The Political Conditions of Economic Development in the Western Balkans

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About the Author

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Summary

The European Union's policy towards the Western Balkan states (Croatia, Bosnia and Herzegovina, Montenegro, Serbia, Macedonia, Kosovo and Albania) has strongly emphasised the need for economic liberalisation and socio-economic reform. Yet, with the exception of minor success stories, this has not resulted in competitive market economies. Some countries, such as Bosnia and Kosovo, have still not returned to their economic performance before the Yugoslav wars, while even the front runners Slovenia (which joined the EU in 2004) and Croatia (which became an EU Member State in 2013) have been severely affected by the most recent financial and economic crisis. This paper argues that rather than focusing on economic reforms in the Western Balkans, it is important to support the establishment and consolidation of the political conditions for economic development and growth. Too often, so the main argument, have the EU and other international bodies focused too strictly on liberalisation and social reform, thereby neglecting underlying political considerations that strongly hamper socio-economic progress in the region.

Introduction

Twenty-five years after the failure of the last Congress of the League of Communists of Yugoslavia started the dissolution process of the state and a decade of war, sanctions and economic downturn, the region of the former Yugoslavia (and Albania) looks very different. Slovenia and Croatia have become EU Member States, other countries in the area have seen remarkable economic growth figures over recent years. All in all, the seven states that make up the Western Balkans (Croatia, Bosnia and Herzegovina, Montenegro, Serbia, Macedonia, Kosovo and Albania) have developed very differently in the last 25 years. Some have successfully consolidated democratic institutions, settled their disputes with neighbouring countries and either joined the EU (Slovenia and Croatia) or are making good headway towards membership in the Union (Montenegro). Others still have to deal with the consequences of war and conflict, inter-ethnic tensions and weak democratic institutions (Bosnia and Herzegovina, Macedonia, Kosovo, Albania). Serbia, while also a candidate country for EU membership and currently in negotiations to join, has still not fully consolidated its statehood (Kosovo-question) and its democratic institutions.[1]

The European Union (EU) has been heavily involved in the region since the late 1990s, providing a perspective for future membership to all Western Balkan states, and also supporting political, economic and societal transformations. To support the economic development of the region, the EU's policies focused on market liberalisation, privatization and socio-economic reforms to support more flexible and investment-friendly conditions for economic development. In many respects, these reforms have been successful in creating liberalised markets. Reforms of the employment laws and social welfare systems have created very flexible provisions. As a leading expert has recently argued, "The Western Balkan candidate and potential candidate countries do seem to have functioning market economies – but markets that function in a sense 'too well', without any countervailing powers or automatic stabilizers that would be provided by an effective system of social protection."[2] This means that while it can be argued that all of the Western Balkan states fulfil the basic criteria of a functioning market economy, these cannot be compared to similar economies in EU Member States. Three basic reasons can be identified for this: First, while the markets in the Western Balkans are liberalised and functioning as market economies, they are not competitive.[3] This is not only the case when comparing these countries to leading European economies such as Germany and France, but also in a wider regional setting, Bosnia and Kosovo are not competitive when compared to Turkey or Slovenia. Second, unlike EU Member States, there are no provisions for financial assistance or bail-outs in case of financial and economic crises. Most of the Western Balkan states have been hit very hard by the most recent financial and economic crisis, for example Croatia's economy shrank by about 11 per cent in recent years. However, local banks could not cope with the financial pressure. This has resulted in a banking sector which is mainly controlled by European banks. It has, however, meant that the countries themselves needed to deal with the economic downturn, growing social spending and reduced tax income. While the International Monetary Fund (IMF) has provided emergency loans to numerous countries in the wake of the crisis, there has been no European assistance and long-term support for overcoming the

[1] For a good basic summary of the situation in the country see: Der Frust im ehemaligen Jugoslawien wächst. In: Frankfurter Allgemeine Zeitung, 22 January 2015.
[2] *Will Bartlett:* The Political Economy of Accession – Forming Economically viable Member States. In: *Soeren Keil / Zeynep Arkan (Eds.)* The EU and Member State Building –European Foreign Policy in the Western Balkans. London and New York 2014, p. 228.
[3] Ibid.

structural economic problems. The crisis has not only been longer in the region, with many countries only returning to growth in 2014, but has created an economic downturn which many find difficult to overcome, including EU Member State Croatia. Third, more so than in any other European country, political issues remain at the heart of weak economic performance and the stronger impact of the recent crisis in the Western Balkans. Hence, while economic reforms have created basic free market economies, these operate in difficult socio-economic conditions and face numerous political obstacles. While there has been some work on the economic situation and suggestions for reforms, this paper aims to concentrate on the political conditions which influence economic performance. To do this, the paper will first discuss the starting point for the Western Balkan states and will then point out key areas of the political circumstances in the countries, which affect the countries' economies. The Conclusion will demonstrate that a new focus on addressing these political issues is needed in order to create better conditions for economic growth and sustainable socio-economic development in the area.

The Starting Point

All countries in the Western Balkans started from a difficult historical legacy. The socialist systems in Yugoslavia and Albania broke down in the early 1990s, in Yugoslavia this was followed by inter-ethnic violence in Croatia, Bosnia and later in Kosovo and Macedonia as well. Their economies were heavily affected, not only by the inefficiency of the socialist tradition and the strong focus on industrial production, but also by war, conflict, inter-ethnic tensions, population displacements and a lack of investment in infrastructure. After its failure to stop the conflicts in the Western Balkans in the early 1990s, the EU became more and more involved in the reform processes of the Western Balkan states after 1999. This involvement showed some success, and between 2003 and 2008, growth rates averaged 4 per cent or more in all countries. However, this economic progress was financed by foreign direct investment; the internal markets remained weak and dependent on credits from foreign banks. Important market reforms were implemented, however, the focus was on liberalisation and the creation of free markets, rather than on sustainable growth. This was to become a major issue once the financial crisis hit the EU, as many investors withdraw their money from the Western Balkans. This left the economies exposed and vulnerable, as domestic consumption could not cover for the lack of foreign investment. With limited possibilities to de-value their currencies (because they are so closely linked to the Euro), a spiral of new debt, more social spending and a lack of economic investment developed, which many countries have so far been unable to escape. The result was a massive economic downturn in all countries, often accompanied by further market liberalisation and cuts to the already weak social welfare systems. In most Western Balkan countries a double-dip recession followed in 2012, in Albania in 2013.

Even after the crisis growth rates stood at 1 per cent, rather than the 4-5% that many countries saw before the crisis, although in 2015 higher growth is forecasted in numerous countries including Kosovo and Macedonia. Furthermore, all countries continue to face soaring high unemployment rate, which put a strain on countries' budgets and threaten social cohesion. Protests in Bosnia in Spring 2014 were about failed economic reforms and similar issues brought people to the streets in Slovenia and Croatia as well. Additionally, it is important to highlight that the economies of these countries remain dependent on aid and support from external organisations, including the EU and the International Monetary Fund (IMF). Many sectors of the economy are controlled by tycoons, who are strongly linked to ruling political elites. Political elites often control employment in the public sector as well, which is the main source of “safe” employment in the majority of Western Balkan countries. Public expenditure in Croatia and Bosnia for example limits possibilities for investment in other economic projects and is a major burden on public finances. While this is less the case in Albania and Macedonia, dependence on jobs in the public sector also explain patronage and corruption in numerous countries, including Bosnia and Montenegro.

The focus of economic reform in these countries has been on market liberalisation. However, underlying issues in the political systems, societal arrangements and welfare reform have been neglected. Economic growth will not return to a sustainable level, and these countries will continue to suffer harder than other European countries in case of another financial/economic crisis until these underlying issues are addressed. Hence, it is important to look at these political problems, discuss them in detail, and explain how they affect economic performance.

The Political Conditions for Economic Growth

1. The Statehood Question

As Will Bartlett argued,[4] while all Western Balkan states fulfil the basic criteria of a free market economy, they are neither competitive nor able to deal with economic and social crises. This is linked to the question of stateness and consolidated statehood. Many countries in the area, from Bosnia to Kosovo, Serbia and Macedonia, face fundamental internal and external challenges to their statehood. While Bosnian statehood remains contested by political elites in the Republika Srpska, the mainly Serb-inhabited entity in Bosnia; Serbia and Kosovo still struggle to define their relations, despite closer cooperation in light of both countries’ EU aspirations. In Macedonia, there have been renewed tensions between Albanians and Macedonians in recent years, as a result of lacking progress in terms of EU and NATO integration. Kosovo itself remains at odds with the Serbs in North Kosovo, who are still not fully integrated into the Kosovan.

Consolidated statehood is important for economic development, not only because it is a key criteria for the success of democratization processes.[5] The state acts as a regulatory framework. In this role, a state ensures the rule of law, pushes for a specific economic model, provides a legal setting for taxation, supports the investment environment and ensures changes and reforms to existing laws as required by socio-economic demands (for example in the area of employment law and social welfare). Moreover, the state is also a service provider. It is responsible for certain services, which directly impact on economic performance, such as welfare and public-private partnerships. In the Western Balkans, the role of the state as an employer is also important to highlight. Jobs in the administration are often better paid and safer than many jobs in the private sector. However, the focus of reforms in recent years has not been on making the bureaucracy more efficient and independent from political influences. Instead, in many countries the bureaucracy remains highly politicised and struggles to implement laws and regulations efficiently. The issue here is not so much of a non-existent bureaucracy, but one which is political and incompetent. In Bosnia and Kosovo, for example, employment in the state bureaucracy is directly linked to the loyalty to certain political parties.

[4] Ibid.
[5] On this see: *Juan Linz / Alfred Stepan*: Problems of Democratic Transitions and Consolidation – Southern Europe, South America and Post-Communist Europe. Baltimore 1996.

2. The Rule of Law

The rule of law is fundamentally important for economic development. Investors want to know that their investment is safe, that there are regulations that protect them and legal ways to challenge those that might try to steal from them. Furthermore, the rule of law does not only protect big foreign investors but also small and medium enterprises (SME), the backbone of most modern economies. A functioning rule of law means that corruption is efficiently fought; there are clear provisions on how to open a business and protection from the police and against unlawful competition and threats. Yet, in most Western Balkan countries corruption remains widespread, permissions to open a business are often hard to get and time-consuming, and police and legal services are themselves involved in corrupt and illegal activities. All of this highlights the need for a functioning and independent bureaucracy as part of a consolidated state, but what is more is that often these practices are a result of existing realities. The black and grey markets function so well in the Western Balkan countries, because there is a general lack of employment opportunities, with official unemployment between 20 and 40 per cent. Salaries are often very low and not enough to cover the basic living costs, which invites corrupt practices. Political connections between bureaucracy and ruling elite provide an unhealthy environment, in which investors face strict restrictions not only politically but also in their economic activities. The often limited social welfare provisions make transitions and privatization especially painful, as there is no social security for those losing their jobs or willing to re-train and re-enter the labour market. Hence, this supports clientilistic networks, in which everyone wants to keep the job they have and swears allegiance to those that supposedly protect this job.

There have been many initiatives from the EU, including the EULEX mission in Kosovo, which have focused on strengthening the rule of law and enhancing good governance. These have all, however, had a limited impact. Judges are still appointed by political bodies in countries like Serbia, while there is a history of threats against NGOs and other activists who work actively against corruption and for better legal protection. However, without a stronger focus on the rule of law, economic development will be limited, investors will be frightened to provide funding, and the bureaucracy will remain politicised and inefficient. The main reason why all these initiatives have failed is not because they were designed wrongly or tackled the wrong issues. Often it was a lack of political commitment by the political elites, who fear for their own benefits, and by the EU, which often accepted half-hearted reform efforts instead of deep-rooted cultural change. The danger of this, of course, is creating more situations like the one in Romania, which clearly was not ready for EU membership in the area of the rule of law and the fight against corruption, when it joined in 2007.

3. Human Capital and Social Welfare Systems

While the former Yugoslavia had a large number of well-trained employees, many of those are now retired, or have indeed settled permanently abroad. The new states have not been able to produce a highly qualified workforce, which would also support economic reforms and political democratization. The reason for this is not that people do not want to be trained or do not gain qualifications anymore. The reasons are mainly political, education systems are out-of-date and in some countries such as Bosnia, Kosovo and Macedonia, ethnic tensions seriously affect the quality and commitment to universal education. Albania recently shut down 18 higher education institutions, demonstrating the massive rise of private universities which often award degrees on a dubious basis and fall outside of any quality control by state officials. Vocational training enjoys very little support in the region, yet it offers another possibility to train the workforce and allow specialisation. Population displacement and ethnic cleansing in Croatia, Bosnia and Kosovo have had a further effect on social mobility. People try to get jobs in EU Member States, but not in neighbouring countries.

The countries also remain highly dependent on payments by ex-patriots who sent money “home” to their family. This form of revenue, essential when the average income is too low to cover basic costs, was highly affected by the recent crisis, as these payments from overseas were substantially reduced. As a result, not only domestic consumption slowed down, because people had less money to spend, but many people across the region were forced into poverty. Weak social systems have also been unable to address rising unemployment figures in light of privatization and economic downturn. People know that if they lose their job, they will not be protected; they will easily slide into poverty. Hence, this support clientilistic networks, corruption and nepotism, as well as grey and black market activities. Functional welfare systems in Eastern European countries have supported economic transitions, because people found it easier to lose their job, re-train and find new employment.[6]

4. Historical Legacies

Historical legacies matter in the Western Balkans. While the countries face similar economic legacies to the countries in Central and Eastern Europe (although Yugoslavia had its very own version of self-management socialism), the legacies of violence, war, ethnic cleansing, population displacement, new social networks and clientilism, shadow economy, physical destruction, and years of economic sanctions and mismanagement after the end of the conflicts in the 1990s have a lasting impact. These legacies matter, because they directly influence social mobility, regional cooperation and the willingness of people and political elites to reform and adapt to the new post-war order. The fact that the political elites of Kosovo were mostly involved in the war in 1999 and that major elites involved in the Bosnian war (1992-1995) remain in charge politically and economically in parts of the country, demonstrates this. Because of the ongoing tensions in Bosnia, numerous infrastructure projects could not be completed, because the entities cannot agree upon who should pay for these and be in charge of them. In Kosovo, the North has more and more integrated into Serbia instead of Kosovo, despite agreements between Belgrade and Pristina to re-integrate the territory into the Kosovan state. In Macedonia, Albanian and Macedonian territories have developed independently and very differently. While the Macedonian government has been relatively successful with investment areas and business parks, the Albanian territories in the South-West have profited from local business developments and strong economic links with Kosovo and Albania. In many countries, including Croatia, Serbia and Albania, cities have profited more from economic growth than rural areas which remain dependent on funding from the central state.

The EU has tried to make economic cooperation between the Western Balkan states a key condition for membership and has supported the Stability Pact and its successor the Regional Cooperation Council, which support local initiatives for economic and social cooperation. However, this has had a diverse impact on countries. While the Central European Free Trade Area (CEFTA) has indeed increased regional trade and economic links, this is more important for some countries than others. Croatia for example is economically strongly entangled with Bosnia and Serbia as well, but other countries in the region depend much

[6] On the issue of social welfare see: *Will Bartlett:* Europe’s troubled region: economic development, institutional reform and social welfare in the western Balkans. Abingdon 2008.

more on their trade with EU countries. One of the success stories in Central and Eastern Europe was new infrastructure and economic projects that enabled international businesses to settle and use the countries' advantages in terms of a highly trained work-force and cheap labour costs effectively. While some progress in infrastructure investment has been made in Croatia, Serbia and Macedonia, countries such as Bosnia and Kosovo still need to restore major parts of their infrastructure and develop competitive business strategies to compete not only with their neighbouring countries, but with other EU Member States as well.

Political Reforms and Economic Development

As the discussion above has demonstrated, many of the economic problems in the Western Balkans, especially those that have become apparent after the recent financial crisis, are home-made and linked to political issues. This has three important consequences. First, political reform and the willingness to put economic development high up on the agenda are key to long-term sustainable development in the region. Hence, a focus on "economics-only" does not only promise little success, it might in fact contribute to a climate in which political problems are ignored. This is why the German-British initiative for economic reform and EU integration in Bosnia promises little success.[7] While it aims at re-starting economic growth and socio-economic progress, it misses the key problems that hold Bosnia back: ethnic divisions, political blockades and elites who are more focused on their own benefits than on the future of the country. Second, when asking the question which reforms the region needs and how these can be achieved, no new conditionality is necessary. A strict focus on the EU's acquis communautaire would be enough to address the majority of issues described above. While the acquis does not deal with problems such as historical legacies, it does address questions of statehood, the rule of law and competitiveness of the market. The key problem here is that enlargement is (and always has been) a foremost political, and not a technical process. Yet, when looking at the economic development of the Western Balkan region, a focus on the technical criteria of the acquis is not a bad idea. It lays the foundations of how Member States should look like, and further details have been provided for example in terms of the banking sector in recent years. While the political commitment of Western Balkan enlargement is certainly important, and necessary, political progress should nevertheless depend on the fulfilment of technical criteria, in particular in the area of economic transformation. Third, when thinking about which reforms are actually necessary and will be successful and in the medium- and long-term, a number of possibilities come to mind:

1. Strengthening the State

Consolidated statehood remains central for economic development. While we have learnt in the last two decades from the success of China, that the state does not need to be democratic to develop successfully economically, it nevertheless needs to be consolidated and capable of using its coordinating and regulatory power effectively.

2. Social Security Matters

Social security is often underestimated in the discussion about functioning market economy. Yet, it is an essential part. Not only does the lack of social security explain patronage and

[7] The text of the initiative is available at: https://www.gov.uk/government/speeches/bosnia-herzegovina-a-new-strategic-approach For a critique of this approach see: *Kurt Bassuener / Toby Vogel / Valery Perry*: Retreat for Progress in BiH? – The German-British Initiative, DPC Policy Paper, Sarajevo, Berlin, Brussels, November 2014.

clientilism, but effective social security systems also demonstrate that the state is able to fulfil its role as a supporter of economic change.

3. Improve Investment Climate

The countries in the Western Balkans remain dependent on foreign investment. Hence, strengthening the investment climate is essential for the support of economic development. To do this, the state needs to involve the private sector more strongly in economic decision-making, better enforce the rule of law and strengthen its anti-corruption policy especially against tycoons which dominate many business sectors in the Western Balkans.

4. Regional Development and EU integration

While the EU's focus on regional development is strongly influenced by the policy of overcoming the legacy of violence and conflict in the region, a new strategy should be devised which combines regional development/cooperation with the EU integration of the Western Balkan states. What is important is that countries communicate and exchange ideas with each other. There are a number of economic success stories, particularly in Slovenia, Croatia and Macedonia, and other countries should be able to learn from these successes and copy them. This form of learning should also be linked to the EU integration of the Western Balkan states, and certainly requires a better coordination of different donors and agencies.

5. Industrial Policy and Future Economic Planning

The legacy of over-industrialisation that could be found in Yugoslavia and Albania during the socialist period has resulted in a massive reduction in industrial production in the 1990s. De-industrialisation has resulted in job losses and social fragmentation. Yet, industrial policy still matters, and all countries in the Western Balkans will need it in order to prepare their economies for competition with each other and other EU Member States. The key is to develop an industrial policy which focuses on "smart growth" in areas where the countries can be competitive and have clear advantages. This has so far not been developed in the majority of countries, only Macedonia has made some progress in this direction in recent years – with some remarkable success in their policy to attract industrial production and businesses.

Conclusion

Economic transition and reform are long-term tasks of governments that often only think in four or five-year timeframes until the next elections. Yet, over the last two decades the countries in the Western Balkans have economically developed very differently. While there are some success stories, overall the story is grim, and especially in light of the most recent financial and economic crisis, the future is not very promising either. Having said this, as the discussion above has demonstrated, many of the problems that hinder economic development and have resulted in the negative effects of the most recent economic crisis on the region are political. The good news is that these issues can be addressed if there is political will to do so. This will of course mean very painful reforms and long-term planning, but if the EU were to support these reforms, real sustainable progress can be achieved. However, if no progress is achieved, the Western Balkans threatens to become the dark hole of Europe, economically backward, politically irrelevant and generally ignored. This will not only increase the spread of organised crimes and labour migration from the region to the EU, but it will also have a profound impact on the socio-political make-up of the region itself. We can already see authoritarian tendencies in Serbia, Macedonia and Montenegro. Open conflicts between political elites and the media, NGOs and even the arrest of opposition leader as most recently in Macedonia demonstrate a worrying trend that goes well beyond the region of the Western Balkans and includes countries as diverse as Hungary and Turkey. Failed economic reforms, the upsetting of the social make-up of these countries, and the feeling of being left behind in an ever-changing world with little hope of EU membership anytime soon, have brought to power semi-authoritarian regimes that promise quick solutions to complex long-term issues. While these regimes will ultimately fail to deliver, evidence from Hungary and Turkey suggests that once they have manifested themselves and control the major political institutions, they are very hard to get rid of, even when they fail to deliver and when their incompetence and involvement in corrupt practices becomes visible. Similar trends can be observed in some Western Balkan countries. The lack of economic progress and the social unsettling of the recent crisis have contributed to this development. It is in the interest of the EU, and everyone interested in the democratization, consolidation and EU integration of the Western Balkan states, to support economic reform, provide a clear perspective for membership and counter-balance authoritarian tendencies with a strong commitment to the conditions of the acquis, including the respect for democracy and human rights.