the “demographic dividend” seems to be short, in particular for those countries with medium-term aging. Aging populations mean that to better use their labor assets to grow, these countries need to increase labor force participation to counter the shrinking workforce and need to raise worker productivity. Bosnia, FYR Macedonia, Montenegro, and Serbia do not have a youth bulge anymore. Aging and stagnant populations will lead to a doubling of dependency of the old on the working age from 2015 to 2050. By the time many countries in the region have exhausted their demographic dividend, they remain at relatively low incomes: GDP per capita in the Western Balkans is less than half of that in most of the new EU member states in the year when their total dependency ratio (ratio of children and elderly to the working age population) begins to rise.

Old dependency ratios are on the rise (2015-2050).
(Expected old age dependency ratio, percent)

By the time many countries in the region have exhausted their demographic dividend, they remain at relatively low incomes.
(GDP per capita, PPP constant 2011 international $, in year in which total dependency ratio begins to rise)


Note: Albania GDP data are for 2014.
Figure 49: Many of the elderly are poor.
(Age-gender poverty population pyramids, millions, Left = Women, Right = Men; Red = below $2.50/day, Purple= between $2.50 and $5/day, Light blue = above $5/day)

Source: ECAPOV.
The Western Balkans: Revving Up the Engines of Growth and Prosperity
Creating a place where more people work

With hot springs, untouched forests, and almost 300 kilometers of picturesque Adriatic coastline, Montenegro long knew it could be a magnet for foreign tourists—but not without the right infrastructure, accommodations, and worker skill set. So through a combination of public and private development, the “Pearl of the Mediterranean” (as the country calls itself in marketing campaigns) has kept the numbers growing year after year since 2000. Today tourism directly employs about 15,000 people, a full 8 percent of formal workers, and has more than doubled its share of GDP to 22 percent.

The Montenegro Tourism Development Strategy to 2020 calls for environmentally responsible expansion of an industry that in places has caused uncontrolled building and pressure on natural resources. The hope is to integrate visits to coastal areas and the lesser-known hinterland to extend the tourism season beyond the short peak of summer months and help develop the country’s northern and central regions. Supporting the tourism value chain will generate new jobs among local suppliers, including farmers.

Employers and government are reaching out to potential workers to facilitate easy access to seasonal jobs and provide monetary and education incentives for youth to learn the necessary skills. At the website sezonac.com, employers can directly access the pool of available employees. Waiters, cooks, receptionists, and maids are the workers most in demand.
1. **What are the most important challenges facing Western Balkan labor markets?**

   The region has very low rates of employment—only about 40 percent of the working-age population actually works. When people do work, it is too often in the informal economy. Low and slowly-growing labor productivity constrains the prospects for real wage growth. And certain groups, notably young and old workers, women, and ethnic minorities, bear burdens of disproportionately high unemployment and low income.

2. **What factors impede the improvement of these markets?**

   High levels of non-labor income—pensions, social assistance, and foreign remittances—may discourage people from seeking work. A high burden of taxes and regulations inhibits job creation, particularly for the low-wage, low-skill segment. Skills that employers seek are sometimes in short supply, and workers’ mobility to take better jobs is limited. Disadvantaged groups face special barriers to economic advancement.

3. **What types of policy initiatives would fix these problems?**

   The region should recraft its labor markets to make them well-functioning, inclusive, and attentive to the demographic pressures that are reducing the number of workers. It needs a friendlier business environment to facilitate job creation by firms. It needs tax and social protection systems that encourage job creation and job seeking, not protection of existing jobs. Building relevant skills, enhancing labor reallocation, and reducing search frictions would further raise employment and labor productivity.
Jobs are a crucial mechanism both for generating strong economic growth and translating that growth into shared welfare gains across the population. Yet today only half of the working-age population in the Western Balkans participate in the labor market, and one in four people are unemployed. The imperative to reduce unemployment and inactivity is even more urgent as the ratio of the working-age population to dependents starts to shrink. In parallel to improving the regulatory environment to encourage business startup and growth, the Western Balkans need labor market and social protection structures by which firms create more jobs, more people work and for longer, and general prosperity rises.

**Levels of employment are low, driven by low labor force participation and high unemployment rates.**

Less than 40 percent of the available population of working age is actually engaged in work. This is about 15 percentage points lower than the world average and more than 10 percentage points below the Europe and Central Asia region average (Figure 50). Employment in the Western Balkans has declined slightly in the last 15 years, while it has remained stable or increased in the 7STEEs and countries in other regions. Employment rates are depressed both by low labor force participation and high unemployment (Figure 51).

Low employment levels mean that a large share of factors of production and sources of income remain untapped, potentially jeopardizing further growth and development. Declining employment-to-population ratio places a greater burden on workers and the government to support the unengaged. Declining employment rates can create a culture of dependency on non-labor benefits such as remittances and pensions, creating perverse incentives and inhibiting the development of a skilled and adaptable labor force. Finally, employment outcomes can be further harmed by a shrinking (or merely slowly growing) working-age population that, without significant changes in labor force participation rates, means a shrinking labor force. While currently 2.2 working-age individuals in the Western Balkans support each dependent, this number is projected to decline to about 1.8 in the next 20 years.

**Informal employment is high.**

Between 25 and 33 percent of total employment in Montenegro is informal, about 33 percent in Bosnia and Herzegovina, between 30 and 60 percent in Albania, and about 43 percent in FYR Macedonia. High informality undermines workers, firms, and the economy at large. People working informally face barriers to work-related legal rights and protection and insurance mechanisms against shocks such as illness, loss of a job, and poverty in old age. Large firms face unfair competition while small firms have incentives to stay informal, both hindering efficient investment and growth. High informality rates can be a drag on long-term growth and prevent income convergence, since the informal sector is usually characterized by low educational levels and lower productivity. A large informal economy also makes it harder and more costly...
to establish social risk pools and effective systems for tax, transfer, and public service delivery.

**Jobs in the public sector are a significant portion of total formal employment.** In 2010, about 45 percent of all salaried jobs in Kosovo were still in the government and SOEs. In the rest of the Western Balkan countries, the share was only about 10 percentage points lower.

**Real wage growth has been constrained by low labor productivity growth in the post-crisis period.**

Low labor productivity growth in the post-crisis period has limited the scope for real wage increases in some Western Balkan countries. Real wage growth in the region was relatively strong over the 2002-09 period, averaging more than 5 percent annually. In Albania, Serbia, and Montenegro, it outpaced labor productivity growth before the crisis, eroding competitiveness. However, this trend has reversed itself since then as Western Balkan economies exhibit low and slow-growing productivity, a topic discussed in greater detail in this report’s chapters on growth and enterprise. Real wage growth was even slower than productivity growth after the crisis hit (Figure 54). It was more than halved over the 2009-14 period compared to before the crisis, limiting earnings convergence with comparator countries (Figure 52). The lack of real wage growth was particularly evident in Albania and Serbia (Figure 53). In Albania, real wages almost doubled before the crisis, but after 2009 slowed down significantly. In Serbia, this growth dropped off significantly in response to the nominal public wage freeze introduced in 2009-10 and a cap that was imposed on indexation of wages in the public sector in 2012-13. However, this trend has started to change in recent years: real wage growth was more than 1 percent between 2014 and 2016. In FYR Macedonia, salaries decreased by 1.9 percent annually on average post-crisis, and the decrease was more pronounced in services.

**Disparities in access to jobs weaken labor market outcomes.**

Disadvantages that Roma people face in access to education and jobs are well documented, but there are also relatively high differences in jobs outcomes by gender and age (Figure 55). Females have significantly poorer work opportunities compared to males, exceeding the gender disparities in the broader Europe and Central Asia region. In 2014, the gender gap in labor force participation ranged from 14.4 percentage points in Montenegro to 40.4 points in Kosovo. While the ECA region had relative parity in the female and male unemployment rates, in the Western Balkans, the female unemployment rate was 20 percent higher on average.

**Young and older workers are particularly disadvantaged** (Figure 55). Young workers face dismal
employment outcomes, with unemployment rates approaching 50 percent on average for the 15-24 age group. Kosovo and Bosnia and Herzegovina had the highest youth unemployment rates at 57.7 and 62.3 percent, respectively, in 2015. The rate of idle youth — young people not in employment, education, or training — stood at 27 percent in the Western Balkans, not only lowering the labor supply but likely undermining the future stock of human capital.²¹

Except for Albania, participation in the labor force peaks at age 35-39 or earlier (i.e. 25-29 in Kosovo), a much younger age than the 45-49 peaks common in other European countries. Serbia’s high inactivity rates among older workers may partially reflect labor market discouragement. Eighty percent or more of people looking for jobs after age 40 have done so for more than a year:

Complex factors cause disappointing labor market outcomes.

Market frictions hold back firms’ creating jobs, workers’ supplying their labor, and efficient matching between them. Analysis of labor demand in the region often faces a knowledge gap caused by lack of access to reliable firm-level data. Box 3.1 summarizes this issue and the limited evidence that exists, and the chapter on enterprise discusses the specific demand-side constraints to private sector development and job creation.

The analysis in this chapter focuses on four major supply-side factors that prevent the development of better labor markets. They are: (1) high levels of non-labor income, (2) burdensome labor tax and regulations, (3) gaps between workers’ skills and those demanded by employers, and (4) barriers to employment and segmented labor markets for disadvantaged groups. In addition, geographic constraints may impede internal labor movement. Estimates based on the 2010 Life in Transition Surveys suggest that less than 20 percent of the population 18 or older in the Western Balkans

²¹Vincelette et al. 2016.
moved to a different city within the same country in the previous 20 years. Less than 40 percent of people aged 18-64 say they are willing to move internally for employment reasons. Weak national employment services, struggling with high caseloads, have trouble providing effective job matching assistance and promoting labor mobility.

High levels of non-labor income—remittances, pensions, and social assistance—can create disincentives to work.

In several countries in the Western Balkans, cross-border labor migration has become a vital strategy for improving household welfare. In 2010, more than 20 percent of the Macedonian-born population was living outside the country. In Bosnia and Herzegovina and Albania, this figure was closer to 40 percent. The region’s very large outward migration has resulted in remittance income averaging 10 percent of GDP in affected economies. Cross-country data shows a statistically significant negative correlation between labor force participation and remittances (Figure 56), although the relationship is not particularly strong. The correlation is stronger when we restrict the sample to middle-income countries, and even more so by looking just at the Western Balkans. As we noted in the welfare chapter, remittances may impact both the willingness to work and willingness to take certain types of jobs, leading to higher unemployment and possibly longer spells of unemployment. Overall, there is a positive relationship between remittances and unemployment in the Western Balkans (Figure 57).

Pensions can also serve to lower employment, because they have high coverage and are often more generous than unemployment benefits and social assistance. Although several countries have introduced reforms,22 pension benefits in Serbia, for example, amount to about 70 percent of average wage and 66 percent of GDP per capita (Figure 59). Early retirement is still common too. In Serbia and Albania, for example, about half of pensioners are below the age of 65. Pensions and remittances together can account for more than 20 percent of GDP, higher than in most comparator countries.

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22 Serbia, for instance, introduced a new pension law in 2014 reducing early retirement and lowering the pay-outs of high-benefit pensions.
Evidence on job creation and job destruction for the Western Balkans is still limited compared to that available for other countries, in part due to lack of access to reliable firm-level data and information about job vacancies. Using firm-level data to analyze firm dynamics, barriers to entry for potential new firms, and barriers to growth for incumbent firms is fundamental to understanding the main constraints on job creation. Disaggregated job creation and job destruction rates are key to understanding which types of firms are responsible for the majority of the job creation (whether small or large firms, high or low productivity firms, and in which sectors). Also unavailable are data on job vacancies, which are necessary to understand the tightness of the labor market, or how well the existing stock of vacancies matches the inflow of unemployed workers (the “matching” process).

Previous empirical analysis has used enterprise-level data to shed some light on these issues. These include two datasets: (1) Amadeus, a cross-country database on enterprise performance and operations, covering some EU-10 countries, some Western Balkan countries, Moldova, the Russian Federation, and Ukraine, and (2) the Business Environment and Enterprise Performance Survey (BEEPS), a cross-country database collecting data on perceptions of the business environment, among other things, covering 29 countries. Earlier studies, such as Arias and Sanchez-Paramo 2014, that used Amadeus have found that net job creation in the region in the pre-crisis period was usually led by a few high-growth firms. In Bosnia and Herzegovina and Serbia, about 20 percent of firms accounted for over 70 percent of net job creation in the pre-crisis period (2006-08). These firms tended to be young and small (so-called “gazelles”), and were more likely to operate in labor-intensive sectors, such as market services.

A number of studies using the BEEPS conclude that the key binding constraints against entry of productive firms as well growth of existing firms are a weak regulatory environment, limited access to finance, and tax regulations that favor capital over labor.

In Albania, large regulatory barriers may have harmed firm growth and job creation. Poor access to financial services also constrains accumulation and use of financial assets by firms in Albania, and affects relatively more the firms with the most rapid employment growth. Barriers to firm registration and high personal income taxes also discourage formal-sector job creation.

In Serbia, net job creation in the few years after the onset of the crisis occurred mostly in the informal sector, particularly in part-time work. The often unfriendly business environment seems to be an important constraint impeding job creation. The formal private sector created few jobs. Exporters and importers do not seem to have different patterns of job creation. In recent years, smaller firms have had higher rates of employment growth but, since they started from a low base, they seem to have contributed less than large firms to overall employment growth. Gross job losses have been concentrated among the transition generation—people 40 and older. About 25 percent of firms perceive corruption as a major constraint on doing business, according to the 2013 BEEPS. Informal employment, poor access to finance, and corruption are also cited as important constraints by SMEs (small and medium enterprises). This segment of firms is important since its members provide 58.7 percent of total formal employment in Serbia.

In Kosovo, net job creation has been concentrated in higher-productivity sectors, mainly construction and other services. Job creation in the tradable sector has been quite limited, in particular in the private sector. Labor costs that rise faster than productivity erode competitiveness and seem to be the most important constraint. Lack of skills appeared to be a binding constraint for large and fast-growing firms.

In Montenegro, most new jobs have been created in skilled labor-intensive sectors. Employment of tertiary educated labor had increased by over 40 percent by 2014 compared to 2008, while the employment of workers with at most primary education faltered by over 40 percent during the same period. Skills per se are generally not identified as an important constraint on firm growth in employment surveys, except by new and innovative firms. Firms complain that they cannot fill vacancies, suggesting that supply side factors may be more important.

In FYR Macedonia, the lack of dynamic private-sector job creation and of structural transformation and labor reallocation from low to high productivity sectors have limited the creation of better jobs. Most formal private employment is in small and less dynamic firms, with limited turnover, low innovation, and limited growth prospects. Gross job flows indicate a significant level of job churning in the enterprise sector, which in turn points to an unfinished transition process. As in other countries in ECA, a small share of firms (gazelles) accounted for a significant share of job creation. Larger firms are not necessarily more productive, signaling that resource reallocation is a significant issue. Two dimensions are identified as the major constraints on doing businesses: access to financial and human capital, and weak institutions. Credit restrictions, skills shortages, and corruption and unfair competition from informal firms are the more salient areas hampering the business climate.


Box 3.1: Demand-side analysis is a critical knowledge gap, mostly due to lack of access to reliable firm-level data.
This may generate a strong supply-side disincentive for older people to work.

Social assistance may have generated disincentives for potential low-wage and part-time earners to shift from inactivity or from informal to formal-sector jobs. Since social assistance generally subtracts a euro from the benefit amount for each euro earned, the cost of moving out of social assistance can be high (the “inactivity trap”). This is particularly true in Serbia and FYR Macedonia, where the effective tax rate (income tax plus lost benefits of gross labor income) for these earners is more than 65 percent.23 In Serbia, people who register as unemployed also get free health insurance, a potential incentive to remain unemployed. In Montenegro, social assistance programs create disincentives to take up part-time, temporary, and sea-

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23 The effective tax rate is measured as the share of gross income of the accepted formal job—including in-work benefits—that is taxed away through personal income tax, social security contributions, and lost benefits (social assistance, family, and housing benefits). Source: Arias et al. 2014.
sonal employment due to a high marginal effective tax rate for earnings below social assistance levels.

Reservation wages (the lowest pay at which people are willing to work) are high. Remittances, large social protection systems, and high public-sector wage premiums in the Western Balkans are creating disincentives to work. High non-labor income can create perverse increases in inactivity by increasing the reservation wages, unemployment rates, and duration of unemployment.\(^{24}\) The higher wages and job security of the public-sector may have pushed reservation wages up as well and created disincentives to take up jobs in the private sector.

Incentives for working can be further hampered by a large public sector that pays significantly more than the private sector, reducing the attractiveness of private-sector jobs, especially among high-skilled workers. FYR Macedonia has a significantly large public-private sector wage gap, and it has widened in recent years. The premium is higher for younger and more educated workers, lowering their probability of accepting private-sector jobs. Even after controlling for worker characteristics, a public sector wage premium exists in Bosnia and Herzegovina and Albania (Figure 60). The premium in Kosovo, meanwhile, is estimated at about 8 percent.\(^{25}\) Public-sector employment in the region is decreasing over time (Figure 61), but still represents a significant share of total employment.

**Burdensome taxes and regulations discourage creation of formal jobs.**

High labor taxes may hinder job creation and work incentives by making vacancy creation and acceptance of jobs in the formal sector less appealing. Social security contributions and other labor taxes contribute to the wedge between the cost of hiring a worker and the wage the worker receives. If these costs cannot be passed to the worker as lower wages, employers will likely adjust by limiting job creation or eliminating jobs, pushing up the unemployment rate.\(^{26}\) On average, labor taxes constitute 37 percent of labor costs in the ECA region.\(^{27}\) The figures are significantly higher in the Western Balkans (Figure 62). Serbia has one of the highest tax wedges at 42.2 percent,\(^{28}\) while Kosovo has one of the lowest,\(^{29}\) due to low pension contributions and personal income taxes.\(^{30}\) High taxes in

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\(^{25}\) Winkler 2014.

\(^{26}\) Alesina and Perotti 1997.

\(^{27}\) Arias et al. 2014.

\(^{28}\) Serbia has not only the highest tax wedge in the region but also high severance payments linked to the employee’s entire work history, not just to tenure with the firm.

\(^{29}\) Other estimates of the tax wedge are 41.4 percent for FYR Macedonia, 34.9 percent for Bosnia and Herzegovina, 40.2 percent for Montenegro, and 33.4 percent for Albania.

\(^{30}\) Though Kosovo has a very low tax wedge, other benefits such
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Progressivity of labor taxes is low, discouraging people at the bottom of the earning distribution from seeking formal employment. The labor tax wedge is especially high among low-wage and/or part-time earners (Figure 62). This means that women, low-skilled workers, and youth, all of whom tend to be more represented in low-wage and part-time employment, face disproportionate disadvantage. Formal-sector matches between firms and unskilled workers are less attractive as a result of higher non-wage labor costs, leading to a higher fraction of unskilled workers moving to either unemployment or informality as they wait for better formal-sector opportunities to come.

Stringent labor market regulations—including restrictions on temporary work, protection of workers against dismissals, and mandatory severance payments—can harm employment, but recent reforms in the region have moved in the right direction. While evidence suggests limited impacts of labor market regulations (unless at the extremes) on overall labor outcomes, there are distributional effects that have stronger impacts on potential low-wage or part-time workers, and on flexible workers and on new and young entrants. The overall OECD employment protection indicator puts the Western Balkans on par with EU comparators but more restrictive than economies in other regions (Figure 63). The degree of employment protection varies across the countries in the region. The World Economic Forum labor market efficiency indicator, combining labor flexibility and talent utilization efficiency, ranks the Western Balkan countries between position 33 and 101 (1 is the most efficient), with FYR Macedonia and Montenegro the most efficient among them. Strong protections for permanent workers in Serbia, FYR Macedonia, and Montenegro make it significantly difficult to attract employment levels when an employer’s circumstances change. Kosovo has some of the region’s loosest controls on hiring and firing of workers. The 2013 BEEPS survey in Kosovo shows that only 4.9 percent of firms there consider labor regulation to be a problem for doing business. Recent reforms across the region have probably made labor regulation more flexible and a less important obstacle to doing business.

“Binding” minimum wages may hinder job creation for low-skilled workers. The ratio of the minimum wage to the average wage is a common proxy used to measure the restrictiveness of minimum wages. In countries with high unemployment among young and low-skilled workers, this ratio should not surpass one-third. By this rule of thumb, all Western Balkan states, like their small transition economy comparators, have relatively high minimum wages (Figure 67). High minimum wages may also have distributional effects, resulting in increased earnings for employed workers but job losses among young and older unskilled workers.

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**Figure 62: The tax burden is high for low-wage workers, suggesting low progressivity.**

(Percentage points)
Workers in the Western Balkans often lack the skills needed in a modern integrated economy.

Skill gaps and skill mismatches may constrain employment in some countries. There exist large differentials between the types of skills demanded by firms and the skills available in the Western Balkan economies.35 Skill shortages and surpluses emerged early in the process of economic transition in the Western Balkans as a consequence of privatization and economic restructuring. The transition induced a growing demand for new skills (not only measured by educational attainment, but also by other proxies that capture cognitive and non-cognitive skills). But the supply of those skills did not keep up, despite the fast expansion of tertiary education. By constructing a skill match index based on variance of unemployment rates across different education groups, signs of possible mismatches in Montenegro and Kosovo have been found. However, firms’ perception of skills as a
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A major constraint is mixed. But on average, the share of firms reporting skills as a major obstacle to doing business is lower in the Western Balkan countries than in other countries in Europe and Central Asia (Figure 68).

**People in the Western Balkans have high access to tertiary education, but the schools seem inadequate for equipping workers with generic skills.**

Generic skills include cognitive skills (literacy, numeracy, and problem solving) and non-cognitive ones (behavior and socio-economic attributes). These skills help workers make use of their human capital flexibly and enhance job mobility. Most countries in the Western Balkans fare relatively well in international student assessments (such as PISA scores) and have relatively high tertiary gross enrollment rates compared to other middle-income countries (Figure 69). Still, many children are not acquiring minimum generic skills, especially when compared to OECD and EU countries. About 77 and 71 percent of 15-year-olds in Kosovo and FYR Macedonia scored below the threshold for functional literacy, which measures the ability to read and write (Figure 70). This may be one of the drivers of the region’s high youth unemployment rates.

**Tertiary education delivers high average returns in the Western Balkans, and, with the**

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**Figure 67:** Restrictive minimum wages can hinder job creation.

(Percentage of average wage)

Source: Arias et al. 2014. Calculations using 2013 data from ILO.

**Figure 68:** Lack of skills a particular problem for firms in Kosovo and FYR Macedonia.

(Percentage of firms identifying an inadequately educated workforce as a major constraint, ECA countries, 2013)

exception of Albania, there is no systematic evidence that the expansion of tertiary education has driven down the college wage premium. The earnings premium over secondary education, often a proxy for a skills premium, was close to 60 percent in 2002 in FYR Macedonia and 55 percent in Albania. In 2009, while those returns remained constant in FYR Macedonia, in Albania they fell by about 10 percentage points. The wage premium is also significant across the wage distribution. In addition to receiving higher wages, individuals with higher education are rewarded with higher probability of employment. In Kosovo, for example, the unemployment rate for those with no schooling was 64.6 percent, but only 18.9 for the tertiary-educated.37

People who do have good skills often leave the country—as of 2013, a quarter of the six countries’ population had moved abroad (Figure 71). The emigration rate among the highly educated is high all over the Western Balkans (Figure 72), particularly in Albania, Bosnia and Herzegovina, and FYR Macedonia (it was almost 30 percent in that country in 2000). If it exceeds a certain threshold, this measure of “brain drain” decreases the stock

36 Arias et al. 2014.
37 Kosovo LFS 2014.
38 Emigration rate of skilled workers is widely used as a measure of brain drain. The emigration rate is defined as the ratio of
of human capital in the country of origin and can produce occupational distortions.

To understand the sources of the brain drain, it is useful to look at the schooling gaps between emigrants and natives, measured as the proportion of skilled relative to unskilled among emigrants relative to the same proportion among native-born individuals. On average, Albanian emigrants tend to be more educated than the resident population, since the share of secondary and tertiary among emigrants is quite high, suggesting that a disproportionate share of high-skilled Albanians tend to emigrate. In Bosnia and Herzegovina and FYR Macedonia, the share of individuals who completed primary education or have incomplete secondary education is higher for emigrants, suggesting that the high skill emigration rate cannot be attributed to higher schooling gaps.39

For the migrant-sending country’s development, a brain drain can have both negative and positive impacts. On the negative side, the country suffers a reduction in the human capital that remains in the country and loses the economic spillovers from that more educated workforce. Positive effects might include increased expectations of return on education, therefore inducing more investment in human capital, and financial, knowledge, and technology linkages with the diaspora. We noted in the welfare chapter that remittances from emigrants make an important contribution to household income in the Western Balkans, but may have also lower incentives to work. All in all, the region would benefit from developing more job opportunities at home, while at the same time harnessing the benefits of emigration such as investment and knowledge transfers from the people abroad.

Aging exacerbates the problems of skills shortages. The skills of older workers are becoming obsolete, making it more difficult for them to transition to new jobs. In FYR Macedonia, the demand for new-economy cognitive skills (usually the types needed in manufacturing or services) has increased across younger cohorts, while older cohorts are employed in occupations that require routine manual skills, typically in agriculture and low-productivity sectors (Figure 73).

Disadvantaged groups face additional barriers to employment.

Gender gaps in the labor market reflect differences in access to income-enhancing assets such as education, but also differences in returns to those assets, barriers to transition into the work force, and cultural norms. In

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Kosovo, which has the region’s highest gender gap in labor force participation, gender disparities are primarily driven by observable differences, notably levels of upper secondary education.\(^4^0\) In other countries, including Serbia and Albania, the causes tend more to be unobservable factors and discrimination. In Serbia, it is women with low levels of education who face the greatest challenges in the labor market. On average, their inactivity rates are 19 percentage points higher and unemployment rates are 2 percentage points higher than those of their male counterparts. Lack of working experience is a contributing factor: about 55 percent of primary school-educated women who are inactive have no paid working experience. In Albania, women face difficulty making the transition from family care-giving or unpaid farm work to the commercial labor markets. Lack of child-care options and cultural norms also play an important role—in traditional society, the priority for women is family.\(^4^1\)

**Poor labor market outcomes among younger workers** are associated with skill gaps, labor taxes, and regulations that particularly affect low-wage and part-time earners.\(^4^2\) Youth unemployment has been associated with skill gaps, difficult transitions from school to work, and vocational programs that are under-resourced and use outdated curriculum. In addition, many firms report that young employees often lack the socio-emotional skills necessary for a smoothly functioning workplace.\(^4^3\) As discussed before, labor regulation and labor taxation may also constrain youth employment. Low-wage earners bear a relatively high burden of labor taxes, so youth are more heavily taxed when working formally (often in part-time and low-wage positions). The youngest labor market entrants tend to be over-represented in informal work.

**Low employment rates among the old** are mostly driven by low rates of participation in the labor force, resulting from work disincentives such as early retirement, disability, dated skills, and low labor mobility. In Serbia, the share of 40-64-year-olds who are inactive due to being discouraged or other reasons unrelated to education are two to three times higher than the share of younger workers. In addition, the share of discouraged and inactive persons who are not in education or training increases with age, pointing to growing problems of finding a proper job in older age. Preliminary evidence for Serbia shows that older people are less likely to find a formal-sector job and exit unemployment than are prime-age and younger workers. Mobility from the public to the private sector among older workers is also limited, considering the generally longer employment duration in public-sector jobs.\(^4^4\)

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\(^{4^0}\) Pastore et al. 2013.

\(^{4^1}\) Western Balkan Gender Assessments.

\(^{4^2}\) Vincelette et al. 2016.

\(^{4^3}\) World Bank 2010. "FYR Macedonia Labor Demand Study."

\(^{4^4}\) World Bank 2013. "Serbia’s Job Challenge Updated."
Labor markets need special policy attention.

In the years ahead, demographic factors will alter the size of future labor markets in the Western Balkans (Figure 74). Countries in the region can be divided into two groups based on their projected population dynamics over the next 20 years: those with growing working-age populations (Albania, Kosovo, Montenegro, and FYR Macedonia) and those with rapid aging in the medium term that will decrease the working-age population (Serbia and Bosnia and Herzegovina). Countries with aging populations need to increase labor force participation to counter the effects of the shrinking workforce and, at the same time, need to raise worker productivity.

Demographic pressures appear also to influence the composition of the working-age population in the Western Balkans. Projections suggest that while the share of young workers in the working age population will decline (Figure 76), the share of older workers will increase in all countries except Montenegro (Figure 77). On average in 2010, about 14 percent of the region’s working-age population was between 55 and 64 years old. That compares with a projected 15.3 percent in 2030. This is an important challenge since the transition to a market economy requires intensive structural transformation including labor reallocation, which is more difficult for older workers. Across the region, there is strong negative relationship between the age of the workforce and the degree of inter-sectoral labor reallocation (Figure 75).

In view of structural and demographic challenges, policy priorities in the region must focus on creating more and better jobs by promoting well-functioning and inclusive labor markets. While making it easier for firms to grow and create jobs, the Western Balkans also need labor market and social protection systems that encourage job creation and offer incentives to raise labor force participation by all population groups. Building relevant skills, enhancing labor mobility, and reducing search frictions would raise employment and labor productivity. The jobs agenda should focus on the following five objectives:

- Addressing work disincentives by reducing labor taxation for low-wage earners and reforming elements of social protection that encourage early retirement and discourage beneficiaries from seeking work. Bosnia and Herzegovina, for example, would benefit from a phased modification of the social assistance system to encourage employment among poorer

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**Figure 74:** Working-age populations are becoming smaller on average in the Western Balkan countries. (Percentage of population 15+)

**Figure 75:** The aging of the workforce is correlated with the lack of structural transformation. (Labor movement across sectors and share of working age population over age 40)

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Note: Sector transition index calculated as sum of the coefficients of variation between 2001-15 in the shares of (a) agricultural employment/total employment, (b) industrial employment/total employment, and (c) services employment/total employment.

Source: Employment shares from World Development Indicators. Share of working age population over age 40 calculated from Population Pyramids of the World (populationpyramid.net).

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The country-level recommendations are drawn from the country SCDs.
groups. In Serbia, it is important to address the high minimum social security contribution and redesign benefits to incentivize transition to work—for example, by requiring able-to-work beneficiaries to register with the National Employment Services and search for jobs.

- Making labor market regulations less stringent to support a more flexible system of hiring and layoffs, while maintaining an adequate level of worker protection. Recent changes in labor regulations in Serbia promote a more flexible system of hiring and firing by reducing severance pay, raising the maximum duration for term employment, abolishing obligations to pay higher salaries for shift work, and changing provisions in collective agreements. There is still room for improvement, however. For example, the maximum length of a fixed-term contract in the country’s services sector is only 24 months.46 In Albania, the severance pay for redundancy dismissal (for a worker with 10 years of tenure) in the services or manufacturing sector is 2.14 weeks of salary, the highest in the Western Balkans, and fixed-term contracts are prohibited for permanent tasks.

- Helping workers acquire market-driven skills, with special attention to younger new entrants to the labor market, older workers, and disadvantaged groups. In Montenegro, 10 percent of firms in the modern and innovating sectors consider the lack of desired workforce skills as a major obstacle to business. Education systems will need to focus on providing skills that allow workers to enter these sectors. In Serbia, expanding access to education for the Roma is critical; in Kosovo, increasing female enrollment in secondary education is a vital goal.

- Removing obstacles to internal labor mobility by implementing policies that reduce the cost of internal migration, promote the sharing of reliable and timely information of job vacancies across sectors and geography, and encourage immigration of young talent. In Bosnia and Herzegovina, increasing private provision of employment services can be useful to supplement the coverage, breadth, and quality of services provided by public employment agencies.

- Removing barriers to employment of disadvantaged groups, by enlarging child care and eldercare options, promoting flexible work arrangements, and strengthening labor market programs that facilitate the transition of minorities, youth, old workers, and women from inactivity to employment. In Montenegro, strengthening efforts to attract FDI in labor-intensive, low-skill sectors could alleviate the large differences in labor market participation and unemployment among population groups. Kosovo may need reforms of its rules on maternity leave, whose current 12-month duration may be leading employers to avoid hiring women.

Fostering labor mobility and effective social protection systems are essential to minimize job losses along the transition path. Market-oriented structural reforms promise to pay off in terms of productivity growth and higher employment, but often with a lag. The experience of past reforms (Figure 78) shows that some employment losses and labor shedding may occur in the short run. In fact, ongoing fiscal consolidation efforts in a number of Western Balkan countries, which are necessary for macroeconomic stability, need to take into account distributional and social impacts of large layoffs. Labor and social security reforms must contribute to the flexibility and efficiency of the labor markets while maintaining a level of protection for workers displaced in changes that are necessary for the future prosperity of the region. In the process of labor reallocation across different sectors, younger and older workers, women, and ethnic minorities are likely to bear a particular burden of losing jobs. For that reason, policies that eliminate their barriers to work, enhance employability, address skill mismatches, and improve labor matching are critical.

As the Western Balkan countries move toward a new growth model, an important goal will be to assure inclusion by providing adequate income opportunities for the less well-off. While higher private sector investment and trade are expected to support income growth of the bottom 40 percent through direct and indirect job creation, this type of change is not always labor-neutral. Should investments filter primarily into capital-intensive sectors, few jobs will be created. Should investments expand mainly in technology-driven sectors, the result could be little job creation for the poor and higher skill premiums, potentially exacerbating wage inequality.

Therefore, to support inclusion and boost employment for those at the bottom, it is important to raise their skills and productivity and continue removing the remaining pockets of labor market rigidity that affect them disproportionately. While export-oriented growth could create jobs in higher-productivity sectors and bring spillovers to other sectors in the economy, promoting opportunities for the poor and vulnerable build human capital and skills could allow them to expand their employment opportunities and obtain some of these jobs. In addition, labor and tax reforms will make low-wage formal jobs (including casual and part-time) more viable so that the less well-off can also find work in supporting services as new businesses enter and grow. Lastly, considering the high share of employment among the less well-off in small firms and self-employment, policies should strive to eliminate barriers for small and medium enterprises (SMEs) and self-employment, and attract investments in agriculture and services to raise productivity in these sectors. The Western Balkans can learn from the experiences of certain EU countries (see Box 3.2).
Box 3.2: Some lessons from Germany and Poland in supporting jobs for the bottom 40 percent.

Germany offers a strong example of effective reforms of labor markets as shown by their resilience after the Great Recession. Germany’s high structural and persistent unemployment over the 1980s and 1990s was often linked to high levels of employment protection and labor costs as well as strict labor market regulation. Labor market reforms implemented between 2003 and 2005 supported a flexible management of working time (through overtime and short-time work, time accounts, and labor hoarding). Reforms also promoted social cohesion, controlled unit labor costs, and a rigid incentive-oriented labor policy supported by effective program evaluation.

As a result, unemployment and employment remained largely unaffected by the economic shock, since most of the employment adjustments were done at the intensive margin and part-time work arrangements. More importantly, the employment outcomes of some vulnerable groups that are often over-represented in the bottom 40 percent (i.e. female workers between 25 and 54, low-skilled workers between 20 and 64, older workers between 55 and 64, and younger workers between 15 and 24 years) improved after the reforms were introduced.

In Poland, strong and steady economic growth was accompanied by higher employment and rising earnings for all income groups, including those in the bottom 40 percent of the distribution. Most of the country’s success in generating inclusive growth was due to labor income growth, largely reflecting improved education levels underpinned by well-functioning labor markets and gains in overall productivity.

Policy reforms concentrated on three key areas. First, they promoted flexibility in the labor market by loosening employment protection. Second, they endorsed increases in access to education (in particular the proportion of workers with tertiary education) and in education quality, which led to across-the-board gains in educational outcomes, raising labor productivity. Third, at the lower end of the market, a national minimum wage policy regularly and significantly increased the minimum wage to enable low-wage earners to share in the productivity gains. As a result, incomes grew across the entire income distribution.

Textile and garment production has been at the core of economic life in the FYR Macedonian town of Stip since as long ago as 1883. But in the 1990s, the mills withered in the face of international competition brought on by the demise of Yugoslavia and communism. Today Stip is again a vibrant apparel producing and exporting town, following the country’s decision to liberalize trade and the private sector and close or privatize parts of two Yugoslavia-era companies in the town, Makedonka and Astibo.

A Turkish investor now operates a former denim plant of Makedonka; Astibo has been born again as a successful private fashion company. Swiss and German investors have relocated garment production to Stip. Foreign direct investment inflows combined with the town’s managers and workers to create vibrant plants that employ nearly a third of the country’s industrial workforce. FYR Macedonia now exports more clothing per capita than any country in the Western Balkans.

Integration with the value chains of foreign companies has given birth to new local ones as well. Fersped Skopje and Deni Internacional are among other enterprises that set up to provide cost-effective transport, logistics, and trade facilitation services. Goce Delchev University in Stip, meanwhile, offers degrees and diplomas in textile and apparel production, design, and management to meet rising demand for skilled staff.
Have trade and financial integration increased in the Western Balkans and have they led to income convergence?

The pace of trade and financial integration was fairly rapid between 2000 and 2008 but has slowed since. The Western Balkan countries’ speed of convergence to higher per capita income has closely followed the pace of integration. There is room to deepen global integration to help speed up income convergence with the European Union, as the experience of the 7STEE countries has shown.

How can the region more effectively expand trade integration?

The surest way to improve competitiveness is to raise productivity faster than costs. Policy reforms in this direction in the Western Balkans have created better incentives for firms, but remain short of EU transition economies’ levels. Lackluster reforms concerning SOE restructuring and regulations that impede domestic competition and labor reallocation have reduced firms’ ability to enhance productivity. The region’s relatively small labor force makes upgrading of exports key to sustained growth of exports. This upgrading would generate economy-wide productivity growth by moving resources to more sophisticated products. There is still major room to lower costs and improve quality of logistics and other services to reduce order-delivery turn-around times and expand participation in global value chains (GVCs). A greater role in European GVCs is crucial to facilitating overall global integration.

Can deeper integration between the Western Balkan countries help their global integration?

For small open economies, greater regional integration brings economies of scale and enhances global integration by making them larger, more efficient, and diverse competitors for places in GVCs. Greater regional integration has many dimensions that would create positive spillovers for global integration. These include trade, the financial sector, transport, regulatory and investment policy, and macroeconomic and fiscal policy.
Trade and financial integration proceeded briskly in the Western Balkans in 2000-08 but suffered a serious blow with the onset of the global financial crisis. The crisis sharply reduced financial inflows as well as external demand. The fall in inflows squeezed imports and consumption precipitously, while the global economic slowdown let the air out of the region’s export growth. The Western Balkan countries slowed the pace of reforms, especially concerning regulatory restrictions and domestic competition, resulting in a general slowdown in integration and income convergence. Nevertheless, both trade and financial integration have continued to make progress on various fronts. There is evidence to suggest that countries that implemented structural reforms and increased public investments after 2008 performed better than others in the efforts to keep the economy, exports, and productivity growing.

Integration that was once brisk needs to accelerate again.

No small country can become rich without accelerating its exports and deepening its integration into the international economy—this is a basic fact that faces the Western Balkan countries today as they seek income convergence with the European Union. Exports face intense global competition that compels firms to allocate resources efficiently, adopt better technologies, tap economies of scale, and improve imported inputs, thus generating higher productivity growth. At the same time, domestic reforms that open up trade and investment flows and facilitate firms’ ability to move labor and other resources to new activities can raise productivity growth, reduce costs, and make exports more competitive. These virtuous cycles explain the positive association between greater trade integration and higher labor productivity (Figure 79).

In the Western Balkans, financial integration has been successful, rising from once negligible levels. Measured as the sum of foreign financial assets and liabilities as a share of GDP, all five countries for which there are data had attained financial integration levels close to 170 percent by the end of 2015, with Serbia reaching 190 percent (Figure 80).

Most of this integration was achieved by 2007, with financial flows falling off precipitously in 2008-09 and recovering gradually since. Given that comparators such as Estonia and Latvia have exceeded 300 percent of GDP, further financial integration is possible.

Most of the cross-border financial flows into the Western Balkans were FDI by European commercial banks in 2000-08. Between two-thirds and four-fifths of Western Balkans banking assets are currently foreign-owned. This has reduced the historically high connectedness of the banking system with state-owned enterprises, making lending more arms-length, a welcome development in SOE-dominated economies. Foreign ownership also helped banks channel offshore funds into faster expansion of domestic credit, supporting growth of private-sector firms.

The greater availability of foreign funds helped underwrite greater investment than would have been possible with national savings alone, but also created new concerns. Higher investment supported growth but also created vulnerabilities in the banking system when investments proved to be less productive and resulted in non-performing loans. Where these inflows financed excessive consumption, they created vulnerabilities too.

In parallel, these countries made significant strides in trade integration in 2000-08, though it was not as rapid as financial integration. Total

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trade (the sum of exports and imports of goods and services) reached almost 100 percent of GDP and more in Serbia, FYR Macedonia, and Montenegro, but 90 percent in Bosnia and Herzegovina and only around 70 percent in Albania and Kosovo (Figure 81). By comparison, small transition countries such as Lithuania, Estonia, and Slovakia have considerably higher trade ratios of 155 to 185 percent of GDP.

Exports have been an important driver of trade integration. In the last decade and half, exports of goods and services grew by more than 10 percent a year in Serbia, Albania, and Kosovo but less than 10 percent in FYR Macedonia and Montenegro, with Bosnia and Herzegovina averaging only 5 percent a year. Exports grew much faster in 2000-08 in all countries despite a domestic demand-driven growth strategy, because of the peace dividend following the 1990s conflicts, the liberalization of trade, finance, and the private sector, and, of course, a booming global economy. The global slowdown of 2009-15 lowered their export growth to 0.5 to 8 percent a year, which was nevertheless commendable in a difficult external environment.\(^\text{50}\)

The export orientation of these economies has increased, some more than others, but they continue to lag the 7STEES. The GDP share of goods and services exports rose to between 25 and 45 percent from a relatively low level, meaning all countries retain considerable room for greater trade integration. Kosovo is the least integrated, followed in order by Albania, Montenegro, Bosnia and Herzegovina, Serbia, and FYR Macedonia. By contrast, Slovakia, Estonia, Lithuania, and Slovenia have export shares in GDP that equal or exceed 80 percent. In terms of per-capita exports, the Western Balkan countries achieve only a fraction of levels in 7STEE countries.

There is room to deepen integration among the Western Balkan countries, building on Cefta.

As countries strive to integrate globally, the small size of their economies suggests that regional integration would be a good first step. While not all countries would be able to attract lead firms like Fiat, this will not be necessary if an integrated regional economy is built. Eliminating barriers to trade and flow of factors of production within the region would help the Western Balkans to expand market size and enter European and global production networks, participation in which is crucial for increasing productivity in manufacturing.

The region increased its export share in global and EU markets over the last 15 years. The countries’ share in the EU market rose by nearly 100 percent between 2005 and 2015 (Figure 83), accompanied by a four-fold increase in total exports.

\(^{50}\) Only five East Asian countries—China, Vietnam, Thailand, Cambodia, and Lao PDR—did better.
to the EU. Western Balkan countries raised their share in world goods exports too, by around 25 percent, with all countries except Montenegro increasing their individual shares. The lessons of this period can be very helpful in the coming years because in the more subdued global and EU economy, strong export growth depends on taking a greater share of a slow-growing market.

There is room to use existing regional agreements to scale up participation in major European value chains. Albania, Bosnia and Herzegovina, FYR Macedonia, and Serbia depend on the EU for 60-70 percent of their exports (Figure 84). The Central European Free Trade Agreement, CEFTA, accounts for about 30 percent of the exports of Montenegro and Kosovo but only 10 percent of the rest of the Western Balkans. Less than 15 percent of the region’s top exports go to CEFTA countries and only plastics, and iron and steel, have a CEFTA share of about 25 percent. The GVCs operating in clothing, footwear, machinery, and automotive subsectors export an even smaller share to CEFTA and source around 90 percent of their intermediate imports from non-CEFTA countries. Most GVC-related FDI comes from non-CEFTA countries. This is not surprising given the relative size of the CEFTA and EU markets, and the latter is likely to play the dominant role in future integration.

The potential for upgrading quality and quantity of exports is high.

Successful upgrading of exports can drive growth in productivity, employment, and GDP as well as faster income convergence. The relatively small labor forces in these economies make the working-age population ranges from about 500,000 in Kosovo and Montenegro to 1-1.5 million in FYR Macedonia, Albania, and Bosnia and Herzegovina to 3 million in Serbia. The labor chapter highlights structural and some intractable factors that reduce the participation rate of the working-age population in these countries to unusually low levels.

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51 The CEFTA countries consist of Albania, Bosnia and Herzegovina, FYR Macedonia, Moldova, Montenegro, Serbia, and Kosovo.

52 The working-age population ranges from about 500,000 in Kosovo and Montenegro to 1-1.5 million in FYR Macedonia, Albania, and Bosnia and Herzegovina to 3 million in Serbia.
expanding exports by upgrading the best route to higher wages and income convergence. The manufacturing sector has managed to generate higher productivity gains and convergence\textsuperscript{53} and thus a shift to higher-skill and technology-intensive products. But productivity increases can also come in agriculture from a rise in the share of processed exports, in metals from a move towards more differentiated downstream products,\textsuperscript{54} and in services from a shift to modern business services including more skill- and ICT-intensive ones.\textsuperscript{55} The low current shares of these types of goods and services suggest a potential for higher export growth through upgrading.

The 7STEE countries increased market share and productivity through continuous upgrading of exports.\textsuperscript{56} The pace and timing of the upgrading of manufactured exports varied among countries, starting with an expansion of low-technology, labor-intensive products such as clothing and footwear to mostly medium-technology ones such as consumer electronics, auto, and machinery, and then more slowly to the production and export of high-technology items within these subsectors. Quality of products within each technology segment rose as well. The continual upgrading and the accompanying rise in productivity raised market share in the face of the region’s appreciating real exchange rates.\textsuperscript{57} The same feat was accomplished in modern services.

There is room in the Western Balkans for increasing export sophistication. The region exports resource-based items, low-technology, labor-intensive manufactures, and higher-technology products. While all countries could benefit from upgrading, differences in their export characteristics and future policies will influence how individual export structures evolve. All countries have a less diversified and less sophisticated export basket in both goods and services relative to the 7STEEs. But the shares of agriculture, minerals, and metals versus manufactures differ greatly among them, with some having a low proportion of medium- and high-skill, technology-intensive exports within manufactures. While export sophistication is an imperfect measure of the quality of exports,\textsuperscript{58} it nevertheless gives some indication of the progress made in the value-added upgrading that brings increases in productivity and therefore faster convergence in income per capita.

The variety of export items in the Western Balkans is smaller, and both product and market concentration higher. Diversification has a different meaning when applied to small countries: specialization in high-value added exports could be more productivity-enhancing than a more diversified export structure (for example, a highly developed automotive industry connected to global value chains could be a stronger engine of growth than a more diversified but less sophisticated export basket). That said, high value added industries also tend to increase the variety of products as backward linkages develop in the economies. There is therefore some value in looking at indices of diversification and sophistication of exports. Albania and Montenegro export the smallest variety of items (500-1,000), with FYR Macedonia and Bosnia and Herzegovina having about 3,000. Serbia, which inherited a relatively developed manufacturing sector from the former Yugoslavia, comes close to 7STEE averages, followed by the other two manufacturing-exporting countries, Bosnia and Herzegovina and FYR Macedonia (Figure 85). On product concentration, the top five exports account for 50 percent of earnings in Montenegro, 40 percent in Albania and FYR Macedonia, but less than 20 percent in Serbia and Bosnia and Herzegovina. Market concentration of exports is significantly greater: the top five export destinations account for 70 percent of export earnings in Albania, 60 percent in Bosnia and Herzegovina and FYR Macedonia, and less than 50 percent in Serbia.

Agriculture, minerals, and metals comprise substantially higher shares of exports than in the 7STEE countries. These products form about a third of merchandise exports in Albania, Bosnia and Herzegovina, FYR Macedonia, and Serbia, and two-thirds in Kosovo and Montenegro (Table 4.1). In addition, most agricultural exports consist of primary unprocessed items, ranging from 7-12 percent in Albania, Bosnia and Herzegovina, and FYR Macedonia to 17-21 percent in Montenegro and Serbia. Similarly, metal exports consist mostly of ores and unwrought items, counting for more than 50 percent of total exports in Kosovo and Montenegro and a smaller but still substantial...
20-25 percent in Albania, Bosnia and Herzegovina, Serbia, and FYR Macedonia.

Exports of processed fruits and vegetables remain small despite easy access to EU markets and their high demand for such products. Bosnia and Herzegovina exports fresh plums and frozen raspberries, and FYR Macedonia apples, peaches, sour cherries, and plums, while Serbia is the third-largest producer of berries in Europe. Albania, FYR Macedonia, and Serbia have exported some processed vegetables such as ketchup based on tomatoes, spiced tomato paste from pepper, and chips from potatoes. Such exports have stagnated, apparently because current production, yield, and consistency of quality are not scaleable for export operations, and storage, transport, and logistics systems are inadequate.

Manufactures dominate goods exports in FYR Macedonia, Serbia, Bosnia and Herzegovina, and Albania, but they remain at the lower end in skill-technology intensity and quality (Figure 86). Labor-intensive low-technology manufactures such as clothing and footwear account for most of Albania’s manufactures exports but only about a fifth of FYR Macedonia’s and Bosnia and Herzegovina’s and a tenth of Serbia’s. On the other hand, machinery and automotive items account for two-fifths of Serbia’s, a third of FYR Macedonia’s, and a fourth of Bosnia and Herzegovina’s manufactured exports.\(^5^9\)

Export sophistication of Western Balkans manufactures remains low, but there has been considerable progress in medium-skill technology exports.\(^6^0\) While the high-skill technology intensity of the region’s exports has remained largely unchanged since the 1990s (Figure 88), high-skilled manufacturing in several countries in the region has recently matured as its share of production increased to the level expected at their income per capita.\(^6^1\) Serbia, FYR Macedonia, and Bosnia and Herzegovina probably account for most of the rise in medium-skill technology exports, given the countries’ success in machinery and auto sector exports (Figure 89). But Figure 87 and Figure 88 also show that their global value chain (GVC) participation is mainly at the assembly and lower-skill end of the subsector, suggesting considerable room to upgrade.

Services account for 70 percent of total export of goods and services in Albania, Kosovo, and FYR Macedonia but only 25 percent for the other three countries. Travel and transport\(^6^2\) dominate service exports in all six countries, with considerable scope for expanding tourism nonetheless. But there is even greater potential for increasing exports of higher-productivity business and ICT services as the 7STEE countries did.\(^6^3\) 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 their domestic markets 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 GVC exports and are thus exported indirectly too. Enhancing the efficiency of these services can contribute to expanding GVCs.

\(^{5^9}\) Montenegro and Kosovo also have high shares of machinery and auto parts in their manufactured exports, but manufactures comprise only 20 percent of their total exports.

\(^{6^0}\) Shimbov et al. 2016.


\(^{6^2}\) Traditional services consist mainly of transport, travel, construction, and personal, cultural, and recreational services. Modern services include communications, insurance, finance, computers and information, and other business services as well as royalties and license fees.

\(^{6^3}\) Fernandes 2008 and Raiser and Gil 2012.
### Table 4.1: Composition of goods exported differs significantly among Western Balkan countries.
(two-digit level, 2014)

<table>
<thead>
<tr>
<th>Category</th>
<th>Albania</th>
<th>Bosnia and Herzegovina</th>
<th>FYR Macedonia</th>
<th>Montenegro</th>
<th>Serbia</th>
<th>Kosovo</th>
</tr>
</thead>
<tbody>
<tr>
<td>01-05 Animal</td>
<td>1.0</td>
<td>2.0</td>
<td>0.6</td>
<td>2.4</td>
<td>1.5</td>
<td>0.1</td>
</tr>
<tr>
<td>06-15 Vegetable</td>
<td>4.0</td>
<td>3.5</td>
<td>3.9</td>
<td>3.1</td>
<td>11.6</td>
<td>2.2</td>
</tr>
<tr>
<td>16-24 Foodstuffs</td>
<td>2.3</td>
<td>3.2</td>
<td>7.4</td>
<td>11.5</td>
<td>8.3</td>
<td>4.0</td>
</tr>
<tr>
<td>25-27 Minerals</td>
<td>15.9</td>
<td>8.2</td>
<td>5.1</td>
<td>21.0</td>
<td>3.3</td>
<td>7.4</td>
</tr>
<tr>
<td>23-38 Chemicals</td>
<td>0.5</td>
<td>7.7</td>
<td>21.6</td>
<td>3.9</td>
<td>5.4</td>
<td>0.5</td>
</tr>
<tr>
<td>39-40 Plastic/rubber</td>
<td>0.5</td>
<td>3.1</td>
<td>1.9</td>
<td>0.5</td>
<td>8.6</td>
<td>4.4</td>
</tr>
<tr>
<td>41-43 Hides, skins</td>
<td>0.9</td>
<td>1.8</td>
<td>0.2</td>
<td>1.2</td>
<td>0.6</td>
<td>5.2</td>
</tr>
<tr>
<td>44-49 Wood</td>
<td>3.4</td>
<td>10.4</td>
<td>0.6</td>
<td>11.3</td>
<td>4.7</td>
<td>1.2</td>
</tr>
<tr>
<td>50-63 Textiles, clothing</td>
<td>16.7</td>
<td>5.5</td>
<td>13.2</td>
<td>0.3</td>
<td>5.2</td>
<td>7.9</td>
</tr>
<tr>
<td>64-67 Footwear</td>
<td>17.7</td>
<td>7.1</td>
<td>1.3</td>
<td>0.2</td>
<td>1.9</td>
<td>0.2</td>
</tr>
<tr>
<td>68-70 Stone/glass</td>
<td>0.4</td>
<td>0.6</td>
<td>0.8</td>
<td>0.3</td>
<td>1.0</td>
<td>5.2</td>
</tr>
<tr>
<td>71-83 Metals</td>
<td>9.9</td>
<td>17.8</td>
<td>15.3</td>
<td>32.8</td>
<td>12.8</td>
<td>51.0</td>
</tr>
<tr>
<td>84-85 Machin/electr</td>
<td>2.3</td>
<td>11.3</td>
<td>21.5</td>
<td>6.5</td>
<td>16.6</td>
<td>6.9</td>
</tr>
<tr>
<td>86-89 Transportation</td>
<td>0.5</td>
<td>4.5</td>
<td>5.2</td>
<td>2.9</td>
<td>12.7</td>
<td>1.9</td>
</tr>
<tr>
<td>90-97 Miscellaneous</td>
<td>1.2</td>
<td>11.3</td>
<td>3.4</td>
<td>2.2</td>
<td>4.4</td>
<td>1.8</td>
</tr>
<tr>
<td>98-99 Special</td>
<td>23.0</td>
<td>3.1</td>
<td>0.0</td>
<td>0.0</td>
<td>1.5</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Source: Comtrade.
Note: Data for 2014 for all countries except Kosovo, which is 2012-13.

### Figure 86: In larger countries of the region, manufactured exports tend to dominate trade in goods…
(Manufactures as share of exports, percent, 2000-15)

### Figure 87: …but upgrading to higher content of high technology and skill content is only starting.
(Manufacture exports by level of skill and technology intensity, 2015)
Western Balkan participation in global value chains is slowly rising.

Expanded and deeper GVC participation facilitates upgrading and diversification and contributes to overall growth of exports and productivity. Export upgrading is especially effective in driving growth in productivity, employment, and GDP in countries with relatively small labor forces. Western Balkan firms’ participation in GVCs has risen for more than a decade because they are able to produce and export a slice of the product value chain at a large enough scale to be globally competitive without having to build the entire value chain in the country. Also, upgrading products and functions along the export value chain is easier because lead GVC firms provide technical advice and support when such help makes the final GVC product more competitive.

The experience of EU transition countries shows that expanding and upgrading final and intermediate exports through GVCs is a potent means of trade integration. Hungary and Slovakia upgraded and expanded their share of domestic value added exports in GDP at double-digit rates between 1995 and 2008, while Czech Republic, Poland, Lithuania, and Slovenia increased theirs by between 5 and 10 percentage points. This was all accomplished through expanded participation in European GVCs. Productivity growth in manufacturing firms that were part of GVCs was found to be higher than those that were not.

Exports typically upgrade along two avenues, one from low-to-medium to high skill and technology intensive subsectors and another from lower-to-higher quality segments within each of these subsectors. Successful EU transition countries started with mostly low-technology products such as clothing and footwear, moved on to mostly medium-technology items in consumer electronics, auto, and machinery, and then as policies, skills, and infrastructure improved, moved increasingly to exports of high-technology items within the auto, machinery, and ICT subsectors. At different points in time, countries simultaneously exported both low-technology clothing in the high-quality segment and medium-technology electronic and automotive items in the low-quality segment.

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64 Taglioni and Winkler 2016.
65 GVCs can “compress” development experience, making non-linear catch-up possible as China did. See Whittaker et al. 2010, Breznitz and Murphree 2011, and Raiser and Gil 2012.
66 Rahman and Zhao 2013.
67 Taglioni and Winkler 2016.
68 For example, within the electronic and optical equipment category, a simple radio alarm differs in quality from advanced scientific equipment, and within the food products, beverages, and tobacco category there are large quality differences between champagne and simple foodstuffs.
69 Fabrizio et al. 2007.
Participation of Western Balkan countries in GVCs has been growing for more than a decade, but they remain well behind levels of the 7STEE countries. Western Balkans firms have joined GVCs in clothing, footwear, machinery, and autos but not yet in processed agriculture or ICT services. FYR Macedonia and Serbia have the highest share of GVC exports participating in all four subsectors, with Albania and Bosnia and Herzegovina coming next, though Albania’s participation is limited mainly to clothing and footwear. In these products there is relatively little backward integration of firms assembling inputs imported mainly from the EU into final products according to designs provided by lead GVC firms in the EU. Cars, buses, and machinery are assembled mainly from imported components but increasingly from parts being made by foreign-invested tier 1 and 2 suppliers operating in Serbia, FYR Macedonia, and Bosnia and Herzegovina—for assemblers in the country as well as for export. These foreign tier 1 and 2 suppliers are still importing a lot of their inputs because there are only a few local tier 3 firms able to supply quality inputs, but that is exactly where there is considerable room for upgrade.

Rising GVC participation generates growing intermediate exports and imports and the latter in turn raise growth in both productivity and GDP. This is not only because access to better-quality inputs improves competitiveness but because when intermediate parts are part of a long GVC supply chain, relationships among producers become much closer, providing many more opportunities for transfers of know-how. When Zastava makes car parts that will be combined with imported parts for assembling into Fiat cars for export, it cannot rely only on existing Serbian expertise. It imports Fiat technology, management, logistics, and other bits of knowledge not available locally, so that the Serbian-made parts fit seamlessly with imported parts from Italy or elsewhere. The same is true when the U.S. firm Johnson Controls invests in FYR Macedonia to produce electronic dashboard components; the components must fit with other parts that are produced in a second country and assembled in yet another. For this reason, GVC investors often work to upgrade technical and engineering skills in the host country, as in FYR Macedonia, where the Johnson Controls Training Center was established as a joint venture with the Faculty of Mechanical Engineering of Saints Cyril and Methodius University in Skopje to ensure a continued supply of skilled workers for the automotive sector.

In 2015, more than half of gross exports were intermediate products in all Western Balkan countries but Albania. Figure 90 provides an economy-wide view of the share of intermediates in total exports and imports of Western Balkan countries, compared to the 7STEEs, in 2004 and 2015. Montenegro had the highest share of intermediates, though it declined from 85 to 70 percent between the two comparison years and nearly 50 percent of the country’s intermediate exports in 2015 consist of alumina, iron, and steel generated by mines that are unrelated to GVCs. Bosnia and Herzegovina, FYR Macedonia, and Serbia were the most integrated in European value chains in clothing, footwear, machinery, and automotive products, with more than half of their gross exports as intermediates, most of them GVC-related.

The share of intermediate exports was much higher in 2015 than in 2004 in FYR Macedonia and Bosnia and Herzegovina, but lower in Serbia and Montenegro. Serbia’s figure declined because car parts and components that were previously exported appear to now be increasingly incorporated into Fiat cars that are assembled in the country and exported in ever-larger numbers. The share of intermediates in Montenegro declined due to issues with the aluminum plant KAP. In the 7STEE countries, half or more of gross exports are intermediates, with the exception of Lithuania.

Annual growth in the Western Balkans countries’ machinery and transport parts and components trade exceeded those of the world and of the EU transition countries (Figure 91). This is due mainly to the Western Balkans’ rising participation in machinery and transport GVCs and corresponding growth in output and exports. The expansion in FDI-financed production capacity in Serbia, FYR Macedonia, and Bosnia and Herzegovina explains most of the growth in parts and components trade.

Growth in domestic value-added (DVA) that is embedded in gross exports of intermediate and final goods is important for the domestic economy. Increases in DVA capture the gains to

71 Shimbov et al. 2016.
72 Gross exports of Western Balkan countries have three
a country’s labor and its entrepreneurs. DVA grows when gross exports grow, even if the DVA share per unit of gross exports is low, as in clothing exports, and not rising. Countries can increase DVA per unit of gross exports by undertaking backward integration and/or product and functional upgrading. This is the route available to Western Balkan countries. For example, producing garments by assembling imported inputs implies low DVA per unit of garment exports, as happens often in Western Balkan countries. But if garment exports through GVCs grow, their DVA could grow even more if exporters procure imported fabrics and accessories and/or produce them domestically before assembling them into garments, as long as they can do such backward integration competitively.

**Growth of gross exports and DVA embedded in gross exports** are useful indicators of GVCs’ components. The first is foreign value added (FVA) that is imported from foreign suppliers, the second is domestic value added (DVA) of gross exports of final goods that are consumed in the foreign destination countries, and third is DVA of gross exports of intermediates that enter as inputs in foreign countries’ gross exports. Total DVA is the sum of DVA from gross exports of final and intermediate goods.

**Contribution to employment, productivity, and income.** Figure 92 shows the compound annual growth rate (CAGR) of gross exports and of DVA in five of the six Western Balkan countries for which there are data. Serbia surged in DVA to 52 percent. The annual growth of DVA in the other four countries, ranging between 12 and 17 percent, is respectable relative to the 10-20 percent range of the 7STEEs, given the latter’s head start. In most cases, annual growth of DVA has nicely tracked the growth in gross exports. The only exception is Montenegro, where export growth has been faster than DVA growth, suggesting that exports from sectors with lower rates of domestic value addition have been growing more rapidly. This may reflect a changing composition of the export basket as well as increased GVC participation using more foreign inputs.

While raising growth of total DVA in gross exports is an appropriate goal, maximizing the DVA share per unit of a subsector’s gross exports is not. Excessive focus on the latter has led to transfer non-proprietary technical know-how to countries and firms if they have potential to upgrade competitively.

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73 Value addition is a function of productivity and is associated with breadth, variety, and sophistication of tasks and activities in which a country specializes. GVCs have a built-in mechanism to outsource tasks and activities to countries that can meet brand quality competitively, because lead firms/tier-1 suppliers are willing to transfer proprietary technical know-how to countries and firms if they have potential to upgrade competitively.

74 There is anecdotal information on Kosovo’s participation in GVCs in garments and in metals.

75 Serbia is a clear outlier, suggesting a need for further examination of the Serbian database used by the EORA database.

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*Figure 90: Intermediate goods trade in Western Balkans and the 7STEEs: 2004 vs 2015.*

(Intermediate imports as % of gross imports)

(Intermediate exports as % of gross exports)

Source: UN Comtrade and World Bank staff calculations.

countries to restrict firms’ access to the often higher quality and more competitive intermediate inputs available abroad. Such actions undermine competitiveness, GVC participation, and ultimately growth in total DVA.76 GVCs require trade regimes that make imports available at close to world prices, allowing firms to make choices based on market demand and competitiveness. Backward integration and product or functional upgrading are highly desirable when they make the GVC product more competitive.

The Western Balkans countries can increase DVA by either raising the DVA share per-unit in existing GVC exports or by attracting GVC lead firms in new subsectors. Existing GVCs in clothing, footwear, machinery, and transport offer considerable opportunities for backward integration and product and functional upgrading, as well as simple expansion of existing intermediate and final good exports. Entering GVCs that have little local participation, as in processed agriculture or ICT services, is another option. This is the way the 7STEE countries did it.

All the Western Balkan countries except Montenegro export clothing through GVCs using mainly cut, make, and trim (CMT) contracts by which imported materials are assembled by local workers. The scope for functional upgrading and product upgrading is high in this sector and success in that effort can generate significant increases in DVA share per unit of clothing exports. This can consist of upgrading products (for instance, shifting from shirts to suits) and upgrading functions (local firms procuring fabrics and accessories, for example, or preparing clothing samples for buyers). But this requires skilled labor. If clothing exports are large enough, backward integration in terms of producing fabrics and accessories domestically may be feasible. Similar upgrading possibilities exist in footwear.

FYR Macedonia, Serbia, and Bosnia and Herzegovina have expanded automotive exports through GVCs but FDI-invested exporters of intermediate and final goods have few linkages to domestic suppliers. FYR Macedonia and Serbia have already begun efforts at further backward integration by encouraging local tier 3 suppliers. They are working with procurement managers of FDI-invested assemblers and tier 1 and 2 suppliers in the two countries to identify parts of the value chain that local suppliers might fill.77

76 DVA and FVA are seen as complements in the context of GVC integration because access to greater variety and/or to higher quality of imported intermediates embodying foreign technology and know-how increases productivity. See Grossman and Helpman 1993.

77 In FYR Macedonia’s bus manufacturing value chain, for instance,
Attracting lead GVC firms in processed fruits and vegetable into the Western Balkans could expand the region’s gross exports and DVA. Albania, Bosnia and Herzegovina, FYR Macedonia, and Serbia have high production capacity and several Western European supermarkets chains have set up retail stores there. But competition from Greece, Italy, Spain, and Turkey, which have similar climates but more modern production processing and logistics systems, makes it challenging to attract GVCs in processed fruits and vegetables. In exporting fresh tomatoes, for example, Albania has many missing links and poor coordination across the value chain, suggesting a need for government collaboration with the right private investors to fill the gaps in the chain.

Steady progress so far in integrating into GVCs suggests they are a good base from which to further accelerate exports, employment, and productivity. Without comparable data on intermediate trade, gross exports, and domestic value added in participating subsector GVCs, overall conclusions have to be tentative. Nevertheless, the analysis above shows that the base is strong for future gains.

To deepen trade integration, reforms should target bottlenecks to GVC participation.

Appropriate changes in policies and public investments to expedite trade integration through exports will be critical for reviving the Western Balkans countries’ growth in productivity and GDP. Higher export growth through upgrading calls for greater GVC participation by reducing tariffs on intermediate imports, increasing domestic competition by reforming regulations and restructuring SOEs, investing in power and transport, enhancing efficiency of connectivity in terms of trade facilitation and logistics, expanding availability of industry-specific skills, and targeting development of domestic-suppliers in existing machinery and transport export sectors.

The trading regime of the region is already very open. Albania, FYR Macedonia, and Montenegro are members of the World Trade Organization (WTO), while Bosnia and Herzegovina and Serbia are at advanced stages of the WTO accession process. Stabilisation and Association Agreements (SAA) have entered into force in all six countries, giving them free access to the EU market. However, current levels of tariff on agricultural products and intermediate imports are affecting GVC competitiveness because intermediate items have to cross borders more than once, making the cumulative impact of tariffs high.

But the domestic regulatory environment remains quite restrictive. These restrictions increase the cost of domestic transactions relating to private investment and firm operations and reduce the competitiveness of exports. Though the regulations impinge on local citizens and foreigners alike, foreigners feel a greater impact because they have less access to and understanding of local processes. Reducing the domestic regulatory burden would enhance competitiveness and facilitate further integration with the rest of the world.

Finding ways to increase competitiveness is critical as countries seek to expand exports in a time of global and European slowdown. The currencies of the Western Balkans countries appreciated substantially in 2000-08 and remained high in the post-crisis period despite the shocks of the global slowdown (Figure 95). Serbia and Montenegro experienced real appreciation of about 80 percent and others of 10-15 percent. Policies to smooth out exchange rate volatility would raise the region’s competitiveness. Though the cost of labor in the Western Balkan is lower than in the rest of Europe, it is higher than in low-cost Asia. Lowering high social security taxes in the region would also be helpful (Figure 96). While these steps would aid competitiveness, far more important is removing the structural and regulatory barriers that harm productivity (see Enterprise chapter).

To export more, the Western Balkans must also deliver goods cost-effectively. Moving goods across borders efficiently requires high-quality logistics and transport connectivity. It also requires efficient and fair border and customs processing. Likewise,
moving service products requires up-to-date digital communications networks. Figure 97 details deficiencies in logistics relative to other European countries.\textsuperscript{82} Despite considerable investments in the South East Europe Transport Observatory (SEETO) Comprehensive Network to create reliable transport, the region needs significant further efforts to ensure competitive delivery of export goods. Such efforts may need to develop “intelligent” transport systems for railways, improve risk management systems, and simplify border crossings. The challenge is to increase reliability in the time and cost of transportation and the moving of goods across borders.

An ambitious at-the-border and behind-the-border reform agenda would help cut costs to increase productivity and competitiveness and facilitate cross-border trade. More analytical work is needed to identify specific constraints to increasing exports from the Western Balkans, as well as to faster climb on the technological ladder. Based on the diagnostic in this chapter, an ambitious agenda is shaping up for reforming both at-the-border and behind-the-border processes and infrastructure. Many reforms will be horizontal in nature and include leveling the playing field between diverse set of enterprises, an agenda more thoroughly described in the next chapter. This chapter has so far advised focusing efforts in trade facilitation and customs, transport and logistics, and retaining qualified labor. Better financial services and a more integrated regional economy would help facilitate such reforms at the national level.

**Greater depth, stability, and efficiency in the financial sector would also facilitate trade.**

Global financial integration has increased substantially over the last two decades, including in the Western Balkans. In Europe, financial integration has been unique as private capital in all its forms—cross border flows and FDI—has flowed from richer to poorer countries, and from low- to high-growth economies. Since the early 2000s, transformation and transition have been particularly deep in the region’s banking sector. Removal of nationality restrictions, the liberalization of market access, the EU enlargement process, and the sale of most state-owned banks have brought about a round of banking consolidations and a large increase of foreign bank participation.

Financial deepening has been uneven across countries and sectors. In terms of size, on average,
**Figure 95: Vigorous reforms in the Western Balkans...**
(EBRD transition score, index)

**Figure 96: ...still fell short of those in other small transition economies of Europe.**
(EBRD transition score, index)

**Figure 97: The Western Balkans are lagging behind 7STEEs on logistics performance.**
(Logistics performance index 2014, Overall, 1=low to 5=high)

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### Table 4.2: Western Balkan countries have a heavy burden of domestic regulation.

<table>
<thead>
<tr>
<th></th>
<th>ALB</th>
<th>BIH</th>
<th>KSV</th>
<th>MKD</th>
<th>MNE</th>
<th>SRB</th>
<th>7STEE</th>
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<tr>
<td>Doing Business rank (2017) - WB</td>
<td>58</td>
<td>81</td>
<td>60</td>
<td>10</td>
<td>51</td>
<td>47</td>
<td>27</td>
</tr>
<tr>
<td>Corruption Perception Index score (2016) - TI</td>
<td>39</td>
<td>39</td>
<td>n.a.</td>
<td>37</td>
<td>45</td>
<td>42</td>
<td>55</td>
</tr>
<tr>
<td>Intensity of local competition (2016-17) - WEF</td>
<td>116</td>
<td>119</td>
<td>n.a.</td>
<td>41</td>
<td>124</td>
<td>128</td>
<td>51</td>
</tr>
<tr>
<td>Extent of market dominance (2016-17) - WEF</td>
<td>124</td>
<td>108</td>
<td>n.a.</td>
<td>67</td>
<td>89</td>
<td>129</td>
<td>64</td>
</tr>
<tr>
<td>Effectiveness of anti-monopoly policy (2016-17) - WEF</td>
<td>112</td>
<td>105</td>
<td>n.a.</td>
<td>49</td>
<td>85</td>
<td>118</td>
<td>64</td>
</tr>
<tr>
<td>Business impact of rules on FDI (2016-17) - WEF</td>
<td>59</td>
<td>127</td>
<td>n.a.</td>
<td>32</td>
<td>95</td>
<td>102</td>
<td>50</td>
</tr>
</tbody>
</table>

Source: Doing Business (DB), Transparency International (TI), and World Economic Forum’s (WEF) Competitiveness Index; latest year available.
the region’s financial sector assets are equal to 93 percent of GDP. Levels of financial sector depth vary across the region ranging from 81 percent of GDP in Kosovo to 103 percent in Albania and FYR Macedonia (Figure 98). While the banking sector has been growing rapidly over the last two decades, the non-bank financial sector remains shallow, with relatively minor capital market activity, negligible penetration of insurance products, and generally insignificant non-bank financial institutions. Overall, financial intermediation in the Western Balkans remains low when compared to countries of the 7STEE group. The depth of the domestic financial sector, measured by private sector credit to GDP, stands at an average of 45 percent, with particularly low levels in Kosovo and Albania (Figure 99).

While foreign bank penetration brought deep and more efficient financial intermediation, it also increased exposure to external vulnerabilities. Commercial banks had access to larger cross-border flows of funds. This supported greater financial deepening than was possible based on domestic deposits, though those deposits continued to dominate banks’ funding sources. Fueled by a favorable global environment and ample lending supported by foreign parent banks’ funding and capital, credit to the private sector grew at rates exceeding 30 percent a year in the pre-crisis years. The associated risks became clear during the global financial crisis when capital inflows came to a halt. Between 2008 and 2015, Bank of International Settlements-reporting banks reduced their cross-border exposure in the Western Balkans by an average of almost 6 percent of GDP. While this deleveraging impacted all countries in the region, Bosnia and Herzegovina and Montenegro felt the heaviest blow. However, the general absence of riskier instruments, and the launch of the Vienna Initiative helped the region’s financial systems weather the global crisis relatively well; deposits take up a major share of the funding structure (Figure 100, Figure 101).

To support sustained growth going forward, the Western Balkan financial systems need reforms to increase efficiency, improve access to finance, and strengthen their own stability. Financial integration brings important benefits to the extent that policymakers address existing vulnerabilities:

- Across the region, high levels of non-performing loans need further urgent policy attention to strengthen regimes for corporate and personal insolvency and creditors’ rights. Regulatory classification and provisioning standards must be strengthened.
- Deleveraging remains a risk as some parent banks plan to further scale back their presence in the region as a result of continued market and regulatory pressures. Shifts in banks’ funding models, increased competition, and low bank profitability in some countries in the region may bring about further bank consolidation.
- Given the high dependency on foreign currency lending and borrowing, governments would
do well to pursue policies that increase the use of local currencies. This would both strengthen financial stability and afford greater policy freedom to monetary authorities.

- Moreover, it is essential to further strengthen the financial safety net by building up the financial and institutional capacity of the deposit insurance systems and by developing a comprehensive resolution regime to deal with the weakest banks.

- In terms of crisis prevention, macro-prudential supervision needs strengthening across the region. This is particularly relevant in Montenegro, Kosovo, and Bosnia and Herzegovina, which have limited monetary policy tools.

- Banking regulation and oversight have improved over the last decade, but a number of important shortcomings remain. Further progress is needed in risk-based regulatory and supervisory practices as well as linking regulatory capital requirements to commercial banks’ market and credit risks. Regulation in corporate governance and identification of ultimate beneficiary owners and related-party lending should also be strengthened in some Western Balkan countries. The EU Banking Union aims for stronger supervision, a level playing field across borders, and simplified “home-host” interactions. Achieving these goals will require close cooperation and communication.

Regional cooperation will reinforce national efforts to deepen integration into the world economy.83

Regional integration is a crucial component of entering European GVCs. Once trade and transportation costs between countries are reduced and distances collapse, GVC entry will be easier. Firms from any country in the region will be able to offer goods and services to the developing GVCs, such as the automotive industry. Some progress has been achieved on this front, with increasing numbers of Serbian and regional suppliers connecting to the automotive value chain through the Serbia-based Zastava plant. An ambitious agenda to cut trade costs between countries would also include reforms to improve connectivity and eliminate trade policy barriers, behind-the-border constraints to trade, and frictions that may arise at border control agencies such as customs. To the extent individual Western Balkans countries implement reforms and investments to foster regional ties, the steps are likely to fit well into EU integration as well. Reducing cross-border costs within the region will be crucial to help a large investment in one given country cause ripple effects in the rest. Several directions of regional cooperation will provide the necessary support for this agenda.

Continuing efforts to maintain macroeconomic stability will benefit the region as a whole. Having weathered the global financial crisis, there is a com-

83 Concerning specific dimensions of regional integration, this section draws on World Bank. 2017e. “Western Balkans: Regional Economic Integration Issues Notes.”
mon 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. A regional commitment to macroeconomic stability—for example, such as the European Union’s Stability and Growth Pact—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, and better monitor and limit fiscal risks.

Regional integration can also accelerate through reforms in investment and competition policy. Investors look at the region and the potential of its markets as a whole. Though the economies do compete to create the most appealing business environment, joining forces in removing barriers to regional investment would help every country. While some basic elements of a regional investment agenda already exist in the Western Balkans, a comprehensive framework aligning key policies is missing. Such framework could promote the region as a unique investment destination. Increased coherence of regional investment policies would cut the time and cost to invest within a region, reduce fragmentation of production and transaction costs for investors, and attract multinational companies. It would also foster development of regional value chains and lead to increased diversification and sustainability of economic growth. Such policy agenda will increasingly include technical areas of regulation, such as investment promotion, entry and establishment, retention through protection, and development of linkages with the local economy and its value chains. Modernized competition policy would help the same goals, in addition to bringing unilateral benefits to the implementing economies.

Countries attract FDI to take advantage of local resources—including natural resources, labor, and skills. These new investments may shift firms’ demand for skills. 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. Mobility of people is one of the key driving forces of regional integration and growth, as it allows for a more efficient allocation of resources, thus raising productivity; it would also alleviate the problem of local unemployment. A regional labor market observatory could help balance the reality of high unemployment while preparing for increased mobility of people. It could include a body of researchers and policy makers who 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 prepare for free mobility of people across countries, maximize the benefits of economic integration, and manage unintended consequences of integration in national labor markets (see priority areas for action).

Finally, there is a compelling case for regional integration of financial and capital markets. Even with success in integration, financial deepening has been uneven across countries and sectors and lacks diversity. Nonbank financial intermediaries and capital markets in the region are shallow and sometimes nonexistent. Stock markets exist in four out of the six Western Balkan countries (Albania and Kosovo are the exceptions), but the value traded is small: stock market capitalization in the Western Balkans is at about 20 percent of GDP, compared to more than 60 percent in Western Europe. Equity markets remain underdeveloped with only a limited number of companies listed, and there is no liquidity of the secondary markets. For small countries whose domestic financial markets lack the necessary diversification of investment opportunities or funding sources, regional integration is often a solution. Regional markets can play a key role in complementing bank-centric financing and help bring in investment and make the financial system more stable. The proposal for a capital markets union for the Western Balkans highlights the need for more action to efficiently link investors and savers with companies and to unlock the potential of capital markets for long-term investment. Although the EU has achieved regional integration at deepest levels, other regions have projects of capital markets integration, such as Latin America, East Asia, and East Africa.

84 On September 30, 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. The SEE Link project, which connects stock exchanges of several countries in the Western Balkans and beyond, is also a step in the right direction (www.see-link.net).
Creating an environment that nurtures private firms

How important is free movement of people within a country? How can companies expand and build value chains if their sales and procurement people are reluctant to travel more than a few kilometers from the home office? That was a serious constraint to enterprise development in Bosnia and Herzegovina following the wars of the 1990s. But the Office of the High Representative came up with a simple initiative to facilitate travel between different zones: automobile license plates that did not include the vehicle’s home jurisdiction.

Today, people can drive the length and width of Bosnia and Herzegovina without concern that they will immediately be identified as outsiders. Analysts call the “uniform license plate” an important security aid in the reconstruction of a single economic space in a country where divisions remain but are declining over time. A similar measure was implemented in Kosovo.

Bosnia and Herzegovina must overcome many obstacles to create an environment in which private firms can be born and flourish. But with the simple and clever device of the uniform license plate, one key obstacle—concerns over security of travel—has been substantially addressed.
1. **Why is the growth of the private sector lagging in the Western Balkans?**

An often unfriendly business environment and competition from protected state-owned enterprises hamper the birth and growth of private firms. Overall, private enterprise in the region accounts for lower shares of investment and output than in other transition economies.

2. **What is driving productivity growth in the Western Balkans’ work places? Is factor allocation contributing to productivity growth?**

Within sectors, productivity growth is largely driving overall productivity increases. The potentially more powerful effect of workers moving from sectors of low productivity to more dynamic and productive ones generally has subtracted from overall productivity growth in countries for which data is available, reflecting the status quo with state-owned enterprises and high informality.

3. **What can be done to make the Western Balkans more business-friendly?**

Improvement of basic infrastructure such as transportation networks, electrical power, and mobile broadband would encourage companies to enter the market. Easier registration and reduction of administrative burden would further help, as would higher access to finance and better enforcement of property rights.
The private sector’s share of GDP has grown more slowly in the Western Balkans than in the other transition economies, now in the European Union. The Western Balkans’ average private sector share—66 percent—compares to a 74 percent average in the 7STEE countries. Serbia and Bosnia and Herzegovina have the Western Balkans’ lowest levels at 60 percent each. Low share of private enterprises in investment, employment, and GDP generally works against long-term growth of the economy as a whole.

Improving the business environment will boost private sector development in the Western Balkans.

The slow pace of privatization and restructuring of large state-owned enterprises accounts for much of this slower growth of private enterprises (Figure 102). The SOE sector not only remains large in terms of GDP and employment, but draws substantial fiscal subsidies, diverting resources from more productive uses. In several manufacturing subsectors such as energy, utilities and telecommunications, and pharmaceuticals, SOEs are dominant, meaning private enterprises face a non-level playing field. Bosnia and Herzegovina and Serbia have been the slowest to privatize large SOEs.

Despite the state’s overly large role in the regional economy, private investment and foreign direct investment have been robust throughout the last decade and a half. Private investment (including purchases of SOEs) has hovered at around 15-17 percent of GDP in Montenegro and FYR Macedonia, 20 percent in Serbia, and 25 percent in Albania (Figure 103). FDI inflows averaged 7 percent of GDP during the 15-year period (Figure 104) but with considerable year-to-year volatility because they were driven mainly by privatizations. These are generally strong figures, but lack of data makes it impossible to calculate precisely what role private investment has played in the overall performance of the economy.

Too high a share of foreign direct investment has gone into non-tradable sectors such as real estate and retailing, which do not contribute directly to exports. The non-tradable shares of FDI in 2007 were 80 percent in Albania, 70 percent in Bosnia and Herzegovina, 65 percent in Serbia, and 50 percent in FYR Macedonia. Large inflows to these sectors can be a net drag on development, because they tend to starve the tradable sectors, reducing export capacity and competitiveness and creating external account imbalances. Generally, capital inflows into non-tradable sectors in Eastern Europe have had a greater role in unsustainable consumption, investment surges, and collapses in GDP growth than have capital inflows into tradable sectors.

Figure 102: The transition from state to private ownership has been slow…
(Evolution of enterprise-related transition indicators)

Source: EBRD and World Bank staff calculations.
Note: WB5 is WB6 excluding Kosovo.

Figure 103: …yet private investment rates have remained robust.
(Private investment as share of GDP, including SOEs)

Source: World Development Indicators and World Bank staff calculations.

85 EBRD 2010.

86 European Commission 2014.
The Western Balkans: Revving Up the Engines of Growth and Prosperity

Stoking productivity is key to speeding up the Western Balkans’ economies.

Western Balkan economies face a challenge of low and slow-growing productivity. In this chapter, we look at various measures of productivity, mostly derived from firm-level surveys aggregated into industry level, including total factor productivity (TFP). All these measures agree that productivity is low, with little progress to date. TFP’s levels dwindled after the global financial crisis (Figure 105), to the point that TFP actually subtracted from growth in most countries, or contributed very little (as in Albania)—this is shown by the growth accounting decomposition of GDP (Figure 106).

Labor productivity in Serbia and FYR Macedonia lags behind most STEE countries (Figure 107). In addition, labor productivity growth of about 0.87 percent annually is much lower than the 2.75 percent average in the STEEs (Figure 108). At the macro level, this translated into slow convergence in output per worker, compared to other regions. Average growth in the Western Balkans’ real output per employed person was about 2.9 percent per year, lower than the Europe and Central Asia (ECA) region average of 5.2 percent and the East Asia and the Pacific (EAP) developing country average of 3.2 percent. Over the 2009-14 period, productivity growth fell to an average of 1.7 percent per year, again below ECA and EAP developing country averages. While this performance was stronger than the Latin American (LAC) developing country averages, that is not surprising as the LAC region has been long struggling with convergence and productivity growth.

The dynamics of labor allocation by sector or productivity is not efficient.

A lack of transformation—growth of new jobs in higher-productivity firms, economic sectors, and regions—has impeded overall productivity growth. This disappointing performance stems in part from a lack of labor reallocation to new and more productive activities, which can be influenced by the aging of the population. This is partly due to legacy protections in the labor markets, which favor older workers (see Labor and State chapters). But other distortions are also at work, such as those in factor and product markets, as well as reduced geographical mobility.

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87 The growth accounting exercise is based on the Solow model and covers data for 2000–2014. Despite its many well established caveats, this simple exercise can provide some intuition about the main drivers of GDP growth during the last 15 years. Annual GDP is assumed to be a function of the aggregate physical capital stock (K) and labor (L), following a Cobb-Douglas technology. In the absence of consistent employment data for all countries, the working age population (age 15–64) is used as a proxy for labor. In the absence of data on capital stocks, physical capital is estimated through a highly simplified perpetual inventory method. In this simple growth accounting exercise, TFP includes the main component—efficiency with which the economy uses the main factors of production—but likely also hides the impact from a combination of factors including skills and labor market dynamics (i.e. converting the working age population into employed human capital), enabling factors that affect the overall efficiency of the economy, as well as technological progress.

88 The accounting method for estimating TFP has a number of drawbacks that are discussed in detail in the literature. See Caselli 2016 in Araujo et al. 2016, for an overview.

89 Countries that have made the data available.

Within industries improvements were the main driver of productivity growth, while labor shifts between sectors and industries, have often harmed productivity growth.\(^9\) In the non-agricultural economy, productivity in mining and quarrying and manufacturing grew between 2009 and 2014 at an annual average of 3.9 percent (Figure 109). The within-sector component was primarily responsible for this rise. While the contribution of the structural change component—the role of labor movement between sectors—was positive in the mining and quarrying industry, pushing productivity up by an average 0.9 percent annually, it was negative in manufacturing. This curtailed productivity by 2.84 percent annually, caused in part by labor shifts between sectors and industries, but could also be linked to the ongoing restructuring and privatization in several industries, such as pharmaceuticals, which could temporarily reduce productivity. Some highly productive sub-sectors such as computer programing, real estate, telecommunications, and rental and leasing activities are also emerging, having recorded increases in employment between 2009 and 2014.

\(^{9}\) These conclusions are based solely on data from Serbia and (in some variables) from FYR Macedonia.
For the construction and services industries, productivity decreased. The fall was by about 1.62 percent and 1.21 percent per year respectively over the period. This was largely due to declining productivity within sectors and to a much lesser extent, labor reallocation, that is, structural change. While in general labor moved into less-productive service sectors, some workers broke with the pattern, migrating to highly-productive sub-sectors. These included computer programming, real estate, telecommunications, and rental and leasing activities, which all recorded gains in employment between 2009 and 2014.

Manufacturing firms in the Western Balkans are less cost-competitive than those in other small transition economies of Europe. Generally, costs of factor inputs are higher in the Western Balkans than in comparator countries (Figure 110). Higher costs accompanied by higher productivity would not necessarily place the manufacturing sector in the Western Balkans in an inferior competitive position. However, even though labor productivity is lower in countries such as Serbia, manufacturing unit labor costs—the ratio of real cost of wages and salaries to real value added at factor costs—are higher than in most comparator countries. High costs, combined with low productivity, mean that only few firms survive; those that do must be making up the difference through other means, such as engaging in unfair competition in the informal economy.

Barriers to formalization reduce labor reallocation. Over the past decade, informality has fallen only slightly. At the level of the individual worker, the ability to move from informal to formal employment is extremely low. Preliminary estimates in Serbia show that an informal worker has a very low probability of finding a formal-sector job, just 11.2 percent in 2013. Likewise, a recent study in that country found that the implicit cost of formalization is quite high: a single person with no children who earns less than the minimum wage in the informal sector has to give up between 40 and 75 percent of income to formalize. Geographical constraints are also discussed in the Labor chapter.

There is broad room for improving productivity and competitiveness in the Western Balkans. Recent research on firm-level productivity shows that in most countries in Eastern Europe, the impact of reallocation of resources on productivity growth is quite strong. However, such reallocation does not occur automatically. It can be facilitated by improving the business climate to provide easier business entry and exit, better access to finance, upgraded infrastructure, a higher-skilled workforce, and greater labor market flexibility. Without these factors, the region will have to wait many years for a productivity-enhancing reallocation of labor to take place.

The business environment is improving, but private enterprise still needs and deserves better.

Western Balkans countries have already made important inroads in improving the business environment. Figure 111 presents individual countries’ distance to the efficient business environment frontier of the World Bank’s Doing Business Indicators. FYR Macedonia moved from a score of 65.8 to 81.7 on the efficiency scale (0 worst, 100 best). But the region still lags behind the 75Tee countries. Similarly, entrepreneurial activity is lower in the Western Balkans. The number of newly registered firms with limited liability is lower in Albania, Bosnia and

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93  Randelovic et al. 2013.
94  See Alam et al. 2008.
Herzegovina, Serbia, and FYR Macedonia than in the 7STEE countries, according to the Entrepreneurship Database of the World Bank’s Doing Business Indicators (Figure 112).

On ease of doing business, Western Balkan countries lag the 7STEE countries. But the former also differ dramatically among themselves in this indicator (Figure 111). Bosnia and Herzegovina, Kosovo, and Albania are below the region’s average, largely because of poor quality and availability of electricity. In Bosnia and Herzegovina and Serbia, the issue is the slow pace of SOE privatization, and in Albania contract enforcement and property rights. At the other, higher-performing end of the scale, FYR Macedonia has made relatively early progress on a number of business environment indicators, with highest payoffs in credit provision. This progress is also reflected in the latest ranking of Eastern European countries based on the Doing Business and Global Competitiveness Indicators (Figure 113), which highlights the contrasts within the region: Albania ranks

Figure 110: The Western Balkans’ manufacturing sector is not cost-competitive or productive, even compared to the EU transition economies.

Figure 111: Western Balkan countries remain a fair distance from the business environment frontier… (Ease of Doing Business, 2010 vs 2017)

Figure 112: …and have sub-par rates of business entry density. (New business density and GDP per capita)
The Western Balkans: Revving Up the Engines of Growth and Prosperity

The Western Balkans: Revving Up the Engines of Growth and Prosperity

58th in the world versus FYr Macedonia’s standing of 10th. The figure also places the 7STEE countries to the right (meaning they perform better) of all of the Western Balkans countries except FYR Macedonia.

Key areas where reform is needed for better productivity and competitiveness include informal competition, electricity, and access to finance. Figure 114 compares the top five obstacles to enterprise in the Western Balkan countries and the 7STEE countries, using data from the World Bank Enterprise Surveys. The top four obstacles to enterprises are similar for both sets of countries. However, informal competition, finance access, and political instability appear to be more severe obstacles in the Western Balkans than in the 7STEE, where respondents call tax rates the biggest problem. The quality and quantity of electricity supply is a major challenge for Western Balkan enterprises, unlike for their counterparts in the 7STEE countries, which list an inadequately skilled workforce as a top-five obstacle.

In the Western Balkans, unfair competition from informal enterprises and lack of access to finance rank in the top five in all six countries. Informality is the biggest obstacle in Albania, Kosovo, and FYR Macedonia. Electricity supply is reported as a top-five obstacle in all countries except Serbia and Bosnia and Herzegovina. In those two countries, political instability is reported to be the biggest constraint.

Modernizing old and unreliable infrastructure is crucial to helping private enterprise set up and prosper.

All private enterprises suffer in competitiveness due to the generally high cost and low quality of infrastructure. This includes logistics, transport, telecommunications, and electricity. According to WEF’s Global Competitiveness Report (GCR), all six Western Balkans countries lag behind the 7STEEs and the rest of the EU on the logistics performance index, a measure that comprises six indicators including efficiency of the customs clearing process, and competence and quality of logistics services. Figure 115 presents the WEF-GCR’s Logistics Performance Index (LPI). Serbia’s overall score is 2.96, the highest among Western Balkan countries, but still lower than the 3.05 scored by the worst-performing 7STEE country, Croatia, and well below the median score of 3.7 for the rest of the EU. Figure 116, which breaks down the various indicators comprising the LPI, shows that all Western Balkans countries score lower than the 7STEEs and the rest of the EU on every indicator. This is a serious constraint to exports, which are a prime source of economic growth in many Western Balkan countries.

In spite of its potential benefits, the ICT sector in the Western Balkans is less developed than in the 7STEE countries and requires significant investment. There is consensus across the EU that extension of broadband infrastructure, particularly to rural areas, may promote economic diversification and address a number of development bottlenecks through skills enhancement and job creation. Extension may also attract FDI and boost such sectors as agriculture and tourism. Figure 116 shows that broadband penetration is much weaker in the Western Balkans than in the 7STEEs. Kosovo stands out as a particularly low performer: only 5.74 percent of the population use mobile broadband services, almost seven times lower than the Western Balkans average and twelve times lower than the 7STEE average. Kosovo was one of the last countries in Europe to launch commercial 3G services. Inefficient spectrum

See, for example, World Bank 2014a. “Rebalancing Serbia’s Economy: Improving Competitiveness, Strengthening the Private Sector, and Creating Jobs.”
Figure 114: The top five obstacles to doing business are similar in the Western Balkans and 7STEEs.


Figure 115: The 7STEE all outstrip the Western Balkan states in logistics quality.
(2014, overall index, 1=low to 5=high)


Figure 116: In other logistics indicators, the Western Balkans states are Europe’s low performers.
(Logistics Performance Index, 2014)

Source: World Development Indicators.
management (for example, slowness in freeing up and issuing additional frequency bands) appears to have been the major cause of delay in the mobile broadband roll-out. The underdeveloped wireless market in turn holds back arrival of high-speed mobile broadband offerings, which are of particular importance in mountainous and sparsely populated rural areas of the country where deployment of fixed broadband networks is not commercially viable.

Unreliable electricity supply is dragging down the productivity of Western Balkans firms, according to the BEEPs survey—the power sector is in urgent need of reform and investment. The World Economic Forum’s Global Competitiveness Index ranks the Western Balkans countries among the lowest in Europe for quality of electricity (Figure 118). The six countries’ 4.6 median (out of a possible 7) ranks well below the 5.7 score of the 7STEEs. Power infrastructure in countries such as Kosovo and Montenegro is aging and inefficient, resulting in high energy intensity and low energy productivity. In Montenegro, the system suffers high transmission and distribution (T&D) losses due to an under-maintained grid, significant non-payment by consumers, and theft of electricity. Transmission losses range from about 4 percent of total power and distribution losses to about 15 percent, compared to average 6 to 8 percent in the past. In Albania, whose grid had been besieged by power losses, favorable weather and improved billing and payment enforcement helped reduce the fiscal costs of the sector. In particular, a decline in non-technical losses from 45 percent in 2013 to 28 percent in 2016 helped the grid’s financial recovery and reduced the need for central government grants and guarantees. Albania and FYR Macedonia have launched reforms to improve distribution efficiency and ensure full liberalization of the sector in line with EU practices. However, connectivity must be improved both internally and within the region. Strengthened tariff policy and institutions, new investments, and expanded supply are necessary.

Further improvements in credit markets and regulatory environment will also help private enterprise.

Credit availability was adequate to support the sustained expansion of output and exports in 2000-08, but after that lenders pulled back because of the high stock of non-performing loans (NPLs) and weaknesses in property rights. Banks in the Western Balkans are carrying a higher stock of NPLs today than in the new EU member states, even though the post-crisis credit correction...
in the region was less severe. Unresolved NPLs constrain economic activity of overextended borrowers and disrupt the allocation of capital to productive activities. Banks troubled by customers’ weak balance sheets become more risk-averse. Unless the NPL problem is addressed, credit availability is likely to remain sluggish and undermine enterprise performance. At the same time, financial intermediation is weak due to high collateral requirements, ranging from 160 percent to 230 percent of loan value in Kosovo to 216 percent for small and medium enterprises in Bosnia and Herzegovina. Lenders have difficulty realizing the value of collateral due to weaknesses in property rights—executing collateral warrants can take long periods of time, up to seven years in Bosnia and Herzegovina. The financial sector needs reforms to facilitate NPL resolutions (loan workouts, loan write-offs, collateral execution), reduce inefficiencies, strengthen stability of banks, and expand credit access. Action is also needed to improve the contract enforcement regime and promote the non-bank financial sector; so as to diversify sources of credit for enterprises. Some countries have already moved forward with these types of reforms, such as the Kosovo Credit Guarantee Fund to help SMEs gain access to credit.

Western Balkan countries have begun concerted efforts to improve the business environment but need to keep with the job, because many challenges remain. In Serbia, for instance, the government is implementing the Strategy for Enhancing Entrepreneurship and Competitiveness for 2014–20. So far, 212 out of 304 recommendations, ranging from comprehensive regulatory reform to the streamlining of administrative requirements, have been implemented. The country would do well to also focus on improving contract enforcement, simplifying planning and construction permits procedure, and reducing labor market rigidities. For its part, Bosnia and Herzegovina has made significant progress with the introduction of a one-stop shop for business registration and a new inspections law that removed some obstacles to exports to the EU. But businesses in that country still face a regulatory maze: The Federation of Bosnia and Herzegovina, one of the two political entities that make up the country, still has 355 separate business-related licenses, permits, approvals, and consents on the books, while the other entity, Republika Srpska, has 319. Added to those are another 102 at the national level. In a similar pattern, FYR Macedonia has improved firms’ access to manufacturing-ready land with the creation of Technological Industrial Development Zones (TIDZs) and industrial zones and the transfer of land management to municipalities. But the agricultural land market in that country remains complex and continues to hinder productivity. These developments also need to expand beyond the special economic zones.

The challenge in the Western Balkans going forward is to promote growth in investment, jobs, exports, and productivity in existing private enterprises and grow the number of new ones. This will be critical to bringing down the current high rates of unemployment in these countries. Privatization and restructuring of SOEs, necessary for sustained growth of the private sector, will require careful management to avoid redundancies that might aggravate unemployment. Overall, the region needs acceleration of reforms to encourage new business registrations, support growth of existing private firms, and promote inflows of FDI into competitive tradable sectors. Careful sequencing of reforms and restructuring will be important for both growth and employment.

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56 As mentioned in the Integration chapter: the median level of NPLs in Western Balkan countries, at 13.1 percent in 2015, is still close to its post-crisis peak of 16.3 percent in 2013. Montenegro, however, has been an exception, significantly bringing down the burden of bad loans, after the adoption of the “Podgorica approach” to NPL resolution.  
Building a state that enables, rather than impedes, a new growth model

In 2013, finance officials in the government of Albania were grappling with a very unwelcome line item in their spreadsheets—overdue bills of more than $700 million, amounting to about 5 percent of the country’s GDP. Different wings of government had accumulated the arrears through years of uncoordinated, undisciplined spending. Even as tax revenues were declining and heavy social spending continuing, agencies had pressed ahead with big infrastructure projects. As liabilities mounted, the government had taken to holding back payment of a wide range of bills, including procurements, utilities, VAT refunds, and disability benefits.

What followed was a textbook example of how a state can reform itself to clear roadblocks to development, growth, and income convergence. In 2014 the government signed a Strategy for the Prevention and Settlement of Overdue Liabilities. Arrears were paid on a first in, first out principle, overseen by special units in the Ministry of Finance and detailed in public reports. To prevent future arrears, government agencies are now required to prioritize activities within approved budget ceilings. Clear criteria ensure that poorly prepared and ill-conceived projects don’t receive financing and that resources go where they will have maximum effect on advancing the government’s objectives.

Arrears were fully cleared by the end of 2015, slightly ahead of schedule. This was beneficial not only for fiscal accounts but Albania’s business environment at large. A government that pay its bills on time fosters private enterprise and employment across the country, as well as investors’ confidence in the economy.
How can the state better support economic growth in the Western Balkans?

The state’s role must shift to become a more effective enabler of private sector-led, productivity-driven, and export-led growth. A number of countries in the region have oversized public sectors - including state-owned enterprises, legacy of socialist times - that tend to crowd out private firms. In these countries, reducing the economic footprint of the state where necessary would open up space for companies both domestic and foreign to hire and expand, raising incomes and promoting convergence with EU standards of living.

What do governments need to do to create an environment that can spur expansion in the economy?

To become an enabler of private enterprise the state needs to create the right regulatory, legal, and fiscal environment for business creation and growth. Enhancing the quality, reliability and timeliness of the state’s legal and regulatory systems is crucial. Throughout the Western Balkans, courts are tied up in red tape, creating opportunities for malfeasance and constraining private sector businesses. Fiscal policy also has a role. Reduced social taxes would make it easier for workers in the region’s large informal sector to shift to higher-productivity jobs in the formal sector. Reforms in pension and social welfare systems could curb disincentives to work, while protecting the vulnerable. Prudent fiscal policy would provide an atmosphere of stability and predictability conducive to investment and the laying of plans for the future.

How can the delivery of social services support the new growth model? Does the state have the capacity to deliver on these reforms?

Better spending on education and health would address skill gaps and enhance human capital and economic opportunities for all. If the benefits of future growth are to be shared across the population, social safety nets will also need to become more comprehensive and, in view of fiscal constraints, better-targeted. Enhancing the capacity to deliver these reforms requires independent, efficient, and honest public administrations that are in line with European standards. Public servants must be empowered to participate in the design and implementation of reforms. Policy processes will also need to be streamlined, the center of government strengthened to improve coordination and accountability and oversight enhanced.
How can the state help support the reorientation of the growth model of the Western Balkans towards one that is private sector-dominant, productivity-driven, and export-led? This chapter offers answers to this question, focusing on three main dimensions. The first (and overarching) requirement is that state institutions and government policies become more effective enablers of private sector investment and growth. Particularly in those countries in the region with outsized public sectors, this will require the state to exit from roles that it should not play. Second, state institutions and policies need to provide the right regulatory, legal, and fiscal environment for business creation and growth. This includes not only their direct impact on firms’ investment decisions, but also their indirect effects, for example, by ensuring the macro-fiscal stability which is a pre-requisite for sustained private investment. Third, the state needs to improve the effectiveness of public spending and the quality of service delivery in support of private sector-led inclusive growth. With many of these objectives long unattained, the chapter concludes with a discussion of how, this time, the reforms can finally succeed.

**The state needs to become a more effective enabler of private sector investment and growth.**

In half the countries of the Western Balkans, the state continues to loom large in the economy, as the transition to a market economy remains incomplete. While transition began in the 1990s in several countries, in others it did not get underway until the 2000s, due to the conflict and turmoil of the previous decade. Since then, the region has achieved substantial progress (Figure 119) but there remain important areas to be addressed. Notable is that for half the countries (Bosnia and Herzegovina, Montenegro, and Serbia), government spending to GDP is well above norms by income level (Figure 120). These countries still have large state-owned and public enterprises. As a result, employment in the public sector can be large, relative to overall formal sector jobs, and public wage bills sizeable. 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 legacy of socialism shapes public expectations of the state’s role in the economy. The size of the public sector and the weight of pensions and public administration costs in overall government expenditure are an important hold-over in the unfinished transition from socialism. A related factor is the public perception of the proper role of the state in the economy. In countries which are aging rapidly, such as Serbia, and Bosnia and Herzegovina, where the ratio of workers to dependents is falling, can the private sector bear the costs of meeting a public perception that access to all government services should be universal? If young adults entering the labor market...
perceive a job in the public sector as more attractive than one in a private company; how can start-ups hire the workers they need to grow or mature firms bring in the new skills they need to reinvigorate their businesses? An evolution in public perceptions of the role of the state will be central to supporting reforms to create a nimbler, and in some cases smaller state that would enable a new growth model.

Providing the right regulatory, legal and fiscal environment will spur business creation and growth.

Enhancing the quality, reliability and timeliness of the state’s legal and regulatory systems is at the heart of improving the business environment to allow a dynamic private sector to drive growth, employment, and poverty reduction. The scope for better performance in the Western Balkans is clear. Governance indicators in the Western Balkan region—looking at an average of perceptions of performance on voice and accountability, political stability and lack of violence, government effectiveness, regulatory quality, rule of law, and control of corruption—remain behind the 7STEEs at the time they joined the EU, and in the five-year period before membership (Figure 121). Measures of these different dimensions of governance are highly correlated with, for example, better regulatory quality going hand-in-hand with improved rule of law. Unsurprisingly, they also relate closely to the ease of doing business for the private sector.

Concerning average time and cost of enforcing contracts, the countries of the region have been improving but still lag the 7STEE countries, as discussed in the Enterprise chapter. Across the region, government’s sensibility toward businesses is perceived to be low. A 2016 survey of business opinion found 39 percent of respondents did not think the government takes into account at all the concerns of business with only 45 percent thinking there was “a little” taking into account. Put another way, on average only 12 percent of respondents thought the government takes account of business concerns quite a lot, with the governments of FYR Macedonia and Albania getting the highest marks at just above 20 percent.

Quality of justice services—a key determinant of the business environment—is low across the region. This includes, for example, inconsistent jurisprudence, and high appeal rates. The EU accession process has created incentives for large-scale legislative reform but, as noted by the European Commission, “across the board effective implementation is very often lacking.” Business operations suffer in this complex and in some cases fragmented legal environment.

Throughout the Western Balkans, courts are tied up in red tape, creating opportunities for malfeasance and constraining private sector businesses. Weak enforcement of commercial decisions and contracts and the related monetary and time costs are dampening the business climate across the region (Figure 122). Of the businesses examined in the World Bank 2013 Enterprise Surveys, the share identifying the courts system as a major constraint was particularly high in Serbia (13.9 percent), Kosovo (13 percent), and Bosnia and Herzegovina (8.2 percent). These figures compare to 5 percent on average in surveyed countries in Europe and Central Asia.

Delays are endemic. In Serbia and FYR Macedonia it takes approximately 635 days to enforce a contract. If they can’t enforce contracts quickly and reliably, firms are less likely to expand their reach of suppliers, take on credit, and expand their businesses. Property rights are a particular issue in Albania and Kosovo. Enforcement of decisions is often unpredictable and intermittent in Bosnia and Herzegovina. Businesses there consider judicial proceedings to be “very slow, too complex and decidedly ineffective.” In Serbia, over one-third of businesses with recent experience in court cases report that the judiciary is a great obstacle for their basic operations, and an additional third call the courts a moderate obstacle.

99 Indeed, a 2016 survey found that on average 80 percent of respondents in the six countries of the Western Balkans would prefer to work in the public sector (public administration or public companies) rather than the private. This share was 87 percent in Kosovo and 82 percent in Bosnia and Herzegovina, with a low of 75 percent in Albania. Across the region, the main reasons cited were a safer job (53 percent of respondents on average), better working conditions including overtime and workload (36 percent), and better salary (35 percent). See Balkan Barometer 2016a.

100 Balkan Barometer 2016b.


This is not due to a lack of resources in the judiciary; most of these countries have an excessive court network and comparatively high ratios of judges and court personnel per capita. Yet backlogs are common. Across the region, the judicial sector tends to have adequate resources compared with EU member states, but resources are not allocated nor used efficiently. Staffing is mismatched with needs. For example, most countries in the region, especially the former Yugoslav countries, have an excessive number of judges at the top and low-skilled ancillary staff at the bottom, but a “missing middle” of specialist staff that is necessary to support judicial modernization. From a perspective of equity, access to justice is often constrained by generally high fees charged by the courts and lawyers. In general, legal aid for the poor deserves to be greatly improved. Meanwhile, there is also inadequate access for everyone to basic legal information, such as consolidated legislation and easily-understandable formats of basic laws. The prospect of alternative dispute resolution holds promise but is not available in the countries of the region.

Enhanced independence, accountability, and professionalism of the judiciary would ensure that laws and regulations are implemented in an efficient and nondiscretionary way, helping to improve the business environment in the region. Countries in the Western Balkans can look to good practices in the new member states of the European Union, particularly the Baltic countries and Croatia, as they work toward these objectives.

Fiscal impediments are holding down private investment.

Current fiscal regimes also often distort incentives and undermine dynamism in the private sector. As highlighted above, the aggregate fiscal burden on the private sector—as proxied by the aggregate revenue to GDP ratio—is particularly high in Bosnia and Herzegovina, Serbia, and Montenegro, standing at comparable levels to the EU’s. Indeed, for the period 2000-10, revenue collections in Bosnia and Herzegovina were about 6.3 percent higher than the level predicted by an economic model based on country characteristics. Across all countries in the Western Balkans, the reliance on taxes on goods and services is high (Table 6.1: Taxes on goods and services are relatively high as a share of GDP, and as a share of total revenues, ranging from a low of 35 percent of total revenues in FYR Macedonia to 44 percent in Bosnia and Her-

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105 For example, in Bosnia and Herzegovina, court expenditures are higher than EU averages, with 0.85 percent of GDP allocated to courts and prosecutors and the High Judicial and Prosecutorial Council in 2015. However, budgets are deeply fragmented, with courts and prosecutors’ offices receiving funds from 14 different budgets, which tends to destabilize the capacities and resources of the courts. See European Commission. 2015. Bosnia and Herzegovina Report, p. 14.

106 Serbia and Montenegro (at 42.4 and 40.5 judges per 100,000 inhabitants respectively) have more than twice the number of judges per capita than the average in the Council of Europe countries.

107 Khwaja and Iyer 2014.
Income taxes are much lower than in the 7STEEs, with the exception of Montenegro. These figures suggest an opportunity for diversification of the revenue base, accompanied by improvements in revenue administration to support compliance and collection rates.

Countries might also investigate lowering high marginal tax and social contribution rates that serve to keep people in the region’s large informal sector and stifle creation of formal jobs. The top rates of corporate and personal income taxes in the region are relatively low (Table 6.2: Social security contribution rates are particularly high in Bosnia and Herzegovina, Montenegro, and Serbia), at 10 percent for both corporate and personal in Bosnia and Herzegovina, Kosovo, and FYR Macedonia. The top corporate income tax rate in Montenegro is even lower, at 9 percent. In part these low rates aim to discourage tax evasion, in the context of high levels of informality in many economies. However, social

Table 6.1: Taxes on goods and services are relatively high as a share of GDP, and as a share of total revenues.

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<td>Total revenue</td>
<td>26.6</td>
<td>43.2</td>
<td>26.1</td>
<td>31.0</td>
<td>41.9</td>
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<td>17.9</td>
<td>25.5</td>
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<td>3.1</td>
<td>1.2</td>
<td>2.2</td>
<td>4.9</td>
<td>1.5</td>
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<td>Taxes on payroll and workforce</td>
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<td>2.3</td>
<td>0.0</td>
<td>3.6</td>
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<td>Taxes on property</td>
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<td>0.4</td>
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<td>Taxes on goods and services</td>
<td>11.5</td>
<td>19.0</td>
<td>10.6</td>
<td>11.0</td>
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<td>16.1</td>
<td>14.3</td>
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<td>Taxes on international trade and transactions</td>
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<td>0.0</td>
<td>8.3</td>
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<td>0.6</td>
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<td>Other taxes</td>
<td>2.9</td>
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<td>15.2</td>
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<td>8.6</td>
<td>12.1</td>
<td>10.9</td>
<td>11.5</td>
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<td>Grants</td>
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<td>0.2</td>
<td>0.0</td>
<td>1.0</td>
<td>0.4</td>
<td>0.2</td>
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<td>Other revenue</td>
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<td>5.3</td>
<td>3.3</td>
<td>3.5</td>
<td>3.9</td>
<td>5.6</td>
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<td>As percent of total revenue</td>
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<tr>
<td>Taxes</td>
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<td>87.4</td>
<td>57.7</td>
<td>60.9</td>
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<td>Taxes on income, profits, and capital gains</td>
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<td>7.2</td>
<td>4.6</td>
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<td>11.7</td>
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<td>1.1</td>
<td>n.a.</td>
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<td>2.2</td>
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<tr>
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<td>40.6</td>
<td>35.5</td>
<td>41.3</td>
<td>39.9</td>
<td>35.2</td>
</tr>
<tr>
<td>Taxes on international trade and transactions</td>
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<td>1.5</td>
<td>2.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Other taxes</td>
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<td>5.3</td>
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<td>Grants</td>
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<td>Other revenue</td>
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<td>12.2</td>
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<td>11.3</td>
<td>9.4</td>
<td>13.8</td>
<td>15.6</td>
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</tbody>
</table>

Note: Government Finance Statistics revenue classification.

For further discussion, see the World Bank’s Kosovo SCD.
security contribution rates are relatively high in Bosnia and Herzegovina, Montenegro, and Serbia, reaching similar levels to those of the EU. In Bosnia and Herzegovina, these contributions are on the order of 35-40 percent of gross wages, the highest in the region. As we noted in the Labor chapter, rates like these may make the cost of bringing a worker into the formal sector prohibitive.

In the wake of the global financial crisis, fiscal management and policies indirectly undermined the business environment through spillovers to macro instability. Starting in 2008, the global financial crisis and later the euro zone crisis rattled the region, tamping down its growth performance. Fiscal accounts deteriorated (Figure 123). Revenues shrunk and interest costs rose, but structural rigidities—for example, due to social spending, particularly on pensions, and government wage bills—prevented changes in spending patterns. These rigidities did, however, support household incomes, mitigating the downturn’s harm to the region’s people. Overall, governments in the region used their fiscal resources pragmatically to manage the impact of the crisis. However, debt ratios shot up (Figure 124), raising concerns in many countries over unsustainable debt trajectories.

**Fiscal reforms to put public debt onto a more sustainable footing are high priorities, particularly in Albania and Serbia, and have helped restore macro-fiscal stability.** International partners (IMF, EC, WB) have supported these efforts. Some countries have also adopted fiscal rules, albeit with inconsistent enforcement (Box 6.1). Expenditure reforms have been a particular focus of fiscal consolidation in Serbia, with an aim to address spending pressures from public sector

**Table 6.2: Social security contribution rates are particularly high in Bosnia and Herzegovina, Montenegro, and Serbia.**

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Threshold (euro)</td>
<td>Current standard rate</td>
<td>Employer rate</td>
<td>Employee rate</td>
</tr>
<tr>
<td>ALB</td>
<td>35,672</td>
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<td>23</td>
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<tr>
<td>BIH</td>
<td>25,524</td>
<td>17</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>KSV</td>
<td>30,000</td>
<td>18</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>MKD</td>
<td>32,462</td>
<td>18</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>MNE</td>
<td>18,000</td>
<td>19</td>
<td>9</td>
<td>15</td>
</tr>
<tr>
<td>SRB</td>
<td>68,099</td>
<td>20</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>WB6 unweighted average</td>
<td>34,960</td>
<td>18.6</td>
<td>11.5</td>
<td>13.6</td>
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</table>

**Selected others:**

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Employer rate</td>
<td>Employee rate</td>
<td>Total rate</td>
<td></td>
</tr>
<tr>
<td>Austria</td>
<td>0</td>
<td>10</td>
<td>25</td>
<td>50</td>
</tr>
<tr>
<td>Croatia</td>
<td>30,077</td>
<td>25</td>
<td>20</td>
<td>40</td>
</tr>
<tr>
<td>Germany</td>
<td>17,500</td>
<td>19</td>
<td>15</td>
<td>45</td>
</tr>
<tr>
<td>Greece</td>
<td>0</td>
<td>23</td>
<td>26</td>
<td>42</td>
</tr>
<tr>
<td>Italy</td>
<td>0</td>
<td>22</td>
<td>27.5</td>
<td>43</td>
</tr>
<tr>
<td>Slovenia</td>
<td>50,000</td>
<td>22</td>
<td>17</td>
<td>50</td>
</tr>
</tbody>
</table>

Source: National authorities data, Eurostat and IMF GFS.
Note: The VAT rate is increased to 21 percent in 2017. The top personal income tax rate in Montenegro is a so-called “crisis” tax that was already reduced in 2016 to 13 percent and further to 11 percent in 2017.
Box 6.1. Fiscal rules in the Western Balkans.

Four of the six countries in the Western Balkans—Kosovo, Montenegro, Serbia and Albania—have adopted fiscal rules aimed at achieving aggregate fiscal discipline and medium-term sustainability, with both entity governments within Bosnia and Herzegovina also putting in place such rules. However, as Koczan 2015 and Murgasova et al. 2015 note, enforcement and commitment have been generally weak. In Serbia, the 2009 Budget System Law adopted fiscal responsibility provisions including fiscal rules effective from 2010. These included a general budget balance rule setting the medium- to long-term deficit at 1 percent of GDP and a 45 percent of GDP ceiling for general government debt, excluding the liabilities arising from restitution. In addition, a Fiscal Council was established in 2011 to assess compliance with the fiscal rules. The Council has actively contributed to the debate on the government’s fiscal consolidation program.

While Serbia’s debt has far exceeded its debt rule, Kosovo has faced the opposite situation with a debt limit of 40 percent of GDP introduced in 2010, which is above the current level of debt. This was supplemented by a consolidated central and municipal budget deficit ceiling of 2 percent of GDP from 2013, with capital spending exempt if financed from privatization and if the government’s bank balance is above certain levels. Kosovo had an expenditure rule from 2006 to 2008, with a ceiling on real current expenditure growth of 0.5 percent per year, but this was not held to. The fiscal rule was also amended in 2015 to allow for an “investment clause” enabling productive capital investments in excess of the 2 percent deficit limit, subject to being financed by development partners and keeping the public debt below 30 percent of GDP.

Montenegro introduced budget balance and debt ceilings from 2014 in line with the EU Stability and Growth Pact levels of 3 percent and 60 percent of GDP respectively. However, given the highway that pushed up capital spending, Montenegro’s rules remove from the budget deficit figure the cost of projects of national importance as well as the costs of debt guarantees that the government provides. The fiscal rule was also revised in June 2016 to mandate that debt decrease every year until it reaches 45 percent of GDP. There is also a “buffer” rule setting the medium- to long-term deficit at 1 percent of GDP and a 45 percent of GDP ceiling for general government debt, excluding the liabilities arising from restitution. The Council has actively contributed to the debate on the

In Albania, the 1998 Organic Budget Law included a rule that the debt stock not exceed 60 percent of GDP. This rule was revised in June 2016 to mandate that debt decrease every year until it reaches 45 percent of GDP. There is also a “buffer” clause mandating that 0.7 percent of total budgeted expenditures be allocated to a budgetary reserve that can be used to compensate for forecasting errors and unforeseen changes in macroeconomic variables. The law also introduces the “golden rule” of borrowing and limits the use of privatization receipts to debt reduction or the financing of capital investments.

While fiscal rules in the Western Balkans have yet to build credibility and effectiveness, they should be viewed within the broader objective of putting in place fiscal institutions and mechanisms to improve medium-term fiscal budgeting and planning and fiscal risk management and control.


wages and pensions. Reducing fiscal pressures from state-owned enterprises has been another priority, through reducing direct subsidies to the enterprises as well as the costs of debt guarantees that the government provides. The fiscal deficit in Serbia has narrowed markedly through such measures, as well as better revenue performance. In Albania, where spending levels to GDP are lower; the focus has been on improving revenue mobilization. On the whole, fiscal deficits in the region had narrowed or stabilized by 2015, but debt levels remained elevated (Figure 124). The exception was Montenegro, where deficits and public spending are on the rise on the back of a significant increase in outlays for a major highway investment.

The Western Balkan countries need to sustain progress on fiscal consolidation and on improvements in public financial management to better monitor and limit the risks of future fiscal slippages. This includes improving control on spending commitments and addressing sources of arrears.109 Absent effective monitoring and
controls on spending commitments, expenditure arrears may re-emerge. Arrears to suppliers can hinder the creditor firm’s financial health and future investment decisions. Furthermore, without appropriate accounting of arrears, the picture from the reported budget deficit or debt figures can be misleading as they may not capture real spending levels or fiscal liabilities. Albania, faced with general government arrears reaching 5.2 percent of GDP in 2013, took steps to clear them and prevent their future accumulation (see Box 6.1). The two entity governments of Bosnia and Herzegovina are also placing an increasing focus on arrears, for example, related, to the health sector and SOEs.

**State funds should be spent more wisely and the quality of public service delivery improved.**

The region urgently needs better patterns and quality of state spending to support a re-orientation of the growth model. Given the fiscal constraints that many countries face, governments will need to improve the allocation, efficiency, and effectiveness of public spending. Improved public services in education and health are needed to address skills gaps and enhance human capital and economic opportunities. Better coverage of last resort social assistance would cushion the impact of shocks on the vulnerable. Higher-quality infrastructure would facilitate access to markets. Here, a cross-cutting focus on improved public investment management, and related medium-term fiscal planning, is required, irrespective of levels of public investment. The agenda for improving the quality of spending is broad-ranging. The discussion below focuses on two transformative areas for reform—spending on public wages and social benefits, and quality of service delivery in social sectors.

**Public sector wage bills make up a major share of current spending.** Government expenses (that is, total expenditures excluding capital investments) represent 85 to 90 percent of total general government expenditures in Bosnia and Herzegovina, Albania, FYR Macedonia, and Serbia. In Kosovo and Montenegro, where government capital spending was higher, its share in 2015 was 74 and 82 percent respectively. Within expenses, outlays for social benefits and wages dominate (Table 6.3). Social benefits accounted from 35 percent of expenses in Kosovo and Montenegro, up to 50 percent in FYR Macedonia, and about 40 percent

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110 Capital spending levels of the government in 2014 ranged from 2.5 percent of GDP in Serbia to the comparatively high levels, relative to 7STEE peers, of 5 percent or more in Montenegro and Kosovo, which have focused on major transport infrastructure projects. In recent PEFAs, countries in the region scored poorly on the existence of sector strategies with multi-year costing of recurrent and investment expenditures and on the linkage between investment budgets and forward expenditure estimates.

111 See recent World Bank public expenditure and finance reviews, for example, Albania 2014, FYR Macedonia 2015, and Serbia 2015.
in the three other countries. This compares to just under 40 percent on average in the 7STEEs. Wages as a share of expenses in Kosovo reached 45 percent in 2015, and around 19-33 percent in all other countries. In the 7STEEs, the wage bill to current spending averaged around 25 percent in 2015. But these figures may underestimate the true size of the Western Balkans’ wage bill. For example, Bosnia and Herzegovina finances health workers through transfers from the Health Insurance Fund, which is an extra-budgetary fund. Including them would add approximately 4 percent of GDP to the wage bill. Thus wage bill reform is a priority in these countries to free up fiscal space and improve the quality of civil service management and performance (see Box 6.3 for Serbia’s strategy on this issue).112

**Social sector spending dominates government spending in most countries of the region.** General government spending on health, education, and social protection ranges from 12-16 percent of GDP in Albania, Kosovo, and FYR Macedonia to 24-28 percent in Bosnia and Herzegovina, Montenegro, and Serbia (Table 6.4: The variation in overall spending levels corresponds closely to the size of social security spending). The higher levels are com-

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112 See also the World Bank 2015g, “Serbia Public Finance Review” and World Bank project documentation for the Modernization and Optimization of Public Administration Program Project for Serbia.
parable to the average spending in the 7STEE peers, and slightly below the EU28 average of 31 percent. As a share of total spending, the figure ranges from a low of 46 percent in Kosovo to the highs of 60 percent in Serbia and 63 percent in Bosnia and Herzegovina, again similar to the 7STEE peers and just below the EU28 average. At a minimum, social protection accounts for just under 20 percent of spending in Kosovo, and up to 35-40 percent for Bosnia and Herzegovina and Serbia. As discussed in the Welfare chapter, this social protection spending is an important source of income for poorer households. However, overall social assistance spending and last-resort (poverty-targeted) assistance does have relatively limited coverage of the poor; and improvements in targeting are needed to make this spending more effective.

Despite recent reforms, high pension spending driven largely by early retirement and high benefits adds to fiscal pressures in Serbia, Bosnia and Herzegovina, and Montenegro. With the exception of Albania, the countries of the Western Balkans inherited fiscally unsustainable pension systems from the former Yugoslavia. Falling pension system revenues (mostly as a result of low employment, as detailed in the Labor chapter) caused further pressure in combination with the rising pension spending. The same factors that subdued growth and employment increased the number of people seeking disability benefits and early retirement. Where pension spending was greatest—in Serbia, Montenegro, and the Republika Srpska entity of Bosnia and Herzegovina—governments have reformed the systems to sharply reduce future spending, but have grandfathered existing retirees who enjoy high benefits and early access to them. The Federation of Bosnia and Herzegovina (the other entity of Bosnia and Herzegovina) has yet to implement a pension reform. While FYR Macedonia’s situation is better, its reform was more structural, involving both the public pay-as-you-go pillar and a savings pillar. These four countries also face the issue of uncovered informal workers, which puts further strain on their social assistance systems. By contrast, Kosovo and Albania have instituted universal social pensions that give all elderly people, regardless of contribution history, a benefit at or above the social assistance level. The reforms in place are forecast to reduce spending considerably, but at the cost of sharp reductions in benefits. This may not be politically sustainable. All six countries’ pension systems are experiencing pressure to restore higher benefits.

High spending in social sectors in the region is often not matched by high-quality and equity-enhancing service delivery. Public perceptions of the quality of public services often do not reflect the levels of spending. In the 2016 LITS study, respondents in countries in the region

<table>
<thead>
<tr>
<th>General government expenditures, percent of GDP, 2015</th>
<th>ALB</th>
<th>BIH</th>
<th>KSV</th>
<th>MNE</th>
<th>MKD</th>
<th>SRB</th>
<th>7STEE av.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditure</td>
<td>31.5</td>
<td>42.6</td>
<td>27.2</td>
<td>49.2</td>
<td>34.4</td>
<td>44.0</td>
<td>42.2</td>
</tr>
<tr>
<td>Expense, o/w</td>
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<td>40.6</td>
<td>20.2</td>
<td>40.2</td>
<td>30.2</td>
<td>41.2</td>
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<td>11.5</td>
<td>9.0</td>
<td>13.2</td>
<td>7.0</td>
<td>8.8</td>
<td>10.4</td>
</tr>
<tr>
<td>Use of goods and services</td>
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<td>7.5</td>
<td>3.7</td>
<td>4.9</td>
<td>4.6</td>
<td>7.5</td>
<td>6.1</td>
</tr>
<tr>
<td>Interest expense</td>
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<td>0.3</td>
<td>2.4</td>
<td>1.2</td>
<td>3.2</td>
<td>1.8</td>
</tr>
<tr>
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<td>1.3</td>
<td>0.2</td>
<td>1.4</td>
<td>2.4</td>
<td>3.3</td>
<td>0.9</td>
</tr>
<tr>
<td>Social benefits</td>
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<td>16.6</td>
<td>7.0</td>
<td>14.3</td>
<td>14.9</td>
<td>17.6</td>
<td>15.0</td>
</tr>
<tr>
<td>Other expense</td>
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<td>2.7</td>
<td>0.0</td>
<td>4.0</td>
<td>0.3</td>
<td>0.8</td>
<td>4.2</td>
</tr>
<tr>
<td>Investment in nonfinancial assets</td>
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<td>2.0</td>
<td>7.0</td>
<td>8.9</td>
<td>4.2</td>
<td>2.8</td>
<td>3.9</td>
</tr>
</tbody>
</table>

Source: National authorities data, Eurostat and IMF GFS.
Note: Note also that the wage bill numbers underestimate the actual wage bill in some countries where, for example, a sizeable share of health workers are financed by extra-budgetary funds.

Table 6.3: Wage bills account for a sizeable share of current spending, with social benefits also high in many of the countries.
Box 6.3. Serbia is reforming its public wage system.

Public sector reform was one of the first priorities for the government that took office in Serbia in 2014. The fiscal consolidation agenda placed a particular focus on the largest single spending category, the wage bill, which accounted for 11 percent of GDP in 2013. In addition, wage bill spending was non-transparent, posing issues of fiscal predictability. The wage system included five different base salaries, 900 job coefficients (multipliers), 2,200 job titles, 71 elements of remuneration, all based on 19 laws and a plethora of by-laws. The payment of salary supplements under the different elements of pay was not rule-based, leading to significant distortions in the pay system. The effect has been to give institutions an incentive to run up wages and staffing to maximize the use of wage bill resources. Establishment control principles are routinely circumvented through the largely uncontrolled hiring of temporary employees.

Since 2014, the government has targeted reducing the wage bill through a comprehensive reform of public administration designed to raise the quality and efficiency of public services, motivate and better reward public employees, and build up the civil service’s capacity to manage the EU accession process. The reform is based on two strategic documents, the Public Administration Reform (PAR) Strategy and the Action Plan for Implementing the PAR Strategy.

To achieve its goals, the government has moved on two fronts, legislative and administrative. The Ministry of Finance created a Registry of Employees in the core public sector (not including state-owned enterprises), which contains information about 465,000 employees. Based on self-reporting, which poses risks of data pollution, data in the registry are regularly cross-checked with data from the mandatory social insurance registry to reduce errors.

To control costs, the wage indexation formula was scaled down, followed by a nominal reduction in wages of 10 percent in November 2014, and the introduction of a ceiling on public sector salaries. In addition to the employee registry, the Ministry of Finance, in partnership with the Ministry of Public Administration and Local Self-Governance, established the Registry of Institutions in the Public Sector.

Establishment control was strengthened through a hiring “freeze” that began in January 2014. This allowed a maximum ratio of 1:5 for replacements (for every five employees who leave the public sector, one employee may be hired). The freeze is being replaced with a system of strict employment ceilings by institution, set under the Law on Maximum Number of Employees in the public sector, adopted in Summer 2015. Under this law, annual ceilings for individual institutions are set by government decree. Finally, the number of contract employees a ministry or agency can hire was limited to 10 percent of its total staff, and ministries were given three months to bring numbers in line with this ceiling.

Other measures are underway to make this reform sustainable. In particular, the government has adopted a new Law on Wages and Salaries in the Public Sector, which sets parameters for the pay and grading systems that apply across the public sector. The law dramatically reduces fragmentation in the wage system and ensures to the maximum extent possible the “equal pay for equal work” principle across the core public sector. In parallel, the government is conducting a thorough review of the functions of ministries and agencies to determine policies for optimization. With an overall goal of streamlining the more than 100 central state institutions that currently exist, the review is giving special attention to ministries and agencies that employ most staff and deliver vital services.

Table 6.4: The variation in overall spending levels corresponds closely to the size of social security spending.
(General government expenditures by functional classification, percent of GDP, 2015, unless indicated)

<table>
<thead>
<tr>
<th></th>
<th>ALB</th>
<th>BIH</th>
<th>KSV</th>
<th>MKD</th>
<th>MNE</th>
<th>SRB*</th>
<th>7STEE av.</th>
<th>EU28</th>
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<tr>
<td><strong>Total, o/w</strong></td>
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<td>42.6</td>
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<td>49.2</td>
<td>46.3</td>
<td>42.2</td>
<td>47.2</td>
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<td>General public services</td>
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<td>6.2</td>
<td>5.5</td>
<td>3.7</td>
<td>10.3</td>
<td>6.1</td>
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<td>6.2</td>
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<td>0.9</td>
<td>1.3</td>
<td>1.3</td>
<td>1.4</td>
</tr>
<tr>
<td>Order and public security</td>
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<td>3.6</td>
<td>2.7</td>
<td>2.1</td>
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<td>0.3</td>
<td>0.3</td>
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<td>0.8</td>
</tr>
<tr>
<td>Housing and communities</td>
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<td>0.5</td>
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<td>0.5</td>
<td>1.3</td>
<td>0.9</td>
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<td>Health</td>
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<td>5.5</td>
<td>5.9</td>
<td>5.7</td>
<td>5.9</td>
<td>7.2</td>
</tr>
<tr>
<td>Recreation, culture and religion</td>
<td>0.5</td>
<td>0.7</td>
<td>0.6</td>
<td>0.8</td>
<td>1.5</td>
<td>1.1</td>
<td>1.6</td>
<td>1.0</td>
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<td>Education</td>
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<td>4.5</td>
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<td>4.2</td>
<td>5.2</td>
<td>4.9</td>
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<td>Social protection</td>
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<td>17.7</td>
<td>13.8</td>
<td>19.0</td>
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<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
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<th>MKD</th>
<th>MNE</th>
<th>SRB*</th>
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<tr>
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Source: National authorities data, Eurostat and IMF GFS.
Note: Data for 2015 for all but * which are 2014.
were less satisfied than those in other countries with the same levels of overall government spending (Figure 125). Looking at different social services (Figure 126), satisfaction levels are generally below the range of the 7STEE countries. Satisfaction with public health services is around 50-60 percent and for social security and unemployment benefits roughly 20 to 40 percent. Improving the quality, efficiency, and equity of social services will require reinforcing systems for monitoring service quality and efficiency. Further gains could come from introducing performance-based financing and enhancing the mechanisms for citizen engagement and accountability of service providers, such as performance scorecards.

Education spending in the region is broadly in line with regional peers (Figure 127) but outcomes are not keeping up. In FYR Macedonia, education outcomes have deteriorated despite increased spending. The countries’ scores on the Trends in International Mathematics and Science Study (TIMSS) declined significantly between 1999 and 2011, and are below those of other European countries. In Serbia, there are similar concerns on education outcomes, based on PISA results. Albania, which spends much less on education than its neighbors, has consistently improved its scores on international student assessments. However, learning outcomes remain stubbornly low even relative to neighboring countries with similar levels of income. More than 60 percent of Albanian 15-year-olds are functionally illiterate in math and about 50 percent in reading. In Kosovo, where education spending is relatively low, the quality of education remains weak and inequitable with significant disparities between municipalities, girls and boys (especially in language tests), and rural and urban students.

Providing greater coverage of pre-school education would raise educational outcomes. Quality preschools can have a significant impact on later achievement in school and lifetime earnings, particularly for low-income and disadvantaged children. Serbia has generally high access to primary and secondary education, but still needs to enhance the coverage of preschool education. At present,
early childhood development programs reach only 52 percent of boys and 49 percent of girls—very low in comparison to the EU 2020 target of 95 percent—and are much lower for Roma at 5 percent for boys and 7 percent for girls. Similarly in Albania, while access to basic education is relatively equitable across income groups, significant disparities remain in access to preprimary and higher education. In Bosnia and Herzegovina, on average only 13 percent of children aged 3–5½ attend preschool, and attendance falls to 8 percent among the poor, Roma, and people living in rural areas. Serbia also faces falling pupil numbers and a need to consolidate the school network and reduce excess teachers in primary and secondary education. In FYR Macedonia and Montenegro, enrollment in tertiary education has been increasing rapidly in recent years, but the efficiency of the higher education system remains low. Tertiary education could improve by coordinating curricula with the needs of the private sector. In Albania, strengthening the regulation of higher education would also help assure quality and guarantee alignment with population trends.

Across the region, reforms to education financing and information management systems would further improve quality and equity of outcomes. Recent expenditure reviews in Albania, FYR Macedonia, and Serbia have highlighted that moves to more equal per-student financing could help address inequities in resources across schools and provide greater transparency on resource allocation decisions. In FYR Macedonia and Montenegro, tertiary education could benefit from setting budget levels based on the headcounts of individual institutions. Across the region there is a need for improved strategic frameworks and information management systems to measure learning outcomes and their linkage to employment outcomes, so as to better inform policy decision-making and resource allocations.

**Government health sector spending varies more widely across the region but countries face a number of common challenges.** Health spending by government is higher in Bosnia and Herzegovina, Serbia, FYR Macedonia, and Montenegro and lower in Albania and Kosovo (Figure 128). At the macro-level, those countries with more rapidly aging populations face a higher burden of chronic disease and a shrinking health insurance contribution base. Arrears accumulation and spending inefficiencies relating to pharmaceutical procurement and staffing composition are common. For example, in Bosnia and Herzegovina, despite the high outlays, the public health sectors in both Republika Srpska and the Federation have accumulated large debts and arrears. In Serbia, roughly 25 percent of public health care expenditures in 2013 were on pharmaceuticals, compared to an EU average of 12.3 percent, while the share of nonmedical hospital staff is particularly high in Serbia and Albania.114 As with education,
sound health information systems are needed to inform sector strategies and resourcing. For example, Bosnia and Herzegovina already has a relatively good primary care health information system, but it needs to be better networked, linked to hospitals and institutes of public health, and monitored systematically. Again, performance-based financing for health has the scope to support efficiency improvements in the sector.

The state needs a higher capacity to deliver.

Delivering on the reform agenda outlined in the sections above will require a strengthening of capacity within public administrations. Institutional reforms across the region will only succeed if rank-and-file public sector employees take part in the design and implementation of these reforms. This will require streamlining the policy process to ensure alignment and consensus, strengthening the center of government to improve coordination, and ensuring continuity in leadership in an environment of perennially fluid politics. In many countries, the very capacity of the public sector to perform its core mandate is a key challenge. For example, the Montenegro Public Administration Reform Strategy 2011-2016 identifies capacity as a key binding constraint. In some cases, the public sector is aging rapidly. For example, in Serbia, the average age in the Veterinary Service is 56. As technically capable staff members retire, governments will need to develop innovative ways to find qualified replacements. In the short to medium term, there is a risk that these dynamics may undermine the capacity of the state to function fully.

With these goals in mind, public administration reforms are rightly receiving strong priority in the region. Comprehensive strategies for public administration reform have been adopted—such as in Serbia and Montenegro—and across the region this is an important area for support from international institutions, in particular the EU in connection with the accession process. Reforms to develop an independent, professional, and efficient public administration in line with European standards can improve the quality of policy formulation, coordination, and implementation. This includes reforms to civil service administrations and the judiciary to improve the selection, professionalism, and management of staff. Serbia, for instance, has recently attempted to overhaul its legal frameworks and reduce public sector head count through right-sizing and strengthening policy coordination and implementation. Enhanced accountability and oversight mechanisms are also needed. E-government (such as the Albania e-Services reform, see Box 6.4) is one entry point to improve accountability and governance, promote

Box 6.4. Albania moves toward e-government reform.

In June 2014, the Government of Albania began a bold reform program of public service delivery, entitled “Innovation against Corruption.” Elected in 2013 with a mandate to reduce corruption, the government’s aim was to change fundamentally how public services are provided through a variety of interventions, including creation of a one-stop shop for administrative services; regulatory reform; re-engineering how services are approved; increasing the number of services provided online; and implementing performance management measures. Through these reforms, the scope for corruption could decline, enhancing the business environment, and the citizen-focus and timeliness of public service provision improved. A one-stop shop citizen service center (CSC) in Tirana, regulatory reform, process re-engineering, and automation are key elements of this strategy. Establishing mechanisms for citizen feedback on the quality and timeliness of service delivery will provide the necessary data to manage performance. The medium-term goal is to automate 90 percent of selected government services for online provision by 2020. This reform is in parallel with other initiatives to automate public service delivery, such as the e-Albania portal (www.e-albania.al) along with online procurement, modernized business registration and licensing. These have helped support an improved environment for private sector dynamism and growth.

transparency, and reduce the scope for such corruption. The incentives of EU accession show up not only in public administration and judicial reforms, but in decentralization and efforts to strengthen the center of government through establishment of “delivery units” to push through improvements in performance in critical areas. Finally, there is a need to strengthen fiscal controls and management information systems for expenditures and personnel. Even if the political will is there, reform can lag if there is zero or very limited basic data about areas of government spending such as personnel costs or there is significant spending outside of the budget.

Can reforms succeed this time, and how?

Changing the role of the state is not easy; reforms in this direction will succeed only if backed by political will. Delivering a set of state institutions and government policies that are more effective enablers of private sector investment and growth is no simple task. Short- and medium-term political dynamics, concerns over the distributional impact of reforms and capture of state institutions by private interests have all impeded reforms over the past decades. However, the need for reforms is becoming more pressing if growth rates are to be raised, convergence in incomes reignited, and sustained improvement in welfare delivered for the citizens of the region.

The level of political support for reform of the state varies across the countries of the region. For example, in Albania, the government is making efforts to improve service delivery while in Serbia, the government is moving forward on a wide range of challenging reforms to the state administration, public enterprises, and SOEs, supported by the EU and international financial institutions. In Bosnia and Herzegovina, while authorities put in place the Reform Agenda, backed by the international community, institutional fragmentation still poses daunting constraints even to reform-minded leaders. Until recently, FYR Macedonia has also been facing prolonged political uncertainty. Across the region, there is also the risk that anti-EU sentiments could reduce political appetite for pushing EU-related reforms of the public sector.

Building understanding of the positive distributional consequences of state reforms can help mobilize political support for their adoption. The prospects of enhanced future growth and prosperity for society as a whole must be weighed against the interests of those who benefit most from the

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**Box 6.5. Tools allow weighing of the distributional impact of fiscal policy.**

Fiscal incidence analysis is a tool that policymakers and other stakeholders in developing and emerging economies increasingly use to measure the impact of a country’s revenue and spending on poverty and inequality and how fiscal reforms might alter the well-being of different segments of the population.

The Commitment to Equity (CEQ) methodology is one such approach. Poland offers a recent example of its application. There the analysis was able to cover 62 percent of tax revenue and 51 percent of government spending. It concluded that the combined effect of taxes and social spending substantially helped to reduce poverty and inequality in Poland in 2014, in line with the findings in other European Union countries, with pensions achieving most of the reduction.

The caveats for the CEQ methodology, as noted in the Poland analysis, are important to highlight. For example, no behavioral, lifecycle, or general equilibrium effects of policy reforms are applied. The quality of services is not captured, and some important revenue and spending items (including infrastructure investments and corporate profits) are not covered. But CEQ insights can still help to inform design of policy, mitigation measures of reforms, and communication strategies. Where fiscal policy reforms affect particular segments of the population, for example in the case of public administration right-sizing, other approaches can provide important insights. This includes examining the resilience of potentially affected households through analysis of household and labor force surveys as well as more targeted quantitative and qualitative surveys.

status quo. These include the usual issues of winners and losers (reflecting demographics and the current bias of spending towards the old). The distributional implications of fiscal reforms, on both the revenue and expenditure side, are increasingly a focus for policymakers across the world, and can be examined through methodologies such as the Commitment to Equity (CEQ) analysis (Box 6.5). Such analysis may be of particular interest for the Western Balkans, given the importance of the state, and the need in many of the six countries for reforms of social spending. Transitional costs of reforms are also important, particularly where they are heightened by fragmented institutional structures and overlapping authorities, such as in Bosnia and Herzegovina.

Even with stable politics and a willingness to reform, the “capture” of state institutions by private interests can impede the quality of public services and obstruct the implementation of reforms. Many people in the region view knowing the right people in government as essential for moving ahead. In the 2016 Life in Transition Survey, 46 percent of respondents in FYR Macedonia chose “political connections” as the most important factor for success in life. This was the highest rate in the survey, ranking above “effort and hard work” (34 percent) and “intelligence and skills” at 15 percent. Bosnia and Herzegovina was not far behind with 45 percent choosing political connections, then Albania (43 percent) and Serbia (42 percent), followed by Kosovo (34 percent) and Montenegro (29 percent). This reflects the fact that corruption and capture of state institutions remain a concern in many countries in the region. This capture can include politicized public administrations, discretionary application of the law, and limited parliamentary and state audit oversight. Public perceptions that government is corrupt and prone to control by private interests remain high (Figure 129), although they are also high in the 7STEEs. Perceptions of governments’ effort in fighting corruption remain relatively weak, particularly in Bosnia and Herzegovina and Kosovo. Perceived political interference in the judiciary raises particular concerns among citizens, firms, and potential foreign investors about the credibility of contract enforcement. While the Western Balkan countries have made reforms to protect the integrity of the legislative framework, corruption is rarely punished in courts anywhere in the region. Enhanced accountability and oversight, including through innovations such as e-government, can help businesses and workers alike to feel secure in committing their funds and futures to the region.

Notwithstanding the challenges we have discussed, there is a growing understanding that the time is now for sustaining and expanding the necessary reforms. There can be no more postponing. Looking outwards, the countries of the region can see the results of the “EU convergence machine,” which has supported improvements in economic governance and higher incomes. Aspiring for the same results, all Western Balkan countries but Kosovo have submitted formal applications to the EU. The context for European enlargement has indeed shifted in recent years, due to the euro zone crisis, experience of previous enlargements, political pressures from migration into the EU, and “Brexit.” The European Commission has reaffirmed a strong focus on the principles of “fundamentals first” in the accession process, prioritizing reforms related to the rule of law and the functioning of democratic institutions including public administration. All in all, the Commission is emphasizing that fundamental changes like these require time, and accession will too. Looking inwards, many governments are taking on such tough reforms, motivated by a growing view that today the opportunity is better than it has been in years for countries to deliver on their potential, to raise economic growth and to ensure sustained improvement in welfare for their citizens.

Figure 129: Concerns over corruption are high.
Percent of respondents agreeing with statements that corruption or bribery is one of the three biggest problems facing the country in the public sector in this country. (percent of respondents)
The six countries of the Western Balkans largely missed out on earlier opportunities to thrive in the post-Cold War era. Today, with peace and enhanced collaboration, coupled with future prospects of European Union membership, the countries have another chance. With the right package of reforms, they can raise economic growth rates and ensure sustained improvement in welfare for all citizens. As late reformers, they can benefit from rising wages in the rapidly reforming transition countries of the European Union and from greater cost-consciousness among firms adapting to lower global growth. The potential for raising productivity through further integration with Europe and the rest of the world is large. The experience of Eastern European transition economies that were early reformers can provide valuable guidance for the Western Balkan countries today.

**It is crucial to act now.** If the countries keep to their current rates of per capita income growth, it will take about 60 years to catch up with their EU neighbors (Figure 130). As things stand now, too few people in the Western Balkans have jobs. Levels of emigration are high as young and educated people look for opportunities elsewhere. Investment is low and private sector firms find it difficult to start up and thrive. Productivity remains largely stuck at long-standing low levels. Populations are rapidly aging.

The prolonged period of sluggish reforms, political uncertainty, and slow convergence in living standards has left citizens dissatisfied with government. The prospect of EU membership continues to provide the strongest anchor for deeper reforms, but implementation has been slow.

**The broad policy challenges are similar across the six nations.** To speed up convergence, the Western Balkan countries need to deepen reforms to raise productivity and economic growth through further integration into regional and world markets. They need higher employment and equity in access.
to services. They must make it easier for private enterprises to grow and reach new markets.

This will require reducing and modifying the role of the state from a direct driver of economic activity to a provider of effective policies, regulatory frameworks, governing institutions, and essential public goods. Improving the business climate will facilitate firm entry and exit and the reallocation of resources to the most productive activities. Improved macroeconomic stability will provide further aid to growth. Reducing the regulatory burden and improving the logistics and trade infrastructure will increase competitiveness and help domestic firms upgrade and expand exports.

Making better use of labor and human capital by enhancing relevant skills and bringing more people into the workforce will be key. Countries need to address disincentives for work and barriers to employment that exist in their labor, tax, and social protection systems, and support acquisition of the skills that workers will need for new jobs created. The countries must create a social services system that achieves the goal of protecting the vulnerable without hindering productivity or discouraging work.

In sum, Western Balkan countries' highest priorities are to:

- Foster macroeconomic stability.
- Remove disincentives and barriers to work.
- Strengthen the business environment and private sector development.
- Improve governance and institutions and deepen public sector reform.

In pursuing these policy priorities, coordination at the regional level would heighten integration within the region and with the rest of the world. Lasting development results would also require ensuring sustainable use of energy and natural resources and stewardship of the environment.116

116 These priorities are consistent with those identified by the World Bank's Systematic Country Diagnostic reports for five of the countries (all but FYR Macedonia, whose report is currently in progress).


