

THE ROAD TO STABILITY AND PROSPERITY
IN
SOUTH EASTERN EUROPE:
A REGIONAL STRATEGY PAPER

March 1, 2000

Europe and Central Asia Region
The World Bank

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CURRENCY EQUIVALENTS (Annual Average)

ALBANIA

Currency Unit = Lek (ALL)

1994	1 Lek = 0.0106 US\$
1995	1 Lek = 0.0108 US\$
1996	1 Lek = 0.0096 US\$
1997	1 Lek = 0.0067 US\$
1998	1 Lek = 0.0066 US\$
1999	1 Lek = 0.0073 US\$

CROATIA

Currency Unit = Kuna (HRK)

1994	1 Kuna = 0.1668 US\$
1995	1 Kuna = 0.1912 US\$
1996	1 Kuna = 0.1840 US\$
1997	1 Kuna = 0.1639 US\$
1998	1 Kuna = 0.1572 US\$
1999	1 Kuna = 0.1405 US\$

BOSNIA AND HERZEGOVINA

Currency Unit = Convertible Marka (KM)

Currency Board Arrangement, effective
June 1997

(KM fixed to Deutsche Mark, 1 KM = 1 DM)

1996	100 BMD ¹ = 0.6645 US\$
1997	1 KM = 0.5780 US\$
1998	1 KM = 0.5682 US\$
1999	1 KM = 0.5952 US\$

FEDERAL REPUBLIC OF YUGOSLAVIA

Currency Unit = Dinar (YUM)

1994	1 Dinar = 0.6211 US\$
1995	1 Dinar = 0.5051 US\$
1996	1 Dinar = 0.1996 US\$
1997	1 Dinar = 0.1730 US\$
1998	1 Dinar = 0.1071 US\$
1999	1 Dinar = 0.0917 US\$

BULGARIA

Currency Unit = Lev (BGL)

Currency Board Arrangement, effective July
1, 1997

(Lev fixed to Euro, 1 Lev = 0.511292 Euro)²

1994	1 Lev = 0.0185 US\$
1995	1 Lev = 0.0149 US\$
1996	1 Lev = 0.0056 US\$
1997	1 Lev = 0.0006 US\$
1998	1 Lev = 0.0006 US\$
1999	1 Lev = 0.0005 US\$
1999	1 BGLN = 0.5457 US\$ ³

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Currency Unit = Denar (MKD)

1994	1 Denar = 0.0231 US\$
1995	1 Denar = 0.0264 US\$
1996	1 Denar = 0.0250 US\$
1997	1 Denar = 0.0200 US\$
1998	1 Denar = 0.0184 US\$
1999	1 Denar = 0.0176 US\$

ROMANIA

Currency Unit = Lei (ROL)

1994	1 Lei = 0.00060 US\$
1995	1 Lei = 0.00049 US\$
1996	1 Lei = 0.00032 US\$
1997	1 Lei = 0.00014 US\$
1998	1 Lei = 0.00011 US\$
1999	1 Lei = 0.00007 US\$

¹ Bosnian Dinar (BMD).

² Lev was fixed to Deutsche Mark, 1,000 Leva = 1 DM, from July 1, 1997 to the end of 1998. Since January 1, 1999 Lev has been fixed to Euro.

³ Since July 5, 1999, the Bulgarian Lev was redenominated at 1 BGLN = 1000 BGL.

ACRONYMS AND ABBREVIATIONS

ATC	Air Traffic Control
ARPU	Average Recurring Revenue Per Subscriber
ATPs	Autonomous Trade Preferences
BiH	Bosnia and Herzegovina
BTF	Balkans Task Force
CEE	Central and Eastern Europe (Czech Republic, Hungary, Poland, Slovak Republic, Slovenia)
CIS	Commonwealth of Independent States
DAC	Development Assistance Committee
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECE	Economic Commission for Europe
EIB	European Investment Bank
EIU	The Economist Intelligence Unit
EU	European Union
FDI	Foreign Direct Investment
FRY	Federal Republic of Yugoslavia (Serbia and Montenegro)
FTA	Free Trade Agreement
GNP	Gross National Product
GFS	Government Financial Statistics
HF	Heritage Foundation
HLSG	High-Level Steering Group
ICRG	International Country Risk Guide
IDP	Internally Displaced People
IFC	International Finance Corporation
IFI	International Financial Institutions
ILO	International Labor Organization
IMF	International Monetary Fund
IMR	Infant Mortality Rate
KKZ	Kaufmann, Kraay, and Zoido-Lobaton
NATO	North Atlantic Treaty Organization
NGO	Non-Government Organization
OCHA	United Nations Office for the Coordination of Humanitarian Affairs
OECD	Organization for Economic Cooperation and Development
RIAs	Regional Integration Arrangements
RS	Republika Srpska
SAA	Stabilization and Association Agreement
SECI	Southeast European Cooperative Initiative
SEE	South Eastern Europe
SME	Small- and Medium-Size Enterprises
TERFFs	Trans-European Rail Freight Freeways
TFR	Total Fertility Rates
TI	Transparency International
TINA	Transport Infrastructure Needs Assessment
UCTE	Union for the Coordination of Transmission of Electricity
UNDP	United Nations Development Programme
UNHCR	United Nations High Commission for Refugees
WDI	World Development Indicators
WLSG	Working-Level Steering Group
WTO	World Trade Organization

ACKNOWLEDGEMENTS

This Report was prepared in response to the mandate given to the World Bank and the European Commission under Article 41 of the Stability Pact to coordinate a regional approach to South Eastern Europe. The Report was prepared by the Europe and Central Asia Region of the World Bank, in close consultation with the International Monetary Fund, the European Commission, the European Bank for Reconstruction and Development, the European Investment Bank, the Organization for Economic Cooperation and Development, the Council of Europe Development Bank and the Council of Europe. The Office of the Special Coordinator of the Stability Pact, especially the Chairman of Working Table II, Fabrizio Saccomanni and Deputy Special Coordinator, Ed Kronenburg, also provided invaluable support and guidance. The views expressed in this Report do not necessarily represent those of the institutions involved in the preparatory work.

The principal authors of the Report were Arntraud Hartmann (Country Director for Croatia and Albania, ECA Region, World Bank), Daniela Gressani (Sector Manager for South Eastern Europe, ECA Region, World Bank), and Kyle Peters (Sector Manager for Macroeconomics II, ECA Region, World Bank) under the leadership of Christiaan Poortman (Regional Coordinator for South Eastern Europe, ECA Region, World Bank). Numerous people from many organizations and institutions assisted in the Report's preparation: George Zavvos, Barbara Kauffman, Dirk Buda, Michael Vedso (EC); Hans Peter Lankes, Marina Wes (EBRD); Massimo d'Eufemia, Axel Hörhager, Kristian Uppenberg, Chris Hurst (EIB); Nick Malyshev, Silvana Malle, Declan Murphy (OECD); Michèle Meunier (Council of Europe Development Bank); Gabriella Battaini-Dragoni, Dimo Iliev, (Council of Europe). Many World Bank staff also made substantive contributions: Constantine Michalopoulos, Gerardo Corrochano, Juan Carlos Ginarte, Zhicheng Li, Nick Manning, Andras Horvai, Francois Etori, Dena Ringold, Gloria La Cava, Steven Holtzman, Mian Ifthikar Khalid, Marjory-Anne Bromhead, Konrad Von Ritter, John Nash, Rita Klees, Stephanie Abdulin, Eva Molnar, Gareth Locksley, Maureen Lewis, Philip O'Keefe, Helga Treichel, Manuel Marino, Alexandre Marc, Walter Stottmann, Severin Kodderitzsch, Graham Smith, Anca Dumitrescu, Louis Thompson, James Stevens and Laura Rose. Kathryn Rivera, Erlinda Inglis, Dorota Kowalska, Viktor Soukhanov and Sherwin Boyne provided invaluable assistance.

Special thanks are also due to the staff of the joint World Bank-European Commission Office for South East Europe (Rory O'Sullivan, Ollivier Bodin, Mandeep Bains, Janet Dooley, Anne Kanarek, and Carol Stemp) for not only their substantive, but also their logistical, support for the preparation of this Report.

EXECUTIVE SUMMARY

This Report outlines a comprehensive approach to regional development and integration in South Eastern Europe. To this end, it develops a comprehensive strategic framework for development activities in the region; it does not contain a specific agenda for regional projects, programs or financing requirements. This strategic framework responds to the Stability Pact mandate (Article 41) for the European Commission and the World Bank to coordinate a regional approach. This Report has been prepared by the World Bank, in close collaboration with our main development partners in the region.

The fundamental objectives of the strategy are increased prosperity and a reduction in poverty for all people living in South Eastern Europe. The Report's main premise is that establishing peace, stability and sustainable growth throughout the region is essential to achieving these objectives. A deeper and more consistent implementation of domestic reform programs, stronger governance and institutions, sound environmental management, and better developed and integrated infrastructure are all needed to provide a solid foundation for sustainable growth and poverty reduction. Policies to foster social inclusion and cohesion within the increasingly fragmented region are also key, as they are the only road to establishing peace and stability.

The South East European region, as used in the Report, refers to Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Federal Republic of Yugoslavia, the former Yugoslav Republic of Macedonia and Romania. It is a diverse region of 56 million people, living at about US\$2,200 per capita, roughly half the income level of the five Central European countries. The past decade of transition and conflict has left the region with a legacy of inadequate growth and declining living standards. As a region, these economies have recovered only 75 percent of their pre-transition income levels. In the past several years, growth has declined in aggregate, increasing the gap between these economies and the rest of Europe. More alarming is that there has been a deterioration in living standards, as evidenced by higher poverty, inequality and unemployment.

This poor economic performance can be attributed to four factors. First, initial conditions in the region at the onset of the transition were adverse: the economies had unbalanced industrial structures, weak institutions, and fragmented civil societies. Second, war, civil strife and ethnic conflict have had a devastating effect on the region. In those countries directly affected, conflict has fragmented societies, and destroyed institutions and infrastructure. In all countries, regional conflicts have disrupted normal economic activities, made for an uncertain business climate and put strains on nascent political systems. Third, macroeconomic stabilization policies have been inconsistent and this has furthered exacerbated the uncertain business climate. Finally, structural reform policies have been weak; progress in trade liberalization, privatization, enterprise reform, competition policies and financial sector development have all lagged the efforts in Central Europe. Similarly, disappointing progress has also been made in institutional, social and environmental policies.

Overcoming the legacy of conflict and a poor economic performance, and achieving success in the fundamental objectives of the Stability Pact requires a 'joint commitment' by all partners. First and foremost, the countries of the region must make a deeper and longer-lasting commitment to reform and intra-regional cooperation than has characterized the past decade. Without such a commitment, no regional strategy can be effective. Yet, as argued in the Report, an approach focussed solely on country-by-country reform and intra-regional integration is necessary, but not sufficient, to achieve our joint goals of prosperity and a lasting reduction in poverty for all people of the region. Success will, also, hinge critically on establishing a credible and predictable path for all countries in the region to integrate with European and global structures, particularly the European Union. Such a path would anchor expectations and provide a strong incentive for today's political leaders to reform and cooperate. The international community must also support the implementation of this strategy, by providing financial, technical and political support to the countries to help them advance on the path of reform and integration with the world economy.

The Report outlines four broad thrusts for action that are designed to support the achievement of the goals of peace, stability and prosperity. These are:

- moving rapidly towards trade integration with the EU and within the South East European region itself, and creating a stable, transparent and non-discriminatory environment for private sector development;
- fostering social inclusion and social change within the region to reduce tensions and create the conditions for peace and stability;
- improving institutional capacity and governance structures, and strengthening anti-corruption efforts in the region; and,
- investing in regional infrastructure to integrate the region physically with the rest of Europe and within itself, which must include initiatives that safeguard the environment.

Improving the climate for trade and private sector development will magnify and accelerate the impact of more determined implementation of domestic reform programs. The first concrete step in eventual integration with European and global structures is trade integration. Trade integration, based on past experience in Europe and elsewhere, is usually a leading component of broader, longer term integration. The countries of South Eastern Europe are small, and thus their development depends critically on international trade and access to European markets. Trade integration is also essential to reduce the dependence of these countries on aid from the international community. Trade integration must also be accompanied by the creation of vibrant private sectors. Without an improvement in the climate for investment and private activity in general, the countries of the region will be unable to realize the benefits of trade integration and will not be able to generate the new employment opportunities necessary to raise living standards.

Given existing ethnic tensions in the region, special efforts are required to include more fully and effectively all population groups in the economic development of the region, especially minority groups. Currently, the region has about 1.7 million refugees

or internally displaced people. These people are separated from their ancestral homes and their physical and economic assets. They create a cauldron of instability in the region. Furthermore, continued increases and persistence of poverty among these people and other minority groups will exacerbate tensions and could lead to a further fragmentation of the region. Ensuring equal access to public services and employment is critical. Efforts also need to be made to reach out to the Roma community, which lives in poverty in many countries of the region. There is also a special role for education in creating leadership, value changes and human capital that will be essential not only for national economic development, but also for regional cooperation. The ultimate goal must be the formation of open, tolerant and cohesive societies that provide the foundations for a stable and prosperous region.

Much of economic development, social inclusion and regional stability in South Eastern Europe will depend on strengthening of institutions, governance and a lowering of the level of corruption. Gradual integration with European and global structures will also require significantly more mature institutional structures. Institutions also play an essential role in poverty reduction, by assuring that public services are delivered to all members of society, including the poor. Cross-country evidence shows that South Eastern Europe has very weak institutions and governance, which constrain economic development and adversely affect investors' perception of the region. Special attention will need to be given to combating corruption. The agenda for action in these areas is large and includes: greater transparency and accountability in the functioning of state institutions, better internal controls, including auditing and financial management, a reduction in administrative discretion and greater participation and oversight from civil society.

Finally, economic growth and regional integration will depend on a better and more efficient infrastructure base and reversing decades of environmental degradation. Wars and civil conflict have resulted in considerable damage to infrastructure. Fiscal pressures during the 1990s have contributed to the deterioration of infrastructure, through limiting maintenance expenditures and the resources available for critical infrastructure investments. An improved infrastructure base, integrating the countries of South Eastern Europe with the rest of Europe is, therefore, essential to achieving prosperity. War-related damage and years of environmentally unsound development have conspired to threaten the long-term sustainability of economic growth. Environmental degradation has also impacted the poor disproportionately, as the poor tend to rely more on natural resources for their livelihood. Many environmental issues are regional in nature, as the countries of the region share many natural resources and major waterways. Working together to reverse environmental degradation and to strengthen environmental policies and institutions is necessary to underpin long-term sustainable economic development and achieve long-lasting prosperity throughout the region.

A concerted effort of the countries of the region to implement deeper and more consistent reform programs, alongside the efforts of the international community to integrate these countries into European and global structures and to provide assistance in key areas, offers the best hope for achieving peace, stability and prosperity throughout South East Europe.

1. THE ROAD TO STABILITY AND PROSPERITY IN SOUTH EASTERN EUROPE—A STRATEGIC APPROACH

“Almost ten years after the fall of the Berlin Wall, the Kosovo crisis has been a bloody reminder of what, in another context, we used to call ‘the cost of non-Europe’. For the current member states of the European Union, the integration process that began in the early 1950s has brought both remarkable political stability and a spectacular increase in economic well being. Conversely, the disintegration in South Eastern Europe during the past decade has exacerbated poverty and inter-ethnic hatred, and cost the lives of many thousands of innocent civilians. The comparison of these two polar cases may not constitute a very rigorous scientific demonstration, but it does provide a prima facie argument in favor of regional cooperation and progressive integration” (Hans van den Broek)¹

A. INTRODUCTION AND OVERVIEW

1.1 This Report attempts to define the broad parameters of a comprehensive approach to regional development in South Eastern Europe (SEE), which in this Report refers to Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Federal Republic of Yugoslavia (Serbia and Montenegro) (FRY), the Former Yugoslav Republic of Macedonia (FYR Macedonia), and Romania. This Report develops a broad strategic framework for regional activities; it is not a blueprint for specific investment programs, projects or financing requirements. It follows the conceptual approach outlined in the Comprehensive Development Framework (CDF). The CDF takes a holistic approach to development, highlighting the interdependence of social, economic, human capital, governance, environment and financial aspects of development.² This comprehensive approach has been developed in collaboration with the countries of the region and the World Bank’s main development partners in the region—the European Commission (EC), European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), Organization for Economic Cooperation and Development (OECD), Council of Europe, and Council of Europe Development Bank (CEB).

1.2 The fundamental objectives of the strategy outlined in this paper are increased prosperity and a reduction in poverty for all people living in the South East European region, which can only be achieved if peace and stability are established throughout the

¹ “Time for Enlargement,” Hans van den Broek, Chapter 5 in *The Second Decade: Prospects for European Integration after Ten Years of Transition*, Sdu Publishers, The Hague, 1999, p. 99.

² See James D. Wolfensohn, *A Proposal for Comprehensive Development Framework*, World Bank, January 21, 1999.

region. A deeper and more consistent implementation of domestic reform programs, stronger governance and institutions, better environmental management and a more developed infrastructure base are all essential to achieving prosperity and a sustainable reduction in poverty. Policies to foster social inclusion and cohesion within the increasingly fragmented region are also essential to achieve both peace and prosperity.

1.3 The past decade of transition and conflict has been exceptionally difficult for the people of South Eastern Europe. Hostilities have created deep-seated resentments. Emerging from these hostilities is a polarized patchwork of nation states, formed largely along ethnic lines. Conflict, an absence of a political consensus for reform, shallow democratic traditions and weak institutions have all combined to constrain economic and political development in most countries in South Eastern Europe. In turn, delays in the implementation of reform programs have prevented economies from embarking irreversibly on the path towards becoming fully functioning market economies. Consequently, these economies have experienced an inferior economic performance and in many cases, declining living standards, rising unemployment and inadequate progress in reducing poverty.

1.4 Even five years after the Dayton Peace Agreement and now following the UN Resolution that ended the Kosovo conflict, South Eastern Europe remains politically and socially unstable. About 1.7 million people are estimated to be displaced from their homes and separated from their assets. A third of Bosnia and Herzegovina's population are displaced. Over 300,000 Serbs from Croatia are estimated to be refugees in FRY and Bosnia and Herzegovina. Refugees and Internally Displaced People (IDPs) represent 13 percent of the population of Montenegro. The recent conflict in Kosovo added to the number of displaced persons in FRY and other neighboring countries. Continued demands for independence of ethnic groups (such as the Kosovo Albanians), and challenges to negotiated agreements also engender uncertainties. The stability of the region is also unsettled by the current political situation in FRY. Even countries, which have not been directly involved in civil and ethnic conflicts, have suffered economic, social and political consequences of the regional instability. **Declining living standards, refugees, border disputes and security concerns in the region are all conspiring to create a cauldron of instability and potential conflict in Europe.**

1.5 There is no denying that achieving social and political stability and sustainable development will take years for most countries. Nor will progress towards these goals be smooth or automatic. Several factors indicate how difficult this road will be. First, while steadfast reform and the clear prospect of EU accession have led to sustained economic progress in Central Europe and the Baltics, in some CIS countries, which share characteristics similar to the SEE countries, even determined implementation of reform programs has not yielded the expected positive results, because of civil conflicts, weak institutions and poor governance. Second, conflicts and ethnic tensions among the SEE countries have opened rifts that will not be easily healed. It will take time to achieve the intra-regional cooperation and trust necessary for peace and stability. These factors suggest that **the concerned countries and the international community both need to make an extraordinary effort to create the conditions for peace, stability and prosperity in South Eastern Europe.**

1.6 In the immediate aftermath of the cessation of hostilities in Kosovo, the international community and the countries of the SEE region have committed themselves to make a determined effort in this direction. This new approach is elaborated in the **Stability Pact**, which was signed by the countries in the region and the international community (see Box 1.1). The Stability Pact proposes the development of initiatives that increase regional integration, foster economic development and absorb these countries into European and global structures, especially the European Union. The effect of the pull of these countries towards Western European organizations is seen as a crucial factor in accelerating intra-regional integration and cooperation, which, in turn, would lessen tensions among the South East European countries themselves, especially those emerging from the former Yugoslavia. To this end, the European Commission is launching a process of stabilization and association with those countries of the region which are not yet associated to the EU through Europe Agreements. This was confirmed by the Heads of States and of Government of the European Union in Cologne on June 4, 1999.

1.7 **The international community has a clear stake in achieving peace, stability and prosperity in South Eastern Europe. Not only will continued instabilities and stagnating economic growth adversely affect the welfare of the people of the SEE region, continued instabilities will also affect Western European economies and societies as well as other countries in the Stability Pact.** The recent Kosovo crisis was a vivid reminder of this reality. An unstable region is a fertile breeding ground for crime, smuggling, illegal activities, which will not only affect the lives of people in the SEE countries but also those in neighboring societies. A more prosperous, stable SEE region would also benefit Western Europe economically, by opening up new markets for investments, sources of skilled, low wage labor and trade opportunities. As articulated in the Stability Pact, creating the conditions for peace and prosperity in the SEE region therefore should be seen not only as an objective for the SEE countries themselves, but also for the international community.

1.8 **A stronger and longer-lasting commitment to reform and cooperation by the SEE countries themselves is an essential condition to overcome the legacy of disintegration and declining living standards.** Without this commitment, no regional strategy can be effective. Performance in the past decade clearly indicates that reform efforts in SEE countries have been too hesitant and attempts at intra-regional cooperation inadequate to bring about sustainable growth and stability. This inadequate performance stems from country-specific difficulties—insufficient government commitment, weak governance, and low levels of investment—as well as regional instability. The situation has improved in recent years, but progress needs to be consolidated and sustained to change fundamentally prospects for peace and prosperity.

1.9 Nevertheless, it is unlikely that sustainable growth will materialize and a virtuous circle of increased prosperity and security can be established solely on the basis of national reform programs and intra-regional cooperation. As the recent Kosovo conflict has demonstrated, neighboring countries bear significant economic and political costs, even if they are not directly involved in the conflict. The continued isolation of FRY also adversely affects the region, as important trading and transport links are disrupted. Moreover, small closed economies do not have sufficient effective demand to sustain

Box 1.1: The Stability Pact and Donor Coordination Mechanisms

Country participation in the Stability Pact is broad and inclusive. It includes all EU members and G-8 countries, Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Romania, Slovenia, FYR Macedonia, Turkey as well as virtually all major international organizations and regional initiatives which are active in the region. The Pact declares “*that the Federal Republic of Yugoslavia will become a full and equal participant in the Stability Pact, following the political settlement of the Kosovo crisis on the basis of the principles agreed upon by G-8 Ministers and taking into account the need for respect by all participants for the principles and objectives of the Pact.*” (Art. 11 para. 2). Representatives from the Republic of Montenegro also attend the meetings of the Stability Pact.

The Stability Pact is being implemented through a Regional Table and three working tables, which include a Working Table on Democratization and Human Rights (Table 1), a Working Table on Economic Reconstruction, Development and Cooperation (Table 2), a Working Table on Security (Table 3). Responsibilities for each Working Table have been assigned under a Work Plan agreed by the Regional Table.¹ At this point, each working table has had initial meetings and begun to address the mandates as outlined in their terms of reference.

The Stability Pact also assigns specific responsibilities to the European Commission and the World Bank. In particular, under the Stability Pact, the World Bank and the European Union are given a special mandate to coordinate a comprehensive regional approach (Art. 41) to development in the SEE region.

Also the major donors have assigned to the World Bank and the European Commission the responsibility of coordinating economic assistance to the region. To support this coordination, the European Commission and the World Bank are chairing a High-Level Steering Group (HLSG). Participants in the HLSG include the Finance Ministers of Canada, the country holding the Presidency of the EU (currently Portugal), France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States, and representatives from the European Bank for Reconstruction and Development, the European Investment Bank, the International Monetary Fund, the Stability Pact for South Eastern Europe, the United Nations, the European Commission, and the World Bank. Its meetings are also being attended by the Minister of Finance of the Netherlands. The work of the HLSG is supported by a Working-Level Steering Group (WLSG). A joint World Bank-European Commission office—the Office for South East Europe—was established in Brussels to facilitate this coordination effort.

The comprehensive regional approach outlined in this Paper is in response to the Stability Pact mandate. It primarily develops themes assigned to the Working Table on Economic Reconstruction, Development and Cooperation (Working Table 2). It is thus primarily an economic development strategy. This Strategy does, however, pursue certain crosscutting themes, such as institutional programs, anticorruption measures, and interventions to encourage social cohesion, which are essential to achieving sustained economic development and which are addressed under other working tables.

1. Stability Pact for South Eastern Europe, Regional Table, Brussels, 16 September 1999, Work Plan (final).
2. The objectives of the HLSG are described in the statement of the HLSG meeting of July 13, 1999.

growth. Small states that are surrounded by instability and conflict will also be unattractive for investment. **The strategy articulated in this paper, therefore, argues that an approach focussed on country-by-country reform and intra-regional**

integration is necessary, but not sufficient, to achieve peace, stability and prosperity in South Eastern Europe.

1.10 **Success hinges critically on a credible and predictable path to integration with European and global structures, particularly the European Union.** Such a path will anchor expectations and provide both an incentive for reform and intra-regional cooperation. The sustained commitments that such a path requires will facilitate political and social changes, and discipline the formulation and implementation of domestic reforms in the SEE region.³ Politically, a credible commitment of integration for this generation will give a strong incentive to today's political leaders to move forward rapidly to improve governance and undertake reforms. Integration with the rest of Europe also raises the cost of bad neighborly policies or improper governance. Ample evidence demonstrates that economic integration with developed economies can accelerate growth, lend credibility to reforms and provide a securer environment for investors. The strategy, therefore, is built upon the assumption that a credible commitment to integration with European and global structures, especially the European Union, is a critical ingredient of success, as it will serve as an external driver of reform and intra-regional integration.

1.11 The remainder of this introductory chapter is organized as follows. The next section (Section B) provides a snap shot of the 'region', as well as 'defining' the region for the purposes of this paper. Section C describes the key elements of the proposed regional strategy. Section D summarizes the broad outlines of the domestic reform agendas in the SEE countries. Section E discusses the importance and underlying rationale of providing the SEE countries with a clear and credible commitment to join European and global structures. Section F provides a road map to the rest of the Report. The following Chapters present the analytical underpinnings of the strategy and outline the areas in which regional initiatives and programs should be developed to support the objectives of the Stability Pact.

B. SOUTH EASTERN EUROPE: A BRIEF SNAPSHOT

1.12 The regional strategy discussed in this Report is primarily focused on seven countries, which are referred to as SEE countries or collectively as the SEE region. The countries are: **Albania, Bosnia and Herzegovina (BiH), Bulgaria, Croatia, the Federal Republic of Yugoslavia (Serbia and Montenegro) (FRY), FYR Macedonia, and Romania.**⁴ The economy of Kosovo, Federal Republic of Yugoslavia (Serbia and Montenegro) ("Kosovo") is included in the analysis and approach as much as possible. Given the scarcity of updated economic information on the economies of Montenegro

³ The beneficial effects of EU membership on democratic consolidation and economic development has been amply demonstrated for Greece, Spain, Portugal. Possible lock-in effects, an acceleration of economic reforms, as well as social inclusion and participatory processes have also all been observed in the CEE countries destined to join the EU as member states. See G. Richard; Diamandouros, P. N., H.-J. Puhle: *The Politics of Democratic Consolidation: Southern Europe in Comparative Perspective*, The Johns Hopkins University Press, 1995; Baldwin, R.E, Francois J.F., Portes, R., *The Costs and Benefits of Eastern Enlargement: The Impact on the EU and Central Europe*, Economic Policy, April 1997.

⁴ Moldova, which participates in the Stability Pact as an observer, shares social, economic and cultural characteristics with the region.

and Serbia, as well as Kosovo, references are made primarily in a qualitative fashion. Moreover, the current political conditions prevailing in FRY also make it difficult at this time to include it fully in the many regional initiatives discussed throughout the Report. Nevertheless, FRY is an important and integral part of the region and its inclusion into regional initiatives would provide a boost to development and security throughout the region.

1.13 These countries have been selected as the primary focus of the regional strategy because they are the countries whose economies were the most badly affected by the Kosovo crisis. According to final estimates prepared by the IMF, in consultation with the World Bank: *“Despite the quick end to hostilities and resolution of the refugee crisis, the Kosovo crisis was a major setback to the region's economies [Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Federal Republic of Yugoslavia (Serbia and Montenegro), FYR Macedonia and Romania]. The crisis is estimated to have reduced output in the six most affected countries by about 2 percentage points in 1999 and significantly raised budget and current account deficits.”* This paper also noted that other countries—including Greece, Hungary, Moldova and Ukraine—were affected to a lesser extent. In addition to the Kosovo crisis, the SEE countries are the ones that have been most severely disrupted in the past decade by the conflicts in the former Yugoslavia and by the periodic embargoes imposed on FRY.

1.14 Other countries in the neighborhood of these seven SEE countries are included in the discussion when and where relevant. For example, it is difficult to discuss regional infrastructure without including Hungary, Slovenia, Greece and Turkey. It is also important to note that all countries in the surrounding region are members of the Stability Pact and therefore, many Stability Pact initiatives would include a broader range of countries than those that are the primary focus of this paper.

1.15 Table 1.1 presents a brief picture of the ‘region’. Its total population is 56 million, about 84 percent of the population of the five Central European countries (CEE)⁵ and 15 percent of the European Union’s population of 375 million. There is a large variation in size: Romania with 22 million people is ten times larger than FYR Macedonia. Total GDP stood at US\$100 billion in 1998, only slightly more than one-third of the five CEE countries. It is important to note, however, that in almost all countries official GNP figures are likely to be underestimated, possibly significantly, due to the large informal sectors in these economies. Per capita incomes in the SEE countries also span a wide range from US\$4,520 per capita in Croatia—which is roughly equivalent to the CEE average—to US\$810 per capita in Albania. The per capita income of FRY—for which there is no official figure—is difficult to estimate. However, prior to the war per capita income was estimated at about US\$3,500 and now, it is believed to have fallen to about half this level.

1.16 From this brief snapshot of the SEE region, one can see that the region, as defined in this report, is extremely heterogeneous: alongside its heterogeneity in levels of income and population, there is also heterogeneity in the region’s structural and social development. This heterogeneity poses a major challenge for the design of a regional

⁵ Poland, Hungary, Czech Republic, Slovenia and Slovak Republic.

strategy. In turn, this heterogeneity is reflected in the countries' differing relationships with European institutions, particularly the EU. Bulgaria and Romania have signed association agreements with the EU and, during the EU Summit in December 1999 in Helsinki, they were invited to begin negotiations for accession. Negotiations for a Stabilization and Association Agreement (SAA) with FYR Macedonia have recently been authorized by the EU.⁶ Other countries are not yet in an association status with the EU, but are expected to be invited eventually to negotiate SAAs.

Table 1.1: Basic Data: The SEE Region

	<i>1998 Population (millions)</i>	<i>1998 GNP (billions)</i>	<i>GNP Per capita^d</i>
Albania	3.4	3.1	810
Bosnia and Herzegovina	4.2	4.0	920
Bulgaria	8.2	12.5	1230
Croatia	4.6	21.3	4520
FR Yugoslavia	10.6	17.4 ^b	n.a.
FYR Macedonia	2.0	3.5	1290
Romania	22.5	38.1	1390
SEE-7 Total	55.5	99.9 ^c	2223 ^e
CEE-5 Total ^a	66.4	274.1	4329
SEE-7 as % CEE-5	84%	36%	51% ^e

a. Countries include: Czech Republic, Hungary, Poland, Slovak Republic, Slovenia.

b. GDP Estimate, Group 17.

c. Includes FRY GDP estimate.

d. World Bank Atlas methodology. Thus, per capita income may not equal exactly US\$ GNP divided by population.

e. Excludes FRY.

Source: World Bank staff estimates; EBRD Transition Report, 1999; Group 17, MONEE database.

C. THE KEY COMPONENTS OF A STRATEGY FOR PEACE, STABILITY AND PROSPERITY IN THE SEE REGION

1.17 As noted in the Stability Pact, a successful strategy for the accelerated development of the South East European region must be built upon a 'joint' commitment of both the countries in the region and the Stability Pact partners. Both sides must work in concert to achieve the objectives of the Stability Pact. This 'joint' commitment would need to involve the following broad thrusts.

- *For the SEE countries*, there needs to be both a strong commitment to working towards political and social stability within the region and a determined effort to implement consistent macroeconomic stabilization

⁶ European Commission, Commission Communication to the Council and European Parliament on the Stabilization and Association process for countries of South Eastern Europe, Brussels, May 26, 1999, COM (99) 235.

policies and deep structural, institutional, social and environmental reforms (e.g., trade, privatization, competition policy and financial sector reforms).

- *For the Stability Pact partners*, there needs to be parallel commitments both to providing a clear and credible roadmap for the eventual integration of the SEE countries into European and global structures and to providing financial and technical and political support to domestic reform programs and regional initiatives.

1.18 Without the countries of the region working towards intra-regional peace and stability, it is unlikely that the objectives of the Stability Pact could be achieved. The past decade of transition, nationalism and conflict has left a region fractured economically and socially. This has disrupted the free flow of goods and people, cutting long-standing transit routes and commercial relationships. The lessening of tensions in the region is, therefore, essential to achieving sustainable growth and social and political stability. The lessening of tensions and a rebuilding of trust would allow a gradual demilitarization in the region. This ‘peace’ dividend would free resources to support growth and poverty reduction. The resolution of the large refugee problem in the region could also accompany a lessening of the tensions.

1.19 It is clear that the pursuit of more consistent macroeconomic stabilization programs, and deeper and faster-paced structural reform programs are needed to improve economic performance. These reform programs would yield benefits in terms of economic growth and poverty reduction irrespective of the existence of a ‘regional’ approach. A major factor underlying the poor economic performance of the SEE region, as a whole, is a lack of progress in the transition towards a market-based economy. On almost all indicators of economic reform, the economies of the SEE region have lagged behind the economies of Central Europe and the Baltics. The key objective of these reform programs should be to improve substantially the climate for private sector development, which would need to underpin the achievement of prosperity and sustainable poverty reduction.

1.20 The underlying logic of the Stability Pact is that the efforts of the countries of South Eastern Europe to improve intra-regional cooperation and economic reform would be boosted by the strong support of the international community. This support would have two basic components. First, the international community would provide a clear and credible commitment to the integration of the SEE countries into European and global structures. The second commitment of the Stability Pact partners must be to provide coordinated support, both technical and financial, to the countries of the SEE region. This support should consist of technical assistance for implementing reform programs, strengthening institutions, governance and the rule of law, and (re)building regional infrastructure which would help integrate physically the countries of the SEE region and modernize their infrastructure and services to enable them to compete within the global community.

D. SOUND DOMESTIC POLICIES—A NECESSARY CONDITION FOR SUCCESS

1.21 A necessary condition for achieving the objectives of the Stability Pact is a strong commitment from the SEE countries to work towards achieving peace, stability and more rapid reform. Without such a commitment, no country has achieved sustainable growth and poverty reduction, and no regional approach or initiatives can be effective. Moreover, establishing political stability, the rule of law, fully functioning market economies that can compete efficiently within European markets are essential conditions for accession to the EU. Thus, while the strategy in this paper attempts to lay out a regional framework for the SEE countries and the international community, the regional strategy needs to be underpinned by a country-specific comprehensive development framework for each country.

1.22 The first essential step in achieving prosperity is for the countries of the SEE region to commit to working together for peace, harmony and a full blown reduction of ethnic tensions in the region. There is consistent international evidence that "good neighborhoods"—areas where a sound policy and institutional environment is maintained by a majority of countries—have a powerful influence on the economic success of individual countries. Therefore, country-specific measures to develop 'good neighborhood policies' will be crucial. This must include efforts to address presently displaced population groups, including the granting of property rights and to accept existing borders. The current refugee and border situations in the region are a major source of instability and conflict in the region. Key steps in this regard are developing more robust democratic institutions, improving the human rights situation, especially for minorities and refugees, and gradual de-militarization.

1.23 The second important commitment by the countries of the region is to implement more forcefully macroeconomic stabilization and structural reform programs designed to place the economies onto sustainable growth paths. Sustaining macroeconomic stability is crucial to the development of functioning market economies. A balanced and comprehensive approach to structural, institutional, social and environmental reform as envisaged in the Comprehensive Development Framework is also essential to underpin macroeconomic stability and to create an environment conducive to private sector development and investment. This would involve putting in place more transparent and predictable legal and regulatory frameworks, implementing measures to promote small and medium enterprises, strengthening domestic financial systems and their associated regulatory frameworks, and promoting and enhancing the role of the private sector in the provision of infrastructure. Given the importance of agriculture, especially in trade and employment, measures will need to be taken to achieve efficiency gains in the agricultural sector. Reforms to ensure macroeconomic stabilization and structural reform would continue to be supported by IMF and World Bank country programs.

1.24 While stabilization and structural reform programs are by nature country specific, the analysis in Chapter 2 indicates that there are a number of broad areas where progress is required that is common to all the SEE countries (see Box 1.2). There are five areas where policy reform appear to be of a high priority:

Box 1.2: Domestic Reform Priorities	
<p>I. <u>Private Sector Development/Trade/Finance</u> Ensure private sector environment conducive to growth, exports and employment.</p> <ul style="list-style-type: none"> ➤ Accelerate privatization and structural reform in the financial and enterprise sector. ➤ Develop effective commercial law legal framework. ➤ Reduce the tax burden on SMEs, foster development of SME financing vehicles. ➤ Alleviate constraints to FDI, including portfolio investment. ➤ Eliminate labor market inefficiency, reduce rigidity in labor market legislation. 	<p>III. <u>Institutional Development/Government and Public Sector/Corruption.</u> Maintain a sustainable and growth-promoting macroeconomic framework, reduce the size of the public sector.</p> <ul style="list-style-type: none"> ➤ Identify areas from which the state needs to withdraw and reduce overall level of public spending, ensure spending decisions are based on clear priorities. ➤ Define the responsibilities and competencies of government entities and equip them with technology and systems to improve efficiency. ➤ Enforce financial discipline, improve resource mobilization by broadening the tax base, improve tax administration and collection, reduce tax rates.
<p>Promote further trade liberalization.</p> <ul style="list-style-type: none"> ➤ Reduce protection through lower, more uniform tariff rates and increase transparency through reducing the number of tariff bands. ➤ Eliminate non-tariff trade barriers, through the removal of licenses, quotas and other instruments. ➤ Strengthen trade-related institutional capacity. ➤ Harmonize existing intra-regional preferences which are not consistent with the WTO. 	<p>Reorient state functions to meet the needs of market economy.</p> <ul style="list-style-type: none"> ➤ Adopt and implement effective legal and regulatory frameworks for the operation of private markets. ➤ Reorganize state institutions, streamline overlapping and outdated structures. ➤ Build local government management capacity and autonomy, strengthen municipalities and enhance devolution of powers to local administrations.
<p>Improve financial system safety, soundness and performance standards.</p> <ul style="list-style-type: none"> ➤ Improve lending policies/practices and risk management of banks. ➤ Efficiently manage foreign debt. ➤ Improve bank governance through privatization and strengthen supervision of banks and financial institutions. ➤ Improve accounting and auditing practices, adopt international accounting standards. ➤ Strengthen institutional/market framework, improve technology of financial intermediaries and markets and enhance information transparency. 	<p>Enhance state role in long-term development planning, strengthen public administration and database management.</p> <p>Strengthen the judiciary, enhance judicial implementation capacity, and provide basic resources for judges.</p> <p>Reduce corruption through identifying areas of public administration most prone to corruption, streamline and rationalize legal and administrative procedures to eliminate corruption encouragement, introduce transparency.</p>
<p>Eliminate distortions in agricultural sector, complete privatization and improve its competitiveness.</p>	<p>IV. <u>Infrastructure.</u></p> <ul style="list-style-type: none"> ➤ Rehabilitate and strengthen existing infrastructure systems through least-cost investments and reducing infrastructure system losses through improved management. ➤ Improve billing and fee collection systems for infrastructure services, insure financial viability of the different sectors, modernize and streamline operations. ➤ Open up major infrastructure units to competition, establish legal and regulatory framework for price liberalization.
<p>II. <u>Poverty Reduction and Social Development.</u></p> <ul style="list-style-type: none"> ➤ Support poverty reduction and address rising inequality. ➤ Promote access to quality education for all children which is suitable for the needs of a market economy, leadership, and democratic society. ➤ Reduce inherited inefficiencies in the health sector, through reorienting the health care system to lower levels of care, reforming health finance, updating clinical practices, and facilitating private sector provision. ➤ Increase the fiscal sustainability and impact of the social protection system, through reform of pension systems, improving contribution compliance, and targeting social assistance more effectively. 	<p>V. <u>Environmental Management</u> Improvement of national resource management and environmental standards.</p> <ul style="list-style-type: none"> ➤ Strengthen institutional capacity of the environmental protection institutions at the central (policy issues) and regional (better enforcement and monitoring) levels. ➤ Develop or enhance systems for environment monitoring and assessing environmental degradation. ➤ Create national strategy for environment priorities and resource management.

Source: Country Assistance Strategies for the six SEE countries, World Bank.

- **Private sector development**, especially through liberalization of trade, improvement of the business regulatory environment, and strengthening of the financial sector, particularly banking regulation and supervision;
- **Poverty reduction and social development**, especially through policies to foster social cohesion and inclusion, including for minorities, refugees and other excluded groups, to encourage democratic and participatory processes, to strengthen social protection, especially for the poor and vulnerable groups, and to ensure adequate access and better performance of social services;
- **Institutional development and governance**, especially strengthening public administration, improving financial control mechanisms and improving the legal and judicial systems;
- **Infrastructure policies**, especially commercializing and streamlining public utilities, and putting in place a regulatory system that would allow the involvement of the private sector;
- **Environmental policies**, especially protecting the region's valuable natural resources and remedying the consequences of recent conflicts and past inappropriate industrial policies.

Specific discussions about the reform agendas for each of the SEE countries (excluding FRY) are provided in Annex Table 1. Annex Table 2 shows existing bilateral and multilateral agencies supporting the reforms in each priority area.

1.25 In a number of SEE countries, progress is already being made in implementing key elements of this domestic reform agenda. Albania, Bosnia and Herzegovina, Bulgaria, and Romania all have IMF and World Bank-supported reform programs in place and these programs are reasonably on-track. They involve both macroeconomic stabilization and accompanying structural reforms. Kosovo is receiving substantial technical and financial support from the international community in rebuilding its economy in the aftermath of the recent crisis. In addition, the World Bank is providing a budget support operation and an operation to support the rebuilding of the financial system. There is currently no program in Croatia, but the results of the recent election bodes well for the resumption of an economic reform program that could be supported by the international community. In FYR Macedonia, no IFI programs have been successfully negotiated since the CCFF and the Emergency Credits approved as a consequence of the Kosovo crisis. Implementation of key structural reforms, especially imposing financial discipline on a number of large loss making enterprises, continues to be required prior to the resumption of balance-of-payments and budgetary support. Thus, there is already a good basis for moving forward on regional initiatives and programs in virtually all countries, based on the current implementation of existing reform programs. However, a rapid achievement of the goals of the Stability Pact would require a much deeper, more consistent and longer term commitment to domestic reform than has been experienced to date in the national reform programs. It is essential that the vigor with which these reform programs are implemented be consistent with the deeper engagement that the international community is offering through its support of the Stability Pact.

E. INTEGRATION WITH EUROPEAN AND GLOBAL STRUCTURES—THE CRUCIAL INCENTIVE FOR SUCCESS

1.26 Better cooperation among the SEE states and the pursuit of sound economic policies are, thus, necessary conditions for achieving peace and sustainable economic growth in South Eastern Europe. It is, however, unlikely that individual countries will achieve prosperity if the region as a whole remains unstable and fragmented. An essential element of this regional strategy and an underlying assumption of the Stability Pact are that a credible and predictable path for integration with European and global structures, particularly the European Union, offers both the incentive and the discipline for achieving stability and growth. In addition, a consensus already exists in all countries of the SEE region that EU membership is an overarching political objective. As a consequence, SEE countries are willing to tailor their policies and politics to achieve this objective. In the current situation where intra-regional hostilities, distrust and difficulties have impeded development and the political situation in FRY is uncertain, this external incentive is likely to be one of the main motivating factors for the countries of the SEE region to accelerate the development and implementation of domestic reform programs and to work together towards intra-regional cooperation.

1.27 The influence of such an external target cannot be over-emphasized and is clearly illustrated by recent developments in Europe. First, prospective entry into the European Union can give impetus to reform programs. The prospect of entry into European institutions has helped discipline economic policies in the new democracies of Central Europe and provided a strong incentive for implementing domestic reform programs. In the SEE region, the opening of negotiations on accession with Bulgaria and Romania is providing an important impetus to stability and reform. Second, the prospect of eventual membership can create positive social and political dynamics which can help overcome the deep-seated resentments that have built up during the last ten years of hostilities and wars. Romania and Hungary, for example, have settled border disputes and strengthened minority protections in order to prepare for membership in NATO and the EU. And finally, the prospect of entry into the EU would provide a framework and specific incentives to improve economic management and strengthen political institutions, as well as cooperate more closely. The process of European integration offers examples of successful rapid development by countries that were characterized by nascent democratic systems, fragile macroeconomic situations, and little intra-regional integration.⁷

1.28 There have also been considerable empirical analyses of the benefits of regional integration agreements (see Box 1.3). These analyses are based on integration initiatives in Europe, as well as trade and regional integration agreements in Latin America, East Asia and Africa. One key finding is that regional integration agreements can lead to improved credibility in policies:

⁷ See, "A European 'New Deal' for the Balkans", Benn Steil and Susan L. Woodward, *Foreign Affairs*, November/December 1999, Vol. 78, No. 6, pp. 95 – 105.

Box 1.3: Regional Integration Arrangements Economic And Political Implications

The World Bank held a symposium on regionalism and development, based on the findings of the Development Economics Research Group's research program on regionalism and development. The aim of the symposium was to advance the debate on Regional Integration Arrangements (RIAs) by subjecting existing arguments to rigorous theoretical analysis and empirical testing. Papers from the symposium were published in the May 1998 edition of *The World Bank Economic Review*.

The findings of the symposium contain important results that are relevant to the formulation of a regional strategy for integration in the South Eastern European region:

- **On growth and industrialization**, a paper by Vamvakidis finds that open economies grow faster; economies that have open and large neighbors grow faster, but the size of closed neighboring economies is of no account; and, economies that have open and developed neighbors also grow faster, but again the level of development of closed neighboring economies is not important. One key finding is that countries benefit from being located close to large, developed open economies. He also finds that agreements between small, closed developing countries are unlikely to have a positive impact on growth. Research by Fernández and Portes's and Puga and Venables's also support these conclusions; their results clearly suggest the advantages of North-South [i.e., between developed and developing countries] RIAs over South-South [i.e., among developing countries only] ones. In conclusion this research clearly demonstrates that: (i) RIAs may boost the industrialization efforts of a developing member but retard those of an excluded developing country; and (ii) countries may derive growth benefits from being a neighbor to a large, developed, open economy, but RIAs between developing countries are unlikely to result in faster growth.
- **On credibility**, Fernández and Portes analyze the economic mechanisms through which a developing-country member may gain policy credibility that is not obtainable unilaterally or multilaterally. Their results show that regional trade agreements can serve a useful purpose above and beyond the direct gains from trade liberalization by reducing uncertainties about national policies or political developments and enhancing credibility. This increased credibility, in turn, makes it easier for the private sector to plan and invest. Schiff and Winters's research contains a dimension about the credibility effects of solving the political problems caused by conflict between two neighboring countries. Vamvakidis's conclusions on the benefits of desirable neighbors relate to credibility changes considering the geographical spillover effects of recent crises, in particular the "tequila effect" in South America or the recent "Asian flu".

Combining these results suggests the possibility of virtuous and vicious circles in RIA formation. A strong, liberalizing RIA with the right partner may lead to a virtuous circle of increased credibility, increased investment and growth, more credibility and political stability, and so on. By contrast, a more-closed agreement or wrong choice of partner could lead in the opposite direction, with reduced credibility and lower investment and growth, resulting in less credibility and more political instability over time.

Source: Abstracted from "Dynamics and Politics in Regional Integration Arrangements: An Introduction", Maurice Schiff and L. Alan Winters, *The World Bank Economic Review*, Vol. 12, No. 2, May 1998, pp. 177–196.

“Attempts at reform are often undermined by expectations of reversal. A regional agreement can provide a 'commitment mechanism' for trade and other policy reform measures: a way of raising the cost, and thereby reducing the likelihood, of policy reversal. This argument can apply to political as well as economic reform, and there are examples where regional agreements have reinforced democracy in member states.”⁸

1.29 Another key finding is that small economies can obtain significant benefits—in terms of higher growth and investment—from regional integration agreements with large and open economies. On the other hand, agreements between small closed economies do not tend to have a significant growth impact.

1.30 The above indicates that the success of the Stability Pact would be greatly enhanced by the establishment of a firm and credible roadmap to the integration of the SEE countries into European and global structures.

1.31 Bulgaria and Romania were invited for formal accession negotiations in Helsinki in December 1999. For the other countries of the region, at the Heads of State and Government of the EU meeting on June 4, 1999, the Cologne European Council reaffirmed the readiness of the European Union to:

“draw the countries of this region closer to the prospect of full integration into its structures. This will be done through a new kind of contractual relationship taking into account the individual situations of each country, including progress in regional cooperation, and with the perspective of European Union membership, on the basis of the Amsterdam Treaty and fulfillment of the criteria defined at the Copenhagen European Council in June 1993.” (Para. 72 of the Presidency conclusions of the Cologne European Council).

This commitment is also reflected in the Stability Pact.

1.32 The importance of the integration of the SEE countries into Europe was also echoed in Mr. Prodi’s recent statement on enlargement: *“In the longer term the EU can best contribute to stability in the region [South Eastern Europe] by drawing it closer to the perspective of full integration into its structures, and should confirm that the countries of the former Yugoslavia and Albania have the ultimate vocation to become members of the European Union.”⁹*

1.33 The roadmap for intra- and inter-regional integration will depend on the content of these proposed new avenues for association and eventual membership in the EU. The European Commission has offered a generic direction in its Communication to the Council and European Parliament on the Stabilization and Association Process for

⁸ See *Trade Blocs and Beyond: Political Dreams and Practical Decisions*, SecM99-809, The World Bank, December 23, 1999, p. 4.

⁹ See “The Composite Paper: Reports on Progress Towards Accession by Each of the Candidate Countries”, 1999, The European Union, p. 37.

countries of South Eastern Europe.¹⁰ The Stabilization and Association process has advanced with the adoption of negotiating directives for a SAA with FYR Macedonia and a review of the feasibility of opening negotiations with Albania (see Box 1.4). While this approach establishes a broad framework applicable to all SEE countries which are not yet associated through an Europe Agreement and is conducive to inter- and intra-regional integration, there are two risks with it. The first is that some countries will perceive themselves as remaining for some time *de facto* excluded, possibly leading to more not less fragmentation of the region. The second risk is that for some countries the perspective of joining the EU would appear to require a time horizon so long that it would not unleash the political and economic dynamics necessary to create the preconditions for stability and economic cooperation among countries in the SEE region. The integration perspective of SEE countries needs to be a "real perspective" which is of relevance for today's political leaders and populations.¹¹ A highly differentiated path to EU accession could well fuel nationalistic sentiments and hostilities caused by those countries which feel left behind.

1.34 Overcoming these risks would require an approach which would allow the SEE countries to move towards the EU according to common rules set within a realistically achievable timeframe. Such an approach would have a strong disciplinary effect on the countries and would provide an important anchor for stability. Such a common approach would be in line with the approach taken by the European Council with respect to the CEE-enlargement countries.

¹⁰ European Commission, Commission Communication to the Council and European Parliament on the Stabilization and Association Process for Countries of South Eastern Europe, Brussels, May 26, 1999, COM (99) 235.

¹¹ The importance of a real perspective for EU membership is reflected in the discussions of the European Parliament in the Commission Recommendation for a Council Decision authorizing the Commission to negotiate a SAA with FRY Macedonia. The draft report states: "*It must be made clear in the Stabilisation and Association Agreement that it is an **evolutionary clause** describing the route from association to membership. It should, therefore, include an **evolutionary clause** describing the route from association to membership.*" See European Parliament, Draft Report, December 9, 1999, Provisional 1999/2121 (COS).

Box 1.4: Stabilisation and Association Agreements

The Stabilization and Association process is based on political and economic conditionality as established by the Council on 29 April 1997. Compliance with this conditionality forms the basis for the development of the relations of the EU with these countries in the field of trade (eligibility for autonomous trade preferences), financial and economic assistance and contractual relations. At present, there are contractual relations, in the form of Cooperation Agreements with two of the five countries—the former Yugoslav Republic of Macedonia and Albania. The new kind of agreements mentioned above—the **Stabilisation & Association Agreements**—for which Bosnia and Herzegovina, Croatia, the Federal Republic of Yugoslavia (Serbia and Montenegro), the former Yugoslav Republic of Macedonia and Albania are eligible as the conditions will be met are intended to govern the political, economic and trade relations between the parties.

At the last review of conditions in Spring 1999, the European Union considered that the former Yugoslav Republic of Macedonia and Albania met the political and economic conditions for a more in depth examination of the feasibility of opening negotiations on a Stabilisation and Association Agreement. The Commission has reported on the feasibility of the opening of such negotiations in the case of the **former Yugoslav Republic of Macedonia**. The Commission then adopted on 8 September 1999 its recommendation to the Council for negotiating directives. Its essential elements are:

- the inclusion in the Agreement of dispositions establishing a **political dialogue** with the former Yugoslav Republic of Macedonia;
- provisions on **enhanced regional cooperation**, including the perspective of establishing free trade areas **between** the countries of the region;
- the **establishment of a free-trade area** between the EU and the FRYOM within ten years after the entry into force of the Agreement; dismantling of tariffs will be asymmetric. It shall be noted that under present Cooperation agreement almost all industrial products enjoy duty free access to the EC market;
- provisions on the movement of workers, freedom of establishment, supply of services, current payments and movement of capital;
- the commitment by the former Yugoslav Republic of Macedonia to **approximate its legislation** with that of the EC, notably in key areas of the internal market;
- provisions on cooperation with the former Yugoslav Republic of Macedonia in a wide range of fields, including **justice and home affairs**.

This led to the adoption of negotiating directives for a Stabilisation & Association Agreement with the former Yugoslav Republic of Macedonia by the General Affairs Council on 24 January 2000. Formal negotiations could start at the end of March 2000. After signature, entry into force will have to wait for ratification by the Member States' Parliaments (which, according to past experience, may last for up to three years). However, trade provisions which are under Community competence and therefore not subject to ratification by Member States Parliaments might enter into force more rapidly through the conclusion of an interim agreement. In the case of **Albania**, the Commission concluded that further examination was needed before entering into the negotiating process, in particular due to institutional weakness of this country. The readiness of the Union to assist Albania in overcoming these weaknesses was reaffirmed.

Source: DG RELEX, European Commission.

F. ROADMAP AND BRIEF OVERVIEW OF THE REPORT

1.35 The remainder of this paper supports the regional strategy by analyzing the ‘initial’ conditions in the SEE countries and proposing a series of interventions designed to support the achievement of regional prosperity, peace and stability. These interventions involve three types of initiatives (i) national reform programs and priorities; (ii) initiatives that foster intra-regional integration or cooperation; and, (iii) initiatives that involve integration with European and global structures. At the outset, it is useful to define the scope of the initiatives discussed in this Report. The Report focuses on those sectors where significant synergies can be achieved by coordinated initiatives, which build upon, but do not substitute for, national programs. So, frequently the Report discusses national programs when their implementation is essential for a regional approach to be effective. The national programs that have been included, however, are selective and are only referred to as they are considered to be relevant for their regional dimensions. Therefore, many important elements of national agendas, which are considered to be of overriding importance for achieving sustainable economic development—for example provision of health services, municipal services, social protection systems, agricultural extension and research—which *a priori* are less immediately relevant from a regional integration perspective, have not been explored. Such programs, however, would be essential elements in the design of a comprehensive development framework for each country.

1.36 Chapter 2 provides an analysis of recent economic developments, and trends in living standards. From this analysis, it is clear that the past decade of transition and conflict has left the region with a legacy of mediocre growth and declining living standards. Calculations show that the region has recovered only about 75 percent of pre-transition GNP. The Chapter also shows that there has been a deterioration in living standards in the region, as evidenced by higher poverty, inequality and unemployment. The Chapter concludes with an analysis of progress on economic reform in the SEE region. It notes that, while good progress has been made in achieving macroeconomic stability, progress on structural reform and institutional development has lagged, especially when compared to the economies of Central Europe and the Baltics. Thus, the gains on macroeconomic stability are fragile and the prospects for these economies to move onto a sustainable growth path are not good without deeper reforms, a strengthening of institutions and governance and measures to reduce poverty.

1.37 The subsequent Chapters each discuss important elements of the regional strategy and outline initiatives that would support achievement of regional integration and development. First, the Report discusses regional initiatives to enhance the environment for private sector development as a way of accelerating and magnifying the impact of more determined implementation of reform programs and of the credible commitment to broader regional integration. The first concrete step in reaching eventual integration into European and global structures would be trade integration. Trading relationships have generally preceded other integrative steps as in Bulgaria and Romania and an opening of trade for the other SEE economies would also provide a badly needed stimulus to investment and economic growth. Trade integration and reform is discussed in detail in Chapter 3.

1.38 There would be scope for a number of regional initiatives to improve the investment climate for the private sector and to support small and medium enterprise development. The goal of these initiatives would be to help create a vibrant private sector that exchanged goods and invested freely across borders. The stimulus of growth and investment will come from the creation of new small business and foreign investments, from market expansion and from building an efficient private and public infrastructure. The perspective of closer integration of the region into Transatlantic and European structures is expected to help mobilize resources for change, raise investor interest and build confidence in the future stability of the business environment. Initiatives in these areas are discussed in Chapter 4.

1.39 Special efforts are also needed to include more fully and effectively all population groups in the economic development of the region, including minority groups living in different countries (such as Serbs in Croatia, Albanians and other minority groupings in FYR Macedonia, Serbs in Kosovo, Hungarians in Romania, and Turks in Bulgaria). Given the region's ethnic mixture, these issues are particularly sensitive. A regional approach is essential in this regard, because displaced minority populations contribute to the continued tensions in the region, and the lack of a satisfactory solution is a major obstacle to peace, stability and economic development. Displaced minority populations for example in Bosnia and Herzegovina and FRY (both from Kosovo and Croatia) lack access to their assets and have a limited ability to plan and invest on a longer term basis. Increased efforts will need to be made to protect vulnerable groups from falling into poverty. Continued increases and persistence of poverty among certain population groups could further increase fragmentation of the already divided societies in South Eastern Europe. Access for all people to public services and employment opportunities, and a minimum level of income support when in need, should be provided. Special efforts need to be made to reach out to the Roma community, which lives in poverty in many countries in the region. There is also a special role for education in creating leadership, value changes and human capital that will be essential not only for national economic development but also regional cooperation. The important role which future generations of leaders will play requires a special focus on employment creation and social programs for the young, to avoid the marginalization of those disconnected from schooling and formal labor markets. Issues of social cohesion and inclusion are discussed in Chapter 5.

1.40 Sustaining sound policy environments and meeting the institutional requirements for a more formal association with European and global structures will require a quantum leap in institutional development in the SEE countries. The importance that institutions play in assuring that competitive markets function efficiently is now widely recognized. Most transition economies have experienced costly setbacks in their development due to inadequate institutional development. The SEE economies are no exception. They currently have important weaknesses in most public service functions, including public policy formulation, public service delivery and oversight and accountability. They need to work towards improving governance, by instituting systems with adequate checks and balances that provide politicians, bureaucrats and economic agents the incentives and flexibility to pursue the common good. Institutions need to represent all segments of society. The agenda is large and includes: greater transparency and accountability in the functioning of state institutions, better internal controls (e.g., strengthened financial

management in sectoral ministries, audits, procurement, watchdog bodies), a reduction in administrative discretion (price liberalization, elimination of excessive licenses), and greater participation and oversight from users and civil society.

1.41 Special attention will need to be given to combating corruption. The economic costs of corruption are well documented.¹² Corruption impedes the development of markets. The transaction costs, risks and problems of credibility generated in corrupt systems limit substantially the interests of investors in the region. There is ample evidence that corruption reduces investment and growth. A Business Environment and Enterprise Performance Survey commissioned by EBRD details that more than in any other region, Small- and Medium-size Enterprises (SME) in Southeast Europe report corruption as an important obstacle to business development. Therefore, if SMEs are to be an engine of growth and employment, a frontal attack on corruption is essential. Regional initiatives for supporting institutional development and combating corruption are discussed in detail in Chapter 6.

1.42 Economic growth, improved intra- and inter-regional trade and integration will depend on incremental and efficient investments in infrastructure. Wars and conflicts which erupted in large parts of former Yugoslavia resulted in considerable damage to infrastructure. The period of unrest and economic decline during the 1990s led to a serious deterioration of maintenance of infrastructure, as declining incomes and tax revenues curtailed maintenance activities. Lack of reforms did not support the shift from public budget based to user-based cost recovery mechanisms, and most of the burden of infrastructure maintenance continues to rest on the public sector. A key element affecting the transport links of the region is the interruption of Danube shipping. The economic consequences of the damages resulting in the interruption of key transport routes are severe as the destruction of a series of bridges across the Danube prohibits long distance shipping. The financing needs in infrastructure are particularly large and adequate funding will be difficult to raise from traditional methods. Thus, there is also a need for more private sector involvement in this area. By implication, this suggests that a substantial effort will also need to be made to put in place a transparent and predictable regulatory framework. Infrastructure is discussed in Chapter 7.

1.43 The Yugoslav war and recent hostilities in Kosovo have damaged the environment in several SEE countries. The Danube has been seriously affected; water quality has badly deteriorated through the emission of effluents resulting from destruction of industries, oil refineries, and wastewater treatment facilities. Environmental damages are also expected in SEE countries located along the Danube from flooding and debris which is caused by the Danube blocked by destroyed bridges. Other war related damages result from land mines placed in most of the war affected areas which have not yet been removed, pollution of water bodies, bombing of cultural heritage sites and damages to coastlines and tourism sites. The wars, civil disturbances and economic declines also in some countries led to breakdown or deterioration of environmental services. Regional initiatives to address existing environmental concerns are discussed in Chapter 8.

¹² Among the large literature see among other Paolo Mauro, "Corruption and Growth", *Quarterly Journal of Economics*, August 1995, p. 695; Shan-Jen Wei, "Why is Corruption so Much More Taxing than Tax Arbitrariness", *NBER Working Paper* 6255, November, 1997.

1.44 It is important to note that growth prospects for the region will depend critically on restoring and maintaining security. As long as the dangers of war and fragile domestic security situations exist, it is highly unlikely that sustainable development can be achieved. This regional strategy does not discuss this point in detail or elaborate on specific initiatives in this area. But, regional cooperation, integration and development will not reach their full potential until specific actions are taken to increase domestic security and limit illegal activities and crime. Detailed security programs to be established for the region are being developed under the Working Table on Security Issues within the Stability Pact framework.

1.45 In conclusion, this Report should be viewed as setting the broad framework for the international community's response to the need to support regional development in South Eastern Europe as articulated in the Stability Pact. Our other development partners are working within this framework to develop further specific initiatives to support regional development. In particular, the EBRD has the lead role in preparing initiatives in the area of private sector development. The EIB has the lead role in developing and assessing projects in the infrastructure sector that could be supported by donors. Finally, a number of other agencies are preparing individual initiatives that are mentioned throughout the Report.

2. ECONOMIC AND SOCIAL DEVELOPMENTS AND PROGRESS ON REFORM IN SOUTH EASTERN EUROPE

A. INTRODUCTION

2.1 The transition has been generally disappointing for the countries in South Eastern Europe. Growth has yet to recover to pre-transition levels. Some countries still face problems of macroeconomic stabilization and in others, stability is still fragile and subject to reversals. These problems have been especially pronounced over the past three years, when a number of countries have experienced bouts of macroeconomic instability. None of the countries have yet established a firm foundation for sustainable growth and progress on improving living standards has also been disappointing.

2.2 This chapter takes a broad overview on the past “decade of transition and conflict” in the SEE region. First, it analyzes the region’s growth and macroeconomic performance (Section B). Next, the chapter discusses progress on improving living standards (Section C). Finally, the chapter examines progress on structural reform in the region, also comparing progress in key reform areas with what has been achieved in the five Central European economies (Section D). The last section concludes.

B. RECENT ECONOMIC PERFORMANCE

2.3 Historically, South Eastern Europe has been the least developed region of Europe. Initial conditions at the onset of the transition process were less favorable than those in other transition countries in Europe. The SEE countries had more unbalanced industrial structures. They lacked traditions in institutional development. Some countries inherited large debt burdens. And finally, distances to western European markets were great and transport links were not well established.

2.4 Poor initial conditions have combined with conflict and uneven implementation of reform programs to yield a relatively poor economic performance since the onset of the transition. **Progress in achieving macroeconomic stability has been good recently, but remains tenuous and subject to reversals.** While the five economies of Central Europe were able to stabilize the macroeconomic situation largely by the mid-1990s, most of the SEE countries have struggled with establishing macroeconomic stability late in the 1990s (see Annexes 2.1-2.8). Albania, Bulgaria and Romania have suffered severe bouts of macroeconomic instability in the last three years. Recently, good progress has been achieved on improving the macroeconomic situation in Albania (through fiscal tightening and a reduction in domestic financing of the budget deficit) and in Bulgaria (with the introduction of a currency board). Romania has also made progress, although inflation remains high and a substantial degree of macroeconomic uncertainty remains. FRY also continues to suffer from extreme exchange rate instability and very high

inflation. The progress achieved throughout the SEE region during 1999 is remarkable, given the uncertainty and economic pressures felt in the region as a result of the Kosovo crisis. The gains in macroeconomic stability have been achieved through the implementation of consistent monetary and fiscal policies along with supporting exchange rate regimes in most cases with reform programs supported by the IMF and the World Bank.

2.5 Nevertheless, the fiscal situations remain clouded with uncertainty in nearly all of the SEE countries, which could pose difficulties for the implementation of the regional strategy outlined in this Report. First, taxes on international trade are important sources of revenues in the SEE region. For 1998 and 1999, international trade taxes accounted in each year for about 3 percent of GDP. In some cases it is higher; in Bosnia and Herzegovina, they account for about 10 percent of GDP; and in FRY Macedonia, they account for about 4 percent of GDP. Thus, if a significant liberalization of trade occurs as part of the SEE region's integration with itself and European and global structures, alternative sources of revenues may be needed to sustain the progress already achieved in improving fiscal management. These revenue losses could be offset, to some extent, however, by higher trade volumes and improvements in collection efficiency. Second, the past decade and the reestablishment of macroeconomic stability in most countries of the region has already resulted in a compression of fiscal expenditures, which has been exacerbated by the need to accommodate the cost of structural reforms. In many cases, social sector expenditures have borne the brunt of this fiscal adjustment. This has been one factor underlying the observed decline in health and education indicators and the lower living standards of pensioners. To foster the social cohesion necessary to underpin the objectives of peace and stability, adequate resources will be needed for social expenditures. One key area for further fiscal contraction to accommodate a higher level of expenditures in other vital categories is military demobilization or the 'realization of a peace dividend' which should be possible given the enhanced security situation as the SEE countries move towards closer integration. In summary, macroeconomic gains are still vulnerable to reversals because of the difficulties of sustaining existing fiscal positions and the further pressures on fiscal policy that could emerge. This macroeconomic uncertainty still clouds the environment for growth and investment in nearly all the SEE economies.

2.6 While recent gains in macroeconomic management are encouraging, **economic growth has been and remains disappointing**.¹³ The transition recession in the Central European economies lasted for some three to four years, and the decline in output was about 15 percent of the 1989 output level on average. In contrast, in South Eastern Europe, the decline was greater, the recovery slower and more recently, aggregate GDP has begun to fall again (see Chart 2.1). The cumulative decline in output was about 30 percent of the 1989 output level. As a group, the SEE economies have contracted by more than one percent per annum, since 1989 (see Table 2.1). In comparison, the five economies of CEE grew by almost 1 percent per year. The six SEE economies have only reached 75 percent of their pre-transition (1989) levels of economic activity. This can be

¹³ It is important to note that in the 1980s, Yugoslavia experienced no growth for an entire decade. This implies that per capita incomes have been falling for two decades in the former Yugoslav republics. The situation is similar for Romania.

compared to the five Central European countries, which on the backs of more resolute and coherent reform programs and more stable political conditions, have grown by nearly one percent per annum on average. As a result, the CEE economies are now nearly 10 percent larger than their pre-transition levels. A worrying trend is that the SEE economies have experienced increasing divergence with western Europe. Per capita GDP (on a purchasing power parity basis) drifted from 33 percent of the EU average in 1990 to 24 percent in 1998.

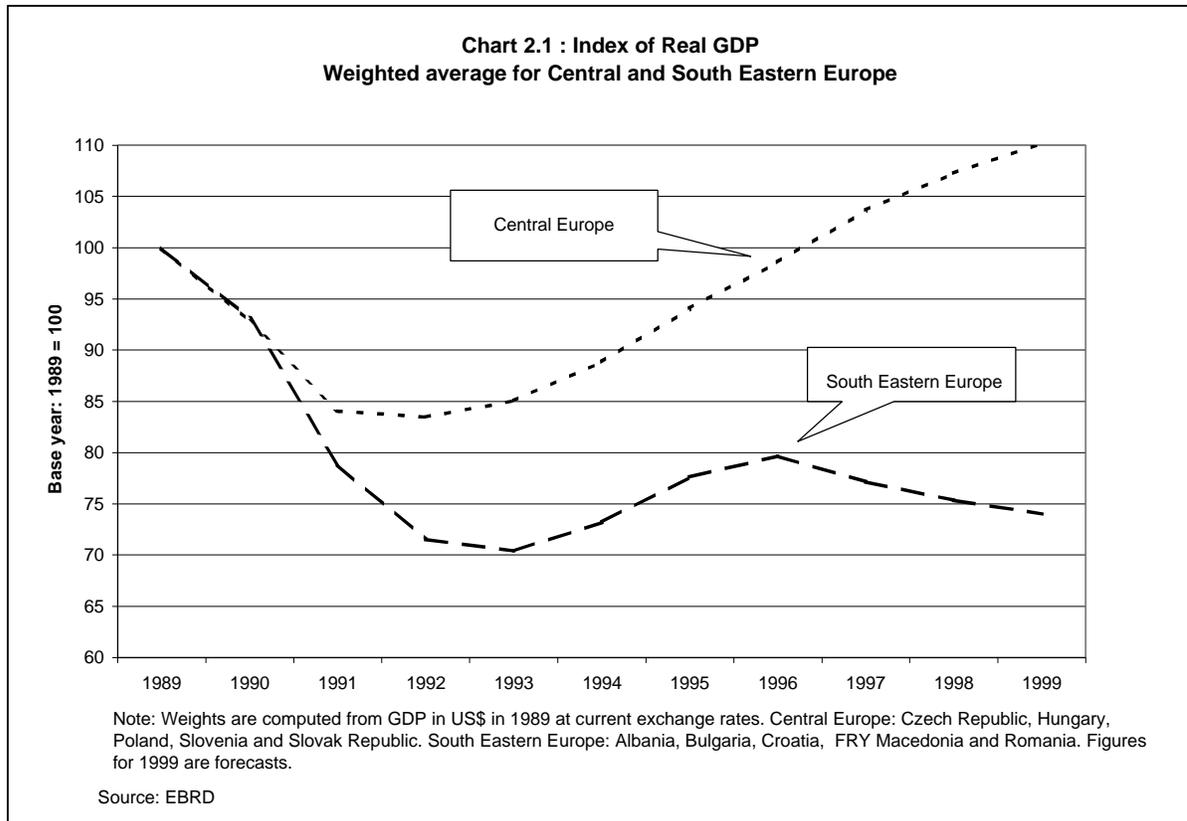


Table 2.1: Economic Performance, 1989-1998

	<i>GDP gr. Ann. Aver. 1990-1998 (%)</i>	<i>1998 GDP as % of 1989 GDP^e</i>
Albania	-0.8	86
Bosnia and Herzegovina	29.9 ^d	n.a.
Bulgaria	-4.0	66
Croatia	-2.4	78
FR Yugoslavia	n.a.	n.a.
FYR Macedonia	-1.2	72
Romania	-2.9	76
SEE-6 Av. ^b	-1.2	75 ^c
CEE-5 Av. ^{a b}	0.8	107

a. Countries include: Czech Republic, Hungary, Poland, Slovak Republic, Slovenia.

b. Weighted by GNP; excludes FRY.

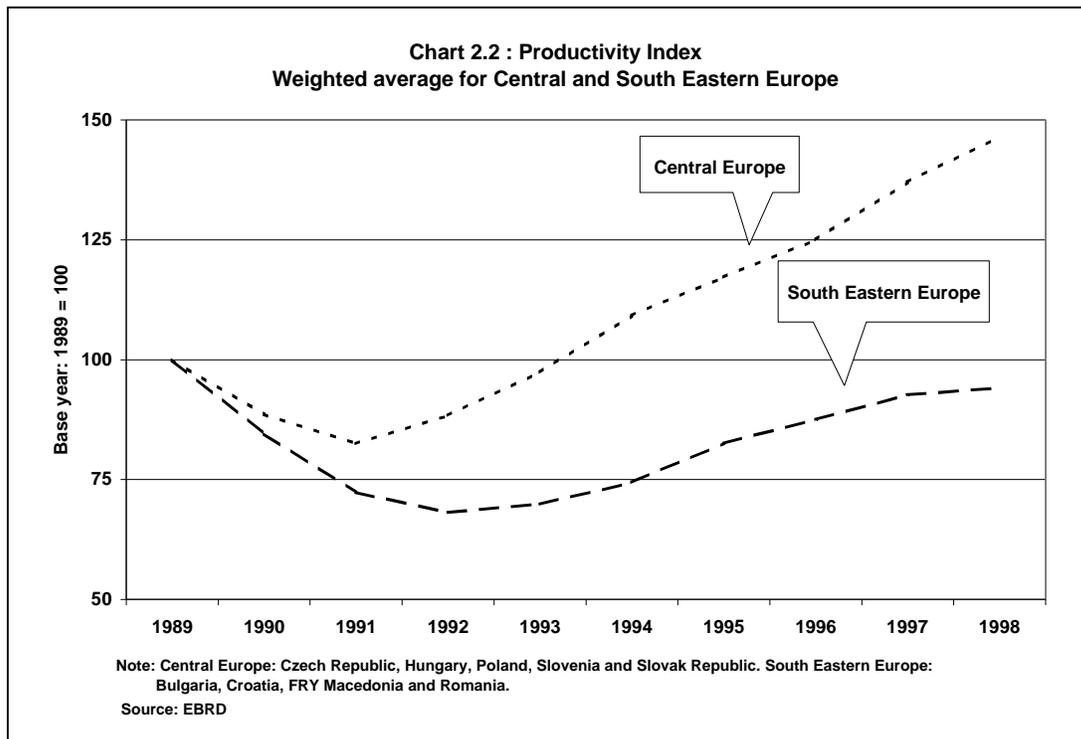
c. Excludes Bosnia-Herzegovina.

d. 1995-99 only.

e. GDP estimates converted at PPP exchange rates were used to calculate the index.

Source: World Bank staff estimates; EBRD Transition Report, 1999.

2.7 While growth has resumed in some SEE economies at the end of the 1990s, it continues to look fragile, as most countries have failed to experience sustained increases in productivity. In all transition countries in Europe, productivity declines were experienced early in the transition. Developments in productivity were dominated by the decline in output, as many firms initially avoided large-scale layoffs even though demand for their products had collapsed. This decline in measured productivity began to be reversed in most countries after two or three years—primarily due to further employment reductions. More recently, some of the Central European countries have entered a phase of productivity growth, driven by product innovation, fresh capital investment, improved technologies and modern management methods (that is, by deep restructuring). Many Central European countries exhibit a J-curve pattern for labor productivity, with especially rapid increases in Hungary and Poland. In contrast, productivity growth in the South Eastern Europe has generally stagnated. Whereas CEE's productivity in 1998 was almost one-and-a-half times as high as the 1989 level, in the SEE economies it only reached about 90 percent of its 1989 level (see Chart 2.2). Deeper enterprise restructuring and new investment will be needed to sustain productivity improvements achieved primarily through the shedding of jobs during the early years of the transition.



2.8 A key factor underlying the poor growth and productivity performance of the SEE region has been inadequate investment. The investment-to-GDP ratio in the SEE region (excluding Bosnia and Herzegovina) has declined from 23 percent of GDP in 1992 to only 18 percent of GDP in 1998 (see Table 2.2). Investment levels in recent years have been particularly low (less than 20 percent of GDP) in Albania, Bulgaria, and Romania. All three countries have experienced bouts of macroeconomic instability recently, which have depressed investment levels. By comparison, the average investment-to-GDP ratio in the more rapidly growing CEE economies has increased from 19 percent of GDP in 1992 to 28 percent in 1998. As noted above, investment has been a driving force behind the productivity gains experienced in the five CEE economies.

2.9 While investment levels overall have been lower in the SEE countries than the CEE countries, foreign direct investment (FDI) as a percentage of GDP has been roughly the same or only slightly less in the SEE economies. This indicates that higher domestic investment levels will be the key to improving the SEE region's growth prospects. It is important to note, however, that the growth impetus flowing from FDI in the SEE economies has been less, as the efficiency of FDI inflows in the SEE region has been diminished by the weaker reform effort. Thus, a strengthening of the reform effort will likely induce both higher levels of investment, as well as improved investment efficiency.

Table 2.2: SEE Region—Aggregate Savings-Investment Balance
(as percentage of GDP)

	<i>Actual</i>			<i>Estimate</i>	
	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>
SEE -6- Average ^a					
Gross Domestic investment	20.5	22.0	22.9	20.1	18.3
o/w Gov't Inv.	4.2	5.3	4.9	4.7	3.8
Gross national savings	15.0	15.2	15.0	12.1	11.8
Government savings	..	-0.2	1.9	2.3	2.2
Non government savings	..	15.3	13.1	9.8	9.6
Foreign savings	5.5	6.8	7.9	7.9	6.4
CEE -5- Average ^b					
Gross Domestic investment	23.9	26.4	28.0	28.6	28.3
o/w Gov't Inv.	..	..	..	..	..
Gross national savings	24.9	23.2	24.3	24.5	23.4
Government savings	0.4	0.7	0.3	0.6	..
Non government savings	24.5	22.5	24.0	23.9	..
Foreign savings	-1.0	3.2	3.7	4.1	4.9

a. This is an average of Albania, BiH, Bulgaria, Croatia, FYR Macedonia and Romania. See Annex Table 2.8 for weights.

b. The weights are: Czech Republic 0.180; Hungary 0.159; Poland 0.524; Slovak Republic 0.069; Slovenia 0.068.

Source: World Bank staff estimates; country sources.

2.10 Low savings rates are a major constraint on economic development in the SEE region (See Table 2.2). The effect of improved fiscal management is apparent in the increase in government savings. But, the low level of non-government savings (which includes state-owned enterprises) has been a key constraint. As a consequence, foreign savings (the inverse of the current account deficit) has financed about one third of gross domestic investment. Achieving the levels of investment necessary to support sustained and higher economic growth will require higher levels of domestic savings as the high level of past foreign savings has added to the region's debt burden. Overall, the SEE region has a debt/GDP ratio of 40 percent and a debt service ratio of over 20 percent in 1999 (see Annex Table 2.8). While the debt service ratio was uncharacteristically high in 1999, primarily due to a bunching of repayments in Romania, the debt burden implies that the SEE countries need to carefully manage their external imbalances. As a consequence, the international community and the SEE countries need to examine carefully the terms, conditions and overall levels of external borrowings in the medium term, as well as the financial viability of any projects.

C. PROGRESS IN LIVING STANDARDS

2.11 As with most transition countries, the SEE countries inherited and largely continue to have social indicators which are significantly better than countries of similar income levels in other parts of the world. Nonetheless, the heterogeneity of the SEE region is also reflected in variations in living standards and social indicators between countries (see Table 2.3). The contrast between Croatia—which ranks 55th in the world on the UNDP's Human Development Index and has almost an OECD-level infant mortality rate- and Albania or Kosovo is stark. This section examines in depth the evolution of living standards in the SEE region during the 1990s, as improving dramatically human welfare in the SEE region lies at the heart of the objectives of the Stability Pact.

2.12 The poor economic performance and regional conflicts during the past decade have taken their toll on living standards within the SEE region, as they have sharply declined during the 1990s. Employment and wages trends provide one indication of this trend. Real wages have declined throughout the 1990s in the SEE countries, whereas in the five Central European economies they fell less in the initial transition period and have risen above their 1990 level by 1997.

2.13 In addition to the deteriorating position of those in wage employment, **a large pool of unemployed emerged in most SEE countries.** Registered unemployment in several SEE countries was easily the highest in the entire ECA region (see Table 2.3). Registered unemployment had reached 36 percent and 30 percent in FYR Macedonia and FR Yugoslavia, respectively. Estimates of combined registered and unregistered unemployment in Bosnia and Herzegovina are over 55 percent for 1998. While unemployment data in transition economies need to be treated with caution, as many registered unemployed work in the informal economy, this is offset partly by the non-registration of the genuinely unemployed, and removal of people from the unemployment roles upon exhaustion of benefits. Unemployment rates are therefore reasonable indicators of the general declines in living conditions, particularly as the unemployed have been found to have amongst the highest poverty rates in SEE countries. While it is important to note that the five Central European economies also experienced high persistent unemployment, the rate has broadly stabilized since the mid-1990s at a significantly lower level than in most SEE countries.

2.14 Data on poverty are more difficult to obtain and trends are therefore, difficult to discern. Despite these data difficulties, country-specific analyses reveal several consistent findings about the features of poverty in the SEE region (see Box 2.1). The limited reliable time series data that are available from individual countries show that **poverty is likely to have worsened dramatically** in recent years. In Bulgaria, the poverty survey found that the headcount rate increased by around seven times between 1995 and 1997, but there may be comparability issues arising from the dramatic increase in prices in 1997. In Romania, the poverty headcount increased fivefold between 1989 and 1998. The dramatic drop in the overall consumption level has been the main driver of increased poverty, with increased inequality a lesser but quite important factor, and probably increasing in importance as time passes.

Table 2.3: Summary of Social Indicators for SEE, 1997

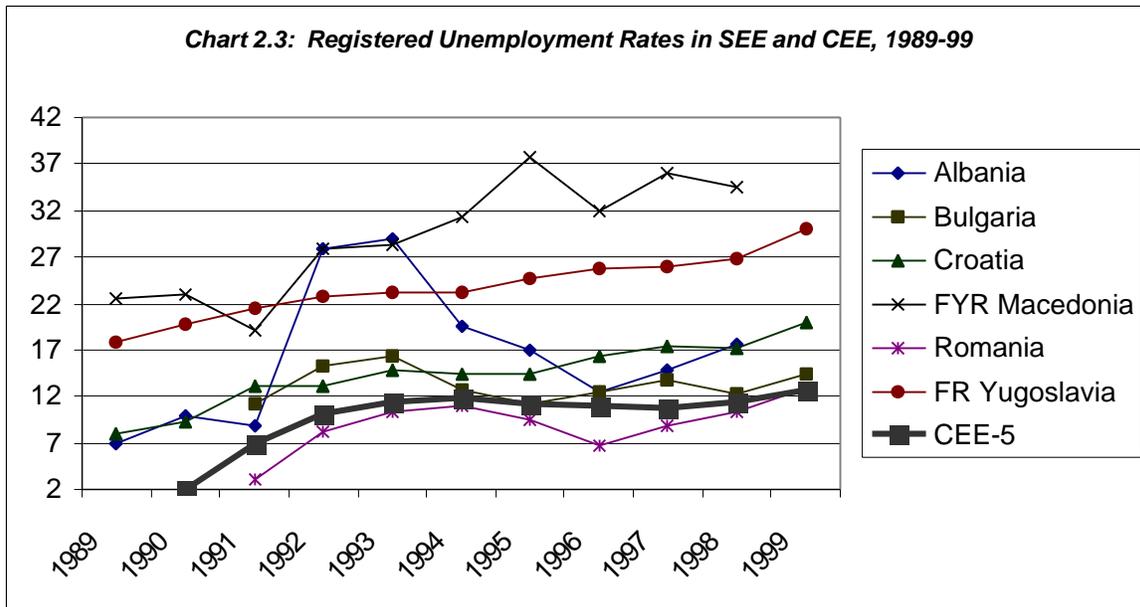
<i>Country</i>	<i>HDI score and ranking 1997^b</i>	<i>IMR (1997 unless stated)</i>	<i>Life expectancy at birth 1997</i>
Albania ^a	0.699 / 100th	25.8	72.8
Bosnia and Herzegovina ^c	N/A	12.7	72.3
Bulgaria	0.758 / 63rd	17.5	71.1
Croatia	0.773 / 55th	8.2	72.6
FYROM	0.749 / 73rd	15.7	73.1
FY Yugoslavia ^c	N/A	14.3	72.3
Romania	0.752 / 68th	22.0	69.6

Note: (a) IMR for Albania is 1996; (b) HDI is composite index of three components: life expectancy at birth; educational attainment (as measured by adult literacy and enrollment rates); and real per capita GDP (in \$PPP); (c) FRY life expectancy 1996, and BiH 1995.

Source: WB ECA Social Protection Strategy (1999 draft); UNICEF Transmonee report (1999); UNDP Human Security in SEE (1999).

2.15 The evidence also suggests that **inequality has increased significantly** in the region over the decade. It is important to note, however, that artificially compressed wages and more limited returns to education in the socialist period made some increase in inequality during transition highly likely. The Gini coefficient—the most common inequality measure—has deteriorated significantly (e.g., Romania, Bulgaria and FYR Macedonia) and the same is true for other measures, such as the decile ratio, which focuses on the extremes of the distribution:

- Inequality in Bulgaria increased sharply between 1995 and 1997, with the Gini rising from 27.1 to 31.4.
- In FYR Macedonia, the Gini rose from under 20 in 1993 to almost 30 in 1996.
- Romania experienced an increase in the Gini from 21 in 1989 to 30 in 1994. Recent work by the World Bank finds a Gini for expenditures of 30 in 1998.
- In Croatia, there also appears to have been a deterioration in inequality. The Gini for expenditures is estimated at 32 for 1998.
- Although no reliable time series data are available, Bosnia and Herzegovina would appear to have among the highest income inequality, but there are significant shortcomings in the data.



2.16 There is clearly a cause for concern if such trends continue. At the same time, SEE countries started with low inequality, at least some of the increase should be seen as a reflection of increasing returns to skills in the labor market. With the exception of BiH and Romania, even the higher percentages place the SEE countries in a normal range for OECD countries. However, this would soon cease to be the case if trends during the 1990s continue. In addition, if one takes CEE as the relevant comparator, inequality levels in SEE by the mid-1990s were already high, with a CEE average Gini for earnings of 30 in 1997. Finally, close attention needs to be paid to measures of poverty such as the decile ratio which focus on the extremes of the distribution, to monitor the share of income accruing at the very top of the distribution, as such glaring inequalities can become a source of social instability.

2.17 It is important to examine human welfare and living standards in the SEE region from perspectives other than income and expenditures. One important factor that has adversely affected living standards in the SEE region is the **large population movements that have been the result of the conflicts in the former Yugoslav republics**.¹⁴ This is a special feature of the SEE region during the transition period. Estimates indicate that some three million people have been displaced either temporarily as was the case during the Kosovo conflict or on a longer term basis, such as ethnic groups in the minority in particular areas, for example in Bosnia and Herzegovina, and Croatia. These displaced persons have been separated from their assets, e.g., housing and land, and from their sources of employment. In many cases, their assets were destroyed. The loss of assets, as well as the social and psychological impact of physical dislocation, has resulted in substantially lower living standards for significant numbers of people in the region.

¹⁴ This is discussed in detail in Chapter 5.

Box 2.1: Characteristics of Poverty in the SEE Region

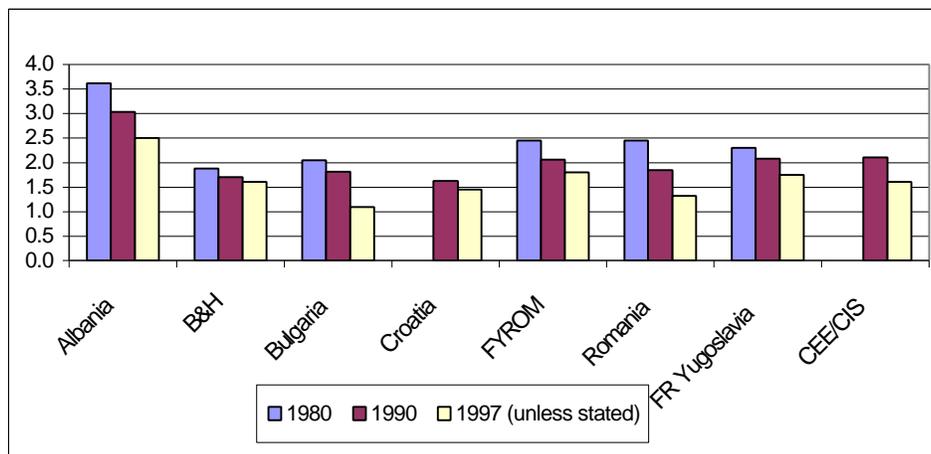
- There are **strong regional variations in poverty levels in all countries**: between upland/mountainous areas and the coastal plain in Albania; between Republika Srpska (RS) and the Federation in BiH (and within each entity); and between the North and the South in Romania. Differentials in terms of consumption are reinforced by variable access to quality social services, increasing the likelihood of geographical areas of persistent poverty.
- **Rural poverty is worse than urban in all countries**. Rural poverty rates were: 80 percent higher in Romania (1994); 23 percent higher in Bulgaria (1997); around five times higher in rural Albania than non-Tirana urban areas (1996); and substantially higher in Croatia (1998). In addition, the depth of poverty (i.e., how far the average poor person falls below the poverty line) and the severity of poverty (which takes account of inequality amongst the poor) are significantly worse in rural areas.
- The **educational attainment level of the household head is strongly correlated with poverty**, with university qualifications making a household highly unlikely to be poor, and households headed by those with less than secondary education having far higher than average poverty rates. Those with less than secondary education account for around 80 percent of all poor in FYR Macedonia and Albania, and over 40 percent of the poor in BiH.
- **Households with unemployed heads have amongst the highest poverty rates**.
- In spite of the high poverty rates among the unemployed, **households with working heads make up a substantial share of the total poor**, due to their large share in the overall population. For example in Albania, around 70 percent of the poor work. In Romania in 1994, around 70 percent of the poor were either working or pensioners.
- **Larger households are poorer**. In Albania, the poor have larger households, and an average of 3.4 children against the population average of 1.5 children. In FYR Macedonia, the number of children in a household is positively correlated with poverty, with households with three or more children having almost double the national poverty rate and constituting almost half of the total number of poor people. In Bulgaria, poverty rates are also worse for large households, and children are more at risk of poverty than the elderly. The one country where this does not appear to be the case is Croatia, where the elderly—who live in smaller than average households—dominate amongst the poor. Preliminary results from BiH also suggest this same pattern; and
- **The Roma stand out as very poor and persistently poor**, though this is difficult to quantify in due to restrictions on ethnicity questions in some surveys. Roma households typically display several characteristics associated with high poverty rates, including high birth rates, low education attainment (including substantial illiteracy), and high unemployment. In Bulgaria, Roma poverty rates were around 85 percent, or almost two and a half times the national average. This is also consistent with findings from CEE, e.g., Hungary.

Source: These conclusions are based on a series of World Bank studies: *Albania: Growing Out of Poverty* (1996), and *Albania: Poverty and Social Welfare* (Rashid et al., 1999); *Poverty in Bosnia and Herzegovina: the Legacy of War* (Bisogno, draft mimeo, WB, 1999); *Bulgaria: Poverty During the Transition* (WB, 1999); *Croatia: Economic Vulnerability and Social Welfare Study*, Issues Paper (mimeo, WB, 1999); *FYR of Macedonia: Focusing on the Poor* (two vols., WB, 1999); and *Romania: Poverty and Social Policy* (two vols., WB 1997).

2.18 Basic services and infrastructure, such as education, health, water supply, sanitation and roads, provide another measure of living standards. Diminished access or quality is likely to show up with a lag, as labor market outcomes deteriorate or the longer term impact of inadequate health care systems shows in morbidity and other health indicators. The distribution of services and infrastructure also matter, as they tend to be unequally distributed within the SEE countries, which adversely affects the poor.

2.19 The demographic structures of the SEE countries are quite heterogeneous: a mix of typical CEE old age structures, alongside regional outliers like Albania and Kosovo, which have the largest share of young in their populations and the highest fertility rates in Europe. In terms of demographic dynamics, the SEE region has experienced substantial declines in total fertility rates (TFR) during the 1990s, a phenomenon which is typical of transition economies (see Chart 2.4). However, it is also important to note that declines in TFR were just as dramatic in the 1980s in most SEE countries. The trends suggest that fertility decline is as at least partly the usual downward movement of such rates over time, and not solely a large fertility response to economic shock.

Chart 2.4: Total Fertility Rates, 1980-97, SEE and CEE/CIS



Note: (a) Bulgaria, Croatia and Romania 1998; CEE/CIS 1995, excludes C. Asia.

Source: Transmonee Report, UNICEF (1999).

2.20 The evolution of life expectancy—particularly male life expectancy—has been dramatically downwards in several transition countries in Europe and the CIS. In contrast, the picture in SEE countries during the 1990s is one of stagnation or slight decline for males, and slight increases for females. Overall, SEE male life expectancy fell from 68.6 to 68.2 years, and female life expectancy increased from 74.5 to 74.7 between 1990 and 1997. However, the aggregate picture masks differences between Albania and Bulgaria—where both male and female life expectancy declined—and FR Yugoslavia and FYR Macedonia, where life expectancy for both increased over the period. This mixed and rather static position contrasts sharply with the 1980s, when the average SEE male life expectancy increased by one year, and female life expectancy by 1.7 years.

2.21 The evolution of health indicators also gives some indication of the progress that has been achieved in living standards throughout the region. While basic health indicators have in most cases been sustained, they are worse than regional averages, and systemic problems raise serious questions as to whether current indicators can be sustained in the future. Mortality rates tell the story nicely (see Tables 2.4 and 2.5): they are very favorable by developing country standards (which is characteristic of transition economies), but they remain high compared to the neighboring CEE economies and they are being reduced more slowly. This also must reflect the fiscal pressures that these countries have undergone in the past decade and the fact that the social sectors have not been immune to the fiscal contraction. It is also important to note that a simple examination of status indicators can give quite a misleading picture of the evolution of access to quality care for the population, in particular the poor population. In fact, access to social services is unequal in most SEE countries.¹⁵ It is also important to note that health outcomes are products not only of the health care system, but of a range of other factors, including housing, female education, and water and sanitation.

Table 2.4: Infant Mortality Rate
(per thousand live births)

	1990	1997	Annual Change (%)
Albania	28.3	25.8	-2
Bosnia and Herzegovina	15.3	12.7	-3
Bulgaria	14.8	17.5	+2
Croatia	10.7	8.2	-4
FR Yugoslavia	22.8	14.3	-6
FYROM	22.8	15.7	-5
Romania	26.9	22.0	-3
SEE-6 average	22.3	18.2	-3
CEE-5 average	16.4	9.2	-8

Source: MONEE database.

Table 2.5: Under-five Mortality
(per thousand live births)

	1990	1997	Annual Change (%)
Albania ^a	41.5	30.6	-4
Bosnia and Herzegovina	17.2	n.a.	n.a.
Bulgaria	18.7	23.5	+3
Croatia	12.5	9.5	-4
FR Yugoslavia	26.2	16.5	-6
FYROM	34.9	18.5	-9
Romania	35.7	26.4	-4
SEE-6 average ^b	29.3	22.3	-4
CEE-5 average	18.8	11.0	-7

a. No data for 1997; 1996 rate is used for 1997

b. Excludes Bosnia and Herzegovina; see (a) above.

Source: MONEE database.

2.22 Living standards in the SEE region have also been adversely affected by the deterioration in the environment over the past several decades.¹⁶ First, the industrialization of the SEE countries during the socialist period was accomplished with little consideration for the impact on the environment. Second, the past decade of transition and conflict also weakened institutions, put additional pressures on the natural resource base as living standards have stagnated, and ruined or severely damaged/degraded specific areas, particularly as a result of armed conflicts. Furthermore, war damage to industrial facilities has created a number of environmental hot spots, which have especially damaged water and soil resources. The poor and lower income groups are especially vulnerable to environmental degradation, as they depend to

¹⁵ LSMS data for 1996 for households in Albania, outside of Tirana, show that 55 percent had access to piped water and less than 14 percent had electricity.

¹⁶ Chapter 8 contains a detailed discussion of environmental conditions in the SEE region, as well as a discussion of important regional initiatives to improve environmental management.

a larger extent on natural resources for their livelihood, use more fragile water sources and may live in closer proximity to degraded areas. Thus, the deterioration in the environment of the SEE region has been another factor in declining living standards of the people of the SEE region, even if the impact is difficult to quantify.

D. PROGRESS ON ECONOMIC REFORM

2.23 The underlying reasons for the poor economic performance of these six economies stem primarily from three sources. First, as noted above, **these economies started the transition from very weak positions—political uncertainty was high, institutions were weak, and civil societies were fragmented.** Political uncertainty was high even in those countries, which were not former Yugoslav republics. Albania, Bulgaria and Romania have all faced, in the past several years, political uncertainties that have severely disrupted economic activities. Second, **the dissolution of the former Yugoslav Republic and the associated hostilities have severely disrupted economic activity and engendered a high level of uncertainty** in all the successor states. As the economic system in the former Yugoslavia was designed in part to foster close ties among the republics, its dissolution magnified the downward spiral of economic activity. In turn, the hostilities among the countries of the region set back economic development even further. These hostilities also affected the economic development of countries not directly involved. The economies of Albania, Romania, Bulgaria and FYR Macedonia were affected greatly by the break-up of neighboring economies, by the sanctions imposed on FRY, which cut off important markets and transit routes for almost all of the countries of the region, and by the destruction of regional infrastructure, most notably in the recent Kosovo crisis.

2.24 Finally, the poor economic performance also reflects **inadequate progress on structural reforms** (see Table 2.6). These economies have not taken the complete step towards free market economies. Commitment to reform in South Eastern Europe has been “stop and go”. Across-the-board, structural reforms have lagged behind those of the CEE economies, although progress has been greater than in the Commonwealth of Independent States (CIS). The average EBRD transition indicator for SEE countries was 2.19 in 1999, compared to 3.16 for the CEE economies and 1.76 for the CIS.¹⁷ Overall, Croatia appears to have been the most successful in the area of economic reform, often close to the performance in CEE countries (see Chart 2.5).

¹⁷ The measure referred to here is the average of scores, on a scale from 1 to 4+, along eight dimensions of transition, including large and small enterprise privatization, enterprise restructuring, price liberalization, trade and foreign exchange regime, competition policy, banking reform and development of securities markets and non-bank financial institutions. The transition indicators thus capture a variety of policy and institutional factors that determine the business climate. 1 represents little or no change from the previous regime and 4+ represents a standard that would not look out of place in an industrialized market economy.

Table 2.6: Progress Towards Reform in the Real Sector

	<i>Agriculture as % of 1997 GDP</i>	<i>Priv. Sector Share Of 1998 GDP</i>	<i>Enterprise Reform Index</i>	<i>Competition Policy Index</i>	<i>Privatization Index^c</i>	<i>Banking Index</i>
Albania	62.6	75	2.0	2.0	3.0	2.0
BiH	17.5	35	1.7	1.0	2.0	2.3
Bulgaria	8.0	57	2.3	2.0	3.0	2.0
Croatia	9.2	60	2.7	2.0	3.7	2.3
FR Yugoslavia	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
FYR of Macedonia	12.0	55	2.0	1.0	3.5	1.7
Romania	19.6	60	2.0	2.0	3.0	2.0
SEE-6 Av. ^b	16.2	59	2.2	1.9	3.1	2.1
CEE-5 Av. ^{a, b}	4.7	70	2.9	3.0	4.0	3.2

a. Countries include: Czech Republic, Hungary, Poland, Slovak Republic, Slovenia.

b. Weighted by GNP; excludes FRY.

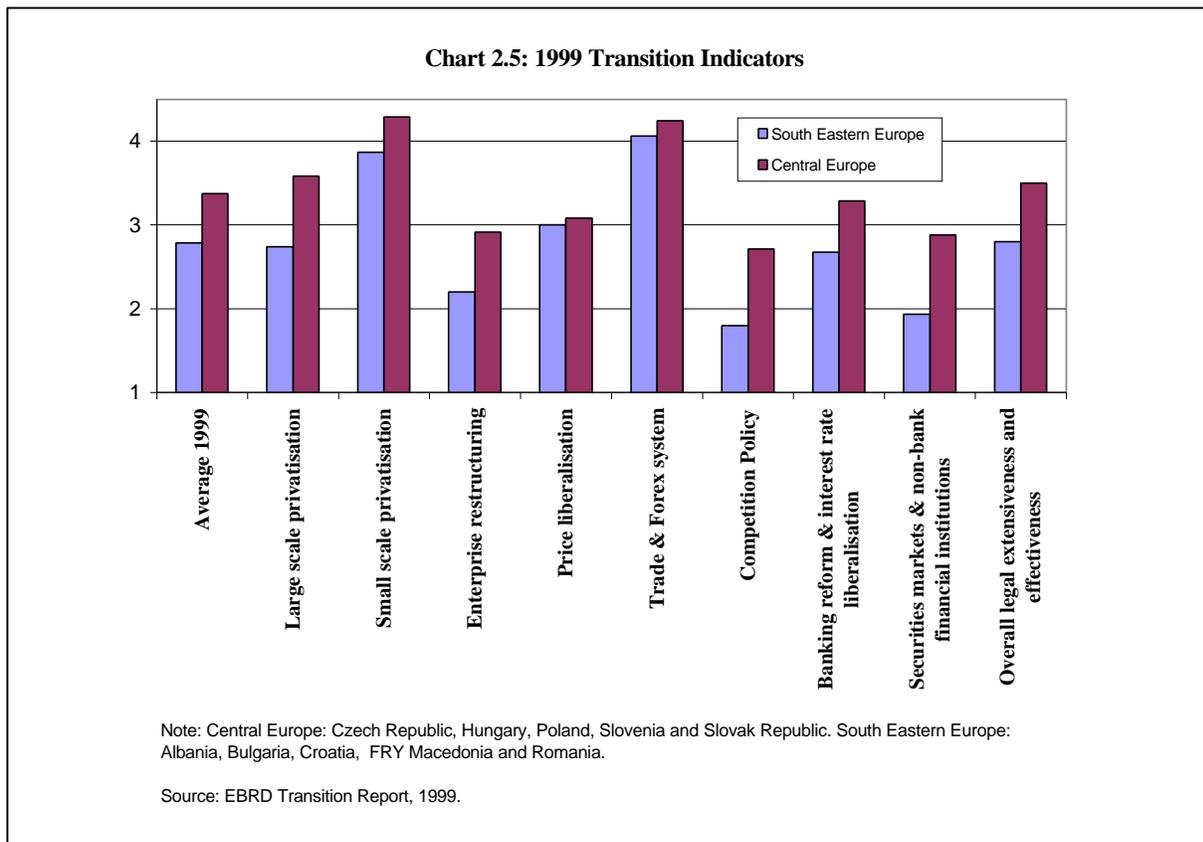
c. Simple average of large and small privatization indexes.

Source: World Bank staff estimates; EBRD Transition Report, 1999.

2.25 Measurable progress has been made in the development of the private sector in virtually all countries in the region. In 1989, only 12 percent of the GDP of the SEE region were produced by private sector entities. Over the first five years of transition, this share rose to 39 percent. Today, the private sector currently generates the majority of GDP (almost 60 percent) in all countries in the region (see Table 2.6). Nevertheless, this share still remains low in comparison to the progress achieved in the Central European economies. Moreover, progress in Bosnia and Herzegovina and probably FRY, have lagged far behind progress in the other SEE countries. In Bosnia and Herzegovina, the private sector still accounts for only 35 percent of GDP.¹⁸ While reliable data do not exist in FRY, it is estimated that some 86 percent of all employment is still in state-or socially- owned sectors, indicating that the public sector still accounts for a large share of overall economic activity.

¹⁸ It is important to note that this is roughly comparable to the progress achieved in the first five years of transition in the other SEE countries, which might be a more appropriate benchmark.

2.26 Alongside the progress in establishing private sector activity in the SEE economies, **considerable progress also has been made in liberalizing markets and trade and foreign exchange systems.** Trade and foreign exchange regimes in the region have been relaxed and many quantitative and administrative import and export restrictions have been lifted. Nevertheless, a further lowering of trade protection, through the elimination of non-tariff barriers, more uniform and lower tariff structures, and fewer tariff bands is still warranted, especially in light of the need to integrate more closely with Western Europe. Price liberalization has also seen substantial progress and state procurement at non-market prices has been largely phased out. Competition policy and legislation have been set up in some countries of South Eastern Europe, yet enforcement actions to reduce abuse of market power have been limited.



2.27 **Privatization has made considerable headway in South Eastern Europe.** Significant proportions of large-scale enterprises have been privatized in all countries—although the methods of privatization of medium-sized and large enterprises have been quite different. In most countries in the region, privatization has significantly benefited insiders, either through voucher privatization with significant concessions to insiders or through MEBOs. Bulgaria is the only country in the SEE region where the primary privatization method has been in the form of direct sales. In contrast to the difficulties in

privatizing medium-sized and large enterprises, privatization of small firms has been much easier. In the countries of the former Yugoslavia, small-scale privatization was initiated before the start of the transition. In Albania, Croatia and FYR Macedonia, the privatization of small-scale industries has been completed. In Bosnia and Herzegovina, a large part even of small enterprises is still held by the state. This largely reflects attempts to maintain control over assets according to political and ethnic criteria. In summary, privatization progress, as measured by the EBRD averages 3.1 for the countries of the SEE region. Their performance in small-scale privatization has been especially good. Nevertheless, progress still lags that of the five economies of Central Europe.

2.28 The progress on privatization has made improving the environment for private sector development especially important. Poor corporate governance remains a key obstacle to enterprise restructuring and sustainable growth. The index of enterprise reform averages only 2.2 in the EBRD rankings—again significantly lower than in the five CEE, although progress in these economies has also been limited (only 2.9). Privatization through vouchers and MEBOs has produced insider-dominated governance structures in most countries of the region. Corporate control is often exercised by management without effective checks by dispersed outside shareholders or by the state. The mix of insider control, dispersed outside shareholders and residual state ownership has inhibited restructuring, and especially reductions in the work force. Yet there is little evidence that majority ownership by domestic outsiders has resulted in faster restructuring. There is evidence, however, that the profitability of new enterprises and enterprises with a majority foreign owner exceeds that of domestically privatized companies.

2.29 Only very limited progress in improving competition and governance structures has been achieved across the region. While most states have taken some steps to tighten credit and subsidy policies, **considerable soft budget constraints still exist throughout the SEE region.** There are a variety of ways in which the budget constraints of enterprises are eased in transition economies. Perhaps the most direct way that governments support enterprises is through budgetary subsidies to producers and through soft government loans. While these production subsidies have been substantially reduced, they still amount to 0.3-2.6 percent of GDP across the SEE region. A further, and probably more significant, means of support for enterprises is the tolerance of tax arrears and the non-payment of utility bills. Survey evidence shows that on average almost one-third of firms in Bulgaria, Croatia and Romania failed to pay all of their taxes—with the share being highest in Croatia, followed by Romania and Bulgaria.¹⁹

2.30 **Banking systems in the SEE region are plagued by a lack of competition and State interference.** With the exception of FYR Macedonia, all SEE countries banking systems include a large proportion of assets controlled by state-owned banks which are generally under ongoing restructuring and privatization programs (see Table 2.7). Banking sector liberalization in all the SEE countries (with the exception of the FRY) has led to a rapid proliferation of small, undercapitalized and poorly supervised private

¹⁹ The incidence of arrears varies with the size, sector, ownership and sales growth of firms. In particular, large firms or those that are state-owned or have been privatised tend to have a greater incidence of tax arrears compared with small firms and new entrants. Also, firms that are growing more rapidly tend to be less likely to have arrears.

banks, whose failure could pose systemic risks. Loan portfolios contain a large share of non-performing loans, ranging from between 11 percent and 91 percent of total loans, which requires large provisions that impact negatively on bank's profitability. Banking skills and institutional weaknesses are severe, particularly in the area of banking supervision. The prudential and regulatory frameworks of SEE countries have been brought to acceptable standards (except in the FRY), though the main challenge remains at the implementation and enforcement level, especially in monitoring and verifying loan classifications. Accounting frameworks are close to nominal compliance with IAS and international standards, except in the FRY and Bosnia and Herzegovina where a major effort is still needed to bring bank accounts and prudential regulations up to international standards. Enforcement of prudential regulations (loss-provisioning in particular) remains weak across the region.

Table 2.7: Comparative Indicators of the Financial Sector in SEE-6 Countries^a

	<i>Albania^c</i>	<i>Bosnia & Herzegovina</i>	<i>Bulgaria^c</i>	<i>Croatia^b</i>	<i>FYR^b Macedonia</i>	<i>Romania^b</i>
Number of banks	11	70	28	60	24	35
Operating foreign banks	9 ¹	2	7	6	2	16
Total bank assets (US\$ bln)	1.5	5.4	4.2	16,8	1.7	13.3
Total bank assets (% GDP)	45	132	35	74	46	35
% of bad loans (in total loans)	91 ²	n.a.	9	11	33	58 ³
% of state assets (in total assets)	90	n.a.	59	42	n.a.	75
Credit to private sector (% GDP)	3	n.a.	16	40	21	13
Total bank deposits (% GDP)	36	n.a.	23	43	12	19
Equity as % of total assets	n.a.	12	11	18	22	12
Required capital adequacy ratio	8	8	12	10	8	8
Number of insurance companies	3	n.a.	30	23	n.a.	47
Total premiums (% of GDP)	n.a.	n.a.	n.a.	4	n.a.	1

a. Data for FR Yugoslavia is not available, b. data as of 1998, c. data as of 1997.

1. All joint venture or are wholly owned subsidiary of foreign banks; 2. Prior to the restructuring program of state-owned banks; 3. Includes loss and doubtful as of mid-1998.

Source: World Bank staff estimates; EBRD Transition Report, 1999.

2.31 Across the region considerable progress has been made in designing a legal framework. Nevertheless, the effectiveness of the legal framework and the environment for private sector development, especially for small and medium-sized enterprises, remains problematic, depressing private economic activity and investment. In the case of commercial law, an extensive legal framework is in place in most countries in the region—with the exception of Albania and Bosnia and Herzegovina. However, the legal framework is largely ineffective in resolving commercial disputes and it may need to be updated for the requirements of an increasingly globalized world. Court proceedings often remain time-consuming and inefficient. Regulations often failed to use their enforcement powers against liquidators, directors, banks, and other financial intermediaries. Failure to take prompt corrective action, coupled with time-consuming court proceedings, means that creditors, investors and minority shareholders are often left with no real or effective legal recourse in certain jurisdictions. Enforcement of

bankruptcy law is a major area of concern across the region. There are real problems with the efficiency and effectiveness of liquidation proceedings.

2.32 New enterprises and the private sector in general face considerable obstacles in doing business. Access to finance, complex tax systems and administrative burdens are the principal hurdles, especially for SMEs. The institutional infrastructure that supports SME information, legal and training needs in most western market economies tends to be weak. These obstacles emerge in an EBRD commissioned comparative study of constraints faced by SMEs in 1998, covering Poland, Slovak Republic, Romania, Ukraine and Russia. In many respects, Romania matched performance in the two central European countries and performed far better than the two CIS economies—e.g., in the growth of SMEs and the diversity of their customer base. But on other dimensions, there were severe shortcomings as compared to Poland, which offered the most favorable business environment among the five countries (see Table 2.8).

*Table 2.8: Obstacles Facing SMES: Comparative Survey
(Responses from SMES)*

	<i>Romania</i> (%)	<i>Poland</i> (%)
SMEs prepared to offer trade credit to customers	31	75
SMES that obtained Bank credit in past year	21	51
“Unofficial” payments required for:		
Telephone connections	39	11
Business registration	25	1
Fire/Sanitary inspections	22	3
Tax inspections	17	1

Source: EBRD survey on constraints facing SMEs. Survey conducted in Poland, Slovak Republic, Romania, Ukraine, and Russia in 1998.

2.33 The ineffectiveness of the legal framework and the difficult climate for private sector development all hamper the investment climate in the SEE region. Business people interviewed in Albania, Bulgaria, Croatia and Romania view macroeconomic and policy instability as the major impediment to investment (see Box 2.2). This is in contrast to most other central and east European countries, where the top obstacle is taxation and regulation. Changes in regulation, taxation and other controls, often at short notice, hamper business planning. Corruption and law and order are also particularly problematic in South Eastern Europe relative to central Europe.

Box 2.2: Obstacles to SME Development in the SEE Region.

The Business Environment and Enterprise Performance Survey commissioned by EBRD provides a detailed assessment of the most binding constraints for the entry and expansion of start-up enterprises. It suggests that there are the following main obstacles to SME development in South Eastern Europe:

- The results show that ***inflation and macroeconomic instability is perceived as the most important barrier to expansion by start-ups***. This is in contrast to the outcome for the transition economies as a whole, where taxes and regulations are considered the most important barrier.
- ***Micro-level non-financial constraints in the form of taxes and regulations are viewed as the next most important barrier to SME development***. Business licensing is perceived as the most serious obstacle to operation and expansion among a broad range of tax and regulatory constraints.
- The next most important obstacle is reportedly ***the lack of access to finance***. Lack of access to long-term bank loans, collateral requirements imposed by financial institutions, and the additional costs of access imposed on enterprises by bank paper work and bureaucracy all discriminate more significantly against SMEs. When credit is available, it is rarely medium or long-term.
- More so than in any other region, SMEs in South Eastern Europe report ***corruption as an important obstacle to business development***. Relative to large businesses, SMEs suffer more from slow bureaucratic procedures and corruption. Many firms prefer to work in the grey economy, creating a non-level playing field.

E. CONCLUSION

2.34 The past decade of transition and conflict has left in the region with a legacy of mediocre growth and declining living standards. The region has recovered only 75 percent of its pre-transition GNP. Living standards, as evidenced by higher poverty, unemployment and inequality, have also deteriorated. The underlying reason is that, while considerable progress has been made with liberalization, and in some countries with privatization, progress in structural reforms has been slow in South Eastern Europe. This includes the privatization of large key industries, as well as the imposition of financial discipline on enterprises and banks. Most importantly, the region has made little progress in establishing the legal and social institutions that underpin effective markets and provide the predictability, fairness and transparency required for private investment. As a consequence, the vicious circle of economic uncertainty—engendered by the decade of conflict in the region and the region’s unclear prospects for integration into Western European structures—and an inhospitable climate for private sector development—stemming from an inadequate pace and depth of structural reforms—have combined to yield a disappointing economic performance during the past decade.

Annex 2.1

Albania - Selected Indicators Table

	<i>Actual</i>			<i>Estimate</i>	
	1995	1996	1997	1998	1999
Part A: Main Macro Aggregates 1/					
<i>Annual growth rates, calculated from constant 1995 price data</i>					
GDP (mp) per capita	7.3%	7.9%	-8.0%	6.9%	..
Total consumption per capita	3.4%	18.1%	-11.1%	8.4%	..
GDP at market prices	8.9%	9.1%	-7.0%	8.0%	8.0%
Total consumption	5.0%	19.5%	-10.1%	..	..
Private consumption	4.3%	22.0%	-9.3%	..	..
Gross domestic investment (GDI)	-0.1%	-9.8%	-4.1%	..	..
Gross dom. fixed investment (GDFI)	..	..	..	..	..
Exports (GNFS) 1/	32.3%	26.7%	-34.7%	21.1%	22.7%
of which Goods 1/	45.1%	11.7%	-27.1%	22.8%	39.0%
Imports (GNFS) 1/	7.6%	33.7%	-25.8%	20.1%	23.9%
of which Goods 1/	13.0%	35.6%	-25.6%	20.6%	24.0%
<i>Savings-investment balances, as percentage of GDP</i>					
Gross Domestic investment	18.3%	15.5%	16.0%	16.0%	16.8%
of which Government investment	8.5%	4.5%	4.0%	5.2%	4.9%
Foreign savings	7.3%	9.1%	12.1%	6.1%	8.6%
Gross national savings	11.0%	6.4%	3.9%	9.9%	8.2%
Government savings	-0.9%	-7.5%	-3.4%	-5.3%	-4.0%
Non government savings	11.9%	13.9%	7.3%	15.2%	12.2%
Gross domestic savings	-3.7%	-11.8%	-9.1%	-6.7%	-3.1%
<i>Other</i>					
GDP inflation	9.8%	14.6%	30.8%	24.8%	0.7%
Part B: Government Finance Indicators 1/					
<i>Percentage of GDP</i>					
Total revenues, of which	24.9%	18.3%	22.1%	20.3%	20.4%
Total expenditures, of which	34.3%	30.3%	29.5%	30.7%	31.3%
Deficit(-)/Surplus(+)	-9.4%	-12.0%	-7.4%	-10.4%	-10.9%
Part C: Debt & Liquidity Indicators 1/					
<i>Total DOD and TDS</i>					
DOD (US\$ millions)	751.1	781.4	706.1	821.0	949.5
DOD / GDPmp ratio	24.7%	25.0%	26.4%	23.7%	25.0%
TDS (US\$ millions)	7.0	34.0	48.0	17.9	23.4
TDS / exports (XGS) ratio	1.1%	3.9%	8.8%	6.2%	5.4%
Total gross reserves (months' imports G&S)	3.8	3.5	5.0	4.9	7.8
Part D: External Financing Plan 1/					
<i>(US\$, millions)</i>					
Official capital grants	118.0	77.0	77.0	89.0	140.0
Private investment (net)	89.0	97.0	42.0	45.0	50.0
Long term disbursements excl IMF	103.0	132.0	67.0	116.0	182.0
Adjustments to scheduled debt service	-61.0	0.0	0.0	0.0	6.0
All other capital flows	-47.0	-18.0	117.0	7.0	20.0
Financing Requirements (incl IMF)	202.0	288.0	303.0	257.0	398.0
of which current account deficit	176.0	245.0	276.0	186.0	326.0

1/ Growth in dollar terms.

Annex 2.2

Bosnia and Herzegovina - Selected Indicators Table

	<i>Actual a/</i>		<i>Estimate</i>		
	1995	1996	1997	1998	1999
Part A: Main Macro Aggregates					
<i>Annual growth rates, calculated from constant 1995 price</i>					
GDP (mp) per capita b/	..	66.9%	28.2%	14.2%	7.8%
Total consumption per capita	..	12.2%	7.3%	6.5%	4.3%
GDP at market prices	20.8%	69.2%	29.5%	15.1%	10.0%
Total consumption	..	13.8%	8.5%	7.3%	6.4%
Private consumption	..	..	..	..	..
Gross domestic investment (GDI)	..	167.8%	18.7%	3.5%	2.4%
Gross dom. fixed investment (GDFI)	..	260.4%	23.4%	4.2%	2.3%
Exports (GNFS) c/	..	72.7%	52.3%	36.4%	14.2%
of which Goods c/	..	121.1%	71.1%	42.1%	18.7%
Imports (GNFS) c/	..	70.8%	14.4%	9.9%	-7.1%
of which Goods c/	..	73.9%	24.0%	10.3%	-6.8%
<i>Savings-investment balances, as percentage of GDP</i>					
Gross Domestic investment	534.5	20.0%	41.4%	38.0%	33.4%
of which Government investment	7.2%	24.4%	23.8%	19.6%	16.1%
Foreign savings	10.3%	27.3%	31.0%	28.2%	16.3%
Gross national savings	9.6%	14.7%	10.4%	9.8%	17.0%
Government savings	..	-3.9%	0.5%	-0.9%	-1.1%
Non government savings	..	18.6%	9.9%	10.7%	18.2%
Gross domestic savings	-31.1%	-17.1%	-5.5%	-0.4%	8.4%
<i>Other</i>					
GDP inflation d/	-4.0%	-25.0%	14.0%	5.0%	0.0%
Part B: Government Finance Indicators					
<i>Percentage of GDP</i>					
Total revenues	..	48.2%	40.4%	44.4%	49.4%
Total expenditures	..	52.7%	41.7%	47.2%	52.7%
Deficit(-)/Surplus(+)	..	-4.4%	-1.3%	-2.8%	-3.3%
Part C: Debt & Liquidity Indicators					
<i>Total DOD and TDS</i>					
DOD (US\$ millions)	3518.0	3884.0	3878.9	2981.4	3100.8
DOD / GDPmp ratio	188.4%	141.7%	113.3%	76.5%	70.2%
TDS (payments due, US\$ millions) e/	424.0	461.0	279.0	152.6	110.7
TDS (due) / exports (XGS) ratio f/	111.3%	70.1%	27.8%	11.2%	7.1%
Total gross reserves (months' imports G&S) g/	0.5	1.1	0.3	0.7	1.7
Part D: External Financing Plan					
<i>(US\$, millions)</i>					
Official capital grants	0.0	842.0	573.8	726.8	572.2
Private investment (net)	0.0	0.0	0.0	100.0	60.0
Long term disbursements excl IMF	0.0	865.0	176.3	223.3	233.4
Adjustments to scheduled debt service	476.0	-125.0	306.0	171.7	52.2
All other capital flows	-152.0	-591.0	95.2	-208.1	282.1
Financing Requirements (incl IMF) h/	324.0	991.0	1151.2	1013.5	1199.9
of which current account deficit h/	193.0	748.0	1060.2	1098.4	722.0

a/ Figures from 1995 to 1998 should also be considered as preliminary as some indicators are still staff estimates.

b/ The per capita figures are based on population estimates.

c/ Foreign savings is defined as the negative of current account balance with the latter including current official transfers.

c/ Growth in dollar terms.

d/ CPI inflation of the Federation.

e/ Payments due.

f/ Exports of goods and non-factor services, factor income and workers remittances.

g/ Imports of goods and non-factor services and factor income payments.

h/ Financial requirements is defined as current account balance plus changes in reserves.

Annex 2.3

Bulgaria - Selected Indicators Table

	<i>Actual</i>			<i>Estimate</i>	
	1995	1996	1997	1998	1999
Part A: Main Macro Aggregates					
<i>Annual growth rates, calculated from constant 1999 price data</i>					
GDP (mp) per capita	3.3%	-9.7%	-6.5%	4.4%	2.5%
Total consumption per capita	1.3%	-14.1%	-19.8%	-2.6%	2.4%
GDP at market prices	2.9%	-10.1%	-7.0%	3.5%	1.5%
Total consumption	0.9%	-14.5%	-20.2%	-3.4%	1.4%
Private consumption	2.7%	-12.0%	-22.8%	-4.7%	1.6%
Gross domestic investment (GDI)	6.3%	-10.9%	33.1%	44.3%	7.4%
Gross dom. fixed investment (GDFI)	16.1%	-21.2%	-23.9%	16.3%	10.6%
Exports (GNFS) 1/	30.5%	-7.7%	0.3%	-11.5%	-11.1%
of which Goods 1/	35.8%	-8.5%	1.0%	-13.0%	-13.6%
Imports (GNFS) 1/	25.1%	-8.5%	-3.7%	2.6%	-6.5%
of which Goods 1/	32.2%	-10.0%	-3.0%	4.3%	-8.4%
<i>Savings-investment balances, as percentage of GDP</i>					
Gross Domestic investment	15.7%	8.4%	11.4%	14.7%	15.8%
of which Government investment	1.5%	1.3%	1.9%	2.6%	3.4%
Foreign savings	0.2%	-0.8%	-4.2%	3.1%	5.7%
Gross national savings	15.5%	9.2%	15.6%	11.7%	10.0%
Government savings	-3.8%	-14.1%	1.7%	4.1%	3.5%
Non government savings	19.3%	23.3%	13.9%	7.6%	6.5%
Gross domestic savings	14.1%	11.5%	16.9%	13.7%	11.1%
<i>Other</i>					
GDP inflation	62.8%	121.0%	949.1%	22.2%	0.5%
Part B: Government Finance Indicators					
<i>Percentage of GDP</i>					
Total revenues, of which	35.8%	32.8%	33.2%	34.9%	34.7%
Total expenditures, of which	41.1%	48.2%	31.1%	32.0%	33.5%
Deficit(-)/Surplus(+)	-5.2%	-15.4%	2.1%	2.9%	1.3%
Part C: Debt & Liquidity Indicators					
<i>Total DOD and TDS</i>					
DOD (US\$ millions)	10305.2	10058.3	9858.7	9906.7	9536.3
DOD / GDPmp ratio	78.6%	102.3%	97.2%	80.8%	79.7%
TDS (US\$ millions)	1144.1	1248.5	932.5	1295.9	1236.2
TDS / exports (XGS) ratio	16.5%	19.4%	14.4%	22.1%	23.7%
Total gross reserves (months' imports G&S)	2.6	1.5	4.7	5.7	6.4
Part D: External Financing Plan					
<i>(US\$, millions)</i>					
Official capital grants	0.0	0.0	0.0	0.0	0.0
Private investment (net)	32.6	8.2	639.4	221.0	545.0
Long term disbursements excl IMF	235.0	200.0	214.0	692.0	56.3
Adjustments to scheduled debt service	0.0	0.0	0.0	0.0	0.0
All other capital flows	223.7	-916.0	-33.1	-205.7	121.6
Financing Requirements (incl IMF)	491.3	-707.8	820.3	707.3	722.9
of which current account deficit	25.6	-82.0	-426.7	375.6	687.9

1/ Growth rate in dollar terms.

Annex 2.4

Croatia - Selected Indicators Table

	<i>Actual</i>			<i>Estimate</i>	
	1995	1996	1997	1998	1999
Part A: Main Macro Aggregates					
<i>Annual growth rates, calculated from constant 1999 price data</i>					
GDP (mp) per capita	6.4%	10.0%	5.0%	4.1%	-1.5%
Total consumption per capita	..	3.5%	7.7%	2.7%	-2.5%
GDP at market prices	6.8%	5.9%	6.8%	2.5%	-1.5%
Total consumption	..	-0.4%	9.6%	1.1%	-2.5%
Private consumption	..	0.4%	12.9%	1.2%	-1.8%
Gross domestic investment (GDI)	..	31.7%	34.2%	-13.8%	-6.5%
Gross dom. fixed investment (GDFI)	..	37.6%	23.3%	3.0%	-10.0%
Exports (GNFS) 1/	-0.5%	10.7%	4.8%	4.3%	-7.5%
of which Goods 1/	8.7%	-1.9%	-7.4%	9.6%	-6.1%
Imports (GNFS) 1/	39.9%	6.9%	14.7%	-6.6%	-9.3%
of which Goods 1/	45.4%	4.2%	14.6%	-7.0%	-9.5%
<i>Savings-investment balances, as percentage of GDP</i>					
Gross Domestic investment	17.6%	21.9%	28.2%	23.2%	22.4%
of which Government investment	2.6%	3.8%	3.4%	4.3%	4.1%
Foreign savings	7.7%	5.8%	11.5%	7.1%	6.7%
Gross national savings	9.9%	16.2%	16.6%	16.1%	15.7%
Government savings	3.1%	5.4%	4.4%	6.2%	1.5%
Non government savings	6.8%	10.7%	12.3%	9.8%	14.2%
Gross domestic savings	6.7%	12.5%	12.0%	14.2%	13.8%
<i>Other</i>					
GDP inflation	5.3%	3.6%	7.4%	9.0%	5.6%
Part B: Government Finance Indicators					
<i>Percentage of GDP</i>					
Total revenues, of which	48.2%	50.4%	48.6%	52.6%	53.1%
Total expenditures, of which	48.9%	50.7%	49.8%	52.1%	54.4%
Deficit(-)/Surplus(+)	-0.7%	-0.4%	-1.2%	0.5%	-1.3%
Part C: Debt & Liquidity Indicators					
<i>Total DOD and TDS</i>					
DOD (US\$ millions)	3562.2	4929.9	6826.6	8069.9	8228.3
DOD / GDPmp ratio	18.9%	24.8%	33.6%	37.1%	40.7%
TDS (US\$ millions)	..	..	..	1121.2	1295.9
TDS / exports (XGS) ratio	..	..	..	11.4%	15.5%
Total gross reserves (months' imports G&S)	2.4	2.7	2.6	3.0	3.5
Part D: External Financing Plan					
<i>(US\$, millions)</i>					
Official capital grants	0.0	16.2	21.5	19.1	0.0
Private investment (net)	100.5	1140.7	966.5	805.6	1447.0
Long term disbursements excl IMF	418.1	844.3	1831.7	1774.9	722.1
Adjustments to scheduled debt service	0.0	0.0	0.0	0.0	0.0
All other capital flows	0.0	0.0	0.0	0.0	-601.8
Financing Requirements (incl IMF)	1700.1	1626.7	2753.3	1657.1	1567.2
of which current account deficit	1451.4	1147.6	2342.7	1543.0	1353.5

1/ Growth rate in dollar terms.

Annex 2.5

Federal Republic of Yugoslavia - Selected Indicators Table

	<i>Actual</i>			<i>Estimate</i>	
	1995	1996	1997	1998	1999
Part A: Main Macro Aggregates					
<i>Annual growth rates, calculated from constant 1995 price data</i>					
GDP (mp) per capita	..	..	..	..	..
Total consumption per capita	..	..	..	..	..
GDP at market prices	6.1%	3.5%	7.4%	2.6%	-35.0%
Total consumption	..	..	..	..	..
Private consumption	..	..	..	..	..
Gross domestic investment (GDI)	..	..	..	..	..
Gross dom. fixed investment (GDFI)	..	..	..	..	..
Exports (GNFS) 1/	..	41.3%	25.9%	..	..
of which Goods 1/	-8.2%	35.4%	46.6%	5.9%	-45.1%
Imports (GNFS) 1/	..	56.0%	17.9%	..	..
of which Goods 1/	25.4%	72.5%	16.8%	1.2%	-34.0%
<i>Savings-investment balances, as percentage of GDP</i>					
Gross Domestic investment	16.5%	16.9%	18.0%	..	..
of which Government investment	..	..	..	..	..
Foreign savings	-4.3%	-9.4%	-9.4%	-8.1%	-8.3%
Gross national savings	12.2%	8.6%	..	..	..
Government savings	..	..	..	..	..
Non government savings	..	..	..	..	..
Gross domestic savings	8.5%	1.9%	9.0%	..	..
<i>Other</i>					
GDP inflation	74.1%	93.1%	15.5%	29.8%	52.0%
Part B: Government Finance Indicators					
<i>Percentage of GDP</i>					
Total revenues, of which	38.8%	38.0%	40.3%	44.0%	47.6%
Total expenditures, of which	40.4%	41.4%	..	..	..
Deficit(-)/Surplus(+)	-1.6%	-3.4%	..	..	..
Part C: Debt & Liquidity Indicators					
<i>Total DOD and TDS</i>					
DOD (US\$ millions)	..	..	..	9192	9592
DOD / GDPmp ratio	..	..	..	57.1%	70.3%
TDS (US\$ millions)	..	..	..	..	..
TDS / exports (XGS) ratio	..	..	..	..	..
Total gross reserves (months' imports G&S)	..	..	..	..	..
Part D: External Financing Plan					
<i>(US\$, millions)</i>					
Official capital grants	..	..	..	..	..
Private investment (net)	0	0	740	..	..
Long term disbursements excl IMF	..	..	..	..	..
Adjustments to scheduled debt service	..	..	..	..	..
All other capital flows	1020	1716	1087	..	..
Financing Requirements (incl IMF)	1020	1716	1827	..	..
of which current account deficit 2/	963	1670	1845	1300	1129

1/ Growth in dollar terms

2/ Estimated on a cash basis.

Annex 2.6

Macedonia, FYR - Selected Indicators Table

	<i>Actual</i>			<i>Estimate</i>	
	1995	1996	1997	1998	1999
Part A: Main Macro Aggregates					
<i>Annual growth rates, calculated from constant 1995 price data</i>					
GDP (mp) per capita	-2.2%	0.1%	0.6%	1.9%	2.1%
Total consumption per capita	-9.2%	12.6%	4.1%	4.7%	5.2%
GDP at market prices	-1.1%	1.2%	1.4%	2.9%	2.5%
Total consumption	0.8%	3.5%	3.4%	4.5%	5.6%
Private consumption	-1.1%	4.6%	4.7%	4.7%	4.9%
Gross domestic investment (GDI)	37.3%	-1.8%	7.5%	1.9%	-35.5%
Gross dom. fixed investment (GDFI)	10.2%	6.5%	-4.3%	1.5%	-1.1%
Exports (GNFS) 1/	8.0%	-4.3%	4.9%	6.5%	-1.2%
of which Goods 1/	10.9%	-4.7%	7.8%	6.9%	-9.3%
Imports (GNFS) 1/	11.3%	-0.4%	6.9%	6.8%	-7.5%
of which Goods 1/	13.1%	1.7%	10.9%	6.1%	-8.8%
<i>Savings-investment balances, as percentage of GDP</i>					
Gross Domestic investment	20.8%	20.1%	22.4%	22.8%	14.3%
of which Government investment	2.8%	2.5%	1.3%	1.6%	2.8%
Foreign savings	5.2%	6.5%	7.4%	8.9%	2.7%
Gross national savings	15.6%	13.6%	15.1%	13.8%	11.6%
Government savings	2.1%	1.8%	0.9%	0.1%	-0.7%
Non government savings	13.5%	11.8%	14.2%	13.8%	12.3%
Gross domestic savings	11.0%	9.7%	8.1%	7.1%	1.7%
<i>Other</i>					
GDP inflation	25.7%	2.8%	3.4%	1.4%	-1.0%
Part B: Government Finance Indicators					
<i>Percentage of GDP</i>					
Total revenues	38.3%	36.6%	34.9%	33.6%	35.7%
Total expenditures	39.0%	36.9%	35.3%	35.2%	39.2%
Deficit(-)/Surplus(+)	-0.7%	-0.3%	-0.4%	-1.6%	-3.5%
Part C: Debt & Liquidity Indicators					
<i>Total DOD and TDS</i>					
DOD (US\$ millions)	1206	1389	1265	1556	1836
DOD / GDPmp ratio	27.1%	31.4%	34.1%	44.0%	48.7%
TDS (US\$ millions)	141	144	120	124	198
TDS / exports (XGS) ratio	9.9%	10.4%	8.2%	8.1%	9.3%
Total gross reserves (months' imports G&S)	1.9	1.7	1.7	1.9	2.9
Part D: External Financing Plan					
<i>(US\$, millions)</i>					
Official capital grants	0.0	0.0	0.0	0.0	0.0
Private investment (net)	12.2	11.5	17.9	175.0	35.0
Long term disbursements excl IMF	0.0	0.0	0.0	215.0	403.4
Adjustments to scheduled debt service	74.0	33.0	-106.0	-2.0	22.0
All other capital flows	204.0	225.5	351.5	-27.7	-233.3
Financing Requirements (incl IMF)	290.2	270.0	263.4	360.3	227.1
of which current account deficit	229.2	289.0	273.4	316.3	102.1

1/ Growth rate in dollar terms.

Annex 2.7

Romania - Selected Indicators Table

	<i>Actual</i>			<i>Estimate</i>	
	1995	1996	1997	1998	1999
Part A: Main Macro Aggregates					
<i>Annual growth rates, calculated from constant 1999 price data</i>					
GDP (mp) per capita	7.4%	4.2%	-6.3%	-7.4%	-4.2%
Total consumption per capita	11.1%	8.3%	-6.6%	-0.9%	-6.6%
GDP at market prices	7.1%	3.9%	-6.6%	-7.5%	-4.5%
Total consumption	10.9%	7.9%	-6.8%	-1.0%	-6.9%
Private consumption	12.9%	10.8%	-6.2%	-3.3%	-2.5%
Gross domestic investment (GDI)	-4.2%	-3.5%	-14.3%	-30.0%	-24.4%
Gross dom. fixed investment (GDFI)	6.9%	3.9%	-15.9%	-19.2%	-23.9%
Exports (GNFS) 1/	30.7%	2.6%	3.2%	-4.4%	-1.8%
of which Goods 1/	28.6%	2.2%	4.3%	-1.5%	-2.1%
Imports (GNFS) 1/	45.4%	10.6%	-1.2%	3.6%	-15.6%
of which Goods 1/	44.6%	11.3%	-1.4%	5.0%	-8.6%
<i>Savings-investment balances, as percentage of GDP</i>					
Gross Domestic investment	24.3%	24.7%	21.5%	17.7%	15.0%
of which Government investment	5.4%	5.6%	4.8%	4.0%	2.1%
Foreign savings	5.0%	7.3%	6.1%	7.6%	5.4%
Gross national savings	19.3%	17.4%	15.3%	10.0%	9.6%
Government savings	2.7%	1.6%	1.1%	0.4%	3.5%
Non government savings	16.6%	15.8%	14.3%	9.6%	6.0%
Gross domestic savings	18.7%	16.3%	14.5%	9.2%	10.5%
<i>Other</i>					
GDP inflation	35.3%	44.6%	146.7%	46.6%	60.0%
Part B: Government Finance Indicators					
<i>Percentage of GDP</i>					
Total revenues, of which	32.1%	30.1%	31.3%	35.2%	37.5%
Total expenditures, of which	34.7%	33.9%	34.2%	37.9%	39.8%
Deficit(-)/Surplus(+)	-2.6%	-3.8%	-2.8%	-2.6%	-2.3%
Part C: Debt & Liquidity Indicators					
<i>Total DOD and TDS</i>					
DOD (US\$ millions)	6666.0	8519.1	9477.1	9513.4	9260.9
DOD / GDPmp ratio	18.8%	24.2%	27.2%	24.9%	28.6%
TDS (US\$ millions)	967.0	1227.5	1539.6	2309.7	3375.0
TDS / exports (XGS) ratio	10.2%	12.6%	15.2%	23.5%	32.7%
Total gross reserves (months' imports G&S)	2.7	2.9	4.4	3.4	2.6
Part D: External Financing Plan					
<i>(US\$, millions)</i>					
Official capital grants	242.0	152.0	43.0	0.0	0.0
Private investment (net)	449.0	1485.0	2107.0	2170.0	1520.0
Long term disbursements excl IMF	1408.0	1416.0	2386.0	1738.0	2434.3
Adjustments to scheduled debt service	0.0	0.0	0.0	0.0	0.0
All other capital flows	-582.0	-265.0	-734.0	-1833.0	-1809.6
Financing Requirements (incl IMF)	1517.0	2788.0	3802.0	2075.0	2144.7
of which current account deficit	1774.0	2571.0	2137.0	2918.0	1750.8

1/ Growth rate in dollar terms.

Annex 2.8

South Eastern Europe - Selected Indicators Table 1/

	<i>Actual</i>			<i>Estimate</i>	
	1995	1996	1997	1998	1999
Part A: Main Macro Aggregates					
<i>Annual growth rates, calculated from constant 1999 price data</i>					
GDP (mp) per capita	..	7.4%	-1.0%	-0.3%	..
Total consumption per capita	..	4.5%	-3.3%	0.9%	..
GDP at market prices	6.9%	6.2%	-0.5%	-0.8%	-1.2%
Total consumption	..	2.9%	-2.9%	..	..
Private consumption	..	..	..	..	..
Gross domestic investment (GDI)	..	14.8%	9.5%	..	..
Gross dom. fixed investment (GDFI)	..	..	..	..	..
Exports (GNFS) 2/	..	8.0%	4.6%	0.7%	-3.0%
of which Goods 2/	..	6.1%	3.0%	3.7%	-2.4%
Imports (GNFS) 2/	..	10.6%	3.3%	1.6%	-10.2%
of which Goods 2/	..	10.2%	3.9%	2.3%	-7.5%
<i>Savings-investment balances, as percentage of GDP</i>					
Gross Domestic investment	20.5%	22.0%	22.9%	20.1%	18.3%
of which Government investment	4.2%	5.3%	4.9%	4.7%	3.8%
Foreign savings	5.5%	6.8%	7.9%	7.9%	6.4%
Gross national savings	15.0%	15.2%	15.0%	12.1%	11.8%
Government savings	..	-0.2%	1.9%	2.3%	2.2%
Non government savings	..	15.3%	13.1%	9.8%	9.6%
Gross domestic savings	10.7%	11.4%	11.9%	10.1%	10.6%
<i>Other</i>					
GDP inflation	27.1%	37.1%	203.5%	27.5%	28.0%
Part B: Government Finance Indicators					
<i>Percentage of GDP</i>					
Total revenues	..	37.1%	36.9%	40.1%	41.6%
Total expenditures	..	41.8%	38.5%	41.3%	43.5%
Deficit(-)/Surplus(+)	..	-4.7%	-1.7%	-1.2%	-1.9%
Part C: Debt & Liquidity Indicators					
<i>Total DOD and TDS</i>					
DOD (US\$ millions)	26008	29562	32013	32848	32912
DOD / GDPmp ratio	37.1%	42.2%	43.9%	39.9%	42.2%
TDS (US\$ millions)	..	..	..	5021	6239
TDS / exports (XGS) ratio	..	..	..	17.9%	23.1%
Total gross reserves (months' imports G&S)	2.5	2.5	3.6	3.5	3.6
Part D: External Financing Plan					
<i>(US\$, millions)</i>					
Official capital grants	360	1087	715	835	712
Private investment (net)	683	2742	3773	3517	3657
Long term disbursements excl IMF	2164	3457	4675	4759	4031
Adjustments to scheduled debt service	489	-92	200	170	80
All other capital flows	-353	-1564	-203	-2268	-2221
Financing Requirements (incl IMF)	4525	5256	9093	6070	6260
of which current account deficit	3849	4919	5663	6437	4942

1/ Country data were weighted by 1998 Atlas estimate of GNP. The weights are: Albania 0.038; BiH 0.055; Bulgaria 0.142; Croatia 0.290; Macedonia 0.036; Romania 0.439.

2/ Growth rate in dollar terms.

3. TRADE INTEGRATION FOR SOUTH EASTERN EUROPE IN THE CONTEXT OF THE STABILITY PACT

A. INTRODUCTION

3.1 Trade integration must be an important and, based on past experience in Europe and elsewhere, probably the leading component of the broader, longer term integration of the countries of South Eastern Europe (SEE) into EU structures as called for by the Stability Pact. These countries are so small that their development depends critically on international trade and access to the European market, which typically accounts for more than 50 percent of their exports.²⁰ Trade integration is also essential to reduce the dependence of these countries on aid from Europe and the international community.

3.2 This long-term vision of regional cooperation and eventual integration with the EU contrasts sharply with present reality. Trade relations in the countries of the region are characterized by a variety of restrictions and impediments to trade with each other and with the rest of the world. Moreover, relations with the EU are shaped by a variety of different bilateral trade arrangements which reflect the different state of play of bilateral relations of these countries with the EU. These range from “Europe” agreements with Bulgaria and Romania—which have recently been invited to initiate negotiations for full EU membership—to Cooperation Agreements with FYR Macedonia and Albania, to lack of contractual relations with Bosnia and Herzegovina, Croatia and FRY.

3.3 This Chapter outlines **a strategy for moving towards fuller trade integration of the SEE countries with the EU**. It addresses trade relations among these countries, between these countries and the rest of the world, and in particular between these countries and the EU. In the latter case, it explores various alternatives which take into account the situation in individual countries and the perspective of EU membership. The focus is on five SEE countries (SEE-5, Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia and FRY) and on the economic aspects, although it is recognized that both the prime motivation and the end objective of trade integration may be political rather than economic.

3.4 In this light, it should be stressed that there are many institutional capacity and trade policy constraints in SEE countries which need to be urgently addressed, irrespective of the prospects of integration with the EU. For example, reforms which

²⁰ See Daniel Gros, *An Economic System for Post War South Eastern Europe*, CEPS, May 19, 1999.

result in lower and more uniform protection, exclusively through tariffs, or increase their supply capacity to export would yield very significant benefits to the SEE countries. Because of their relatively small size and the low level of trade and investment links with the rest of the world, these economies would also greatly benefit from increased external demand for their products, and from the learning and innovation that are associated with higher levels of foreign investment. Integration in international trade with the rest of the world, including through membership in the WTO, should be actively pursued. Naturally, the EU would be the main source of increased external demand as well as foreign investment, as it already is, because of geographical proximity, size and openness.

3.5 There is also little doubt that intra-regional trade can expand and be a stimulus for growth, even though the economic structures of some of the countries are quite similar, leaving less room for obvious increased trade opportunities based on structural complementarities. The size of the economies and markets of South Eastern Europe suggest that the stimulus would be far smaller than the stimulus provided by closer integration with the EU and should not be seen as an alternative to EU integration; but progress in intra-regional integration is needed both for its direct economic benefits and the contribution it makes to the wider political integration of these countries. At the same time, increased intra-regional trade should not imply the re-establishment of some of the economic links that existed under the former Yugoslavia—which would be neither desirable nor feasible.

B. TRADE PATTERNS

3.6 Trade plays a varied role in the SEE economies, with trade/GDP ratios ranging from a high of 91 percent in FYR Macedonia and Bulgaria, to a low of 30 to 40 percent for Albania and FRY (see Table 3.1). In terms of aggregate size of the trade sector, there is a big divide between Bulgaria, Romania, Croatia and FRY on one hand, and the much smaller and poorer Albania, Bosnia and Herzegovina, and FYR Macedonia, on the other.

3.7 The EU is the biggest trading partner for all SEE economies, ranging from just under 90 percent of exports in the case of Albania to around 46 percent in the case of Croatia (Table 3.2). On the other hand, **all of these economies together** account for a very small fraction, 1.6 percent of EU imports from and 4.4 percent of exports to third countries. These countries are simply not major markets for EU exporters and are even less important as competitors to EU industry and agriculture. Excluding Bulgaria and Romania they account for less than 1 percent of extra EU imports—and of course much less of the EU market, if EU production and intra-EU trade are included.

Table 3.1: Trade Openness: 1998 (in %)

	$X + M / GDP$
Albania	34
BiH	83
Bulgaria	91
Croatia	61
FRY (1997)	40
FYR Macedonia	91
Romania	58

Source: World Bank staff estimates.

3.8 But these indicators, as well as others involving trade performance, must be interpreted with considerable caution because of the following factors: (a) trade totals are distorted by conflicts and trade blockades against FRY, and strained relations between FRY and Croatia; (b) there is considerable evidence of unrecorded trade flows between some countries and regions; (c) some import categories (e.g., agricultural products) have been constrained by EU quantitative import restrictions.

3.9 Intra-regional trade is on average small, 12 to 14 percent of the total (Table 3.2). But this average conceals very wide variations: trade can be very substantial between two specific countries or regions, e.g., Croatia with parts of Bosnia and Herzegovina (over 30 percent); and FYR Macedonia with almost all countries in the region (Table 3.2). Some portions of this trade are unrecorded, for example between Republika Srpska (RS) and FRY. In contrast, there may be almost no trade between some countries for political or other reasons, for example between Croatia and FRY, or Albania and Croatia.

3.10 Detailed information on the commodity composition of trade is currently available only regarding SEE trade with the EU. Exports of SEE countries to the EU tend to be concentrated in five sectors: agricultural and related processed products, textiles and clothing, iron and steel, wood products and shoes (Table 3.3). Only in four of these categories—iron and steel, textiles, shoes and wood products—do these exports account for more than 1 percent of EU imports from all sources (See Tables 3.3 and 3.4).

3.11 Exports of textiles are important to all countries: the share in exports ranges from 18 percent in the case of FRY to 39 percent for FYR Macedonia. Around 65 percent of Albania's exports to the EU are accounted for by textiles and shoes. But some of countries, e.g., Bulgaria and Croatia, have a more diversified export structure.

Table 3.2a: Direction of Trade Flows of the SEEC-7, by Major Partner, 1998 in Million U.S. \$

	<i>Albania</i>	<i>BiH</i>	<i>Bulgaria</i>	<i>Croatia</i>	<i>FRY</i>	<i>FYROM</i>	<i>Romania</i>	<i>SEEC-7</i>
	\$	\$	\$	\$	\$	\$	\$	\$
Imports								
Industrial countries	707	1133	2418	5616	2042	1192	7637	20744
Europ. Com.	683	1048	2019	4586	1878	1089	6535	17839
Partner 1	334	372	631	1616	652	297	2039	
Partner 2	211	297	356	1500	588	285	2033	
Partner 3	68	124	289	401	228	184	810	
Other countries	25	85	398	1030	165	102	1101	2905
SEECs & Slovenia	60	1096	155	959	449	597	174	3490
Albania			0	1	0	5	0	6
BiH			0	156		1	11	169
Bulgaria	27	11		9	94	107	47	295
Croatia	7	719	5		0	65	4	800
FRY	1		37	0		236	5	279
FYROM	15	1	38	56	125		61	295
Romania	5	15	57	15	117	7		216
Slovenia	6	350	18	722	113	177	46	1431
Other countries	97	296	1956	1324	95	275	3866	7910
Total	864	2525	4528	7899	2587	2064	11677	32145
Exports								
Industrial countries	239	268	2304	2360	972	786	5745	12673
Europ. Com.	226	253	1946	2024	941	617	5101	11107
Partner 1	150	111	531	816	367	266	1809	
Partner 2	33	93	443	767	335	135	1587	
Partner 3	21	22	373	102	70	44	476	
Other countries	14	15	358	336	31	169	644	1566
SEECs & Slovenia	8	195	312	1121	340	271	267	2513
Albania			25	6	1	13	4	49
BiH			10	654		1	14	715
Bulgaria	0	0		5	37	34	78	118
Croatia	1	142	7		0	51	15	215
FRY	0		94	0		125	117	336
FYROM	4	1	97	59	236		7	404
Romania	0	10	51	7	5	4		77
Slovenia	2	42	29	390	61	43	33	599
Other countries	7	33	1448	941	**	135	2116	4681
Total	254	497	4064	4421	1312	1192	8128	19867

Source: IMF Direction of Trade.

* Figures in italic for regional trade for FRY are estimated using non-adjusted partner data.

** The total for exports from FRY does not include exports for developing countries.

Table 3.2b: Direction of Trade Flows of the SEEC-7, by Major Partner, 1998 in %

	<i>Albania</i>	<i>BiH</i>	<i>Bulgaria</i>	<i>Croatia</i>	<i>FRY</i>	<i>FYROM</i>	<i>Romania</i>	<i>SEEC-7</i>
	%	%	%	%	%	%	%	%
Imports								
Industrial countries	81.9	44.8	53.4	71.1	78.9	57.7	65.4	64.5
Europ. Com.	79.0	41.5	44.6	58.1	72.6	52.8	56.0	55.5
Partner 1	38.7	14.7	13.9	20.5	25.2	14.4	17.5	
Partner 2	24.4	11.8	7.9	19.0	22.7	13.8	17.4	
Partner 3	7.9	4.9	6.4	5.1	8.8	8.9	6.9	
Other countries	2.8	3.3	8.8	13.0	6.4	5.0	9.4	9.0
SEECs & Slovenia	6.9	43.4	3.4	12.1	<i>17.4</i>	28.9	1.5	10.9
Albania			0.0	0.0	<i>0.0</i>	0.2	0.0	0.0
BiH			0.0	2.0		0.1	0.1	0.5
Bulgaria	3.1	0.4		0.1	3.6	5.2	0.4	0.9
Croatia	0.8	28.5	0.1		<i>0.0</i>	3.1	0.0	2.5
FRY	0.1		0.8	0.0		11.4	0.0	0.9
FYROM	1.7	0.0	0.8	0.7	<i>4.8</i>		0.5	0.9
Romania	0.6	0.6	1.3	0.2	<i>4.5</i>	0.4		0.7
Slovenia	0.6	13.9	0.4	9.1	4.4	8.6	0.4	4.5
Other countries	11.3	11.7	43.2	16.8	3.7	13.3	33.1	24.6
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Exports								
Industrial countries	94.0	54.0	56.7	53.4	74.1	65.9	70.7	63.8
Europ. Com.	88.8	50.9	47.9	45.8	71.7	51.8	62.8	55.9
Partner 1	58.9	22.3	13.1	18.4	28.0	22.4	22.3	
Partner 2	12.8	18.8	10.9	17.3	25.5	11.4	19.5	
Partner 3	8.3	4.5	9.2	2.3	5.3	3.7	5.9	
Other countries	5.5	3.0	8.8	7.6	2.3	14.2	7.9	7.9
SEECs & Slovenia	3.0	39.3	7.7	25.3	25.9	22.8	3.3	12.6
Albania			0.6	0.1	<i>0.1</i>	1.1	0.1	0.2
BiH			0.2	14.8		0.1	0.2	3.6
Bulgaria	0.0	0.1		0.1	2.8	2.9	1.0	
Croatia	0.3	28.6	0.2		<i>0.0</i>	4.2	0.2	1.1
FRY	0.2		2.3	0.0		10.5	1.4	1.7
FYROM	1.7	0.2	2.4	1.3	<i>18.0</i>		0.1	2.0
Romania	0.1	2.0	1.3	0.2	<i>0.3</i>	0.3		
Slovenia	0.7	8.4	0.7	8.8	4.7	3.6	0.4	3.0
Other countries	2.9	6.7	35.6	21.3	**	11.3	26.0	23.6
Total	100	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: IMF Direction of Trade.

* Figures in italic for regional trade for FRY are estimated using non-adjusted partner data.

** The total for exports from FRY does not include exports for developing countries.

Table 3.3 Commodity Composition of SEE exports to the EU in 1998
In Thousand ECU and as % of Total

	<i>Albania</i>		<i>BiH</i>		<i>Bulgaria</i>		<i>Croatia</i>	
TOTAL	21610		24580		222410		182357	
of which		%		%		%		%
<i>Agriculture</i>	2146	9.9	5211	2.1	24032	10.8	5783	3.2
<i>Textile</i>	7607	35.2	8292	33.7	58940	26.5	50879	27.9
<i>Footwear</i>	6398	29.6	4009	16.3	10559	4.7	15493	8.5
<i>Iron and Steel</i>	1201	5.6	8992	3.7	32067	14.4	1302	0.7
<i>Wood</i>	7459	3.5	4024	16.4	5598	2.5	16525	9.1
Total of the above	18098	83.8	17747	72.2	131198	59	89984	49.3
<i>Other</i>	3511	16.2	6833	27.8	91211	41	92373	50.7

	FRY		FYROM		Romania		Total SEE-7	
TOTAL	106412		59586		512950		1129907	
of which		%		%		%		%
<i>Agriculture</i>	14380	13.5	5578	9.4	14829	2.9	67277	6.0
<i>Textile</i>	18614	17.5	23421	39.3	196465	38.3	364238	32.2
<i>Footwear</i>	4241	4	2184	3.7	56498	11	99391	8.8
<i>Iron and Steel</i>	20383	19.2	13994	23.5	40720	7.9	110576	9.8
<i>Wood</i>	4502	4.2	9202	1.5	12922	2.5	45244	4.0
Total of the above	62123	58.4	46098	77.4	321436	62.7	686727	61.8
<i>Other</i>	44288	41.6	13487	22.6	191514	37.3	443179	39.2

Source: Database COMEXT, European Commission.

Table 3.4: Composition of EC Imports from SEE Countries
In % of Total EC Imports by Sector

	<i>Albania</i>	<i>BiH</i>	<i>Bulgaria</i>	<i>Croatia</i>	<i>FRY</i>	<i>FYROM</i>	<i>Romania</i>	<i>Total SEE-7</i>
TOTAL (%)	0.03	0.03	0.31	0.26	0.15	0.08	0.72	1.59
<i>of which</i>								
<i>Agriculture</i>	0.04	0.01	0.40	0.10	0.24	0.09	0.24	1.11
<i>Textiles</i>	0.13	0.14	1.02	0.88	0.32	0.40	3.39	6.29
<i>Footwear</i>	0.91	0.57	1.51	2.21	0.61	0.31	8.08	14.21
<i>Iron and Steel</i>	0.10	0.08	2.77	0.11	1.76	1.21	3.51	9.54
<i>Wood</i>	0.07	0.36	0.50	1.49	0.41	0.08	1.16	4.07
<i>Other</i>	0.01	0.01	0.16	0.16	0.08	0.02	0.34	0.79

Source: Database COMEXT, European Commission.

C. TRADE POLICIES AND INSTITUTIONS

SEE Trade Policies and Institutions²¹

3.12 Trade patterns in SEE countries are a reflection of current capacities and trade policies, as well as other factors, such as continuing ethnic conflicts and uneven progress in introducing broader market reforms. Trade policies vary considerably, but they are characterized by significant levels of protection, differentiated tariff structures—resulting in high effective rates of protection—and differing levels of access for different trading partners (Box 3.1).

Box 3.1: Trade Policy in SEE Countries

Simple average tariff levels are in the range of 12-16 percent in Albania and Croatia and somewhat higher in FYR Macedonia, but there is tariff escalation resulting in substantial effective protection. In addition, there are specific duties for a number of agricultural products (Croatia); licensing (Croatia and FYR Macedonia); and surrender of export receipts (FYR Macedonia).

- **Bosnia and Herzegovina** has a lower average external tariff rate (7 to 8 percent), but the tariff schedule is highly disaggregated, leaving the potential for protectionist practices. There are still substantial differences in tax policies and limited official crossing points between the Federation and RS, resulting in de facto restrictive trade practices as well as smuggling between the two entities.
- **Bulgaria's** trade regime is relatively liberal with average import weighted MFN tariffs of 9 percent and 21 percent for industrial and agricultural products respectively. Moreover, these are scheduled to be reduced over time.
- **Romania's** tariff structure is less liberal, with applied, trade weighted tariffs averaging over 11 percent for industrial products and 28 percent on agricultural products. This is even after substantial decreases agreed under the World Bank's Agricultural Sector Adjustment Loan.
- **FRY** had significant trade and foreign exchange restraints even before the Kosovo conflict as a result of slow progress in introducing market reforms, and appears to have even more controls now.
- The **Kosovo** conflict has resulted in further trade dislocation—in particular in the trade between FYR Macedonia and FRY. The de facto establishment of a different tax regime in the province has also affected the flows of commodities and services between Kosovo and other parts of FRY, FYR Macedonia and Albania.²²
- Some of the countries that emerged from former Yugoslavia have established bilateral free trade arrangements with each other, but this is not the case for all. Croatia has a free trade agreement with Slovenia, and FYR Macedonia; FRY has an agreement with FYR Macedonia; FYR Macedonia with Slovenia and Bulgaria. But none of these agreements have been 'multilateralized', i.e., they involve different sets of preferences over different periods with varied product coverage and unclear long-term objectives for each of the different countries involved; and they would not appear to be consistent with WTO Article 24 requirements.

²¹ The basic source of information for this section (except for Bulgaria and Romania) is the Trade Development Institute (TDI), *Study on Trade Policy in South Eastern Europe*, September 1999, and the *Second Report on Economic Relations Between the Countries of South-Eastern Europe Concerned by the EU's Regional Approach*, Commission Staff Working Paper, 1998.

²² The FYR Macedonia/FRY Free Trade Agreement still applies to Kosovo.

3.13 All countries, and especially the poorest, show significant weaknesses in trade-related institutional capacity. This includes tax administrations which rely too heavily on customs revenues; customs services that are weak and ineffective; inadequate physical and financial infrastructure to support trade; and weaknesses in ministries and agencies entrusted with the implementation of trade policy.

3.14 **WTO membership** varies. Bulgaria and Romania are already members. Croatia and Albania are at late stages of negotiations for WTO accession, while Bosnia and Herzegovina and FYR Macedonia are only at the beginning. The WTO has not acted on FRY's application for accession. Thus, SEE countries face a variety of challenges for more effective integration in international trade at all three levels, intra-regional, with the EU and with the rest of the world.

3.15 While information available at this point does not permit a quantitative assessment of the impact on growth of existing policy induced and other restraints to trade, some qualitative judgements are possible. For example, since these economies are on the whole quite small, they would be expected to rely on and benefit a great deal from international trade. Yet, the existing levels and patterns of protection appear to be high (with some exceptions, e.g., Albania, Bulgaria) in comparison with countries of a similar size and level of development,²³ resulting in significant distortions and economic costs. Reducing these levels of protection should therefore receive high priority in any future strategy to integrate these economies into the EU. Another important issue to be addressed is how the existing complex trade distorting pattern of bilateral preferences, can be simplified and made multilateral. Finally, trade related institutional capacity of the countries in the region should be strengthened to permit them to design and implement trade policy and related reforms.

Trade Relations Between EU and SEE

3.16 The EU has established a variety of bilateral trade relations with SEE countries. In each case, the content and nature of the agreements varies. For Bulgaria and Romania, existing 'Europe Agreements' aim at establishing a free trade area and foresee a gradual liberalization of trade restrictions by both parties. In the case of the non-associated countries, the EU provides Bosnia and Herzegovina, Croatia, FYR Macedonia and Albania, wide-ranging unilateral trade preferences which in substance go back to the former Cooperation Agreement between the EC and the former Yugoslavia (denounced by the EC in 1991). The main features of these agreements are summarized in Box 3.2.

3.17 The existing agreements are characterized by a more favorable treatment of industry than agriculture, and by uncertainty because of "managed" trade provisions. In fact, these provisions target a significant portion of SEE-5 exports; and, when quotas on these exports are exceeded, they may result in the application of tariffs—on a mandatory basis in the case of agricultural products, or on a discretionary basis in the case of industrial products.

²³ See C. Michalopoulos, *Trade Policy and Market Access Issues for Developing Countries*, World Bank Policy Research Working Paper # 2214, October 1999.

Box 3.2 : Trade Agreements Between the EU and SEE Countries

The agreements with Bulgaria and Romania—who have been invited to initiate negotiations for full EU membership at the Helsinki European Council summit in December 1999²⁴—provide for free trade in manufactures (with exceptions and limitations in some specific sectors e.g., steel) with a variety of transition periods (asymmetric between these countries and the EU); and some more limited specific preferential arrangements for agricultural products.

The concessions to Bosnia and Herzegovina, Croatia as well as Albania (on a separate basis and for different products) are made on the basis of autonomous trade preferences (ATPs); while for FYR Macedonia they are granted “on a contractual basis in the framework of a bilateral cooperation agreement”, but also involve unilateral preferences.²⁵ The ATPs and the contractual agreement with FYR Macedonia contain preferences covering both industrial and agricultural products. As a general rule, industrial products are admitted duty free with no quantitative restrictions, within the limits of tariff ceilings for certain industrial products (including *inter alia* iron and steel). Textiles and clothing products are subject to various treatments: Bosnia and Herzegovina and Croatia have duty free quotas as part of the worldwide EU Generalized System of Preferences (GSP); Albania has ceilings within its ATP regime, while FYR Macedonia has unrestricted duty free access. Some agricultural products benefit from duty free treatment and others are subject to duty free quotas or reduced customs duties (processed agricultural goods).

3.18 While exceptions from free trade in the ATPs and the FYR Macedonia agreement cover only a relatively small number of products (5 to 20 percent of the tariff lines), the products involved tend to be important exports for the SEE countries. For example, in the case of Albania only 5 percent of products (by tariff line) are subject to “managed” trade; but this represents 62 percent of exports to the EU. In Bosnia and Herzegovina, Croatia and FYR Macedonia, whose coverage is very similar, the 9 to 12 percent of the “managed” products accounted for 26 to 43 percent of their exports. These shares would be even larger, if products subject to ‘surveillance’ were included.²⁶

3.19 ‘Management’ of trade by the EU differs as between agriculture and industry: in the case of the former, when quotas are exceeded, tariffs are automatically reintroduced; in the case of the latter, they are reintroduced on a case by case basis, only at the request of an EU member. It appears that quotas have been exceeded for very few agricultural products, while among industrial products, only in iron and steel—and in that instance, duties were reintroduced only when the quotas were exceeded tenfold. Thus, according to Commission estimates, perhaps as much as 80-90 percent of SEE-5 exports enter the EU duty free.

3.20 There are several different economic reasons why these SEE countries are far from filling their quotas for most products. Firstly, quotas may be quite generous. If so,

²⁴ Subject to their meeting certain conditions, see Prodi, October 1999.

²⁵ The discussion of EU relations with SEE countries in this section (except for Bulgaria and Romania) is based on the discussion paper prepared by the European Commission “Trade Relations between the European Community and Southeastern Europe” prepared for the meeting of the Economic Working Table, October 8, 1999.

²⁶ See TDI, 1999, *cit.*

the economic question is why do they exist at all. Alternatively, the existence of quotas could be an inhibiting factor on exports, which would be higher in their absence. Or, there might be significant supply constraints in these economies at present, which, if relieved, could result in substantial export expansion. Further detailed analysis would be needed to reach more conclusive judgement about the precise protective effects of current EU policies in the region. However, it would appear that while duty free access may already be substantial, there is still some room for improvement.

3.21 The Council has recently authorized the Commission to negotiate a Stabilization and Association Agreement (SAA) with FYR Macedonia. This is a new type of association agreement which aims to establish a Free Trade Agreement over a period of maximum ten years involving asymmetric liberalization based on improved EU preferences and conditioned on FYR Macedonia actions in support of structural adjustment (see Box 1.2) The agreement envisages, *inter alia*, special protocols in textiles, iron and steel, and processed agricultural products, as well as a commitment to product by product discussions of agricultural and fishery products to determine the scope of further concessions on a reciprocal basis. The agreement will also require FYR Macedonia to start negotiations towards the conclusion of a free trade arrangement with any country with which the EU signs an SAA in the future. The Commission is also considering the feasibility of an SAA for Albania.²⁷

3.22 The implication of this approach is that, as the EU signs individual SAAs with the SEE-5 countries, over time, the countries themselves would be linked through free trade arrangements with each other. In another recent paper the Commission also recommended that Union membership be conditional upon, among other things, “the establishment of a regional organization for free trade and economic cooperation as a basis for closer integration into the Union”; and that the “SAAs should make association status conditional upon membership of that organization”.²⁸ Finally, in a speech to the European Parliament, Commission President Prodi suggested that longer-term integration could be achieved through a free trade area “leading to a customs union which would later merge with the EU’s customs union as a first step towards accession”.²⁹

3.23 The issues that would need to be resolved in a strategy for the integration of SEE-5 countries into the EU would include:

- (a) the kind of preferential relationship the EU establishes with the SEE-5 countries, including the time frame, scope and nature of preferences provided;
- (b) whether a region-wide agreement or individual bilateral agreements are negotiated. If the former, which countries might be involved; if the latter, the degree of similarity and links between the various agreements; and

²⁷ See Commission of the European Communities, *On the feasibility of Negotiating a Stabilization and Association Agreement with Albania*, COM 599, Nov. 24, 1999.

²⁸ European Commission, *Composite Paper of the 1999 Regular Reports*, 13 October 1999 p. 37.

²⁹ Speech by Mr. Romano Prodi, President of the European Commission to the European Parliament on Enlargement, Brussels, October 13, 1999.

- (c) the relationship between such agreement(s) and those that have been negotiated with some other countries in the Stability Pact (e.g., the Europe Agreements with Bulgaria, Romania, Slovenia).

3.24 As with other aspects of the strategy, there are important economic and political aspects of these issues. The analysis below will focus on the economic ones.

D. ELEMENTS OF A STRATEGY FOR TRADE INTEGRATION

3.25 The current state of trade relations—discriminatory, variable, and sometimes high protection in SEE countries and a network of EU bilateral preferential agreements with variable coverage and limitations—is a long way from the ultimate goal of SEE countries of full trade integration with the EU. The end objective is integration of the SEE countries in to the European structures as envisaged by the Stability Pact and in keeping with the vision articulated by Commission President Prodi. There is no single or simple way of moving towards this end objective. This paper outlines a possible approach to meeting the overall objective of full trade integration. The approach envisages a coordinated integration process in two phases with a review in the middle that would permit a review of progress made and allows for further integration to the EU to be well tailored to the situations in individual countries.

3.26 **First phase.** The main elements of the first phase (lasting 2 to 3 years) for the SEE countries would be:

- (a) a gradual, but general liberalization **of all trade**, supported by the World Bank and possibly the IMF; and
- (b) **regarding regional trade partners**, elimination of administrative barriers to trade, a standstill on new measures of any kind that restrict such trade, and the beginning of the multilateralization of existing bilateral trade preferences to other countries in the region.

3.27 **For the EU**, the main element during the **first phase** would be the early conclusion of coordinated bilateral agreements with the SEE-5 countries (taking into account the evolution of the political situation in FRY) which would provide with improved access to EU markets, but also stimulate regional integration. These bilateral agreements—asymmetric FTAs or autonomous trade preferences (ATPs)—would need to take into account the separate paths to integration with the EU already decided upon with respect to other Stability Pact countries (Bulgaria, Romania, Slovenia) so as to establish a consistent economic framework covering all SEE countries.

3.28 **Review.** During the review at the end of the first phase, **the EU** may wish to decide among various options for future relations with the SEE-5 countries. These decisions will of course need to be tailored to the situation of the individual countries. The decisions taken might include the following:

- (a) which countries would simply continue towards implementing the FTA.³⁰
- (b) which, if any, to invite to negotiations for EU accession, with the perspective of them meeting the Copenhagen criteria before eventual entry;
- (c) which, if any, to invite to negotiations towards the future establishment of a customs union on the way to fuller integration with the EU.

3.29 **Second Phase.** During the second phase, the SEE-5 countries will need to establish a full-fledged Free Trade Area with the EU and among each other. In some cases, this may lead directly to full association with the EU; in others, a customs union may be an intermediate step. In both cases, countries will need to implement a convergence of their external tariff to that of the EU; in addition, they would have to make progress in aligning economic policies and institutions in other areas needed to make a customs union and/or fuller integration effective; while the EU will need to progressively eliminate remaining restrictions on imports from these countries according to timetables to be negotiated.

3.30 All the dates for the different phases suggested below are solely indicative of what may be technically possible to achieve in institutional and policy reforms as well as in the signing of agreements, in light of the urgency of moving forward with trade integration. Naturally, all these dates would have to be adjusted if—for political or other reasons—the implementation of reforms or the signing and implementation of the agreements are delayed for some country.

Phase I: 2000-3[4]

SEE Countries

3.31 There is little doubt that current trade regimes in several SEE countries need to be urgently reformed with the aim of providing lower and more uniform protection, exclusively through tariffs. Establishing a relatively uniform tariff range of 5 to 10 percent, with as few exceptions as possible (mostly in agriculture) and a low ceiling, is an important priority that should be adopted by all SEE countries. A flat rate for all products, say at 5 or 10 percent is the least distortionary. But even two to three rates will be an improvement over the current situation.

³⁰ Assuming they have signed an FTA with the EU during the first phase. Otherwise, they may still have only an ATP arrangement—with no direct prospects for further integration (see below).

3.32 With that objective in mind, SEE governments should develop phased plans for implementing trade reforms in pre-announced steps over the next 2 to 3 years. Such plans would need to take into account the social impact of the trade reforms as well as their fiscal revenue implications. Regarding the latter, there is no presumption that a lower, and flatter tariff structure with few exemptions would yield lower revenues—especially if there is a parallel effort to improve customs administration. Governments should be encouraged to design and implement trade reforms with the assistance of the EU, the IFIs and other members of the Stability Pact. Unless there is proper ‘ownership’ of these reforms by the governments and civil society, they are not likely to be effectively implemented. While the focus of these reforms should be the SEE-5 countries, the trade capacities and policy regimes in the other Stability Pact countries in the region could also be strengthened.

3.33 A key question in implementing these reforms is whether they will be regionally coordinated and whether they will involve regional trade preferences. A strong argument in favor of a coordinated approach is that it could reduce incentives to smuggling and corruption. In fact, the presence of high tax/trade controls in one country with limited enforcement capabilities together with a more liberal trade regime in a neighbor can create powerful incentives for smuggling and corruption. This situation can be avoided through coordinated trade reforms in the region, involving coordinated reductions in tariffs and trade restrictions. If such coordination can be achieved, subsequent movement to a common external trade policy (including that of the EU) will be facilitated.

3.34 Trade integration among countries in the region has been significantly constrained by a variety of factors. There are sharp political divides between several countries (and within some others) in the region, resulting in the fragmentation of preferential arrangements and the interruption of trade. There are institutional weaknesses and inadequacies in infrastructure. Moreover, the economic structures of some of the countries are quite similar, leaving less room for obvious increased trade opportunities based on structural complementarities. There is little doubt however, that intra-regional trade can expand and be a stimulus for growth. The size of the economies and markets involved suggests that the stimulus would be far smaller than the stimulus provided by closer integration with the EU and should not be seen as an alternative to EU integration. But progress in intra-regional integration is needed both for its direct economic benefits and the contribution it makes to the wider political integration of these countries.

3.35 Progress toward the establishment of a free trade area will also impose significant demands on the customs services of SEE countries. The implementation of rules of origin will in fact be very difficult given prevailing institutional limitations. Thus, the implementation of a free trade, preferential arrangement among most or all the SEE countries will require not only the inducement of improved EU access, but also significant technical assistance to strengthen the capacity of customs.

3.36 Progress in this area—as necessary for its direct benefits and its contribution to the wider objectives of the Stability Pact—will require that steps are taken in the immediate future to strengthen trade relations among these countries, including as a minimum the following—some of which could be key priorities for the recently formed Working Group on Elimination of Trade Barriers among the SEE countries:

- (a) **Elimination of obstacles to intra-regional trade** such as de facto administrative controls in the movement of goods or services. A systematic identification of these should be a high priority task.
- (b) **A standstill** regarding any measure affecting **imports or exports which restrains trade within the region.**
- (c) **Converting existing pairs of bilateral trade preferences into multilateral ones:** i.e., if both Slovenia and Croatia have a bilateral free trade agreement with each other as well as with FYR Macedonia, all the preferences extended to each country by each partner should be made available to all; the agreements should be made WTO compatible in light of these governments' current or imminent membership in the Organization.
- (d) **Strengthening customs administration** through technical assistance and investments.
- (e) **Regional cooperation**, in support of projects such as the Trade and Transport Facilitation project to be undertaken by the World Bank (see Box 7.1)

3.37 These measures could be expanded and strengthened through the development of ties between these countries with the EU, and linking SAAs as envisaged by the EU in the case of FYR Macedonia (see below).

The European Union

3.38 At the same time as the SEE countries undertake the trade reform outlined in the previous section, and in parallel to this effort, the EU should develop a **new, coordinated approach**, which would lead, over time, to the integration of the **SEE-5** countries in the European structures. The approach could help to integrate the countries into the EU as well as with each other. It should be coordinated with parallel negotiations that other Stability Pact countries (Bulgaria, Romania, Slovenia) are pursuing for integration into the EU. It is critical to the success of the Stability Pact. While it is difficult to provide at this point quantitative estimates of the actual gains in terms of economic growth these countries can achieve through EU integration, it is hard to visualize any scenario under which these countries are economically stable and prosper without substantial economic integration with the EU.

3.39 The main need for the EU during this early phase is to establish **strongly coordinated and virtually identical bilateral trade arrangements** with Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, as well as FRY, when political circumstances permit. There are two key challenges: (a) how to take into account of the differing levels of development (and political factors) in the countries involved, while maintaining a common framework for trade preferences; and (b) how to relate integration of these five countries to the EU to that of the broader group of SEE countries in the Stability Pact (Bulgaria, Romania) as well as other countries in the region (Slovenia) which have already an agreed path to EU accession.

3.40 There are various options regarding the kind of agreements that the EU might wish to establish: (a) they may be unilateral ATPs; (b) alternatively, they could be similar to the SAA proposed for FYR Macedonia. In terms of trade coverage, the form of the agreement, especially in its early phases may not matter much, as the SAAs involving asymmetric liberalization may not involve significant difference in terms of EU market access compared to enhanced ATPs.

3.41 There are, however, other advantages and disadvantages in each agreement. The ATPs may be simpler to design and implement. But the SAAs provide a more secure path towards future integration, and hence provide greater stimulus to foreign direct investment. SAAs may also be much better as vehicles for stimulating regional integration. And they would be consistent with the WTO, while ATPs will require a WTO waiver—which should not be difficult to obtain, however.³¹

3.42 While the SAAs may be more comprehensive and provide a more secure basis for longer-term integration, they take time to put in a place, while there may be some urgency to move forward expeditiously on trade issues. To do this, it may be possible to **implement** these new SAAs on an **interim basis, without waiting for full parliamentary ratification, thus having an impact on the region more quickly, provided** the countries are willing to commit themselves to the structural adjustment measures envisaged by the SAAs.

3.43 Whether trade arrangements between the EU and SEE countries will take the form of ATPs or SAAs, it will be easier—and politically less sensitive—to contract with each country separately, than to condition the agreements to the formal establishment of regional trade organization, as it has been suggested in a recent EU document.³² Indeed, establishing a regional trade organization may be undesirable because it would tend to reduce flexibility in the integration process for countries which are at different levels of development.

3.44 From the economic standpoint, virtually identical SAAs, negotiated with all countries at the earliest—say in 2000—and to be put in place by 2001, may be the optimal solution. On the other hand, if for essentially political reasons different agreements, ATPs and SAAs, are signed with different countries, the key concern is to ensure that they involve enhanced access to EU markets as well as similar product coverage and exceptions so as to avoid having to design and implement different rules and procedures for a large group of small countries. Indeed one could visualize a sequence in which a country is first offered an “enhanced ATP” package immediately, and moved to an SAA somewhat later.

3.45 Whatever arrangement the EU decides to propose, it would be helpful for the realization of the economic objectives of the Stability Pact if it contained the following common economic features:

³¹ Such a waiver request has already been introduced in the WTO for the existing ATPs and the FYR Macedonia agreement.

³² See Commission of the European Communities, *Composite Paper*, October 1999.

- First, whatever the nature of the formal agreement, the key question is how liberal are the preferences to EU markets it contains; while present access is substantial, there is some evidence that it could be improved in such areas as agriculture and steel. But it should be recognized that improved access, in sectors such as steel, might also need to be conditioned on SEE commitments to long term adjustment and reduced government support.
- As export structure in SEE countries is relatively similar, it would be less distortive from the economic viewpoint, as well as less demanding in its implementation, if exceptions involving separate protocols were kept to the absolute minimum, and a common list of product exceptions or limitations were introduced. It would be very hard to police different sets of exemptions for each of these small countries, given weaknesses in their customs administrations.
- Also, given the small size of the countries involved, sensitive EU sectors may be protected solely through surveillance rather than through the introduction of quotas; past EU experience has shown that quotas provided under previous agreements were rarely filled.³³ In such cases the quotas could be eliminated.
- If quotas were to be negotiated, it is economically better to have them apply to all the countries with which agreements have been signed as a group and not to individual countries separately. Country-specific quotas tend to provide each country with more security of access and thus may appear to ‘help’ a relatively less developed country, such as Bosnia and Herzegovina, but they reduce incentives to raise productivity and compete and hence are inimical to longer term integration efforts.³⁴
- All agreements signed would have a provision of linking them to the establishment of a free trade area among the countries with which these agreements have been signed.
- The EU may wish to integrate these countries into the system of Pan-European Diagonal Cumulating for purposes of determining rules of origin during this phase of the regional integration.
- While the adjustment faced by these countries in joining the EU is very substantial, consideration should be given to shortening the time frame over which an FTA is envisaged—from the currently proposed 10 years in the case FYR Macedonia to 5-6; and similarly to reduce the envisaged time frame (3 years) envisaged by the original Commission proposals over which these countries are expected to conclude agreements with their regional partners, to no more than one-two years. Long time frames sometimes result in

³³ See TDI, 1999, *cit.*

³⁴ It is, of course, recognized that with porous borders, global quotas can pose a problem, if it is the intention of excluding from EU access a particular country.

postponement of decisions to introduce reforms until the last possible moment.

3.46 In terms of overall access provided to the EU markets, these new agreements would also need to be coordinated with those offered to other countries in the Stability Pact (Bulgaria, Romania, Slovenia) that will be negotiating EU accession. Several issues would need to be addressed in this context:

- The **comparability of the preferences** provided to countries under the new agreements to those provided to the other countries under the earlier agreements. In this context, the most economically efficient option would be for all these countries to have the same exceptions, common quotas, etc. One can visualize Bulgaria and Romania not wishing to reopen these matters unless there was a clear indication that the EU would be prepared to improve the market access it was offering to all Stability Pact countries.
- The **linking of preferential arrangements**. EU should encourage (rather than discourage, as e.g., in the case of Slovenia's agreement with Croatia) the maintenance and future development of preferential arrangements among countries which are at various stages of integration with the EU, provided they fall into a common pattern rather than a complex set of bilateral arrangements and are fully compatible with the EU preference system at the time of their accession.³⁵ In this connection, consideration should be given to conditioning the new SAAs on the establishment of arrangements that promote regional trade with Bulgaria and Romania. Consideration should also be given to the possible future membership of SEE-5 countries in CEFTA, especially because such membership might be useful in securing the maximum benefit from the rules of origin in the system of the Pan-European diagonal cumulation.
- In all circumstances however, these countries would need to be assured that additional links with other SEE countries, in no way would delay their future accession prospects with the EU.

Other Members of the Stability Pact

3.47 Other members of the Stability Pact, besides the EU, would be encouraged to support the integration effort as well as enhance market access to exports from SEE countries by offering them preferential treatment in their markets. To the extent that such preferences are not part of a long-term free trade and association agreement, it may be necessary for governments to seek a WTO waiver for this purpose—but again that should not prove a serious obstacle.

3.48 Given the major deficiencies in the trade-related physical and financial infrastructures of the SEE countries and their demonstrated institutional weaknesses, which affect their capacity to trade, all members of the Stability Pact need to provide technical and other assistance to support SEE country efforts towards greater integration

³⁵ It is of course understood that when a country such as Slovenia becomes a member of the EU, it would have to adopt the EU external tariff and all other EU preferential arrangements.

in the world economy. Key areas where improvements are needed *inter alia* include: (a) overall tax administration (and reduced reliance on trade taxes); (b) improved customs performance; and (c) strengthening of regional transport infrastructure. The EU effort to strengthen the customs administrations in these countries is critical to future integration efforts. Similarly, the World Bank project on Trade and Trade Facilitation in South Easter Europe can provide impetus in this area by addressing administrative and infrastructural bottlenecks and thus make an important contribution to regional integration.

The World Bank

3.49 Given the large and inter-related needs to strengthen trade-related institutions in the SEE countries, other activities with region-wide scope will also be needed. The World Bank may be asked to play a role in helping coordinate these and other similar efforts in support of trade-related capacity building.

3.50 In addition, in the light of the World Bank experience in supporting trade reforms worldwide, it may usefully help support SEE country efforts to design and implement such reforms. Trade liberalization in these regimes would be useful both for these countries longer-term growth and for their long-term integration efforts with the EU almost irrespective of the nature of the specific shorter-term arrangements they conclude with the EU.

The Review: 2003[4]

3.51 At a predetermined date at the end of Phase I, it will be desirable to have a review of the overall progress the SEE-5 countries have made in political, economic and trade integration and to examine alternative paths for the future integration of individual countries to the EU. This is consistent with the provisions for mid-term reviews that existing or proposed EU free trade arrangements already contain.

3.52 The review, led by the EU, would need to determine: (a) the extent to which SEE-5 countries have met their commitments to trade reform and liberalization; (b) which, if any, countries have made sufficient progress in meeting broader political, economic and institutional criteria that would permit them to be judged as eligible for negotiations for full EU membership; (c) what additional steps—e.g., the formation of a customs union—might be appropriate for specific countries; and (d) specific problems and constraints faced by individual countries that require additional financial and technical assistance.

3.53 Depending on the findings of the review, some of the SEE-5 countries may be found to have satisfied the Copenhagen criteria, which would permit them to move forward as candidates for full EU accession. Others in the group which have liberalized their trade and otherwise met their commitments under their agreements with the EU, but do not satisfy the more stringent EU accession criteria, could at that point be offered the opportunity to start negotiations to establish, over time, a customs union with the EU, as an intermediate step before full integration. Still others may continue with the free trade area (assuming they have signed an SAA). The review would also be expected to make

recommendations to other members of the Stability Pact for further assistance to SEE countries in support of trade related capacity building and infrastructure.

Phase II: 2004[5]-

3.54 During this phase, the five SEE countries that are implementing a free trade area with the EU will have to take the following steps:

- Complete the implementation of a free trade area among each other—probably in advance of the implementation of the FTA with the EU. This involves extending duty free treatment to trade with each other for all or substantially all goods and services (consistent with the WTO provisions); as well coordinating policies and supports to agriculture, where the trade issues have to be addressed in the context of the Aggregate Measures of Support (AMS—as defined in the WTO agreements) provided to agriculture.
- Complete their domestic adjustment so as to fully implement a free trade area with the EU—at the end of the agreed period—which would vary by country. In implementing the FTA, the phasing of tariff reductions should be clearly predetermined balanced across sectors, (and not concentrated on early reductions in tariffs on raw materials and intermediates) so as to avoid increases in effective protection and related distortions and excess profits.
- Complete their domestic adjustment in agriculture so as to able to integrate the sector into the EU agricultural policy, keeping in mind that the latter provides far greater supports to the sector than these countries may be able to afford.
- Bring their overall policies and institutions in closer alignment with those of the EU in order to prepare for eventual integration. This would include the progressive realigning of their external tariff as well as their agricultural policies and supports to those of the EU.

3.55 In parallel, the EU would eliminate remaining restrictions on these countries exports to the EU market.

3.56 All donors continue, during this period, trade related technical and financial assistance to these countries, based in part on the recommendations of the priority areas identified during the Review.

3.57 Realignment of tariffs to those of the EU would need to proceed both for countries which are going to be involved in a customs union with the EU as well as all others wanting to integrate in the EU. The only difference is that those with which a customs union may be negotiated will have to do so at a predetermined and agreed pace and specific intervals. Also, establishment of a customs union with the EU (as well as a Free Trade Area) would require not only realignment of tariffs, but also of a variety of other policies affecting international competitiveness and trade and may itself take time to negotiate and implement—beyond the time that would be needed to implement a free trade area. Thus, in some respects and for some countries, the establishment of a customs

union with the EU on the way to full integration may be an inferior alternative to negotiating a free trade arrangement which leads directly to membership.

3.58 At the conclusion of the second phase, i.e., when the EU has completed the free trade arrangements with all SEE-5 countries, the EU will need to look again to determine which additional countries would be ready for further integration commitments. It could be expected that by the end of this period, countries that have effectively committed themselves to integration with Europe will have free trade with the EU and would either be EU candidates for full EU accession or in a customs union with the EU. Countries in the latter situation can, of course at a later date move to become candidates for full EU membership, once they meet the EU criteria. And all countries will have a free trade area with each other.

E. CONCLUSION

3.59 The strategy outlined in this chapter is not the only possible path towards fuller trade integration of the SEE countries with the EU. This strategy aims at achieving rapidly the benefits from increased trade with the EU as well as within the SEE region, through a coordinated integration process. The main challenges for the SEE countries, as discussed above, will be to liberalize their overall trade regime and strengthen trade institutions—most important customs. For the EU, the main challenge will be to establish strongly coordinated and virtually identical bilateral trade arrangements that would provide improved access to EU markets, stimulate regional trade integration, and take into account different levels of development and different state of play of bilateral relations.

3.60 The next steps toward the implementation of this strategy are as follows:

- **SEE Countries** should undertake the structural reforms needed to support overall trade liberalization as well as Stabilization and Association Agreements with the EU;
- **The EU** needs to implement a comprehensive overall framework for relationships with the SEE countries, including the negotiation of SAAs or ATPs to be put in place in early 2001; and
- **The international community**—including the World Bank—needs to initiate or intensify work in support of regional structural adjustment and reform as well as the projects in support of trade related regional infrastructure.

Tentative Timetable For Trade Reforms and Agreements In Context Of Stability Pact³⁶

	<i>Phase 1 (2000-2003/4)</i>		<i>Review</i>	<i>Phase 2</i>
	<i>2000/1</i>	<i>2001- 2003/4</i>	<i>2003/4</i>	<i>2004/5+</i>
SEE COUNTRIES				
- gradual overall liberalization of trade				
- elimination of administrative barriers to regional trade				
- conversion existing bilateral trade preferences into multilateral ones				
-conclude negotiations on FTA with EU				
- implementation of FTA with EU				
- initiate negotiations for FTA with regional partners				
-Implementation of FTA with regional partners				
- possible negotiations for a customs union with the EU				
- harmonization of policies and institutions with the EU in view of future membership				
- regional cooperation on projects				
EU				
- conclusion of coordinated bilateral agreements (FTAs or ATPs with SEEs) within a single economic framework				
- Implementation of Asymmetric FTAs or ATP with SEE countries				
- review progress made by SEE countries in political, economic and trade integration				
- possible decisions on future trade and political relations with SEE countries				
- elimination of remaining restrictions on FTA with SEE countries				
- possible negotiations for customs union with one or more SEE countries				
World Bank				
- support to SEEs for liberalization of trade regime				
- provision of trade related financial and technical assistance to improve integration of SEE into world economy				
Other members of the Stability Pact				
- increasing market access for SEE countries				
-provision of trade related financial and technical assistance				

³⁶ All the dates for the different phases suggested are **solely indicative** of what may be technically possible. See para.3.30.

4. CREATING AN APPROPRIATE ENABLING ENVIRONMENT FOR PRIVATE SECTOR DEVELOPMENT

A. INTRODUCTION

4.1 Social and political stability will be greatly enhanced through the achievement of sustained economic growth. In turn, sustained economic growth can only be achieved with a stable and certain environment for the private sector. As noted earlier, much progress is still required on domestic reforms to put in place a stable macroeconomic climate and a market economy. Ensuring that adequate progress is achieved on the reform agenda of individual countries is the sole responsibility of the respective governments. If the governments do not embrace this responsibility, “regional initiatives” will be ineffective. Without these domestic reforms to put in place an appropriate policy, legal and administrative framework, the private sector will not be able to play its role. In fact, in an environment lacking transparency and competition, the private sector may even develop into an obstacle to market-based efficiency and fairness.

4.2 Nevertheless, the Stability Pact partners have a crucial role to play in supporting the SEE countries in their reform efforts through **regional initiatives designed to support the implementation of reforms and to magnify their impact**. The ultimate goal of a regional approach to supporting private sector development is the creation of a vibrant private sector exchanging goods and investing freely across borders in a region that is integrated closely with the larger European and global economy. The clear prospect of future integration into European and global structures that underlies the Stability Pact would help to mobilize political resources for change, raise investor interest in the region and build confidence in the future stability of the business environment.

4.3 This Chapter looks in depth at regional initiatives that would facilitate the creation of a stable, transparent and non-discriminatory environment for private enterprises to take the risk of investing and producing in the SEE countries.³⁷ In fact, it will be the willingness of private entrepreneurs to take these risks that will transform the opportunities created by increased integration in the global economy into higher growth and employment generation. After this introductory section, Sections B and C discuss initiatives to improve the investment climate for both foreign and domestic investors, and to support small and medium enterprises, which are expected to be the main engines of growth and private sector development in the SEE region, as elsewhere. Section D discusses the role of privatization and private participation in infrastructure, and Section E concludes this Chapter.

³⁷ This Chapter draws extensively from documents prepared by the EBRD and OECD, as well as from work undertaken by the IFC.

B. ACCELERATING GROWTH THROUGH A STABLE, TRANSPARENT AND UNIFORM INVESTMENT FRAMEWORK

4.4 The initiatives described in Chapter 3 to foster trade integration in the global economy are one key component of the effort to create a dynamic private sector that trades and invests freely across borders. Seizing the opportunities presented by an opening of trade, both within the region and with the broader international community, will be possible only if domestic and foreign entrepreneurs increase their investment dramatically. As discussed in detail elsewhere,³⁸ a sizeable and sustained increase in private investment will in turn require a significant improvement in the overall investment framework, including: adequate protection of property rights; fair and non-discriminatory taxation; market-based competition; sound corporate governance; and transparent, effectively enforced administrative practices.

4.5 Progress toward the establishment of these prerequisites has been made at different speeds in the SEE region, but has in general lagged behind the economies of Central Europe. As documented in the EBRD *Transition Report 1999*, survey results and other indicators of the quality of the investment climate reveal that the economies of South Eastern Europe are characterized by widespread perceptions of corruption and cronyism, and of unpredictability in the implementation of the regulatory framework by the public administration.

The Investment Compact for the SEE Region

4.6 Governments throughout the region must do much more to create the conditions under which the private sector will invest. With the objective to establish a stable, transparent and uniform framework for private sector investment, the Governments of the region, in collaboration with their partners in the Stability Pact, decided to pursue the implementation of the Compact for Reform, Investment, Integrity and Growth (referred to as the Investment Compact). The Investment Compact outlines a very ambitious agenda of legal, regulatory and institutional reforms, to establish fair and non-discriminatory treatment of domestic and foreign investors, with full protection of their property rights, not only by the letter of the law but also by its administrative implementation and judicial enforcement. The specific policy areas covered by the Investment Compact include: banking; capital markets; corporate governance; policies and promotion strategies for foreign direct investment; commercial law, including business licensing and formation; administrative efficiency and bureaucratic obstacles for private sector initiative; competition law and policy; fighting bribery and corruption; the system of justice; SME support; privatization; fiscal reform and taxes; and accounting regimes and practices.

4.7 The commitment of the Governments of South Eastern Europe to the introduction and implementation of the Investment Compact will be supported by Governments outside the region, international institutions and other donors. Following the finalization and approval of the Investment Compact by the Governments of South Eastern Europe,

³⁸ EBRD, *Promoting Private Sector Led Growth and Integration in South Eastern Europe, An EBRD Perspective*, September 1999 and subsequent implementation papers.

technical support and assistance to strengthen institutional capacity to implement it will need to be mobilized.

4.8 The Stability Pact Working Table II agreed that a Coordination Group, supported by the OECD, would be charged with the development of a roadmap for the implementation of the Investment Compact. A draft roadmap was developed by the OECD in the autumn of 1999, setting out a three-phase approach (i) diagnosis of current investment conditions in the countries of the region; (ii) development of country-specific policy recommendations and the design of regional policy initiatives; and (iii) monitoring progress in policy implementation, improvement of the investment conditions and actual investment performance in South Eastern Europe. The finalization of the roadmap will continue to require the active participation of Governments, business communities, civil society, and international institutions. Emphasis will be needed in particular on the strengthening of public institutions—including both state and local administrations—which generally requires long gestation periods and sustained attention by policy makers. (This topic will be discussed in detail later in the report.)

4.9 The first stage envisaged in the draft roadmap involves collecting information on policy areas that are vital to reform, revitalization and reconstruction of the SEE economies through increasing local and foreign direct investment. On the basis of the currently available information, a few preliminary conclusions can be drawn at this stage:

- The SEE countries are in very different situations, with large variations not only among countries but also, within countries, among policy areas. The policy dialogue will have to reflect these differences, reinforcing the need for a country-specific approach that should be complemented by regional initiatives.
- Despite these differences, there is a strong need for regional initiatives right from the start, if the potential positive externalities of national reforms are to be fully exploited. Policy areas with a clear international dimension are prime candidate for regional initiatives.
- In many cases, key obstacles to a favorable investment climate and areas for priority action relate to implementation and enforcement of policies, rather than design and parliamentary enactment of policies. Institution building—specifically the capacity to undertake constructive action on an ongoing and progressive basis—therefore seems to be a critical and priority task.
- Timing and duration of the three phases of implementation envisaged in the draft roadmap of the Investment Compact will vary from country to country, reflecting their different stages of economic development, needs for technical assistance, capacity to engage in policy dialogue, and ability to follow through with implementation.
- Given the complexity of the task, managing the expectations and establishing realistic but tough timetables for action and results will be crucial to ensure public support in the countries and in the international community.

- Close cooperation among governments, international organizations and other agencies is essential for success. National project teams would therefore could be very useful to complement the overall implementation of the compact.

4.10 In addition to committing to the broad reform agenda outline in the Investment Compact, the Governments of the SEE region have agreed to take steps to ensure that: the countries will adopt international norms for business taxation, public procurement, and accounting standards; investment regulations will adequately protect health, safety and the environment; labor standards will be consistent with the 1998 ILO Declaration on Fundamental Principles and Rights at Work; the countries will embrace the OECD Principles of Corporate Governance and the OECD Guidelines on Multinational Enterprises; and a dialogue will be established between countries and the private sector, including civil society and labor unions. In addition, the new Stability Pact Anti-Corruption Initiative (see Box 6.4) includes commitments to fighting bribery and corruption of public officials—taking into account OECD and Council of Europe conventions—and to fighting money laundering—taking into account the recommendations of the international Task Force Against Money Laundering.

Additional Measures for the Restoration of Investor Confidence

4.11 The creation of a climate conducive to a strong recovery of private investment in SEE countries will greatly benefit from the establishment of a stable, transparent and non-discriminatory regulatory framework, along the lines discussed above, but the restoration of investor confidence will require more than the implementation of ambitious reforms. Measures to improve security in general, and in particular to facilitate the return of refugees and displaced persons and the rightful repossession of their assets, will all contribute to investor confidence. Initiatives to enhance economic cooperation in the broader neighborhood of South Eastern Europe—for example, the recently established Black Sea Trade and Development Bank—can also play an important role.

4.12 The maintenance of a stable macroeconomic environment will also be critical for the return of investor confidence. Low inflation and stable exchange rates are as necessary for private entrepreneurs to take risks as is a stable and transparent regulatory framework. As discussed earlier in the report, the SEE countries that have experienced periods of macroeconomic instability recently—Albania, Bulgaria and Romania—have also recorded particularly low levels of investment, below 20 percent of GDP. Progress made towards macroeconomic stability in the SEE region will thus need to be consolidated in order to provide a more predictable and more stable framework for private investment.

4.13 Finally, the international community can work with the Governments of SEE countries to devise mechanisms for the mitigation of political risks, in particular through the provision of insurance and/or guarantees. Political risk insurance facilities have been successfully implemented for Bosnia and Herzegovina and for Albania, and a new one is under development for FYR Macedonia. Building upon these experiences, the creation of a regional facility for the countries of South Eastern Europe is now being considered. A regional facility would in fact realize significant benefits in terms of risk pooling and

economies of scale; would provide effective coverage for intra-regional trade; and would facilitate the cooperation with private political risk and export credit insurers—through the development of relations with investors and financiers, the sharing of information, and the marketing of guarantees.

C. INITIATIVES FOR SME DEVELOPMENT

4.14 Small- and medium-sized enterprises (SMEs) have a crucial role in the transition process. Already SMEs make up the vast majority of private businesses operating in the countries of South Eastern Europe; and, because of their size and adaptability, they are likely to be the largest source of employment generation in the next few years. As in more mature market economies, a vibrant SME sector will eventually become not only a source of employment, but will also be a key source of innovation, entrepreneurship, and productivity growth. The development of dynamic SMEs also creates a group with a strong interest in social stability and a healthy market economy. For these reasons, improving the business environment for SME development is a key objective of the policy framework for all SEE countries.

4.15 SMEs are likely to benefit greatly from the improvement of the business climate in the direction envisaged by the Investment Compact for the SEE region. International experience indicates that SMEs are at a strong disadvantage—as compared with larger enterprises—when the investment framework is opaque and uncertain, public officials have large discretion in the administration of regulations and incentives, and entry and/or competition are restricted.

A Three-Pillar Strategy for SMEs

4.16 An effective strategy directed to promoting SMEs and the active support of governments from the region will however be necessary. In fact, while many SEE countries have already seen strong growth in SMEs, SMEs still face substantial obstacles. As noted earlier in this report, a comparative study of constraints faced by SMEs³⁹—conducted in 1998 and covering Poland, Slovak Republic, Romania, Ukraine and Russia—clearly identified access to finance, complex tax systems and administrative burdens as the principal hurdles; institutional infrastructure to support SME information, legal and training needs was also generally found to be weak. In particular, the study found that Romania—the only SEE country in the sample—compared well with the CIS economies, but had severe shortcomings compared to Poland and Slovak Republic: limited access to credit, low levels of trust in the court system to enforce claims, and the need to pay significant bribes for access to basic public services. Evidence for other SEE countries has also revealed patterns similar to those found in Romania.⁴⁰

³⁹ Johnson/McMillan/Woodruff (1998).

⁴⁰ E.g., a survey of SMEs in Albania conducted by the EBRD in mid-1999, and evidence relating to Bosnia and Herzegovina (work by USAID and the EU Representative Office).

4.17 As discussed in detail elsewhere,⁴¹ an effective strategy to promote SMEs in the region must simultaneously tackle the three “pillars” of (i) finance; (ii) improvements in the business environment; and (iii) the strengthening of SME support networks.

4.18 **Finance.** Throughout the region, SMEs lack adequate access to credit and equity finance. This lack of access stems from the weaknesses of banking institutions in the region, the absence of capital markets, and the weak legal framework for credit and collateral. Supportive action from the international community is needed to address these weaknesses in the institutional infrastructure and in the incentives of financial intermediaries. One option in this area is to work with existing financial intermediaries with the potential to reach SMEs and with the commitment to develop SME finance into a core part of their business. These will often be banks with wide branch networks or a regional basis, such as savings and cooperative banks.⁴² An effective strategy would be to provide technical assistance in the specific skills required for SME finance and to provide finance, on appropriate terms and maturities, to these financial intermediaries. Another option is the establishment of new institutions, e.g., regional equity or small-enterprise development funds. These funds could elicit sorely needed equity funding in combination with technical support for SMEs in the SEE region. Successful examples include the IFC’s Mekong Project Development Fund (MPDF) in Vietnam, Lao PDR and Cambodia. The MPDF is a facility (supported primarily by bilateral donor funds) to advise small- and medium-scale enterprises on preparing business plans and arranging financing for new investments, as well as investing in such enterprises.

4.19 **Improving the SME Business environment.** As discussed above, the costs imposed on SMEs by a hostile business environment are generally more severe than those suffered by larger firms. Thus, SMEs can also be expected to greatly benefit from the establishment of an efficient and non-discriminatory investment framework, along the lines set out by the Investment Compact for the SEE region. In particular, the establishment of fair and transparent tax systems, and a regulatory framework that allows SMEs to take advantage of the opportunities offered by privatization, could greatly contribute to the development of this sector. Strong commitment by the Governments of the region, on the one hand, and technical support and assistance from the international community, on the other, will be crucial. An active policy dialogue through IMF and World Bank-supported programs with authorities at different levels of government—since many obstacles are local in nature—would also help to realize these reforms. The establishment of business advisory councils, as called for under the Stability Pact, would make an important contribution to this process by ensuring that policy makers and international institutions receive feedback and proposals from the private business community.

⁴¹ EBRD, *Promoting Private Sector Led Growth and Integration in South Eastern Europe, an EBRD Perspective*, September 1999 and subsequent implementation papers.

⁴² The main focus should be on debt instruments, since this is the area in which the broadest immediate benefits can be obtained. However, a comprehensive approach should also cover equity instruments, which, while reaching fewer companies by number than many debt facilities, are usually associated with the provision of a highly intensive and hands-on form of support.

4.20 **Support networks.** SMEs are at a disadvantage—often because of limited linkages with other firms, insufficient technical or financial resources, and lack of access to information—not only when starting up but also when entering new markets, or expanding their activities. Their support requirements are often specific to stages in a small business’ development cycle: how to transform ideas into business plans, how to find partners for expansion, etc. Assisting small businesses in “helping themselves”, whatever the nature of the challenge, is a promising area for partnership between SEE Governments and the international community. The EU has been active in this field, as have several bilateral organizations and the proposed regional equity fund would also provide such support as noted above. Another example is the EU Phare program, which provides technical assistance to chambers of commerce and other business associations in transition economies. A different example is the German Business Cooperation Program which aims at the development of company-to-company linkages between German and foreign SMEs. The EBRD TAM program’s activities are a successful example of how managerial assistance can help steer SMEs through the challenges of adjustment. The recently created Balkan Enterprise Facility, supported by the IFC and the donor agencies of Austria, Canada, Germany, Greece, Netherlands, Norway, Slovenia, Sweden and Switzerland, plans to contribute to building managerial and technical skills and facilitating access to knowledge and information for SMEs. These examples must be built upon.

Capacity Building for SME Support and the Need for Grant Financing

4.21 An active policy for the development of SMEs—beyond improving the investment framework—requires significant investments in capacity building, especially in private institutions. Financial intermediaries and support networks require specific technical assistance to develop SME-specific skills; and micro-banks consume approximately US\$1.5-2.5 million for the first two to three years before commercial viability is established. Corresponding needs for grant financing will thus be large; and while the EU, US and other bilateral donors have already made available significant technical assistance and cofinancing, further funding may become necessary. Flexible funding and disbursing conditions will greatly facilitate the administration of grants and reduce the organizational cost of TA utilization. Efforts on the part of the international community to simplify and harmonize their procedures for grant financing of technical assistance could thus greatly increase its speed and effectiveness. These results can also be obtained through initiatives to pool donors funding for technical assistance—as for example the Balkan Enterprise Facility mentioned above.

D. THE ROLE OF PRIVATIZATION AND PRIVATE PARTICIPATION IN INFRASTRUCTURE

4.22 As discussed earlier in this report, privatization has advanced significantly in South Eastern Europe, especially with regard to small-scale enterprises. The privatization of large- and medium-size enterprises has recorded less progress, and has generally benefited insiders; both results stem from the persistence of soft budget constraints and the reluctance of some countries to privatize “strategic” sectors—including public utilities, infrastructure and enterprises where large redundancies are

Box 4.1: EBRD Support for Private Infrastructure

Municipal utilities. Private sector projects in this sector are slow in coming and limited in number compared to investment needs and to the large potential for efficiency gains. While there is a gradually growing interest in private sector participation in one form or another, major obstacles remain. In the region, EBRD is working with eight municipalities on the development of projects which involve the private sector in the financing and provision of municipal infrastructure and services, and with a number of municipalities on municipal investment financing without state or commercial bank guarantee. These private projects concern the privatization of the water and sewerage companies in Sofia, Rijeka, Timisoara, Pitesti, Brasov and Burgas, and water sector BOT projects in Zagreb, Bucharest and Constanta. These projects are scheduled for financial closing in or around 2000. They all involve reputable international operators of water and wastewater services. In addition, the EBRD is maintaining an active dialogue on investment financing to municipalities without state or commercial bank guarantees with Dubrovnik, Constanta, Brasov and Pazardzik. Corporatization and commercialization of publicly-owned municipal utilities often lays the groundwork for private sector involvement at a later stage. There are further opportunities in working with municipalities directly, through sovereign structures, where the regulatory and legal framework governing central-local fiscal relations and the provision of municipal infrastructure does not allow non-sovereign or private financing. Especially in countries such as FYR Macedonia, where the EBRD is working with five selected municipalities, this approach remains important and provides the sole entry into this sector.

Telecommunications. As part of the division of labor between IFIs in Bosnia and Herzegovina, the EBRD has taken special responsibility for the telecoms sector. Privatization of all three operators is planned. A similar division of labor may emerge in Kosovo, where the Bank currently conducts a damage assessment. In Albania and FYR Macedonia, the EBRD is considering participation in private GSM ventures. Privatization of incumbent operators with EBRD equity support is also under way in FYR Macedonia and, potentially, in Croatia.

Power. The "unbundling" of power generation, transmission and local distribution, based on appropriate legal and regulatory frameworks, as well as more ambitious models of private sector involvement in power projects are gaining acceptance in South Eastern Europe. In Romania and Bulgaria independent power projects are under consideration. In FYR Macedonia consideration is being given to financing a co-generation plant for the city of Skopje on a private sector basis.

Transport. Private involvement in the transport sector remains a difficult proposition in the region and the EBRD must continue to consider sovereign structures. Nevertheless, the EBRD has implemented one private sector project in the region (grain terminal in Romania) and is considering others: a toll road in Croatia, railway wagon refurbishment/leasing and port commercialization in Romania, and, in the longer run, possibly port and inland terminals and train operations in Bulgaria.

Source: EBRD, Promoting Private Sector Led Growth and Integration in South Eastern Europe, an EBRD Perspective, September 1999.

expected. Overall progress—together with the growth of private enterprises—has resulted in the public sector accounting now for less than 50 percent of GDP in all countries except Bosnia and Herzegovina (where it still accounts for about 65 percent of GDP).

4.23 Public utilities and infrastructure—especially telecoms and power—are, however, sectors where rapid progress towards commercialization first and eventually privatization could yield very significant benefits. Financing needs for rehabilitation and modernization are in fact very large, and unlikely to be fully met by the public sector; in addition, sustained improvements in efficiency in these sectors—as needed to lower costs for consumers as well as businesses—require also the introduction of competition or at least contestability. International experience strongly indicates that—both to attract private participation and to translate it into benefits for consumers and producers—a sound regulatory framework, providing predictable treatment of investors and adequate contestability—is necessary. The international community can assist—and is already in the process of assisting—the countries of South Eastern Europe in the establishment of the appropriate regulatory framework, and additional assistance in this area should be given high priority.

E. CONCLUSION

4.24 The establishment and consolidation of macroeconomic stability, the implementation of trade liberalization, and improved access to EU and regional markets will offer new opportunities for higher growth and employment. Seizing these opportunities will require a dynamic private sector, willing to take the risk of investing and producing in SEE countries, and the mobilization of significant foreign investment.

4.25 The initiatives outlined in this Chapter are aimed at accelerating the development of a dynamic private sector in the SEE countries through the establishment of an efficient and non-discriminatory investment framework, active policies to promote SMEs, and an intensification of efforts to privatize remaining public enterprises and to develop private sector participation in the provision and financing of infrastructure. The role of the international community is to support these reforms and magnify their impact through regional initiatives. Several initiatives are already under implementation, but their continuation and intensification remain a priority, and will require increased financial resources as well as improved mechanisms for delivery of technical assistance and its financing.

5. SOCIAL INCLUSION AND SOCIAL CHANGE— CONDITIONS FOR PEACE AND PROSPERITY IN THE SEE REGION

“Social Cohesion is one of the foremost needs of the wider Europe and should be pursued as an essential complement to the promotion of human rights and dignity.”⁴³

A. INTRODUCTION

5.1 Much of the prospect of creating peace, stability and prosperity in the SEE region will depend on the success of efforts to establish stronger cohesion among the countries of the region. One of the greatest casualties of war is the weakening of social capital and dissolution of bonds of trust between individuals, social groups and countries in the region. Even prior to the current conflicts, decades of state socialist systems have left civil society in South Eastern Europe weak and fragmented. Only with a greater tolerance and willingness of the people of the region to live side by side, will the dangers of renewed armed conflicts be contained, investments take place, orderly regional trade develop and economies flourish. Re-establishing and further developing social cohesion needs, therefore, to be one of the guiding principles when defining priorities and interventions in the region under the Stability Pact. Measures will need to be taken to mitigate the social exclusion created as a result of the Balkan wars and from the economic declines experienced in the region in the transition to market economies.

5.2 Social cohesion within and among SEE countries is also threatened by wide differences in living standards, some worsening social indicators and increasing poverty. Chapter 2 provides a summary of living standards and social indicators in the region. While SEE countries inherited and largely continue to have social indicators which are significantly better than countries of similar income levels in other parts of the world, there is large variation between SEE countries. Based on limited data available, poverty has increased significantly during the transition. In Bulgaria and Romania, poverty has risen from marginal levels at the outset of the transition to significant levels by the end of the 1990s. In all countries of the region, rural poverty is worse than urban, low educational levels of the household head is strongly correlated with poverty, and large families and families with unemployed household heads have among the highest poverty rates. In all SEE countries, the Roma stand out as very poor and persistently poor (see Chapter 2, Box 2.1). Poverty studies also point to limited access of the poor to public services, especially safe drinking water and sanitation, electricity, and secondary

⁴³ Council of Europe (1997) Final Declaration, Second Summit of Heads of State and Governments of the Council of Europe.

education. Many poor also have restricted access to health services, owing to inability to pay formal or informal charges.

5.3 The concept of social cohesion stems from a deep concern about social exclusion, which in itself is a process leading inevitably to a denial of human rights. The Council of Europe Report on Human Dignity and Social Exclusion (Duffy Report) has singled out social exclusion as one of the main threats to democracy, human rights, human dignity and stability.⁴⁴ Conceptually social cohesion has been seen as combining the political determination of governments to bring in social development policies and make a success of them with their citizens' aspirations towards greater solidarity. Social cohesion concerns the society as a whole and all its members. It aims to promote active participation in decision making, restore civic and social ties, and develop sound relationships between state, market, and civil society. As part of the efforts to create social cohesion, vulnerable groups, minorities, people with disabilities, ethnic groupings need to be assured integration into societies, access to social services and benefits and in satisfying their social needs.

B. THE NEED TO REDUCE SOCIAL EXCLUSION

5.4 Much of the social exclusion existing in SEE countries today results from conflict, from years of economic transition, and from underlying historical social patterns which predate the recent period of conflict. All SEE countries have minority populations and long histories of inter-ethnic conflict and, at times, accommodation and cooperation. The conflicts in Bosnia and Herzegovina, Croatia and Kosovo have led to separation of several ethnic groupings into new nation states. Many minorities have suffered atrocities and were forcibly displaced during recent conflicts. The memory of long periods of conflict and displacement has a lasting impact on the psyches and social fabric of war-affected societies, even after formal hostilities have ceased and many have returned home. UNHCR estimates that at least 1.7 million people, 6 percent of the population, are still displaced in the countries which formerly were Yugoslavia. Millions remain without access to property or stable livelihood. Others have not suffered these massive disruptions but remain disadvantaged and are prevented by a wide range of de jure and de facto obstacles from full participation in education, accessing public services and maximizing individual economic opportunities. Croats, Serbs, Albanians, Hungarians, Greeks and others are minorities in one country, yet majorities in adjoining societies. Roma live in all SEE countries and some neighboring countries. They have suffered from prejudice and exclusion for generations.

⁴⁴ Council of Europe (1998) Opportunity and Risk: Trends of Social Exclusion in Europe.

Table 5.1: Major Ethnic Groups In SEE Countries^a

<i>Country</i>	<i>Population (in millions)</i>	<i>Major Ethnic Groups</i>
Bosnia and Herzegovina	4.3	Bosniacs (38%), Serbs, (40%), Croats (22%), Roma (1%) ^b
Croatia	4.8	Croats (78%), Serbs (12%), Roma (1%) ^b , Others (9 %)
FYROM	2.1	Macedonians (66%), Albanians (23%), Turks (4%), Roma (3%) ^b , Serbs (2%), Other (2%)
FRY	10.5	Serbs (63%), Albanians (14%), Montenegrins (6 %) Hungarians (4%), Roma (4%) ^b , other ethnicities (9%)
Albania	3.3	Albanians (95%), Greeks (3%), Roma (3) ^b
Romania	23.3	Romanians (89%), Hungarians (9%), Roma (9%) ^b
Bulgaria	8.2	Bulgarians (85%), Turks (9%), Roma (3%), Macedonians (3%)

a. These data in some cases are not consistent with nationally reported statistics. For instance, Romanian Government statistical estimates for 1999 are: Romanians, 90%; Hungarians, 7%; and Roma 4%; and total population is estimated at 22.5 million. In Bulgaria, according to the 1992 census, only about 10,000 people (0.1 percent of the population) identified themselves as Macedonian.

b. Overall country statistics, particularly concerning Roma populations, do not reconcile to 100 percent due to rounding of numbers and use of differing sources and should be viewed as expressing magnitudes rather than definitive statements.

Source: General statistics are from Amnesty International. Statistics on Roma are from Liegeois, J-P., *Roma, Gypsies, Travelers*, Council of Europe, 1994. Statistics for successor states of the Former Yugoslavia may not be completely accurate due to impacts of ethnic cleansing and displacement across national borders related to conflict.

5.5 The Roma community is perhaps the most visible minority in the SEE region. Eastern Europe hosts most of the Roma communities, with largest groups in FYR Macedonia, Romania, Slovak Republic and Bulgaria. Most Romas live excluded from the social structures of their countries, while engaging in diverse economic activities which are often viewed by outsiders as being near the border of legality. For many Romas an extended family continues to be the focus of their existence, often more important than the increase of individual wealth and material well being.

5.6 Apart from their vulnerable political situation, Romas are one of the social groups which has suffered the most severe economic deprivation during the process of transition from a socialist to a market economy. They have generally been among the first to become unemployed and given their low skill level have found it difficult to find reemployment. Their health status is generally significantly poorer than that of their host communities. Access to health services remains limited due to remoteness from facilities and lack of participation in normal structure of service provision. Malnutrition is to be found among some Roma communities, mostly affecting children and young mothers. Illiteracy levels are high. A significant number of school-age children never attend school and therefore remain excluded from advancing in skill levels. With the support of NGOs and international organizations, special efforts are now being made by several SEE countries to reach out to the Roma community.

5.7 Animosity and distrust between ethnic groups represent significant impediments to the exchange of goods, services and ideas and present important barriers to trade and investment. De jure and de facto obstacles to participation of minority groups in education and economic opportunity deny the countries of SEE the full utilization of its store of human capital. The perpetuation of ethnic tensions and the threat of a return to conflict absorb the time and efforts of the leaders of governments and institutions of civil society. They limit the capacity to address pressing issues of economy and governance. Ethnic exclusion contributes to a perpetuation of an environment of conflict and undermines efforts to promote intra-regional cooperation.

5.8 But social exclusion does not affect ethnic groups only; societies are also divided along non-ethnic line. Years of warfare as well as painful economic restructuring have left a wide range of vulnerable groups in all segments of society and in all ethnic groups. Economic restructuring and demobilization of soldiers has and will continue to leave groups of able-bodied men and women without employment. In addition, children, pensioners, widows, orphans, war-disabled and other vulnerable groups need to be taken into account, and targeted safety net strategies be put in place to provide a minimum level of protection. The lingering frustrations of the disenfranchised, the unemployed, the socially marginalized fuel tension and unrest which could be redirected into crime and civil violence, much of which may easily become ethnically based. Special efforts need to be made to assure full inclusion of women. Gender based exclusion has not primarily resulted from conflict but represents an endemic element of social relations. In addition to the overall objective of gender equality from the standpoint of equity, inclusion and economic productivity, it is also important to recognize the special role that women and groups of women have played in the transition from conflict in other areas of the world. Women to varying degrees have played the role of peacemaker in many conflicts and the support of women's associations to build bridges across ethnic groups and national borders should be encouraged.

5.9 Of all the elements of social exclusion which prevent regional stability and a return to normalcy, the situation of the war-displaced is the most significant. Lasting peace requires a sustainable resolution of the current situation of displacement and consequent confusion of property rights of ethnic minorities within/between the Bosnian entities, Croatia and FRY. Millions of Serbs, Croats and Bosniacs are denied access to their homes and to their most valuable assets, residential and commercial properties. At least 20 percent of Bosnia and Herzegovina's population remains displaced from their homes and many more have varying degrees of access to their properties due to double occupation and destruction. 340,000 Serbs from Croatia remain as refugees in FRY and Bosnia and Herzegovina. Refugees and IDPs represent 13 percent of the population of Montenegro.⁴⁵ While this issue directly impacts only these countries, it represents one of the most serious constraints to regional stability and, in specific countries, prevents the development of a sustainable, long-term vision for development.

⁴⁵ These figures are based upon UNHCR statistics.

Table 5.2: Currently Displaced Persons (Refugees and IDPs) in SEE Region

<i>Country</i>	<i>Total Population (millions)</i>	<i>Displaced Persons (thousands)</i>	<i>Percentage of Total Population</i>
Croatia	4.6	69.5	1.5
BiH	4.2	878.7	21
FRY	10.6	747.3	7
FYR Macedonia	2.0	21.9	1
Albania	3.4	3.6	Negligible
Total	23.8	1,720.9	7

Source: UNHCR, November 15, 1999.

5.10 These figures highlight the high level of displacement which remains from the conflicts in South Eastern Europe. Numbers reflect those currently displaced and still seeking sustainable solutions, either the return home or integration. The true significance of the displacement problem must also take into account the wider effects of these displaced populations on the communities where they are temporarily settled. In addition, according to UNHCR figures, 209,000 citizens of BiH and FRY have sought asylum in Europe since 1990.

5.11 Continued insecurity of housing tenure leads to less incentive for individuals to invest in properties. This instability may also be detrimental to long-term economic planning and risk taking of households. The freezing of assets tied up in residential properties represents, to some degree, a potential store of small-scale investment capital which could otherwise be available for economic activity. As long as the property situation is uncertain, retention or distribution of “temporary” rights may represent a perquisite for political loyalty which could reinforce the position of political leaders and contribute to polarized extremist politics.

5.12 Resolution of the situation of Internally Displaced Peoples (IDPs) and refugees will require regional strategies and reciprocal agreements among affected countries in close alignment and sequencing with regional plans for productive investment. In addition to the political and social difficulties of reintegration, the poorly performing economies of many regions limit the options of refugees and IDPs to gain their livelihoods once they have returned home. Solutions will entail return of some populations and provision of viable alternatives for others when return is unlikely. The magnitude of these populations in some SEE countries implies that significant economic gains and stability will be dependent upon finding a sustainable solution to the return or permanent integration of refugees and IDPs.

C. INVESTING IN SOCIAL COHESION AND INSTITUTIONAL CAPACITY

5.13 Social cohesion will only develop if the peoples of the region are prepared to strive for peace and collaboration. This requires, inter alia, national leaderships determined to pursue these objectives, values imbedded and taught in SEE societies

which make social cohesion and regional collaboration a desirable behavior, policies which enforce mutual collaboration and interaction. Social cohesion will further be developed through functioning institutions which bring together ethnically, socially, economically diverse groupings, and provide possibility for participation, representation and dispute resolution. This will require strengthening of public as well as non-governmental institutions, professional associations, universities, women's associations, trade unions and other groups. Equally important is the support of media open to all members of society which supports participation and inclusion.

Box 5.1: FYR Macedonia: Promoting Inter-Ethnic Dialogue and Supporting the Learning Environment of Youth affected by the Crisis

With two million inhabitants, the FYR Macedonia is a multi-ethnic society consisting of Macedonians (66.5 percent), Albanians (22.9 percent), Turks (3.9 percent), Serbs (1.9 percent), Romas (1 percent), in addition to other smaller minorities.⁴⁶ Even before the escalation of the war in Kosovo, NATO intervention and the flood of refugees, peaked at 15 percent of its population, FYR Macedonia's different ethnic communities had a fragile relationship. So far, internal ethnic tensions have been successfully managed, but they continue to put a strain on the country, particularly owing to the situation in neighboring Kosovo.

Recognizing this, the World Bank in partnership with UNICEF provided assistance through a Post Conflict Grant of US\$2 million aimed at supporting the communities privately hosting refugees in Skopje, Tetovo, Gostivar, and Kumanovo, among other municipalities. The project specifically focused on ethnic conflict prevention by: (i) improving the learning environment of Kosovar and Roma refugee children, as well as Macedonian children from hosting communities; (ii) creating an Early Child Development network of mothers in disadvantaged communities predominantly inhabited by ethnic minorities or mixed groups, benefiting 5,000 families; (iii) promoting the inter-ethnic dialogues among youth through video productions; and (iv) sponsoring participatory social research addressed to the needs of conflict-affected and minority groups. With the end of the emergency refugee crisis, the project is being focused on Early Child Care and Development and life education activities for youth, with special attention to the Roma teenagers.

The project contributed to address the immediate emergency needs resulting from the refugee crisis, while introducing and testing new approaches to medium term conflict prevention, which would have been more difficult to be adopted without the pressures of a nearby conflict. Important experience was developed about ways to support the immediate educational needs of refugees, to improve the livelihood of disadvantaged ethnic groups, to encourage social development in potentially conflict-prone areas, and use the experience in conducting the broader policy dialogue in South Eastern Europe.

D. EDUCATION—INVESTING FOR SOCIAL CHANGE AND HUMAN CAPITAL FORMATION

5.14 Higher education for leadership formation. The importance of education as an instrument of social change as well as for human capital formation cannot be overemphasized. Special higher education programs will be needed to form new élites

⁴⁶ 1994 census.

from the region able to perform leadership functions within the near future. New leadership in the SEE region is needed to provide political and social guidance to its peoples which will encourage tolerance, respect of human rights, cooperation and collaboration. Different education initiatives have started to be launched under the enhanced “Graz Process” which has been assigned under the Stability Pact as the “Lead Agency” to coordinate and present education initiatives.⁴⁷ The formation of élites in multicultural settings, including students and learners from SEE countries as well as non-SEE countries is essential. The establishment of Centers of Learning in such multicultural settings, possibly through the establishment of a University for the South East European Region, similar as the Central European University, or establishing a center of Higher Learning which resembles the “College de Brugge” in the European Union, are being debated. A proposal to establish a Dubrovnik Foundation for Education and Culture has been advanced in order to foster these objectives.⁴⁸ Large scale student exchanges within the SEE region and with other countries could be an essential element for the reconciliation of future generations—as they have been in the period after the Second World War to support the reintegration of Germany into the international system and the assure the rapprochement between the German and French youth as part of the French-German Friendship treaty.

5.15 Education to establish peace and stability in the next generation. Education of today’s youth in the SEE countries will be essential for laying the foundations for tomorrow’s peace and prosperity. Much of the support provided needs to focus on the “youth” as their values and actions will be the foundation for a more peaceful future. A well-trained population which values diverse, multicultural, democratic systems, supports their peaceful interaction and cooperation, is needed that Stability Pact’s objectives of peace, stability and prosperity may become reality in the region. Education systems which too narrowly focus within their own national setting and do not reach out to the international community and especially other SEE countries, could well run counter to these objectives. Under the enhanced Graz Process education programs have been discussed under: (i) Higher Education and Its Role in the Development of Civil Society; (ii) History and History Teaching; (iii) Education for Democratic Citizenship; (iv) Education and the Management of Diversity; and (v) Vocational Education and Training and its Role in the Development of Civil Society.⁴⁹

5.16 Education for human capital formation. Well-trained human capital is essential for economic development. Poverty in the region is strongly correlated with educational attainments (see Chapter 2, Box 2.1). In comparison with other countries of similar income levels, the SEE region has achieved and maintained good education indicators. There is high demand for education amongst people of the region. Participation rates have remained high by international standards. Governments of the region and their citizens often articulate pride in the traditions of education in their countries. Yet, public allocations to education remain low in all countries, except FYR Macedonia. Fiscal allocations as shares of GDP have decreased during past years in

⁴⁷ See Conclusions of Working Table on Democratization and Human Rights, Geneva, October 18/19, 1999.

⁴⁸ See CEPES, The Future of Education and Training in South-East Europe, Brussels, October 1999.

⁴⁹ See International Conference on South Eastern Europe “Educational Co-operation for Peace, Stability and Democracy”, Expert Conference in the Framework of the Enhanced Graz Process, Stability Pact for South Eastern Europe, Working Table 1.

Albania and Bulgaria due to a decline in overall fiscal envelopes. As all countries have experienced significant declines in GDP throughout the transition, the education resource envelope available for each student has declined significantly. In several countries the institutional capacity in the education sector has been weakened with dilapidated infrastructure, poorly paid, trained and motivated teachers, outdated education materials, curricula and teaching styles.

Table 5.3: Educational Indicators In SEE Countries

	1990	1992	1994	1995	1996
Public Education Expenditure (% of GDP):					
Albania	4.2	4.2	3.2	3.8	3.2
Bosnia and Herzegovina	-	-	-	-	-
Bulgaria	-	6.1	4.8	4.0	3.2
Croatia	-	-	3.0	3.0	3.0
FR Yugoslavia	-	-	-	-	-
FYR Macedonia	5.9	5.4	5.7	5.7	5.9
Romania	2.8	3.6	3.1	3.4	3.6
Primary School Enrollment rate: ¹					
Albania	90.7	85.9	87.6	-	-
Bosnia and Herzegovina	-	-	-	-	-
Bulgaria	98.6	95.1	94.3	93.7	93.6
Croatia	94.0	79.0	89.0	88.0	89.0
FR Yugoslavia	95.0	72.7 ⁴	72.5	71.6	72.7
FYR Macedonia	89.4	86.2	86.8	86.5	86.9
Romania	89.5	89.6	91.4	92.6	93.9
Secondary school enrollment rate: ²					
Albania	79.1	47	38.1	36.6	38.5
Bosnia and Herzegovina	-	-	-	-	-
Bulgaria	77.2	72.4	73.8	74.2	73.6
Croatia	-	-	-	-	-
FR Yugoslavia	64.1	54.3	54.3	56.5	57.3
FYR Macedonia	-	-	55.6	57.3	59.3
Romania	90.8	67.0	65.7	68.3	68.1
Tertiary school enrollment rate: ³					
Albania	5.8	5.9	4.6	-	-
Bosnia and Herzegovina	-	-	-	-	-
Bulgaria	18.8	19.8	23.0	26.0	27.3
Croatia	-	14.3	16.5	16.6	17.2
FR Yugoslavia	16.9	13.7	14.5	14.9	16.5
FYR Macedonia	-	14.4	11.3	-	-
Romania	10.1	12.2	13.4	13.3	18.6

Note: (1) gross rates, percent of relevant population; (2) gross rates, percent of 15-18 population; (3) gross rates, percent of 18-22 population; (4) The decline in primary enrollment rates was most importantly caused by the exit of Kosovo Albanians from the official to a parallel school system.

Source: World Development Indicators, TransMONEE Database, IMF.

5.17 Human capital formation and the reforming and strengthening of education systems is a long-term process which requires substantial ongoing support. Most of the

region's educational systems must re-align to meet the needs of market economies and open societies. All must reform their governance structure. In virtually all of the SEE countries, the needs for physical rehabilitation of school buildings and the provision of furniture, equipment and learning materials are daunting. Even more important are measures to improve the quality of education, the development of institutions and capacities to manage and operate the education systems so that they can fulfill their re-articulated objectives will be a long and costly process. It is important that the support for the establishment of performing *education systems* should not be overlooked in the zeal to find solutions which will have quicker, visible impacts under regional initiatives. In improving the performance of education systems, one important issue in the SEE region is the rising dropout rate of poor students from secondary schooling—even if the returns to education are estimated to be high. This phenomenon comes out clearly in a number of poverty studies, most prominently for Albania.⁵⁰ As secondary education is important for skill formation and access to the labor market, declining enrollments of the poor in secondary schools can lay the foundation for further segmentation of societies, by eroding their future employment options.

E. A FOCUS ON YOUTH—CREATING OPPORTUNITIES FOR EMPLOYMENT AND INTEGRATION

5.18 Years of war, economic declines, and the transition from planned to market economies have resulted in high levels of unemployment. Lack of possibility to gain employment has exacerbated the situation of many refugees and IDPs. Unemployment is especially high among young people. Long disconnects between the completion of school and entering into the labor market affect work habits and values of future generations. Unemployed youth often seek refuge in illegal activities and criminal organizations posing serious obstacles to economic development and stability in the region. The possibility to work and be an active part of society is perceived by most members of society as a value of itself. Finding employment for demobilized soldiers will pose a special challenge. As a substantial demilitarization of many SEE countries is required, additional employment opportunities will need to be created for soldiers to be redeployed into the regular labor force. Without such formal absorption of military personnel, it is unlikely that significant gains will be made in demilitarization.

5.19 Employment not only provides the opportunity to gain an economic livelihood. It also provides a sense of dignity and self-worth among most individuals, which is essential for the creation of cohesive as well as inclusive societies. The need for employment, ideally for all, but especially for youth, is important to put to economic use underutilized human capital. Equally important is the need to utilize the socialization which comes along with structured employment to foster cohesion and inclusion in the presently segregated societies in the SEE region.

5.20 Efficient employment will depend importantly on economic growth brought about through stability in the region, economic reforms, and investments in labor intensive industries. Yet, in the short term, employment generation might be supported by employment generation schemes targeted on youth and/or war affected areas with high

⁵⁰ See Box 2.1.

unemployment and poverty. These schemes would need to be designed in such a way that they will not distort labor markets or lead to economic inefficiency. Selected employment schemes might also need to be considered to further encourage the return of refugees and IDPs. Special vocational training and re-absorption programs might need to be considered and could be financed from part of the savings achieved through demilitarization. Employment and/or vocational training programs for youth in post-conflict programs in the regions could well be complemented through specific youth programs organized around culture, sport and civil activities, to ensure that the younger generation find incentives to integrate in the society and resist the temptation of moving to criminal activities or join extremist groups. Such programs, while generally rather inexpensive in cost, can provide important directives to young people and provide fora in which active forms of participation and inclusion can be exercised.

Table 5.4: Levels of Unemployment in SEE Countries
(annual average, percentage)

Country	1991	1993	1995	1997	1998e
Albania	9	29	15	15	18
Bulgaria	11	16	11	14	12
Croatia	13	15	15	18	17
FYR Macedonia	19	28	38	36	35
Romania	3	10	10	9	10

Source: EBRD, Transition Report 1999, World Bank estimates.

5.21 To foster youth involvement in social development activities, youth participation in civic activities, cultural processes, entrepreneurial undertakings, and entertainment, needs to be encouraged. Pilot projects should be launched which foster social integration and community-based peace building. One example of pilot project would be the promotion of cultural youth networks, one for each country, by relying on telematic technology and community-based youth cultural centers. The network would have a web site with pages designed to respond to socio-cultural needs and preferences of youth, as evidenced by social analysis. Residents and expatriates of the country's diaspora in the world and neighboring countries would be able to interact through a number of peripherals placed in Youth Centers in country's urban or rural nodes or in equivalent Internet-connected communities abroad. The audience will access the site to: (a) draw from it, but also; (b) nourish it with content generated by the audience itself, as a result of organizing (and not only recording) community/city events, cultural interviews, entertainment programs, seminars on "education for life", reading of new books, visits to the region's cultural heritage monuments, and contests.

F. CREATING AN INCLUSIVE CIVIL SOCIETY

5.22 Efforts will need to be made to strengthen all elements of civil society which add to social cohesion and inclusiveness. This will require some well-targeted visible interventions which carry sufficient momentum so that they reach beyond localized

initiatives. Civil society groupings which are exclusive in nature, organized for example along ethnic identities or religious extremism, can add to the segregation of a society and push communities apart. Strengthening civil society along overarching themes, such as professional organizations, chambers of commerce, and trade associations has proven effective in other societies to reach for integration. An important role can be played by Western European civil society organizations in trying to help and support groups in SEE that would support integration and reconciliation and giving these groups means to develop and expand.

G. OPENING MEDIA AND KNOWLEDGE TRANSFER

5.23 In an increasingly globalized world, the SEE countries will benefit from integration into the knowledge transfer through provision of technology and multiple access to media. Opening up of multiple media channels will increase the possibility of different groups in society to make themselves not only heard and understood, but also to control propaganda which might be disseminated through controlled media systems. A modernized media system also allows for knowledge transfer to large number of people and to connect the people of SEE countries to an increasingly integrated world.

5.24 A special focus should be placed on providing technology so that knowledge transfer can take place. Special programs to provide access to the internet, directed to institutions of higher learning, secondary schools, government and parliamentary organizations, public institutions, civil society, etc. could be an important tool in bringing new objectives and ideas to inspiring leaders in SEE countries and to reach conciliation. The attractiveness of surfing the internet and communicating together across borders might quickly entice young people in SEE countries to adjust their aspirations and reach out beyond the restricted horizons in which they otherwise live. The technological means to connect to a broader world, shaped according to different values, might prove to be a more potent means of inclusion—allowing possibly for both, knowledge and value transfers.

H. PROTECTING SOCIAL RIGHTS

5.25 Protection of social rights will be essential to further strengthen social cohesion within and among SEE countries. The European Social Charter, which is regarded as the counterpart of the European Convention on Human Rights in the economic and social sphere, was signed in 1961. The Social Charter has subsequently been updated by a series of protocols; the revised Charter is dated 1996. The Social Charter safeguards nineteen fundamental rights plus another four enshrined in its additional Protocol of 1988. These rights can be divided into several groups: rights relating to work, the right to organize and to bargain collectively, rights relating to the protection of workers, rights relating to vocational training and the rights of foreign workers. Among SEE countries, Albania, Bulgaria, Croatia and FYR Macedonia have signed, Slovenia and Romania have ratified the Charter. While rights embedded into the European Social Charter will need to be interpreted within the economic realities of the SEE countries, the charter presents the social rights that SEE countries should strive towards in order to assure and strengthen social cohesion inclusive of all members of their societies. In addition to the

rights enshrined in the European Social Charter, the European Code of Social Security (revised) of the Council of Europe guarantees a minimum level of social security protection and lays out a common framework of social standards. Albania, Bulgaria, and FYR Macedonia have asked for assistance from the Council of Europe to develop their social protection system towards these standards. It will, however, take time for SEE economies to achieve sufficiently high levels of labor productivity, employment, and economic performance with sufficient fiscal revenue to sustain a social protection system as outlined in the European Code of Social Security.

I. CONCLUSION

5.26 Governments, civil society, international partners need to pursue multiple avenues to support social cohesion and inclusion in the SEE region and within SEE countries. These should include the development of élites and leaders from SEE countries which respect and support the values of open, multi-ethnic and diverse societies. Educational programs, especially in higher education, exchanges within SEE and with other countries are essential. Cultural programs, support to allow access to media and to the “Global knowledge system” are important to allow the people of the SEE region to share and absorb values which are shaped by other considerations than the pursuit of nationalist objectives. Multiple efforts will be needed to make domestic institutions inclusive to all members of societies and to hold them accountable to its citizens. A special focus on youth is essential to allow for the development of an open, tolerant future generation. Providing perspectives, possibilities for productive employment and engagement within the region and the SEE countries will be essential for fostering cohesion and building foundations for a stable and prosperous region.

5.27 The formation of open, tolerant and cohesive societies require access to social services and efforts to constrain poverty. But education systems need to be utilized not only for the transfer of knowledge and the development of skills, but as a process of modernization and value change. Changes in curriculum, teacher behavior, learning content, and learning styles are essential in order to assure that education will lead to development of values and behavior which are consistent with objectives of social cohesion and inclusion. Social rights to be protected are most comprehensively presented in the European Social Charter which most of the SEE countries have already signed. It lays out an important road map to the guarantees of social rights, which SEE countries should strive to achieve within the limitations of their own economic development objectives and possibilities.

6. THE NEED FOR STRONG INSTITUTIONS AND GOOD GOVERNANCE

A. INTRODUCTION

6.1 Much of economic development, social inclusion and regional stability in the SEE region will depend on strengthening of institutions, governance and in consequence lowering the level of corruption. Gradual integration with the European Union will require significantly more mature institutional structures, which are able to satisfy the economic, political framework conditions of the EU and to implement the “*acquis communautaire*”. Given the importance that the prospect for European association will assume for peace and stability in the SEE region (see Chapter 1), the emphasis that will need to be placed on institutional development necessary to gradually become a sufficiently reliable partner in the EU integration process cannot be overemphasized. Institutions also play an essential role in poverty alleviation, by assuring that public services are delivered to all members of the population, including the poor. And institutions that provide access and representation to all members of society are the underpinning for multiethnic, socially diverse societies to operate peacefully and sustainably. Institutional weaknesses are often expressed through conflicts around participation in policy decisions, around services to be provided to different ethnic groupings, and around the languages used. While most of the institution building efforts in a society will need to take place on a national or subnational level, strong institutions are the underpinning of any regional developments, including regional integration. Almost all regional or supranational policies, such as the EU “*acquis communautaire*” will need to be implemented through domestic institutions. Functioning domestic institutions are needed to effectively implement regional initiatives and policies.

6.2 Good governance is more than luck and tradition. Good governance comprises a set of hard to change institutions which structure political and economic life.⁵¹ The significance of these state institutions can be seen in their contribution to the development of a robust market economy, the part that they play in the management of public finances and the delivery of public services, and in the protection from arbitrary action that they offer for the citizen.

6.3 The importance which institutions are playing in assuring that competitive markets can function is now widely recognized. Despite the difficulties of gathering empirical evidence, there is a proven relationship between strong institutions and growth. Good governance in the form of public institutions and policies that enforce property rights and contracts, providing the underpinnings for creditor and shareholder rights, and the regulation of infrastructure and finance, while restraining corruption, is now widely

⁵¹ The term “institution” is here broadly defined, referring to the “rules of the game” that emerge from formal laws, informal norms and practices, and organizational structures in a given setting.

recognized as a necessary condition for long-term economic growth. Recent empirical work quantifies the costs of over-regulation, corruption, and other manifestations of weak institutions in terms of foregone investments and growth.⁵² Since economic growth contributes to lower rates of poverty, there exists a positive relationship between good governance and poverty alleviation because of the impact of governance on GNP growth rates and, as illustrated in recent empirical evidence, because good governance can have some egalitarian effects.⁵³

6.4 Clearly, many transition economies have experienced severe difficulties in establishing market-supporting institutions, frequently due to a weak financial sector. However, it is in the core public institutions of the government, in the services that it provides and in the legal and judicial protection that it offers citizens, that institutional weaknesses have persisted most stubbornly. For minority groups, the failure of public institutions to achieve social inclusion contributes to a vicious circle of mistrust and arbitrary action.

6.5 Corruption is a manifestation of weak institutions and good governance and strong institutions which reduce corruption underpin poverty reduction and improvements in the quality of life. A large and statistically significant positive relationship can be found between corruption and poverty.⁵⁴ The economic costs of corruption have been well documented.⁵⁵ A Business Environment and Enterprise Performance Survey commissioned by EBRD details that more than in any other region, small- and medium-size enterprises (SME) report corruption as an important obstacle to business development. Relative to large businesses, SMEs suffer more from slow bureaucratic procedures and corruption. Many firms therefore prefer to work in the gray economy.

6.6 Studies also show that corruption has a disproportionate impact on the poor.⁵⁶ The poor are hurt directly when they must pay unofficially for health care, education, and civil registrations. They are hurt indirectly when the quality of services erodes and when the

⁵² See Stephen Knack and Philip Keefer, "Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures," *Economics and Politics*, v. 7, 1995; and Paolo Mauro, "Corruption and Growth," *Quarterly Journal of Economics*, v. 110, 1995. The theoretical arguments behind this have been well established. Douglass North and many others have generated a growing body of work that combines rational choice theory, information economics, game theory, law, and organization theory to focus on the incentives that shape decision-making by public and private actors.

⁵³ See Stephen Knack and Gary Anderson, "Is Good Governance Progressive? Property Rights, Contract Enforceability and Changes in Income Equality." Paper presented at the 1999 Annual Meeting of the American Political Science Association, Atlanta, GA.

⁵⁴ Gupta, Sanjeev, Hamid Davoodi and Rosa Alonso-Terme (1998), "Does corruption affect income inequality and poverty?", *IMF Working Paper*, WP/98/76, May.

⁵⁵ Among the large literature see among other Paolo Mauro, "Corruption and Growth", *Quarterly Journal of Economics*, August 1995, p.695; Shan-Jen Wei, "Why is Corruption so Much More Taxing than Tax Arbitrariness", *NBER Working Paper* 6255 (Nov. 1977).

⁵⁶ World Bank diagnostic studies in Latvia and Georgia found that the poorest strata of society pay a larger fraction of their income in bribes than does the richest strata.

budgetary allocation to social services contracts.⁵⁷ The poorest may suffer the greatest for their inability to pay the necessary bribes.

6.7 This chapter argues that the institutional environment in SEE countries is poor and that significant efforts need to be made to facilitate institutional development in order to achieve progress in economic and social development. Data coverage on institutional development is weak for SEE countries. Where governance-related data is available that can be compared to international comparators, SEE countries seem to be below averages. Within the region, Albania and Bosnia and Herzegovina tend to score worse than Bulgaria, Croatia, Romania and FYR Macedonia. Data presented below draws from a variety of sources for quantitative measurements (World Development Report Survey of Enterprises 1997, the EBRD/World Bank 1999 Business Enterprise Performance Survey, Transparency International, KKZ, International Country Risk Guide, Heritage Foundation, IMF Global financial Statistics, and the International Telecommunications Union—see Annex 1 to this chapter for data sources and descriptions).

B. WEAK PUBLIC SECTOR INSTITUTIONS – AN IMPEDIMENT FOR PRIVATE SECTOR DEVELOPMENT

6.8 SEE countries have weaknesses in those public sector service functions, including credible and consistent regulation and infrastructure necessary for private sector development. According to the EBRD/World Bank 1999 Business Enterprise Performance Survey, the quality of the investment climate in Bulgaria, Romania, and Croatia (the only SEE countries included in the survey) registers in the bottom half of the transition economies. Croatia ranks just above Bulgaria, Romania has been ranked towards the very bottom. In the institutional infrastructure component, which measures perceptions of the Judiciary, Corruption, Street Crime and organized Crime, Croatia is rated 1.62 on a scale of 0 (major obstacle) to 3 (no obstacle), Bulgaria 1.49 and Romania 1.48. This compares to Hungary (2.34), Slovenia (2.23), Czech Republic (1.97) and Poland (1.7).⁵⁸ As Chapter 2 indicated, overall it is taxes and regulations that are viewed as one of the most important barriers to SME development. Business licensing is particularly problematic across the region.

⁵⁷ One study finds that corruption reduces government spending on education in a cross section of countries. (Paolo Mauro, “Corruption and the Composition of Government Expenditures”, *Journal of Public Economics* 69, 1998: 263-279).

⁵⁸ The EBRD/World Bank 1999 Business Enterprise Performance Survey, conducted in collaboration between the World Bank and EBRD, focuses on business environment and enterprise performance. Feedback was received from over 3000 enterprises in 20 transition economies. The survey asked managers in each country to describe the investment climate in the country.

Table 6.1: Selected Corruption Indicators

	<i>Albania</i>	<i>BiH</i>	<i>Bulgaria</i>	<i>Croatia</i>	<i>FYROM</i>	<i>Romania</i>	<i>FRY</i>	<i>Hungary</i>
EBRD bribes as percent of firm revenues	NA	NA	3.50	2.10	NA	4.00	NA	3.50
EBRD percent firms paying bribes frequently	NA	NA	23.90	17.70	NA	50.90	NA	31.3
TI TI index (0-10)	2.30	NA	3.30	2.70	3.30	3.30	NA	5.20
KKZ Graft Index	-0.99	-0.35	-0.56	-0.46	-0.52	-0.46	NA	0.61
ICRG corruption (0-6)	2	NA	4	2	NA	3	NA	5
FH Corruption /3	4	3	3	3	3	3	4	1

Note: Bigger numbers indicate worse governance for FH, EBRD bribery questions - bigger numbers indicate better governance TI, KKZ, and ICRG.

6.9 The problem for investors is a combination of weak legal and judicial institutions, providing little confidence that contracts will be enforced, and over-ambitious policies that presume strong oversight mechanisms coupled with a robust and efficient judiciary. The continuing extensive involvement of the state in productive sector is not only inappropriate but also diverts public sector resources to the wrong type of interventions. Most of the productive sector remains in public ownership in FRY. Privatization of large scale enterprises has been slow to advance in virtually all SEE countries, with the exception of Albania, where most large scale enterprises have been closed.

Table 6.2: Selected Legal/Judicial Indicators

	<i>Albania</i>	<i>BiH</i>	<i>Bulgaria</i>	<i>Croatia</i>	<i>FYROM</i>	<i>Romania</i>	<i>Kosovo</i>	<i>Hungary</i>
FH Rule of law	5.25	6.00	3.75	4.75	4.50	4.25	5.00	1.75
WDR Predictable judiciary	4.66	NA	4.61	NA	4.28	NA	NA	3.65
EBRD Law and order index	NA	NA	1.38	1.43	NA	1.07	NA	2.34
KKZ rule of law index	-0.92	-1.11	-0.15	0.15	-0.26	-0.09	NA	0.71
ICRG law and order (0-6)	2	NA	4	5	NA	4	NA	6

Note: Bigger numbers indicate worse governance for FH and WDR97. Bigger numbers indicate better governance for EBRD law and order index, TI, KKZ, and ICRG.

6.10 A functioning financial sector is central to a market economy by enabling payments, savings and investment. The financial sector in Southeastern Europe remains comparatively underdeveloped in delivering these services of financial intermediation to the real economy. Based on EBRD Transition Indicators, the regulation of financial institution in the region received an average score of 2.2 on a scale of 1 to 4, compared to 1.8 for the CIS and 3.1 for CEE countries. Across the region, lending to the private sector

is limited and banks are not fully playing their role as financial intermediaries. Banking systems in most countries remain dominated by a lack of competition; restructuring is hampered by slow privatization. As a result in many of the countries, the banking sector is highly concentrated and carries a high proportion of bad loans. Bank management in the region is often inexperienced in the core activities of providing credit in a market economy. Institutional weakness in the judiciary and law enforcement place constraints on commercial lending. For instance, commercial banks suffer from weak protection of creditor rights, in particular as it concerns their ability to collect collateral, discipline the management of firms in default on loans, or effectively pursue bankruptcy and liquidation through courts.

C. CHECKS, BALANCES AND SOCIAL COHESION

6.11 Institutions that promote social inclusion have measurable benefits. There is strong suggestion that democratic institutions impact on poverty as measured in terms of infant mortality rates, literacy rates and other objectively measurable outcome indicators.⁵⁹ Inclusion at the community level also brings benefits. There is some evidence that participation in both local and national decisions helps improve the quality of projects⁶⁰ and on the welfare of vulnerable groups such as women and their children.⁶¹

6.12 Balancing diverse and competing interests is a key task of the state and inclusion is an important foundation. Social exclusion contributes to a vicious circle of poor governance, arbitrary state action and continuing mistrust. As noted in Chapter 5, poor property rights for sectors of the population encourages the retention or distribution of “temporary” rights as a perquisite for political loyalty which could reinforce the position of political leaders and contribute to polarized extremist politics.

6.13 Holding the executive to account rests on two foundations: answerability and enforcement. First, there must be some bodies or groups that the executive must answer to. Complaints about the behavior of the executive from the electorate, legislature, interest groups, judiciary, political parties, procurators office, the media, audit body, civil society groups, local government and the donors must matter. Second, the executive must be required to change course in certain circumstances. If the answers that it provides are not seen to be satisfactory then, in some situations, it must be possible to enforce alternative behavior. Those levers provide the foundations for horizontal accountability, or relationships between the executive and those players of more or less equal power, and vertical accountability, or relationships where power is predominantly on one side. In developed democracies vertical accountability is provided by the electorate, and by competition for resources between levels of government. The legislature and the judiciary provide formal horizontal accountability, but crucially, informal horizontal accountability is provided by NGOs, interest groups, and an informed media.

⁵⁹ Sen, Amartya (1999), *Development as Freedom*, New York: Alfred Knopf. Sen suggests that democracy can make positive contribution to development through providing political incentives to the rulers to respond positively to the needs and demands of the people.

⁶⁰ Isham, Jonathan, Daniel Kaufmann and Lant Pritchett (1997), “Civil Liberties, Democracy and the Performance of Government Projects,” *World Bank Economic Review*, vol. 11(2), p. 219-42.

⁶¹ Narayan, Deepa (1999), “Social Capital and the State: Complementarity and Substitution,” The World Bank, *Policy Research Working Paper No. 2167*, Washington, D.C.

Table 6.3: Selected Indicators On Political Process/Accountability/Participatory Institutions

		<i>Albania</i>	<i>BiH</i>	<i>Bulgaria</i>	<i>Croatia</i>	<i>FYROM</i>	<i>Romania</i>	<i>FRY</i>	<i>Hungary</i>
FH	Political processes	4.50	5.00	2.75	4.25	3.50	3.25	5.00	1.25
FH	Civil society	4.25	5.00	3.75	3.50	3.75	3.75	5.00	1.25
FH	Independent media	4.75	4.75	3.50	4.75	4.00	4.00	4.50	1.25
KKZ	Voice and Accountability Index	-0.01	-0.97	0.6	-0.32	0.09	0.41	NA	1.20

Note: Bigger numbers indicate better governance for KKZ, and worse governance for FH.

6.14 As a region, South Eastern Europe is not homogenous. However it is the general weakness of civil society and the independent media, combined with other weak state institutions, which provide public officials the opportunity to promote their own interests, or those of friends or allies, at the expense of the general interest.

6.15 There are some promising examples of country-level actions in increasing oversight of government by the business community through regional and national trade associations. The development of regional networks of supreme audit institutions is a promising initiative. There are some groundbreaking attempts by civil society groups, such as Coalition 2000 in Bulgaria, which has developed a common program of practical actions, with active participation of government and national NGOs.⁶²

6.16 Civil society could play an important role in helping to develop social capital. Stronger social capital in SEE countries is required in order to provide voluntary compliance with established laws, trust, cooperative behavior and basic codes of conduct. Social capital can be seen to be fundamental to the development of institutions. While weak social capital can undermine the functioning of institutions, strong institutions in themselves can also foster the development of social capital.⁶³

D. BUILDING A STRONGER PUBLIC SECTOR

6.17 Corruption is one of the symptoms of weak public institutions. Poor service quality and erratic regulation is equally a product of a weak institutional base.

⁶² See www.online.bg/coalition2000. Other exemplary NGOs in the region include Transparency International - Romania (www.transparency.ro), and the Institute for Contemporary Studies (Albania) and the Albanian Center for Economic Research.

⁶³ See Raiser, M., “Informal institutions, social capital and economic transition: reflections on a neglected dimension”, EBRD Working Paper No. 25,

Table 6.4: Indicators On Government Services

		<i>Albania</i>	<i>BiH</i>	<i>Bulgaria</i>	<i>Croatia</i>	<i>FYROM</i>	<i>Romania</i>	<i>FRY</i>	<i>Hungary</i>
FH	Government and public administration	5.00	6.00	4.00	4.00	4.00	4.00	5.00	1.75
ICRG	Bureaucratic quality (0-4)	1	NA	2	3	NA	1	NA	4
WDR	Time spent dealing with government officials	2.19	NA	2.81	NA	2.13	NA	NA	2.09
WDI/ITU	Wait in years for telephone line	4.9	4	6.6	0.8	1.7	4	NA	0.1

Note: Bigger numbers indicate better governance for ICRG. Bigger numbers indicate worse governance for WDR97, and wait for telephones lines.

6.18 The degree to which governments can not achieve consistent policies in the face of conflicting political interests can be seen in the differential performance on some basic indicators of reliable policy.

Table 6.5: Indicator on Predictability of Public Sector

		<i>Albania</i>	<i>BiH</i>	<i>Bulgaria</i>	<i>Croatia</i>	<i>FYROM</i>	<i>Romania</i>	<i>FRY</i>	<i>Hungary</i>
WDR	Predictability of rule making	2.76	NA	4.62	NA	3.38	NA	NA	3.71
KKZ	Political instability and violence index	-1	-1.16	0.43	0.41	-0.4	0.02	NA	1.250
IMF GFS	Policy volatility	NA	NA	0.34	0.1	NA	0.11	NA	0.08

Note: Bigger numbers indicate better governance for KKZ. Bigger numbers indicate worse governance for WDR97 and policy volatility.

6.19 Improvements in service delivery and policy-making will emerge from three key sets of institutional reforms: (i) reforms in the budget process; (ii) improved public administration and civil service; and (iii) reforms in the legal and judicial systems to assure the rule of law and to provide a check on arbitrary state action.

6.20 Improvements in the institutional arrangements for budget formulation and execution are fundamental. In common with the wider region, especially FSU, countries in the South Eastern Europe have generally found it difficult to establish a process of budget formulation that establishes genuine policy contestability. Reform of budget preparation requires shifting central agency responsibilities from a central planning and control function, to a role in which aggregate fiscal discipline is maintained both in budget formulation and execution and a less directive, more collaborative process is developed to encourage bottom up preparation of policy and budget options, from sector agencies and policy units. The story is mixed on the former but fairly uniformly weak on the latter.

6.21 Transparency in budget execution is essential. The successor states of former Yugoslavia have shown a range of divergent paths out of the ZPP system, which previously carried responsibilities for treasury functions, payments systems, some statistical functions, and interface with parastatals, among others. Some countries have attempted to develop treasury systems as stand alone agencies, while removing the payments system responsibilities that belong to the central bank and banking sector, while others have aimed at a more conventional treasury function within the central Finance ministry. In most cases there have been some common problems in establishing treasury operations as a transparent, non-discretionary function that are focused purely on implementation of an approved budget. The broad institutional objective does not differ from non-Yugoslav cases (e.g., Albania) but there are some distinctive features of the task of dismantling the ZPP system.

Box 6.1: Budget Management Reforms in South Eastern Europe

There are several common elements in budget management issues in South Eastern Europe. The region includes a number of countries facing issues associated with a rapid influx of aid, such as:

- finding mechanisms to ensure adequate accountability for donor financing, in a context in which long term formal structures of accountability for public resource management are not in place;
- accommodating major flows of aid within the budget on a sustainable basis: (i) ensuring that aid flows are in aggregate and in composition compatible with plausible longer term budgetary projections; and (ii) establishing mechanisms for integrating aid financing within the Government's own budget process.

A key challenge is to meet the specific accountability concerns of the Bank and other donors in a manner that provides maximum support to the development of sustainable patterns of accountability to local stakeholders. There is a significant opportunity and risk here. Donors accountability concerns may be addressed in ways that act as a catalyst to accelerate the development of local accountability and the growth of broad transparency in budget management. Examples might include:

- using expenditure tracking studies as a means of identifying system weaknesses in public expenditure management;
- integrating the discussion of donor financing plans within Governments own budget cycle, in a way which maximizes transparency and predictability of both Government budgetary planning and donor financing;
- reviewing Government expenditure plans and performance in a way which maximizes the participation of civil society, e.g., legislature, NGOs;

Alternatively, the donor community may expend its leverage in ensuring narrow, bilateral accountability for aid flows, meeting individual donor audit concerns or required expenditure practices, etc. in a manner which effectively supplants demand for sustainable patterns of accountability. This not only misses an opportunity to develop long term institutions of accountability, but may delay such progress, by developing parallel systems of accounting and by encouraging Government to view its accountability obligations discharged in meeting donors immediate concerns. Using the opportunity to strengthen long-term accountability means, among other things:

- giving more attention to accountability for total public expenditure rather than exclusively donor funded activities;
- focussing on transparency/contestability in budget formulation, as well as downstream concerns on implementation;
- focussing on realistic programs for strengthening accountability for the whole budget, based on a credible sequence of institutional reform (e.g., avoiding over ambitious goals such as some of the attempts to introduce performance budgeting in the region).

6.22 Public institutions can only function with a strong civil service and functioning public administration. Civil servants need incentives for adequate performance, which requires the establishment of merit-based bureaucratic career paths. Many of the civil services in the region lack a structured civil service, established and managed according to merit principles and evaluated according to performance and not subject to arbitrary political interference. Size, as far as the limited data indicates, is not a particular problem, but salaries are.

Box 6.2: Public Administration in Romania

Romania's civil service has been spared the two most salient problems of many former Soviet bloc civil service systems—it is neither overly large nor too great a fiscal burden on the overall economy. However, Romania's public administration suffers from two fundamental structural weaknesses: fragmentation and the absence of an agency in charge of personnel management and policy. These have consequences throughout the system—from availability of data and coherent leadership to overall coordination between objectives and subsequent courses of action.

Romania has taken some significant steps in redefining the scope of Government. Pre-1989 the country had the largest number of Ministries of any centrally planned economy outside the Soviet Union. Since 1990, the number of Ministries has fluctuated, reaching 24 in the early 1990s. In the last two years the number of Ministries has been reduced to 15 with about 24 specialized agencies. Although this consolidation has been helpful government nonetheless remains excessively fragmented. The latest, and admittedly incomplete account, counts some 1,821 institutions subordinate to these Ministries and agencies. Within Ministries and subordinated agencies lines of authority are fairly clear on paper. In practice it is a highly fragmented service, where departments in Ministries do not communicate with one another, where inter-Ministerial relationships are highly rivalrous, and where duplication, and independent uncoordinated initiatives are the norm:

- there are too many agencies, with excessive duplication of tasks and outputs, and almost impossible to coordinate;
- Internal Ministry procedures are highly suspect and it does sometimes take between 10 and 15 signatures to obtain a paper clip or a pencil;
- Romania's public administration lacks a "service" mentality and reports abound of petty discourtesies, rudeness and contempt visited upon ordinary people in their dealings with the bureaucracy.

Size is not the problem. After increasing by some 15 percent between 1999 and 1995, the total number of employees of the state and local administrations declined by 5 percent between 1995 and 1998. In cross-country comparisons these totals are not high and Romania's civil service is not overly large compared to other European countries. However, wages are. Between 1990 and 1998, civil servant wages fell by 38 percent. By contrast, real net average wages elsewhere in the public sector fell by between 16 and 20 percent. Average wages in the banking and financial sectors, increased by over 70 percent in real terms in the same period.

Source: Romania, Public Expenditure Review Part II—Civil Service Reform (IBRD Report No. 17744–RO) June 2, 1998; "Public Administration Reform, Judicial Reform and Anti-Corruption", Farid Dhanji, November 1999 (mimeo).

6.23 In relation to legal and judicial reforms, considerable progress has been made across the SEE region in designing a legal framework. In the case of commercial law, an extensive legal framework is in place in most SEE countries (with the exception of Albania

and Bosnia and Herzegovina), although some fine-tuning is still needed. However, the enforcement arrangements remain an area of concern. Court proceedings often remain time-consuming and inefficient. Regulators often fail to use their enforcement powers against liquidators, directors, banks, and other financial intermediaries. Failure to take prompt corrective action, coupled with time-consuming court proceedings, means that creditors, investors and shareholders are often left with no real or effective legal recourse. Poor contract enforcement has supported a “non-payment culture”.

6.24 A regional center for judicial training could build on the experiences of the regional working groups on legal approximation established under the Cooperation Agreements in Albania and FYR Macedonia. The Council of Europe and others have highlighted the significance of regional training for judges, and the potential of networks of Presidents of Supreme Courts.

E. COMBATING CORRUPTION

6.25 Monitoring of corruption and other key aspects of government performance must be stepped up. There is a growing consensus that corruption in all its forms must be identified and credibly deterred. However, in addition to deterrence there could be some positive incentives provided for government progress towards stronger institutions that conform more to EU and OECD norms. Based on indicators available, corruption in SEE countries is high. The Transparency International Corruption Perceptions Index places—among a total of 99 countries ranked—Bulgaria, FYR Macedonia and Romania on country rank 63, Croatia on rank 74 and Albania on rank 84. This compares to Slovenia (rank 25), Hungary (rank 31), Czech Republic (rank 39) and Poland (rank 44).⁶⁴

Table 6.6: Transparency International Corruption Indicators ¹

<i>Countries</i>	<i>1999 CPI Score (Index ranges from 1-10)</i>	<i>Country Rank (among 99 countries rated)</i>
Hungary	5.2	31
Bulgaria	3.3	63
FYROM	3.3	63
Romania	3.3	63
Croatia	2.7	74
Albania	2.3	84

1. The Transparency International Corruption Index for 1999 has been published on October 26, 1999. CPI scores relate to perceptions of the depth of corruption as seen by business people, risk analysts, and the general public and ranges between 10 (highly clean) and 0 (highly corrupt).

6.26 Important programs to combat corruption in the region are already under implementation. A comprehensive program has been formulated in Albania after the

⁶⁴ Transparency International (TI) is a not for profit, non-partisan organization that works to mobilize civil society, business, academia and government, to curb corruption.

completion of a survey on corruption. This program is presently under implementation. Corruption surveys and programs are being prepared also for Bulgaria and Bosnia and Herzegovina. In Bulgaria, this will supplement and support the Government's own program and the survey work undertaken by Coalition 2000.

Box 6.3: Actions against Corruption in Albania

In Albania, a Commission Against Corruption was created by the Government Decree no. 72 of January 30, 1998 with the formal objectives (i) to establish a strategy for the organization and direction of the fight against corruption; (ii) to realize an effective co-ordination of the anti-corruption activities of the state institutions and private sector; and (iii) to ensure the necessary cooperation with the International Financial Institutions supporting the Government's anti-corruption initiatives.

In collaboration with the World Bank and USAID, independent surveys of enterprises and households, as well as interviews with public officials were conducted by the Albanian Center for Economic Research, a non-governmental organization.

The surveys indicated that:

- more than one-half of the firms admit they pay bribes to public officials. the cost of corruption to these firms is approximately 7 percent of turnover;
- the incidence of bribery from firms to public officials is greater for trade and construction enterprises than in manufacturing and services; approximately three-quarters of firms in trade or construction admit to paying bribes;
- almost one-half of private citizens admitted to paying bribes since 1991;
- public officials confirm that corruption is pervasive: more than two-thirds of public officials surveyed said that bribery is extremely prevalent in Albania;
- according to public officials, more than 50 percent of customs inspectors 'purchase' their positions;
- 1/4 of private citizens who had a family member who was seriously ill admitted to paying bribes to state medical workers.

A major program of institutional and policy reforms designed to reduce corruption was developed and openly discussed at a workshop on June 30th 1998 in Tirana. The workshop provided an opportunity for the Prime Minister to demonstrate significant commitment to the program. A government action plan to address corruption was the subject of intense debate during the workshop. The results and conclusions of the Workshop made the headlines of all newspapers and TV stations, opening up a robust public debate.

The success of the workshop depended on the extensive planning and analytical work that had preceded it, and on the compelling data concerning corruption provided by the surveys.

The flagship reforms proposed to the Workshop were:

1. Support for the judiciary in its radical overhaul.
2. Radical overhaul of tax and customs.
3. Budget transparency for schools, hospitals and other public services, facilitating customer complaints.
4. Further improvements in public procurement, audit and civil service professionalism.

Overarching these flagship reforms, government is committed to publish the recent survey data, undertake regular surveys in the future, and work with NGOs to review progress on the agreed action plan.

6.27 Under the Stability Pact an Anticorruption Initiative has been announced during the OSCE summit in Istanbul in November 1999.⁶⁵ The Initiative defines three different objectives: (i) economic objectives; (ii) public integrity objectives; (iii) civil society objectives. The different objectives provide for catalogue of different measures to be taken.

Box 6.4: Stability Pact for South East Europe - Anti-corruption Initiative

The Anti-corruption Initiative acknowledges corruption and other fraudulent and criminal activities as:

- Highly damaging to the stability of democratic institutions, erosive to the rule of law, breach of fundamental rights and freedom.
- Undermining the business climate, discouraging for domestic and foreign investment, constituting a waste of economic resources and hampering economic growth.
- Thus, detrimental to the very objective the Stability Pact.

The Initiative defines the following commitments governments of the region will undertake:

- Adoption and implementation of European and other international instruments. Taking effective measure on the basis of existing relevant international instruments, in particular those of the Council of Europe, the European Union, the Organization for Economic Cooperation and Development, the United Nations and the Financial Action Task Force on Money Laundering.
- Promotion of good governance and reliable public administrations. Promoting good governance, through regulatory reforms for better transparency and accountability of public administrations, through development of institutional capacities and through establishment of high standards of public service ethics for public officials.
- Strengthening of legislation and promotion of the rule of law. By ensuring true separation of executive, legislative and judiciary powers and the independence of investigative and judiciary bodies and by enhancing investigative capacities.
- Promotion of transparency and integrity in business operations. Through inter alia enactment and effective enforcement of law on accepting and soliciting bribes, open and transparent conditions for domestic and foreign investment, corporate responsibility and modern and internationally accepted accounting standards.
- Promotion of an active civil society. By empowering civil society and media to galvanize community action, generate political commitment, creating a pattern of honesty in business transactions and a culture of lawfulness throughout society.

The Council of Europe and the OECD are asked to co-chair this initiative and with the full support of the Special Coordinator of the Stability Pact. An Action Plan will be drawn by the co-chairs, together with the Office of the Special Coordinator and all the members of the Pact and countries committed to the Corruption Initiative in order to develop concrete projects, reforms and actions within a jointly agreed timeframe to fulfill the objectives of the Initiative.

⁶⁵ See Special Coordinator of the Stability Pact for South East Europe, communication of November 16, 1999.

F. MONITORING FOR LONG-TERM INSTITUTIONS BUILDING

6.28 The institutions which comprise ‘governance’ can be characterized in three broad groups. There are institutional arrangements that in effect make up the basic architecture of the state. These include the relationships between the executive, legislature and judiciary, and the arrangements for the transfer of power between successive governments including voting arrangements and electoral laws. There is every reason to believe that these institutional arrangements are fundamentally involved in creating or preventing corruption, even though it is difficult to point to the exact linkages.⁶⁶ There is also a series of institutional arrangements that are more technical and potentially ‘tractable’ through external interventions. These include public expenditure management arrangements and budgetary processes, inter-governmental relations including fiscal transfers, civil service pay and personnel management and legal and judicial arrangements. In addition there are the institutions of civil society, the NGOs and the media, that place pressure on governments to improve accountability.

6.29 There are two clear lessons from experience with governance reform: institutional reform is very difficult, and even the seemingly ‘tractable’ institutions such as budgetary processes or legal and judicial arrangements are hard to fix.

6.30 These difficulties arise, in part, because reform arrangements are often technically complex and can fail in any number of ways.⁶⁷ More noteworthy is that all institutional and governance reforms upset prevailing interests. Interests presently vested in the status quo understandably will oppose changes likely to adversely affect them. Resistance can come from civil servants that feel threatened by a loss of influence, or interest groups that fear

⁶⁶ Dr. Johann Graf Lambsdorff (senior research adviser to Transparency International and assistant professor at Göttingen University) notes that the empirical evidence that democracy reduces corruption is weak. He cites two unpublished studies by Paldam [1999] and Treisman [1999] that investigate this relationship while controlling for the level of development as depicted by GDP per capita. In such multivariate regressions democracy does not significantly impact on levels of corruption (as measured by the Transparency International index). The two authors therefore argue that the effect of democracy is ambiguous. There only appears a small but significant influence when testing for countries that have been democracies without interruption since 1950. The only tentative conclusion possible is that while the current degree of democracy is not significant, a long period of exposure to democracy is associated with less corruption. See Paldam, M. (1999), "The Big Pattern of Corruption. Economics, Culture and the Seesaw Dynamics", Unpublished manuscript, Aarhus University, Denmark, June, and Treisman, D. (1999), "The Causes of Corruption: A Cross-National Study." Unpublished manuscript, University of California, Los Angeles, June.

⁶⁷ For example, 'tractable' institutions in public expenditure management include complex institutional arrangements to ensure fiscal discipline by maintaining stable macroeconomic and fiscal frameworks which are consistent with government estimates and which avoid divergence between potential revenue as sanctioned by tax legislation and actual revenue. It also includes arrangements that ensure that the budget is a credible signal of government policy with a clear role for the legislature. Intergovernmental arrangements include mechanisms for preserving stability and predictability in transfers with clear assignment of revenues to each level of government. Civil service arrangements must constrain the total costs of employment while preserving incentives that avert resistance by public sector employees to the implementation of legitimate policies. Legal and judicial arrangements must underpin property rights and contracts and ensure that the poor are able to turn to the courts for resolution of private disputes.

that their normal points of access to influence will be cut off, or legislators in some settings who will worry that reform will enhance executive power and thereby diminish their own.

6.31 In summary, although governance reforms are generally described in terms of efficiency, they are not Pareto optimal: they produce losers as well as winners. The typical makeup of these would-be winners and losers can give rise to a daunting collective action problem. Institutional reforms tend to impose direct and immediate costs on relatively small, privileged groups that can be expected to act collectively in defense of their interests. Meanwhile, the same reforms promise only uncertain benefits to a dispersed and unorganized population. Compensating the losers may be a way out of this political dilemma. However, reforms designed to enhance economic efficiency tend to come at the expense of instruments that facilitate political consensus, including the side payments available to cut deals and pay off otherwise recalcitrant players. Despite these commonly observed difficulties, reform of ‘state architecture’, ‘tractable’, and ‘civil society’ institutions is possible. But there are three important caveats concerning participation, ownership and information.

6.32 Participation within government is important. Engaging effectively with the arrangements concerning these three types of institutions within government requires a constituency for change. Beyond the usual rhetoric concerning political will, it is crucial to build partnerships with those who must implement the reforms. The participation of key players (court clerks in the case of judicial reform, senior officials in the case of changes in employment arrangements, etc.) is key.

6.33 Participation from civil society and the service recipients and stakeholders is crucial. Placing pressure on government to perform requires building constituencies among those that would benefit most from improved services. International partners and donors cannot invent and sustain genuine grassroots associations. However, donors have demonstrated an ability to empower the “voice” of established or incipient groups by brokering discussions with government representatives, and facilitating contacts with like-minded domestic and/or international counterparts.

6.34 Participation rests on information—transparency matters and indicators can be a powerful device for conveying information. Information is essential for interested parties within and outside government to reach consensus about the nature of a governance problem and agreement over how to measure improvements. For both government officials and stakeholders, a modest but credible and regularly published set of indicators provides some benchmark data against which they can judge their own experiences and assess concrete improvements. Only with adequate information will it be possible to benchmark progress in governance reforms and guard against program “capture” by societal groups that were not the program’s intended beneficiaries.

6.35 Broadly speaking, beneficiaries care about performance and public officials care about the institutions. The trick is to find indicators that will have resonance with these different constituencies. The indicators should ideally respond in a timely fashion to improvements in governance, and be relatively resistant to manipulation or distortion from extraneous events.

6.36 The development of a set of agreed measures and indicators to monitor progress in the implementation of such measures would help in assessing institutional progress in the region. This would respond to the reality that data in the SEE regions is sparse, and would provide a common set of targets to aim for. This would be accompanied by continuing determined focused assistance for priority institutional reforms such as budget management.

G. CONCLUSION AND PRELIMINARY ACTION PLAN

6.37 This section proposes four concrete sets of actions. First, on the premise that the Pact can only meet its aims if it has, and is seen to have, effective monitoring capacities, it outlines how an innovative ‘governance measurement’ program could be developed by the international organizations and Governments collaborating through the Stability Pact. It outlines how eye-catching but robust measures can be developed in relation to ‘state architecture’, ‘tractable’ and ‘civil society’ institutions and then widely publicized. It also suggests how these might be used to provide incentives on governments towards reform.

6.38 Second, it proposes that a basket of regional advisory services be provided through the Stability Pact, although undertaken on the ground by the International Financial Institutions and other donors and partners. These services would be provided to governments at their request, and could include experts review panels on legislation, a regional procurement advisory office, a regional training facility for senior officials, and a public audit regional support team.

6.39 Third, it proposes that regional and national technical assistance programs be coordinated through the Stability Pact. This would require a light touch as there are many diverse activities and donors would resist additional levels of negotiation. However, the scale of technical assistance that is and will be flowing into the region is such that the risk of overlap and lack of coordination is considerable.

6.40 Finally, this section proposes that a rapid start be made on the governance measurement program. The World Bank is offering collaboration with two key donor partners in an Institutional and Governance Review for the region. This analysis could launch the first set of indicators on a regional governance web site within six months.

6.41 The first action proposed is that the international organizations and Governments from outside the region involved in the Stability Pact and in the associated Anti-corruption Initiative develop and widely publicize a common set of indicators and benchmarks. The explicit intention will be to provide maximum publicity to performance measures and indicators of institutional progress, encouraging comparison between countries and over time. International organizations and Governments may in time wish to link some of their technical and other assistance to improvements in key measures. Donor coordination mechanisms might be developed around the indicators that provide incentives for more rapidly reforming countries.

6.42 The framework proposed is that a common set of indicators of government performance and institutional progress are prepared and extensively publicized under a ‘governance measurement’ program. Government performance indicators relate to services

and interactions with government that the public and businesses directly experience, while indicators of institutional progress are intrinsically more technical and likely to interest government officials more than civil society. These indicators of institutional progress will not remove the role that judgments play in assessing institutional reforms.

6.43 The costs of launching this ‘governance measurement’ program would be modest, particularly if the emphasis on data collection is in self-reporting by governments, with the burden of proof falling on the country in the event that any data is challenged by any of the Stability Pact members. However, the cost is not insignificant and operational funding will be necessary to support the key monitoring functions including both active monitoring functions (undertaking surveys, etc.) and passive (e.g., receiving appeals).

6.44 Annex 2 to this chapter provides an illustration of the measures that would be developed and publicized. It shows some likely indicators for the ‘tractable’ institutions. Robust methodologies already exist for the majority of these indicators and some international comparative datasets are available. Similar indicators would be constructed for the ‘state architecture’ and ‘civil society’ institutions. The Annex also shows the methodology for the institutional measures and the growing international constituency for their development and use, coordinated via the Development Assistance Committee of the OECD.

6.45 On the second proposal, the basket of essential regional services be provided directly through the Stability Pact could include expert review panels on legislation with capacities to respond to government requests for the review of laws, regulations and amendments to ensure compliance with Stability Pact objectives. A regional procurement advisory office, could assist in guiding procurement for major and regional purchases and develop procurement capacities in countries.

6.46 In addition a regional joint training facility for senior officials could provide a much-needed boost to the development of professional public services. By providing a multi-country facility for training at very senior levels in administration and policy development, this institution could encourage convergent policies could assist in building communication channels among civil servants of the respective centers of Government.

6.47 A Public Audit Regional Support Team could respond to the reality that the process of creating an Independent Supreme Audit Institution has proved difficult throughout the region. Such a Support Team could be called on by the existing state audit bodies or governments in response to immediate concerns and could assist in both filling the immediate needs for technical assistance, and developing state capacities in the longer term.

6.48 The third proposal is that regional and national technical assistance programs be coordinated through the Stability Pact. As noted, this would require a light touch as there are many diverse activities and donors would resist additional levels of negotiation. However, the volume of technical assistance that is needed by governments in relation to issues as diverse as policy formulation and policy coordination, governmental information systems, capacities of national Parliaments, budget execution and procurement, civil

service management, and capacities at sub-national levels of government suggests that then risk of overlap and lack of coordination is considerable.

6.49 Finally, and as a kick start to the development and explicit use of measures of institutional progress to provide incentives for reform, the World Bank is proposing to undertake a regional Institutional and Governance Review, in collaboration with two key donor partners. The results from this political economy and institutional analysis would launch the first set of indicators on a regional governance website.

DATA SOURCES

Abbreviations:

FH	Freedom House
WDR	World Development Report Survey of Enterprises 1997,
EBRD -	EBRD/World Bank 1999 Business Environment and Enterprise Performance Survey
TI	Transparency International
KKZ	Kaufmann, Kraay, and Zoido-Lobaton, 1999
ICRG	International Country Risk Guide
GFS	IMF Government Financial Statistics
WDI/ITU	International Telecommunications Union (from World Development Indicators)

Indicator	Year	Source	Sample Size (number of countries)	Definition
Political processes	1998	FH	28	From the Freedom house publication "Nations in Transit": 1-7 scale based on expert perceptions. Lower values are an indication of free and fair elections.
Civil society	1998	FH	28	From the Freedom house publication "Nations in Transit": 1-7 scale based on expert perceptions. Lower values indicate stronger NGOs and trade unions, and interest group participation in the policy process.
Independent media	1998	FH	28	From the Freedom house publication "Nations in Transit": 1-7 scale based on expert perceptions. Lower values indicate greater freedom and financial viability of private media.
Rule of law	1998	FH	28	From the Freedom house publication "Nations in Transit": 1-7 scale based on expert perceptions. Lower values are an indication of judicial independence and human rights protection.
Corruption /3	1998	FH	28	From the Freedom house publication "Nations in Transit": 1-7 scale based on expert perceptions. Lower values indicate less corruption.
Government and public administration	1998	FH	28	From the Freedom house publication "Nations in Transit": 1-7 scale based on expert perceptions. Lower values indicate greater transparency, decentralization, and power of the legislature.
Predictability of rule making	1997	WDR	67	Average of four survey questions on predictability of laws and policies, each based on a 1-6 scale, from the WDR 1997 survey of private firms.
Predictable judiciary	1997	WDR	67	Average response on a 1-6 scale, agreeing or disagreeing with statement that "unpredictability of the judiciary presents a major problem for my business operations." From WDR 1997 survey of private firms.
Time spent dealing with government officials	1997	WDR	67	Country average of survey responses on a 1-6 scale, with larger values indicating more time spent.
Law and order index	1998	EBRD	20	Constructed from survey responses to several questions on the Business Environment and Enterprise Performance Survey. Responses are on a 0-3 scale, with larger values indicating greater law and order.
bribes as percent of firm revenues	1998	EBRD	20	Average level of bribes paid by firms as a share of revenues. Based on a question in the Business Environment and Enterprise Performance Survey.
Percent firms paying bribes frequently	1998	EBRD	20	Percentage of firms that "always," "mostly" or "frequently" make "unofficial payments."
TI Index	1999	TI		Based on a question in the Business Environment and Enterprise Performance Survey. Composite of survey indicators (from up to 14 sources). Larger values indicate less corruption.
Graft Index	1997	KKZ	155	Composite index of various survey indicators (from KKZ, 1999). Larger values indicate less corruption.
Voice and Accountability Index	1997	KKZ	173	Composite index of various survey indicators (from KKZ, 1999). Larger values indicate greater voice and accountability.
Political instability and violence index	1997	KKZ	155	Composite index of various survey indicators (from KKZ, 1999). Larger values indicate less instability and violence.
Rule of law index	1997	KKZ	166	Composite index of various survey indicators (from KKZ, 1999). Larger values indicate greater law and order.
Bureaucracy Quality	Dec.-99	ICRG	140	The institutional strength and quality of the bureaucracy is another shock absorber that tends to minimize revisions of policy when governments change. High points are given to

Law and Order	Dec-99	ICRG	140	countries where the bureaucracy has the strength and expertise to govern witho Law and order each comprises zero to three points, and assesses the strength and impartiality of the legal system, and popular observance of the law respectively. Higher values indicate greater law and order.
Corruption	Dec-99	ICRG	140	Measures corruption within the political system. Higher values indicate less corruption.
Policy volatility	1993-96	GFS	83	Median percentage year –to-year change in the share of central government expenditures accounted for by each functional classification, over the last 4 years.
Wait in years for telephone line data coverage	1997	WDI/ ITU WB		Average, from ITU number of above sources out of the following 8 with available data: HF, WDR97, EBRD, TI, KKZ, ICRG, GFS, WDI/ITU

MEASURING INSTITUTIONAL PROGRESS

The Menu Of Options

There are broadly three types of governance indicators:

1. published 'perception' indicators
2. World Bank, internally-generated perception indicators
3. hard measures of institutional arrangements

These three types of indicator are complementary, but have different characteristics. In essence, the characteristics are:

	Published 'perception' indicators	Bank-generated perception indicators	Hard measures of institutional arrangements
Availability	Extensive - many published indicators.	Now available within the World Bank but not released for dissemination	Very few currently available.
Country coverage	Varies - but few indicators cover all countries.	Covers all countries	In principle could cover all countries.
Focus	Very general - tend to refer to broad areas of concern.	Fairly general.	Point to specific institutional arrangements.
Proven relevance to development	High - known to correlate closely with development outcomes.	High.	Widely asserted by the relevant professional specialists, but unproven.

1. The first category (external published 'perception' indicators) are the most readily available. Recent work by Kaufmann, et. al has aggregated these to produce a composite series of indicators. Individual indicators tend to be unreliable, however if multiple indicators are aggregated together, what is gained in reliability is lost in precision and focus. Although subjective ratings of the quality of governance obtained from different sources tend to rank countries similarly, the discrepancies are large enough that we often cannot make confident conclusions to the effect that, for example, corruption is less of a problem in country X than in country Y. Discrepancies among various subjective ratings reflect some unknown combination of measurement error and differences in what each data source purport to measure. (As an example of the latter, corruption ratings may variously attempt to measure bureaucratic, legislative, or judicial corruption, and may attempt to measure the severity of corruption as a cost of doing business for either foreign

or domestic firms). Whether the source of these discrepancies across ratings reflects differences in definition and criteria employed, or alternatively reflects biased or inaccurate information, the fact that these discrepancies exist implies that indicators from any one source will not fully and accurately measure the relative severity of corruption, or of other dimensions of institutional performance, across countries.

2. By aggregating multiple subjective measures obtained from various sources, we can capture more dimensions of institutional performance, as well as reduce measurement error somewhat. However, this gain comes at the expense of an even greater loss in specificity (lack of specificity is a drawback even to individual subjective indicators). Aggregation leads to very broad and general measures of government performance, but no particular policy or institutional change flows from that measurement, since there has been little work on how to "change" these indicators.

3. The second category of indicator has not solved these problems but has the advantage of being in circulation and recognized within the World Bank. Significantly, the potential value of these indicators is that the Bank is in a position to improve their construction. Currently some members of the Board are skeptical about their use but this may change.

4. In summary, existing published governance data sets individually are only partial or inaccurate indicators of performance; if aggregated to gain accuracy, their lack of specificity is compounded to a degree such that they cannot point the way towards particular institutional reforms. The consequence is that existing indicators when used by themselves carry an implicit 'loading' of assumptions concerning proposed policy and institutional reforms. Since the indicators report that government performance is bad, but without giving an indication of what to do, they implicitly argue for less government. Broad brush 'corruption' indicators tend to be associated with arguments for de-regulation and independent judiciary able to constrain the executive. They are less automatically associated with budget process reforms or altered civil service career paths. Solutions that constrain or reduce the executive become favored over those that reform it. However, it will require a substantial investment in measures of institutional arrangements to develop a set of indicators that will allow targeted institutional reform proposals to be developed.

5. For benchmarking progress in the region, it is necessary to draw from the third category of indicator (hard measures of institutional arrangements). Tracking good government at any level below the broad-brush generalities that predominate in this area (i.e., if we were to look at good regulation, good macro policy, good rule of law, etc. as distinct components of good governance) requires that we assert that specific institutions, legal, political, bureaucratic, are associated with good government outcomes.

An Illustrative Set Of Indicators For The ‘Tractable’ Institutions

Governance concerns	Indicators of performance - useful to build constituencies with beneficiaries	Indicators of institutional progress - useful to build constituencies with public officials
Implementation of strategic priorities which are pro-poor, avoiding underfunding of sectors such as health or education and inequities in regional funding.	<ul style="list-style-type: none"> • Share of the budget allocated to key sectors • Deviations between allocations and actuals 	<ul style="list-style-type: none"> • Policy volatility • Delays in auditing • Compliance with auditing standards for military expenditures • Central government “bail outs” of local governments
A results-focus in providing pro-poor services and a capacity to facilitate private sector production of key services from ministries and sub-national governments.	<ul style="list-style-type: none"> • Service utilization rates • Estimates of demand/supply gaps • Cost per output • Timeliness • Customs delays • Time spent dealing with government officials • Unofficial payments to secure government contracts. 	<ul style="list-style-type: none"> • Variance by spending units at sector level • Numbers of civil and public servants in comparison with international practice • Civil service pay (vertical compression) • Civil service pay (comparisons with the private sector) • Civil service pay (horizontal compression) • Political appointees in the civil service • central government “bail outs” of local governments
Ensuring that the poor are not distinctively vulnerable to crime and that they have access to justice, without gender and ethnic inequities enshrined in legislation.	<ul style="list-style-type: none"> • Adequacy of legal assistance • Availability of material that explains legal processes • Perceptions of the degree of corruption of courts, police and prosecutors. 	<ul style="list-style-type: none"> • Percent of private land formally titled.
Adequate market opportunities for the poor.	Costs in time and money to obtain business permits.	

Methodology For The Institutional Indicators

6. A list of credible measures of institutional arrangements is set out below, generated by extensive dialogue with public institutional specialists. These represent the underpinning professional assumptions in relation to public expenditure management, audit, civil service, legal and judicial strengthening, etc. It should be emphasized that these indicators are highly credible, and derive from professional experiences. However, we can not test the robustness of any relationship between these and governance outcomes since, as yet, we do not have the data. In effect, although we know that in the aggregate institutional strength is related to development, we do not know specifically how budgetary arrangements, or legal institutions, or civil service pay, contribute to that relationship.

Indicator	Underpinning assumption	Proposed method of calculation
<i>Policy and public expenditure management</i>		
Policy volatility.	The budget should be a credible signal of government's policy intentions - and radical variations indicate that there is no coherent set of policy priorities and that officials charged with implementation will not take policy statements seriously because it is likely to change.	Volatility will be calculated as the percentage difference from year to year in approved budgets, by functional classification, over the last five years (summed over functional classifications). The presence of "very large" differences is to be defined after collecting the data for numerous countries.
Excessive consistency.	The budget should be a credible signal of government's policy intentions and the absence of any changes indicates that the budget is not linked to policy priorities, is formulated incrementally, and is not performance oriented.	"Excessive consistency" will be calculated as the percentage difference from year to year in approved budgets, by functional classification, over the most recent five-year period. "Very small" to be defined after examining data to be collected for numerous countries.
Delays in auditing.	The government should be held accountable by the legislature for its policy actions. Lengthy delays are an indication that the government is not held accountable by the legislature for its actions.	"Delays in auditing" will be measured as the elapsed time between the end of the financial year and the tabling of externally audited financial statements in the legislature.
Compliance with auditing standards for military expenditures.	Lack of compliance indicates lack of accountable and suggests military spending is not for legitimate purposes of defense.	Methodology under development building on the experiences of the US State Department in measuring this.
Variance by spending units at sector level.	Spending units should know in advance what their budget funding would be as a prerequisite for operational efficiency and managerial accountability.	"Variance by spending unit" is the total of the absolute deviations between: (i) budgeted allocations for non-personnel costs (operations and maintenance) and other recurrent costs; and (ii) actual expenditures under these appropriations, divided by the total budget for that sector, averaged across five key sectors: health, education, defense, roads and agriculture.
Improvements in revenue predictability.	Unplanned revenue shortfalls reflect low administrative capacity and/or deliberate overestimates to avoid difficult spending reductions, and should be reduced over time.	"Improvements in revenue predictability" will be measured as the average annual improvement in the difference between actual central government revenues and those projected in the budget, taken over the last three years, divided by the average annual shortfall.

Indicator	Underpinning assumption	Proposed method of calculation
<i>Public employment</i>		
Numbers of civil and public servants in comparison with international practice.	Government should be a responsible employer, restraining employment costs while ensuring that remuneration arrangements do not establish perverse incentives.	Methodology as per 1997 Schiavo-Campo, de Tommaso and Mukherjee study on public sector pay and employment.
Civil service pay (vertical compression).	Vertical decompression outside the range 1:7 to 1:20 undermines incentives for public officials to pursue a career and take disciplinary threats seriously.	The degree to which vertical compression ratios (the ratio of the midpoint of the highest civil service pay scale to the midpoint of the lowest civil service pay scale) are less than 1:7 or more than 1:20.
Civil service pay (comparisons with the private sector).	Average central government wages as a proportion of average private sector manufacturing wages below 0.5 provides inadequate attraction for skilled staff, or above 1.5 indicates capture by existing personnel.	Average central government budget funding for salaries divided by the total budget funded staff (excluding health and education personnel as necessary) as a proportion of average manufacturing wages.
Civil service pay (horizontal compression).	Horizontal decompression (discretionary allowances over and above base pay) in excess of 1:1.2 provides opportunities for excessive managerial discretion, facilitating organized corruption and rent seeking.	Horizontal decompression (within the lowest civil service pay scale, the ratio of the highest proportion of discretionary allowances, as a percentage of total compensation, to the lowest proportion of discretionary allowances, as a percentage of total compensation) is more than 1:1.2.
Political appointees in the civil service.	Government employees should be held in some respect by business and the general public, partly on the basis that they have been transparently appointed on merit.	"Political appointees" will be measured as the ratio of public officials who are appointed by a politician, without a formal merit-based selection procedure, to all public officials, in excess of 1:400.
<i>Inter-governmental relationships</i>		
Central government "bail outs" of local governments.	A hard budget constraint between tiers of government should be maintained through the intergovernmental system and the financial system.	Number of times in the last five years central government has had to assume financial or service delivery responsibility for a subnational government.
<i>Legal and judicial arrangements</i>		
Percent of private land formally titled.	Property rights and contracts should be respected.	Methodology under development.

Building An International Constituency For The Indicators

7. The Development Assistance Committee (DAC) of the OECD has been working to establish indicators which measure movement towards the meeting of major UN conference goals since the early 1990s. In "Shaping the 21st century: the contribution to development cooperation" (OECD, 1996) the DAC confirmed the goals and set out the areas of democratic governance that it saw as essential for achieving these goals. These

areas are: good governance (including public sector management, rule of law, corruption and military expenditure); human rights; democratization and participatory development. In 1996, the DAC ad hoc working group reported that it had failed to forge a consensus around some core indicators for these issues. However, since that time, demand for measurements of progress has increased significantly, particularly from the aid agencies.

8. A DAC proposal to a joint OECD/UN/World Bank joint meeting on Agreed Indicators of Development Progress in February 1998 re-launched the process and considerable progress has been made since that time. Detailed work is in progress by the Technical Group on Indicators of Participatory Development and Good Governance. The Technical Group has membership from the African Development Bank, Asian Development Bank, World Bank, Office of the High Commissioner for Human Rights, UN Economic Commission for Africa, UN Human Development Report office, UN Development Group Working Group on Indicators, European Commission, European Center for Development Policy Management, and the governments of France, Sweden, UK, and USA.

9. The World Bank has been asked to lead the working group examining indicators for good governance (to include Public Sector Management, Corruption and Military Expenditure). The working group will provide governance indicators for the publication by DAC of its work on indicators in January 2000, and the subsequent planned international forum to review the indicators and the data to be hosted by DAC on March 9 to 10, 2000.

10. The Technical Group has agreed that it will not be possible to identify corruption data at the country level where both the data and the method of interpreting are seen as credible or legitimate. The technical group has also accepted the proposition that indicators of military expenditures as a percentage of GDP or as a percentage of total expenditures are flawed as potential measures of good governance. The need for accountability of military expenditures is similar to all other functional categories of expenditure and the point of entry into governance is through strengthened financial management, transparency and audits.

11. The Technical Group has agreed that consequently the appropriate way forward is to develop simple empirically verifiable measures drawing from the following areas of institutional arrangements:

- public expenditure management performance measures;
- revenue mobilization performance measures;
- public employment performance measures;
- inter-governmental performance measures;
- legal and judicial performance measures.

12. These measures are consistent with the indicators being proposed in this note. For the DAC, one or two indicators will be drawn from this longer list. The DAC output is expected to contribute to the Common Country Assessment of the UN Development Assistance Framework.

7. INFRASTRUCTURE PROGRAMS IN SUPPORT OF ECONOMIC GROWTH AND REGIONAL INTEGRATION

A. INTRODUCTION

7.1 Improving infrastructure in the SEE region will be important to support economic growth and regional integration. The availability of infrastructure services—in transport, energy, telecom and water—is key to economic growth. In addition, without adequate transport systems linking countries together, trade cannot flourish; and without adequate communication facilities, citizens of different countries cannot be in reliable contact with each other, which also constrains possibilities for trade. Availability of adequate infrastructure is also essential for social cohesion in the region: the possibility to travel, interact, meet, trade is in fact necessary to create a multicultural society which respects and tolerates each other, and appreciates and recognizes cultural differences and values.

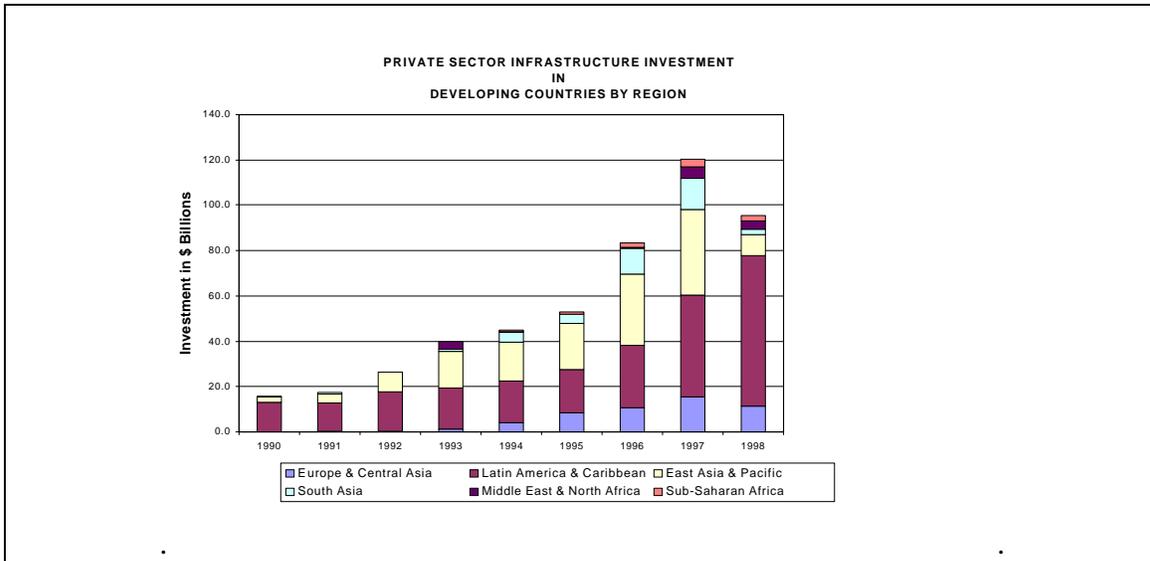
7.2 It is important to stress, however, that while infrastructure is important it is not sufficient to promote growth, integration, or social cohesion. Investments without the reforms necessary to strengthen institutions and promote private sector investment and trade will not be sustainable and will not generate their full potential benefits. In addition, investments without political and social leadership which supports tolerance and interaction in the region will not be sufficient to promote social cohesion. As discussed in Chapter 6, the creation of open, democratic participatory societies which allow for cultural and social diversity—including ethnic diversity—is equally important as investments in infrastructure to facilitate mobility, communications and cooperation. **Building large infrastructure without sound policies and institutions for private sector development and social cohesion and inclusion, means wasting large amounts of resources without achieving the objective of sustainable economic growth and prosperity for the region.**

7.3 Financing needs for infrastructure in SEE countries are high.⁶⁸ About half of public investment in SEE countries—estimated at around 4 percent of GDP—is infrastructure. These investment levels are in line with averages observed in other emerging market economies; they are however likely to be low, in light of the special circumstances of the region, where infrastructure needs to be rehabilitated or reconstructed as a result of wars, neglect and civil disruptions, and also in the perspective of improved integration within the region and with Europe. At the same time, as discussed in Chapter 2, many SEE countries could not increase their public spending

⁶⁸ The assessment presented here reflects positions taken by EIB in “Basic Infrastructure Investments in South Eastern Europe”, Summary prepared for the Working Level Steering Group for Donor Coordination in South Eastern Europe, Meeting on 24 September 1999 in Washington, D.C. and subsequent papers presented to the Stability Pact and the WLSG. EBRD contributions and the EC-funded PHARE studies have also been valuable sources of information for this chapter.

and/or borrowing because of domestic macroeconomic considerations; and it may also be difficult to raise adequate funding from traditional sources. For these reasons, as well as to increase competition and improve the cost/quality mix of services, it will be increasingly important to make progress in the commercialization of utilities, and in private involvement in funding infrastructure development, which are currently at a very early stage in the SEE region. The experience of developing countries shows in fact that it is possible to attract private investment, especially in telecom, energy and water (see Chart 7.1).

Chart 7.1: Private Sector Infrastructure Investment in Developing Countries



Source: World Development Report.

7.4 Infrastructure has important regional dimensions. First, significant efficiency gains can be made by pursuing infrastructure development regionally rather than on a national level. Given the small size of most SEE countries, development of infrastructure investments and policies strictly on a national basis does not allow for the exploitation of economies of scale, which are likely to be important especially in transport and energy. For example, trade in energy (power, gas, water for hydro-generation) will be facilitated through regional integration, and energy costs can be reduced through open and reliable energy trading systems. Second, since the benefits from regional projects are realized beyond national borders, fair mechanisms for financing, and in general burden sharing, of these regional projects will need to be established, again at a regional level. Third, the creation of new nation states with international borders can be an obstacle to trade and integration, if each border crossing is associated with long waits, new visa requirements, high transaction costs. Such obstacles can only be addressed by reaching international agreements on border crossing processes, the establishment of the necessary infrastructure at the border transit points and the implementation of supportive and efficient customs administrations. And fourth, the development of infrastructure is constrained by issues—including weak institutional arrangements and large rehabilitation and reconstruction needs—that are shared by SEE countries and thus warrant a coordinated, regional approach to addressing them.

7.5 One additional common element of infrastructure development in the SEE region will be the gradual adjustment towards EU standards and the EU *acquis communautaire*. This report argues (see Chapter 1) that clear prospects for European integration is an essential condition for sustained stability, security and prosperity in the region. Gradual progress towards the *acquis communautaire* is therefore essential. EU policies for the transport, telecommunications and energy sectors will need to be gradually and prudently introduced by SEE countries. A regional approach to providing assistance to SEE countries towards this objective should be considered.

7.6 This Chapter lays out sectoral policy and investment issues in transport, telecom, and energy. This Chapter limits itself to a general discussion on the selection policy for regional projects and does not review in detail individual projects. The EIB has in fact been given by the Stability Pact the leading role for developing and assessing projects in the infrastructure sector.

B. TRANSPORT SECTOR

Performance of the Sector and Key Issues

7.7 South Eastern Europe is on the crossroad between Europe and Asia and is also the natural transit route between Greece and the other EU Member States. Six out of ten multi-modal transport corridors included in the Helsinki and TINA Networks⁶⁹ go through South East European countries. The war in Yugoslavia, the sanctions and embargo, and the Kosovo crisis have resulted in significant disruptions on these corridors. Starting from the early 1990s, interruptions in the natural connections between Western, Central and South Eastern Europe have led to the diversion of traffic towards longer routes; at the same time, the creation of new nation states has increased the number of border crossings. More recently, the Kosovo war—despite causing limited damage to transport infrastructure in Kosovo—brought about extensive damage in infrastructure in FRY and new costly disruption of traffic throughout the region. Damage to road and rail bridges in FRY—whose replacement value exceeds EUR 1 billion according to EIB estimates—has again forced traffic to alternative routes and has blocked the Danube navigation.

7.8 Recent wars are not the only cause for the generally poor availability and quality of transport infrastructure and services in the SEE region. Though the countries in the region are significantly different, institutions and policies in the transport sector are generally weak. These weaknesses have led to decades of inadequate maintenance; continuing over-regulation of the sector; dependence of transport enterprises on

⁶⁹ The TINA (*Transport Infrastructure Needs Assessment*) process was launched in September 1995. Its mandate was to identify the transport investment projects in the accession countries along the pan-European Transport corridors as defined by the 2nd Pan-European Transport Conference (Crete, 1994) and updated at the third Pan-European Transport Conference (Helsinki, 1997). At the Helsinki Conference the concept of Pan-European Investment Partnership was endorsed to promote the connection of the Trans-European Transport Network (TEN) on the EU territory with the TINA Network of the accession countries, the Pan-European corridors on the territory of the NIS and the four Pan-European Transport Areas of the maritime sea basins and the Euro-Asian links, i.e., the TRACECA corridors.

subsidies; and insufficient progress towards commercialization and privatization of transport services (except trucking). As a result, low quality of transport infrastructure and services, and relatively high transport tariffs limit international competitiveness of SEE countries.

Roads

7.9 The networks of national and rural roads in the region are significant in density, though below the EU average. Motorways (1435 km) are concentrated in FRY, Croatia, Bulgaria, Romania and FYR Macedonia. The network is mostly in poor or fair condition. As priority has been given to new construction, in particular new motorways, without reforming the road financing system and introducing the *users pay* principle, huge backlogs of maintenance have resulted.

7.10 Traffic safety is of low standard (see Table 7.1). The risk of being involved in a road traffic accident is rapidly growing due to higher rates of motorization, speed levels, numbers of young inexperienced drivers, and numbers of vehicles with poor technical standard, at the same time as road surfaces have been deteriorating. The socio-economic cost of road traffic accidents is high, as it is estimated to cost around 1.5 to 2 percent of GDP on average.

Table 7.1: Road Fatalities in SEE Countries, the EU and the USA

	<i>Fatalities/10,000 vehicles</i>	<i>Motor vehicles (per 1000 people) in 1996^a</i>
Albania	27.8	31
Bosnia and Herzegovina	n.a.	24
Bulgaria	5.0	234
Croatia	8.1	196
FYR Macedonia	6.3	142
Romania	7.9	124
CEE-5	n.a.	295*
EU average	3.8	447
USA	2.1	506

• in 1997.

a. The World Bank, "World Development Indicators: 1998" Washington, DC: The World Bank, 1998.

Source: Eurostat and World Bank.

7.11 Trucking throughout the region has been privatized and licensing practices in Romania, Bulgaria and Croatia are close to those in the EU. The trucking sector is mostly operated by small entrepreneurs with limited financial viability. There are only a few international operators with long traditions in international markets, such as the recently privatized Bulgarian freight operator SOMAT. Further growth in the trucking sector will depend on access to international markets. The still protectionist bilateral quota system and the difficulties in acquiring multiple entry visas for commercial drivers

further constrain competitiveness. Romania, Bulgaria and FYR Macedonia have negotiated agreements with the EU on relatively liberalized transit arrangements,⁷⁰ but these do not provide for easier access to *bilateral and third country permits*.⁷¹ In case of Romania and Bulgaria liberalization of all trucking services (both international and cabotage⁷²) is expected when they join the EU. All SEE countries have also signed a SECI Memorandum of Understanding on the Facilitation of International Road Transport of Goods with the intention to gradually liberalize intra-regional road freight transport.

7.12 In order to facilitate international passenger transport by road a pan-European agreement, called *INTERBUS*, is under preparation. The agreement would liberalize certain occasional transport services and at the same time would provide for harmonization of rules on admission to the occupation, as well as technical (safety and emission), social and fiscal matters. This technical harmonization, however, will be difficult for many SEE operators, who cannot afford to replace their fleet with vehicles meeting the EU standards. In this way not all SEE countries will be able to have the benefits of liberalization.

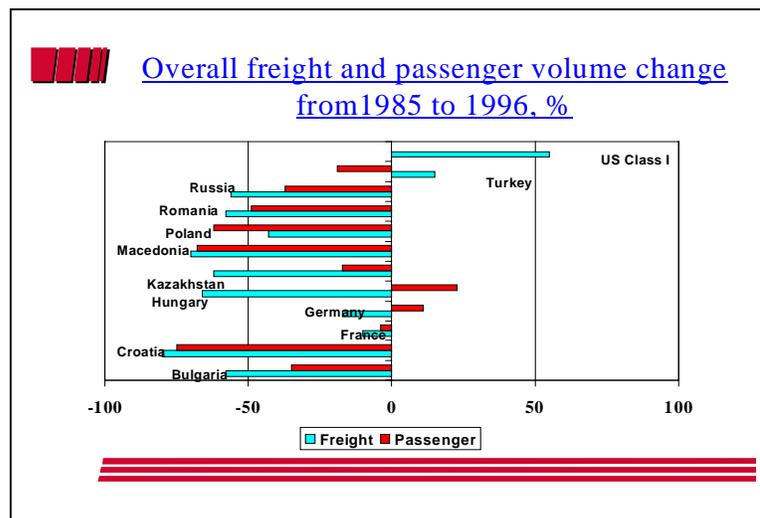
Railways

7.13 Railways networks are extensive in most South East European countries (except for FYR Macedonia, Bosnia and Herzegovina, and Albania) and often form the backbone of national and regional transport network. Railways are also important in economic terms, despite drastic traffic reductions resulting from weak economic activity throughout the region and increased competition from the newly liberalized road transport sector. In fact, the share of combined freight and passenger revenues still amounts to 0.6 to 1.9 percent of GDP in Romania, Bulgaria and Croatia (by comparison in the USA 0.4 percent, in France 0.5 percent).

⁷⁰ As a follow-up to the Europe Agreements three Transit Agreements have been negotiated between the European Community and Bulgaria, Romania and Hungary. These agreements ensure progressive and mutual liberalization of transit by the introduction of transit quotas in addition to the bilaterally existing quotas. Reciprocity is based on the recognition of transit through any Community Member States. The Transit Agreements also accelerate the adoption of EU standards, particularly the higher weight limits of vehicles. While this is part of the integration process, the consequent deterioration of the road networks in these countries will impose increased spending on road maintenance without the users' contribution (vehicles with over-weight are obliged to pay a fee; by the increase of the limits the amount of the collected fee will decrease). The Agreement between the EU and FYR Macedonia in the field of transport was concluded in 1998. It offers more limited transit opportunities for FYR Macedonia operators, as transit is restricted to journeys through the whole Community territory and destined for or originating from a third country.

⁷¹ *Bilateral or loco permits* allow delivery between the two contracting countries; *third country permits* allow transport between the other contracting party and a third country.

⁷² Cabotage: when a foreign operator is involved in domestic transport.

Chart 7.2: Recent Trends in Railways Traffic

7.14 The capacity and service of rail enterprises have deteriorated significantly, as a result of funding shortages leading to obsolete rolling stock, poor infrastructure and outdated signaling and telecommunications. These funding shortages have occurred despite the significant burden that railways continue to impose on their governments (in Croatia over 1.2 percent of GDP, in FYR Macedonia over 1 percent of GDP).

7.15 In order to address the challenges posed by increased competition and declining public subsidies, it is essential to improve rail operation and management, increase self-financing and open the sector to the private sector, especially in the provision of services. Major progress in these directions has already been made in Romania, with significant reform programs also underway in Bulgaria, Croatia and FYR Macedonia. The Romania Railway (SNCFR) was divided into five companies (infrastructure, passengers, freight, management services and assets), staff reduced by 21 percent and excess rolling stock sold. Bulgarian Railways reduced its staff by 12 percent in 1998 by eliminating regional management levels and started closure of non-core businesses. In Croatia, HZ was separated into two companies (infrastructure and operations) and staff was reduced by over 12 percent between 1997 and 1999.⁷³ Additional reforms are also necessary to progress towards the adoption of the EU framework.

7.16 The focus of new railway projects should also be on restructuring in line with EC legislation and to achieve compatibility with EU practices. This will significantly improve economic efficiency in transport, improve regional linkages and reduce financial burdens on the national treasuries. It will also improve access for the poorer regions to EU markets and for the urban poor to domestic employment.

⁷³ In all the three countries joint IBRD-EBRD projects are assisting the governments and the railways to make progress with the restructuring.

7.17 In the process of European integration, closer cooperation among the SEE railways and rationalization of investment in locomotive and rolling stock workshops, management information systems and route structure could help them improve cost efficiency due to their smaller size and scale. SEE governments could facilitate the revitalization of their railways and stop or possibly reverse their decline by introducing liberal conditions for their mergers across national frontiers and even for privatization of certain rail businesses.

Shipping

7.18 The South East European region has direct access to the Adriatic sea and the Black sea. **Maritime transport and ports** play a key role in international trade and could be a source of economic development. However, the major ports, like Rijeka, Zadar and Ploce in Croatia, Bar in FRY, Durres in Albania, Burgas and Varna in Bulgaria, and Constanta in Romania are at very different level of development. In addition, institutional and policy constraints are similar to those discussed for the transport sector in general, and include poor cost/quality mix of services, dependence of subsidies, low level of competition, and slow progress towards commercialization and private sector involvement.

7.19 The largest ports of the South East European region are located on the Black sea, linked to industries, close to the Danube: Burgas (15 m tons, industrial), Constanta (35 m tons). A number of small ports can also be found at the entrance of the Danube. The inter-dependence between the navigability of the Danube and the development of the ports is far from negligible. Varna (5.5 m tons, average multi-purpose port), Nessebar (small port for ferries and cruise ship), Mangalia (small developing port) are also important in regional development. Along the Adriatic coast, the new countries are small and many of them are landlocked. Three major ports, Trieste (Italy),⁷⁴ Koper (Slovenia) and Rijeka (Croatia) are in competition with each other. Rijeka enjoys relatively good connections but owing to decades of poor management, lack of maintenance and development, most traffic has shifted to Koper and Trieste. Numerous small-size ports belong now to Croatia (Sibenik, Split, Ploce and Dubrovnik), Montenegro (Kotor and Bar) and Albania (Durres). Due to a semi-continuous mountain range along the coast, their road and rail connections are rather limited. Their access to cargo is mainly in the niche markets (e.g., Ploce, for BiH) and local industries.

7.20 The main factor of development along this part of the Mediterranean basin can be the development of the Pan-European corridors, as they offer connections with the Central European markets, and a regional port reform based on commercialization of former SOEs and concessioning of the main facilities.

7.21 The **Danube** (Corridor VII in the Pan-European Network) is the longest navigable river of Europe and for nearly a decade has been connected via the Rhein-Main Canal to the Rhein. It offers unique transport opportunities between the Black sea and the Atlantic ports, but has been very under-utilized in the past, and is currently not navigable owing to

⁷⁴ Though Trieste is outside of the SEE territory, its significance for the Central European hinterland and its competitive services warrant its mentioning here.

the debris from the destruction of bridges in FRY during the recent Kosovo war. Re-opening the Danube to commercial navigation should receive high priority, as increased use of its waters for shipping could ease the pressure on the road network, and also because it is the most environmentally friendly mode of transport. Complementary progress in both regulatory and institutional reforms, as well as improvements in infrastructure (e.g., depth and width of the fairway, free height under bridges), are however necessary to the development of the sector. In turn, progress in these areas as well as a recovery of traffic will depend critically on the reintegration of FRY in the region. In fact, under the current circumstances, the Danube Commission established by the Belgrade Convention cannot fulfill its mission as far as facilitation of cooperation among the Danube states is concerned.

Civil Aviation

7.22 Airports. There is an extensive air route network in the region, but its use decreased significantly in the past ten years. In 1998, the number of air passengers in all the South East European countries amounted to six million air passengers. In the CEE-5 the number of air passengers was 13.5 million.⁷⁵ In comparison, Marseille (a French airport) has around 5.5 million and Milane Linate (an Italian airport) has around 13.6 million passengers. The 20 major EU airports have 466 million passengers annually. In addition to air traffic directed to the region, there are increasing over-flight demands along the routes to the Middle East and beyond; the most economical (shortest) routes are, however, passing over FRY.

7.23 The challenges facing civil aviation in the SEE region are not dissimilar from those facing the transport sector as a whole. Once again, improvements in policies and institutions should be given high priority, in order for investments to produce their potential benefits. An important example of the need for parallel progress in investments and regulatory reform is the improvement of Air Traffic Control (ATC) Systems, which is of high priority both for the region and for foreign airlines operating in or transiting through the region, and will need to be complemented by basic airport modernization in order to increase traffic safety and security.

7.24 Progress toward European standards and progressive liberalization of the skies is also necessary. In this regard, a pan-European Air Services Agreement covering the EU, EEA and the Central and East European countries is under negotiation. The Agreement would substitute the current bilateral air transport agreements, would expand the EU air legislation, and would improve liberalized market access conditions. One of the greatest advantages of the proposed agreement is to simultaneously open up markets also among the East European countries and thus facilitate more intensive regional connections.

Logistic services

7.25 One of the greatest impediments to international rail, road and river transport is the long waiting time at the borders. This is primarily due to the border procedures and not to the lack of infrastructure. The World Bank Trade and Transport Facilitation

⁷⁵ In 1998.

Box 7.1: Trade and Transport Facilitation Program for South Eastern Europe (TTFSE)

Background: The collapse of the Soviet Union and the break-up of the Yugoslav Federation led to radical changes in the direction of traffic flows and the creation of new frontiers and customs services. Performance of the border control agencies has been unsatisfactory: traffic has been subject to long waiting times, raising the cost of transport services and making them unpredictable; customs revenue collection has fallen short; and smuggling and corruption have become widespread. These deficiencies amount to bottlenecks to trade, with macroeconomic effects similar to those of protectionist trade policies; they undermine incentives to improve competitiveness; and deter foreign direct investment. To address these problems, the EU has been advising Romania and Bulgaria on customs reform and computerization, as part of its pre-accession assistance, and Albania and FYR Macedonia, as part of the approximation process. In Bosnia and Herzegovina, it has provided substantial direct operational support to build up the customs administrations after the war and likewise in Albania after the civil unrest of 1995-97. The Southeast European Cooperative Initiative (SECI) has, in parallel, set up national “PRO” committees to mobilize public and private sectors to simplify procedures and otherwise facilitate trade. In this connection, the governments of Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia and Romania have each asked the Bank to finance improvements to border crossing points.

Objectives and Description: The border crossing problem, by its nature, requires coordinated and mutually reinforcing action in many areas. The Program, therefore, aims to integrate the efforts of the EU, SECI and the World Bank Group for: (a) physical improvements to border crossings; (b) technical assistance to strengthen the customs administrations; (c) computerization of procedures at the border crossings and electronic filing of customs declarations; and (d) improved exchange of information between the border control agencies and the business community, through seminars, training and the development of Internet web sites (“trade facilitation”). At the regional (i.e., international) level a steering committee is to provide a forum for exchange of experience among the countries, the collective aligning of procedures on EU standards, and the coordination of operating practices at “twin” crossing points. Thereby the Program aims to reduce costs to trade and transport, at the same time reducing smuggling and corruption at border crossings, and strengthening regional partnerships and trade.

Costs and Financing: The total cost of the Program is estimated at US\$109 million equivalent. IBRD loans of US\$37 million and IDA credits of US\$30 million would finance about 61 percent of this total. The EU is providing grants of about US\$20 million equivalent, while the US government has been asked to provide grants of about US\$9 million. The recipient governments will finance the remaining US\$13 million, about 12 percent of total estimated cost.

Implementation: who and how?: The Program is conceived as six near-simultaneous country operations to be implemented over three years, starting in 2000. The borrower for each World Bank loan/IDA credit will be the government. The customs agencies will be responsible for implementing most components, though the border police will also be involved in some countries; and the trade facilitation activities will be hosted by the chambers of commerce in cooperation with the ministries of trade. The regional steering committee will be responsible for coordination across countries; each government will be represented by a high-level project coordinator authorized to speak on behalf of all border control agencies. To the extent possible the project implementation teams will be built around officials already managing the EU assistance and SECI coordinating functions. The donors will fund a secretariat for the regional steering committee and experts to assist each government in procurement and loan management.

Program for the SEE countries aims to give assistance to the improvement of road transport transactions (see Box 7.1). In the field of railways, rail operations need to be drastically reformed to enable the enterprises to improve their marketing and offer customer focused services. Pilot shuttle trains could pave the way for the extension of the *Trans-European Rail Freight Freeways* (TERFFs) to the SEE region, which soon then could be the engine of these reforms.

Regional Approaches to Transport Sector Development

7.26 There are several areas in transport, where a **multi-country approach** could bring more benefits than the execution of individual projects:

- The Danube for example lends itself to a multi-sectoral regional development program. Progress has been made in the field of environment based on cooperation with the other international organizations. In the field of transport studies financed by the multi-country Phare have been prepared as a first stage to identify investment needs.
- The elimination of border crossing obstacles in land transport calls for harmonized regional investment and development programs, too. The TTFSE project under preparation by IBRD aims at offering solutions to the most acute problems (see Box 7.1 above). The project, which focuses on transport and trade facilitation, is designed in a way to build on and support the EU programs in the field of customs reforms.
- The improvement of and investment in upper airspace navigation control can be most cost effective, if it is done for many participating countries, similarly to Maastricht and to the planned investment program of the Central European Initiative.⁷⁶
- The set up of regional traffic forecasting could help the SEE countries to prepare commercially footed investment projects, which take into account both the national and the regional trends. It could also promote the intellectual integration of transport in Europe, as new dimensions could be opened for the cooperation with Eurostat and other regional transport statistics centers (CETIR for the CEE countries).

7.27 An important contribution to the preparation and institutional assessment of infrastructure investments is already being made by the Transport Infrastructure Needs Assessment (TINA) program. The TINA process has established a viable multi-country process for regional investments. As the TINA program do not include all the SEE countries, it is recommended to charge the TINA Secretariat to prepare an addendum to

⁷⁶ In the process of European integration, all SEE countries will have to consider their accession to the European international organizations, e.g., Eurocontrol, which plays an important role in European Air Traffic Management.

the TINA final report⁷⁷ using the same methodology as applied for the accession countries.

7.28 Regional Transport Project Selection Criteria. In addition to the overall selection criteria for regional infrastructure projects presented in the Annex, regional transport projects should be favored to the extent that they:

- Give priority to rehabilitation over new construction.
- Accelerate the development of legal and regulatory framework and institutional reforms: promote transparent relationship between state and infrastructure operators and service providers (e.g., internationally acceptable procurement practices); enforceable agreements on Public Service Obligations and compensations; and increased private participation in the provision of transport services, etc.
- Support national programs for traffic safety and environment protection.
- In the field of railways, restructure the railways enterprises to improve their efficiency and decrease their reliance on government subsidies, as well as to improve cross-border linkages.
- In the road subsector: increase capacity of the road administrations; promote sustainable road financing structures; give special attention to rehabilitation and maintenance; and lend more balanced support to rural roads.
- In inland navigation and maritime transport: restructure port operations according to market economy requirements.
- In aviation: support demonopolization and progressive liberalization.

C. TELECOMMUNICATIONS

Performance of the Sector and Key Issues

7.29 Telecommunications are an essential element in the infrastructure of modern economies, and are crucial in the development of both national and international trade. While traditional fixed networks exist throughout the region, the availability and quality of telecom in SEE countries vary widely; regulatory and institutional arrangements are also at different levels of development. In addition, the recent Kosovo conflict has destroyed some key elements of the long distance fiber optic routes.

7.30 **Fixed Networks.** There is a wide range of fixed telecom line densities in the SEE region, ranging from high (Croatia and Bulgaria, above 30 percent), medium (FRY, FYR Macedonia, Romania and Bosnia and Herzegovina, at 10 to 25 percent), to low (Albania, 2 percent) (see Table 7.2). It should be noted that penetration indicators may

⁷⁷ Published October 1999.

be misleading as several households may share a single mail line, or lines may be economically sub-optimal. In addition, as a result of low revenues—generally owing to low tariff rates and low collection rates—all countries except Croatia have experienced very low investment in recent years, which is likely to conceal poor quality equipment and obsolete technologies.

Table 7.2: Telecommunications Systems

<i>Country</i>	<i>Population 1998 million</i>	<i>Fixed Lines 1998 thousand</i>	<i>Penetration lines/100</i>	<i>Mobile Lines 1998 thousand</i>	<i>Total Penetration lines/100</i>
Albania	3.4	118	3.5	6*	3.7
Bosnia and Herzegovina	4.2	337	8.0	26	8.6
Croatia	4.6	1594	34.9	213	39.5
FRY	10.6	2190	20.7	216	22.7
FYR Macedonia	2.0	453	22.7	35	24.4
Bulgaria	8.2	2715	33.1	131	34.7
Romania	22.5	4513	20.0	720	23.2
SEE Total lines and average penetration	55.5	11920	21.8	1346	24.3

* As a result of recent up-grade in Albania the current number of mobile lines amounts to 20,000.

Source: ITU, national

7.31 Mobile networks. All countries now have digital GSM networks, with some in addition retaining parallel analogue NMT networks. Development of mobile networks broadly parallels that of fixed, with the highest penetration in Croatia (5 percent), medium levels in Romania, FYR Macedonia, FRY and Bulgaria, and almost no usage in Bosnia and Herzegovina and in Albania. This suggests that mobile networks are not substituting for lack of development of the fixed networks in countries such as Albania and Bosnia and Herzegovina and that their development is instead linked to the availability of investment funds and the number of users who can afford a service priced at market levels.

Regional Approaches to Telecom Development

7.32 For the SEE countries to leap frog to a new stage of telecom development, top priority should be given to the establishment of a legal and regulatory framework which encourages and provides long-term support for investment. The high quality, low cost telecoms infrastructure that provides the backbone of today's "web economy" is normally provided by private investment in a competitive environment; regulatory reform is thus needed to provide the necessary security for investment and structural reform, essentially market opening, is required to provide opportunities for private investment. There are trade considerations associated with both aspects of reform, most notably with the WTO and EU linkages, which spill over onto any foreign ownership restrictions and even taxation matters. As it has been observed for a different set of countries, "Without

government commitment to regulatory stability, frequent changes in the regulatory regime can have the same effect as outright expropriation of sunk investments”.⁷⁸

7.33 It will be advantageous for the SEE countries to adopt closely aligned frameworks for the development of the telecom sector. Institutional and regulatory reforms of the telecom sector are crucial for future development of the region. The instruments of policy reform include the progressive opening of different segments of the telecom market, facilitating private investment and privatizing the state monopoly operator. There are three key decision areas: what market segments to open; when to open them; and whether to privatize the state operator. For SEE countries, there are advantages in aligning as closely as possible what market segments to open and when to open them. It should be noted that in Romania the state operator has already been privatized, and that in Bulgaria the process has been initiated but awaits completion. In both instances, extensive exclusive rights have been granted until 2003. A full audit of all policies is required for SEE members.

7.34 Regulatory reform is needed to support the implementation of policy reforms and ensure the transition to, and orderly functioning of, market relations. In this respect, the Regulatory Reference Paper of the WTO is a relatively low hurdle in comparison to the European Directives and the *acquis communautaire* and can be implemented in the short term. However, in the medium term it will be advantageous for SEE to implement the EU framework. The key features of both frameworks are independent National Regulatory Authorities, transparent licensing regimes, controls on “dominant or major suppliers”, competitively neutral Universal Service Obligations and cost oriented interconnection. These elements should form the basis of the regulatory framework for SEE constituents.

7.35 A program of regulatory reform to provide an environment in which private investment can flourish and in which cross border cooperation and market integration can take place will include the following recommendations for actions. First, reforms among SEE countries will need to be coordinated, and consensus built on policies, regulatory framework, and timing. Second, once the overall regulatory framework has been established, regulatory capacity building will need to be emphasized. Finally, the establishment of “clubs” of mutual interest should be facilitated. The SEE region presents in fact a fragmented market, and this may act as a handicap for development in the telecom sector. While not all SEE countries may wish to integrate their markets in the short run, in the long term the EU aspirations of the constituents will ensure that the SEE region becomes an integrated market. It is possible for those wishing to achieve a degree of integration to establish sub-regional “clubs” in the short term. The alignment of policy reform and regulatory frameworks will facilitate such “clubs” of mutual interest, which could take the form of the mutual recognition of certain classes of license. In addition, “clubs” may wish to cooperate in the area of numbering to facilitate cross border service provision or to ensure that a cross border call within the “club” is not treated as an international call.

⁷⁸ See “Overcoming Obstacles to Liberalization of the Telecom Sector in Estonia, Poland, the Czech Republic, Slovenia and Hungary”, World Bank Technical paper No. 440.

7.36 One essential element of reform in the telecom sector—necessary both to provide low cost, high quality services and also to pave the way to the privatization of the sector—is the commercialization of existing operators and separation of services aimed at reducing cross-subsidization. In turn, tariff reform is a key element of regulatory reform and an element of privatization policies. Where such reform could lead to a significant reduction in the customer base, it may be necessary to design ‘low user schemes’ to ensure continued access. In addition, alternative options to the traditional privatization model—to bring a strategic partner to the incumbent operator—could be considered in a number of countries, and in general where it is unlikely that there will candidates for the post of strategic partners.

D. ENERGY

Performance of the Sector and Key Issues

7.37 The SEE countries are net energy consumers, with energy imports from outside the region representing approximately 40 percent of total energy consumption. Both energy production and consumption have fallen during the last decade due to major economic adjustments and/or war. However, energy consumption is likely to increase as economies recover, although several of the current energy-intensive industries may no longer be competitive and therefore exit the market. Per capita primary energy consumption in the region is about half of that in developed European countries. Consumption per unit of output is two to three times the OECD-Europe average, which illustrates the inefficient production, supply and use of energy in much of the region. Prevailing high-energy intensities constitute economic and environmental liabilities. Heavily polluting coal accounts for 85 percent of electricity generation in FYR Macedonia, and one-third or more in Bulgaria, Romania and Bosnia and Herzegovina. Increasing energy prices may also be contributing to over-cutting of forests for fuel-wood which has especially taken place in lower income countries such as Albania.

7.38 While the need to improve overall energy conservation and efficiency is well recognized in the region, and all governments have embarked on market-oriented reforms, progress has been uneven. Energy prices are, on the whole, well below economic levels, and pricing/tariff structures are inappropriate. Energy trade is hampered by poor infrastructure and the rupture of traditional transport interconnections, as well as by the political and social legacy of the conflicts in the region. Energy sector institutions are generally still state-owned vertically integrated entities. Institutional capacity is often limited. Energy policies, legislation and standards differ substantially from European norms and practices. The region is not yet equipped to address its increasing importance in transiting supplies of oil and gas. In general, the policy and institutional framework required to encourage private sector investment does not yet exist.

7.39 **Electricity.** The development of the electricity generation and transmission systems in each country has been based on autonomous expansion plans, without taking into consideration the opportunities offered by exchanges with other countries, except for ad hoc exchanges. However, considering the generation mix of hydro and thermal

production and the seasonal demand characteristics, a number of opportunities would appear to exist for mutually beneficial exchanges. This is applicable to the region as a whole, but particularly for the countries that previously were republics within the former Yugoslavia, as generation and transmission infrastructure was based on significant exchanges between the republics. A regional approach should, therefore, provide significant potential for benefits in the form of future investment savings, increased reliability and quality of supply, reduced environmental damage and opportunities for electricity trade.

Table 7.3: Energy Use (1995)

Country	GDP per unit of energy use (US\$ per kg oil equivalent)	Sources of electricity (%)					Consumption per capita kwh (US\$)	Transmission and distribution losses (% of output)
		Hydro- power	Coal	Oil	Gas	Nuclear power		
Albania	1.8	95.2	0.0	4.8	0.0	n.a.	623	51
BiH	n.a.	64.5	35.5	0.0	n.a.	n.a.	n.a.	23
Bulgaria	1.0	3.1	43.1	3.6	7.9	42.4	3,415	13
Croatia	2.8	59.4	2.7	27.7	10.1	n.a.	2,074	19
FYROM	n.a.	13.1	86.3	0.6	n.a.	n.a.	2,443	12
Romania	0.7	28.2	35.1	9.8	26.9	2.3 ^a	1,603	11
FRY	n.a.	30.2	25.0	2.4	3.7	69 ^b	2,921	30

a. In 1996.

b. Thermal power.

Source: World Bank, "World Development Indicators", 1999 and OCHA Belgrade (United Nations Office for the Coordination of Humanitarian Affairs). "Electricity and Heating in the Federal Republic of Yugoslavia: Executive Summary of Predicted Winter Shortages and Recommended Humanitarian Measures". September 1999.

7.40 Current installed capacity in South Eastern Europe is about 40,000 MW of thermal generation (including about 5,000 MW from three nuclear power plants) and about 18,000 MW of hydro generation. Because of the overall fall in demand, installed capacity in the region is generally adequate. However, the power industry in the region is characterized by polluting, inefficient and aging capacity. Environmental and safety considerations may necessitate restrictions on the operation and development of nuclear and solid fossil fuel-fired plants, and this could considerably change the current supply-demand situation as well as operational practices and expansion plans. Thus significant refurbishment and augmentation of this capacity may be required in the coming years. Another important consideration could be the high demand projections for Turkey, which could result in a need for increased electricity imports from South Eastern Europe—but this may not be a long-term opportunity and investments to meet this demand may not be justified.

7.41 The majority of the SEE countries are not interconnected with the West European UCTE (Union for the Coordination of Transmission of Electricity) integrated system. Prior to the conflicts in the region, some of these countries were interconnected to the UCTE system. Restoring the interconnection for these countries and extending the network to others will contribute to overall stability of the transmission network and facilitate increased power transactions.

7.42 **Coal** (mainly lignite) is the main indigenous source of energy supply, even though the reserves are of low quality with high sulfur and ash content. It is particularly dominant in the electricity-generating sector. Although it will remain an important source of energy in the region despite its environmental drawbacks, its share of the total energy market is likely to fall over time. Some of the mines are uneconomic and should be closed.

7.43 **Gas.** One of the important constraints for the gas industry is significant dependency on external gas supply sources, notably from Russia (Gazprom). Natural gas from Russia is transported to the region using two networks: (i) the pipeline system linking Russia to the former Yugoslav Republics through Hungary; and (ii) the North-South trunk line crossing Romania and Bulgaria into Turkey. Albania is the only country in the SEE region that does not have any natural gas interconnections. Underground gas storage capacity is limited and insufficient to support domestic or regional needs, and needs to be increased.

7.44 There is a need to optimize gas imports and to diversify the gas sources, but the near to medium-term diversification options are limited. Given Gazprom's interest in developing markets in the region and its need to transit certain SEE countries to access key larger markets (e.g., Turkey and Greece), a regional approach to negotiating with Gazprom warrants consideration.

7.45 Natural gas demand is expected to increase as countries respond to environmental problems, but this may be offset to some extent by the impact of pricing at international parity levels and of payment discipline. Furthermore, the increase in gas demand will depend on the rate of expansion and interconnection of the natural gas grid system in the region. Except for Romania, these systems are not well developed and integrated. The full market potential for gas can only be realized with the construction of new gas transport pipelines, the further development of gas distribution infrastructure and greater integration of the gas markets in the region.

7.46 **Oil.** The regional demand for crude oil cannot be satisfied by the region's own oil resources. Only Romania, Croatia, FRY and Albania have sizable oil production. In spite of the high nominal refining capacity, the actual available capacity is not sufficient to provide the required product mix. Furthermore, it is expected that, although the demand increase for crude oil and refined products will be moderate, there will be considerable modification in the product specifications with a greater increase in the demand for high-quality and lighter products, thereby placing greater pressure on the need to modify the output and technological processes of existing refineries. A critical decision to be taken in the affected countries will be to choose between costly upgrades of existing refineries and increased product imports. Such decisions, together with

demand growth both in the region and in other regions to be supplied through South Eastern Europe, will have a major impact on the future development of the transport infrastructure for crude oil and key products such as gasoline and diesel.

7.47 The increasing volumes of crude oil that will enter the Black Sea market provide an opportunity to the region to take advantage of the competition between supplies from both the east and the west. The region can also play a key role in getting crude oil from the Caspian to market and in helping to reduce the environmental concerns associated with increased oil shipments through the Bosphorus.

Regional Approach to Energy Sector Development

7.48 **Benefits of regional approach.** The availability of reliable, low-cost and environment-friendly sources of energy will be a critical input for the rapid and sustainable economic development of South Eastern Europe. A regional approach to energy supply will offer significant advantages both in terms of improved utilization of existing supply/production capacities as well as in optimizing future investments. As stated earlier, considering the generation mix of hydro and thermal electricity production and the seasonal demand characteristics, a regional approach will provide significant benefits in the form of future investment savings, increased reliability and quality of supply, reduced environmental damage and opportunities for electricity trade. Similarly, a coordinated regional approach for gas (both in terms of negotiations with Gazprom and construction of new gas transport pipelines), as well as oil will enable optimized investment decisions to be made.

7.49 **Energy sector study for the region.** Region-wide analytical work needs to be carried out on energy balances and associated issues to justify decisions related both to increased supply and to transmission interconnections, while also taking into account the large energy sectors of Turkey and Greece and the issue of transit of gas to Western Europe. This will be a major undertaking and will include a detailed review of all recent studies (including the work done by SECI and the Balkan Energy Interconnection Task Force), analysis of energy balances and associated issues, development of an appropriate energy strategy for the region and identification of specific energy infrastructure investment needs. A major focus of the study will be to review the current pace of sector reforms in different SEE countries and make recommendations on the measures to be taken to achieve rapid and compatible reforms, so that an environment conducive to attracting private sector investment is created. The identification of specific projects itself could also help attract private sector investment.

7.50 **Implementation of projects.** Concurrently, certain projects can be taken up for immediate implementation provided they meet the criteria of improving regional or intra-regional cooperation and the project justification is sufficiently well-established to warrant proceeding prior to the completion of the comprehensive energy sector study mentioned above. These will include projects such as the reconstruction of the high voltage power transmission networks in Bosnia and Herzegovina and Croatia, which would facilitate reconnection of the power systems of the SEE countries to the UCTE.

7.51 **EU-accession issues.** In the context of the eventual integration of SEE countries in the European Union, attention has to be given to the wide range of accession requirements related to the energy sector. One critical requirement relates to the implementation of Community Directive 96/92/EC, which created a single EU market for electricity and has required progressive liberalization of national markets. The Directive's basic objectives are increased competitiveness through better service for energy consumers, improved environmental protection, and greater security of energy supplies, while ensuring the continued meeting of basic public service requirements. To these ends, the Directive sets out the minimum conditions under which competition can develop in a fair and transparent manner, but does not impose a rigid single market structure. While many SEE countries have already been moving towards the liberalisation of their electricity sectors, the development of a competitive electricity market is a complex task, requiring considerable sector restructuring and legal development. Development and implementation of technical assistance plans, tailored to the specific requirements and needs of each country, is therefore an important input. Such technical assistance is already being provided in the case of several SEE countries, but any additional requirements should be assessed and financing provided.

E. CONCLUSION

7.52 This Chapter identifies a number of important issues for infrastructure development that would yield significant benefits to the SEE countries if addressed within a regional approach, instead than on a national level. These include not only the design and financing of investments in regional infrastructure proper—for example the major transport corridors, or the connection with the European (UCTE) integrated electricity system—but also regulatory improvements to take advantage of potential economies of scale—for example through improving airspace navigation control, facilitating energy trade, or promoting integrated telecom systems. In addition, a regional approach to infrastructure development would be necessary to reduce transaction costs associated with the creation of new nation states with international borders, facilitate the strengthening of institutional arrangements through the region, and assist the SEE countries in adopting EU standards for infrastructure development and regulation, with a view to future integration.

TABLE 7.4: SELECTION CRITERIA MATRIX FOR SEE REGIONAL INFRASTRUCTURE PROJECTS

	Regionally Joint Project	Multi-country Project	National/Bilateral Project with Regional Impact
<i>Agreement among SEE countries, most concerned</i>	On location, ownership, project implementation, operation.	On cooperation, mutual control of supervision, peer pressure.	Commitment of the project government to share information with other countries in the region
<i>Sectoral policy/institutional reforms</i>	The project fits into the national sectoral policy acceptable to IFIs		
	<ul style="list-style-type: none"> • Introduction of European/international standards • Economies of scale 	<ul style="list-style-type: none"> • Regional and European legal harmonization • Efficiency improvement • Synergy effect 	<ul style="list-style-type: none"> • Ambitious sector restructuring/policy reforms to be set as an example to others • Pilot character • Efficiency increase • European/international standards • European integration: EU compatible institutions
<i>Emergency character</i>			
<i>Bankability criteria</i>	<ul style="list-style-type: none"> • Financially, economically justified • Environment and social assessment • Readiness for implementation 		
<i>Other</i>	Project conditions on a case by case basis		
	<ul style="list-style-type: none"> • At least two countries • Joint investment 	<ul style="list-style-type: none"> • At least three countries • Synergy from the harmonization of several national projects 	<ul style="list-style-type: none"> • Sectoral reform with regionally demonstrative impact and/or part of a regional/Trans-European network

8. ENVIRONMENT PROGRAMS IN SUPPORT OF ECONOMIC GROWTH AND REGIONAL INTEGRATION

A. INTRODUCTION

8.1 The SEE region has valuable environmental resources. These resources need to be preserved to safeguard future development prospects. At the beginning of the decade, industrial structures and energy systems of the old socialist regimes, which were established under an unrealistic set of relative prices and with minimal consideration for their environmental impact, had already mortgaged the region's future. During the past decade, conflict, the weakening of institutions and declining living standards all degraded further the region's environmental resources.

8.2 Strengthening national policies, institutions and environmental controls is essential. The rich natural resource base with which the SEE region has been endowed and the legacy of the socialist past already have led the SEE countries to define national environmental priorities. Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania and FYR Macedonia have produced, or are producing, National Environmental Action Plans: (FRY produced an Environment Strategy in 1990). Croatia, Romania, and Bulgaria have also completed Biodiversity Strategic Action Plans.

8.3 Many environmental issues, however, must be tackled on a regional level and require improved cooperation between countries through information exchange, setting up of (bilateral) joint bodies, and accession to and implementation of international conventions. The Danube, which is the major waterway passing through the region, poses special environmental challenges. Water management and water pollution in one country affects the quality of water or water conditions in downstream countries. Damage occurring in adjacent countries, such as flooding, are often caused by inappropriate water resource management in upstream countries. Many of the region's protected areas are located at borders. Their ecological viability is reliant on maintenance of the same protected areas in neighboring countries, making conservation a regional issue. Industrial pollution and dangers emanating from unsafe nuclear plants are not limited to national territories. Regional and international cooperation is required to manage risks and negative impacts resulting from these environmental hazards.

8.4 Moreover, the overall strategy in this Report proposes an approach based on a path towards European structures and their regulatory regimes. The EU has an agreed set of environmental principles and regulations, which are laid down in the "acquis communautaire". These impose stringent environmental standards, for which compliance by the SEE countries will take some time. Nevertheless, these standards provide a clear set of guidelines, which when aligned with the key immediate environment issues in the SEE region, helps prioritize the core agenda for both national and regional programs.

Regional programs, which provide technical and financial support, can be important in supporting the implementation of these programs and in addressing the specific regional challenges in the environmental agenda. Learning of best practice examples undertaken in some countries should assist in the transfer of knowledge.

8.5 The remainder of this Chapter uses the National Environment Action Plans to identify priority environmental issues of both national and regional importance. Section B provides a brief geographic overview of the SEE region. Section C describes the key environmental issues and problems, which have arisen because of conflict and transition. The following three sections (D, E and F) present the key issues and priorities for action in three categories: natural resource management—coastal zones, forests, land, and biodiversity (Section D); pollution control (Section E); environmental policy, legislation and institutions (Section F).

B. GEOGRAPHIC OVERVIEW

8.6 South Eastern Europe has a total land area of 645,000 km² and a population of 56 million (see Table 8.1). The region's topography is a combination of mountains and hilly plateau and basins surrounding the Danube Plain, extending from the Alps in the north-west and the Carpathians in the north east to the Balkan mountains in the south. Mountain elevations range from 3000m in Bulgaria to 2500 m in Romania. The Balkan plateaus are 1500 to 2500m and have abundant rainfall and numerous karst features (caves, sinkholes and treeless valleys). Recreational value of the mountains and the Adriatic and Black Sea coastlines are very high.

Table 8.1 Population And Population Density

<i>Country</i>	<i>Population (in millions) in 1998</i>	<i>Population density (people per sq. km.) in 1996</i>	<i>Rural population density (people per sq. km.) in 1995</i>	<i>Urban population (% of total population) in 1996</i>
Albania	3.4	120	354	38
Bosnia and Herzegovina	4.2	44 ^a	516	42
Bulgaria	8.2	80	67	69
Croatia	4.6	90	189	56
FYR Macedonia	2.0	80	130	60
Romania	22.5	100	107	56
FRY	10.6	100	123	57

a. In 1997. The World Bank. "World Development Indicators: 1999" Washington, D.C.: The World Bank: 1999.

Source: The World Bank. "World Development Indicators: 1998" Washington, D.C. The World Bank: 1998.

8.7 Climate varies from subtropical Mediterranean in the west and south to moderately continental in the north and east. Winter temperatures vary from -10C in the mountains to +10 C in the lowlands and average summer temperatures from 25C to 10C. The mountains receive abundant rainfall, averaging 1500m and as much as 3000-4000m along the westerly slopes of Croatia, while the Danube plains, with fertile chernozem soils receive only 300-400m, requiring supplementary irrigation for agriculture.

8.8 The Danube River and its tributaries constitute the hydrological backbone of the region and are also important as inland waterways. Major lakes include Ohrid, Prespa and Skoder on the borders of Albania, FYR Macedonia and Montenegro.

8.9 About one-third of the region is covered with forests (see Table 8.2): high value broadleaf and coniferous forests in the Carpathians and Alps; and drier open woodlands of Mediterranean type in the southern Balkan plateaus. Forest cover varies from over 50 percent in Bosnia and Herzegovina, 40 percent in Albania, to about 30 percent in Romania and FRY. Another third of the land is cultivated (13 percent in Bosnia and Herzegovina and 40 percent in Romania, FRY and Bulgaria).

8.10 The region's landscape and climate are important economic assets for both mountain and coastal tourism, which need to be managed on a sustainable basis as the economies recover. Its cultural heritage (rural and small town architecture and the built environment as well as individual monuments) is rich and varied and a further attraction.

Table 8.2: Land Use In The South East European Region

Country	Total Country Area (per 1000 km ²) ^a	Land Use (% of land area)			"Ratio of self- sufficiency in forestry" (how much more or less a country produces than it needs) ^e
		Cropland in 1995 ^b	Permanent Pasture in 1994 ^c	Forest Land ^d	
Albania	28.7	26	15	38	77.5
BiH	51.1	13	24	53	n.a.
Bulgaria	110.9	38	16	30	119.7
Croatia	56.7	22	20	44	127.0
FYR Macedonia	25.7	26	25	37	52.1
Romania	238.4	43	21	26	175.0
FRY	102.2 ^f	40	21	28 ^g	n.a.

a. Forest and Forest Industries, Country Fact Sheets, FAO 1997.

b. The World Bank. "World Development Indicators: 1998." Washington, DC: The World Bank, 1998.

c. The World Bank. "World Development Indicators: 1998." Washington, DC: The World Bank, 1998.

d. Forest and Forest Industries, Country Fact Sheets, FAO 1997.

e. Forest and Forest Industries, Country Fact Sheets, FAO 1997.

f. UNEP/UNCHS Balkans Task Force (BTF). "Assessment of the Damage to Biodiversity in Protected Areas of the Federal Republic of Yugoslavia." October 1999.

g. UNEP/UNCHS Balkans Task Force (BTF). "Assessment of the Damage to Biodiversity in Protected Areas of the Federal Republic of Yugoslavia." October 1999.

C. ENVIRONMENT IMPACTS OF WAR

8.11 Wars and conflicts which erupted in large parts of former Yugoslavia have resulted in adverse environmental impacts. Specific national level information on war-related environmental impacts is available only for Kosovo and Croatia, as follows, but the environmental impacts in other war-torn SEE countries can assumed to be similar:

- **Water and soil pollution around main military targets:** The Joint UNEP/UNHCS Balkans Task Force (BTF) found that the Kosovo conflict has not resulted in an environmental catastrophe.⁷⁹ In Croatia, surface water and soil pollution from burnt chemical facilities, forest fires, and munitions residue have been documented. Ground water pollution from war activities has not been evaluated but is considered to be a significant threat due to the extent of surface water and soil pollution, the karstic geology of the country, and the increased fissures due to detonations. In Kosovo, there are four environmental “hot spots” where surface water and soil quality have deteriorated due to hazardous material leakages from war-damaged industrial plants. These “hot spots” pose an immediate threat to human health and may pose a threat to neighboring countries. Leakages into the Danube attributable to the conflict include 100+ tons of ammonia, and 1000+ tons each of ethylene dichloride; and hydrogen chloride. A large part of the existing contamination of the water and soil pre-dates the conflict, and there are deficiencies in the treatment and storage of hazardous waste. Immediate actions recommended by the BTF to reduce the risk of future leaks are: clean-up of mercury and oil products from the sediments of the canal leading from Pancevo’s industrial complex to the Danube; clean-up of industrial sites with significant PCB contamination in Krajujevan; steps to ensure safety of drinking water in Novi Sad where groundwater is polluted with petrochemicals; and reduction of sulfur dioxide emissions from the copper mine in Bor which create transboundary air pollution issues in Bulgaria. Specific activities to accomplish the clean up and remediation efforts can be found in additional BTF reports.⁸⁰
- **Biodiversity:** A BTF report⁸¹ has concluded that war damage to ecosystems and related biodiversity, although significant within limited areas, was of relatively of minor importance in relation to the overall size of the protected areas.
- **Disposal of military waste:** Military waste, in particular land mines and unexploded bombs, litter the landscapes in Bosnia and Herzegovina, Croatia, and FRY. These are a significant threat to human safety and have negative economic impacts. In Croatia since 1991, over 1,000 people including 300 children have been killed by land mines. Landmines negatively affect the return of refugees, the reconstruction of homes, tourism, the regeneration of industry, and the economy. In Bosnia and Herzegovina, where forestry was once a major contributor to the

⁷⁹ “The Kosovo Conflict: Consequences for the Environment & Human Settlements,” UNEP/UNHCS Balkans Task Force, 1999.

⁸⁰ “Environmental Damage Assessment at Industrial Sites”, UNEP/UNHCS Balkans Task Force, July, 1999.

⁸¹ “Assessment of the Damage to Biodiversity in Protected Areas of the Federal Republic of Yugoslavia” UNEP/UNHCS Balkans Task Force, October 1999.

economy, over 20 percent forests are inaccessible because of landmines. Some of the areas, which drew tourists to SEE countries, are now inaccessible due to mines. Accumulation of expired pharmaceuticals and related medical waste, donated for the war-effort, is a significant problem in Bosnia and Herzegovina.⁸²

- **Breakdown of municipal services:** The conflict seriously affected environmental conditions in human settlements in FRY, including Kosovo, both in terms of infrastructure and the provision of municipal services. The damage to, and neglect of, existing solid waste facilities and collection infrastructure has resulted in the accumulation of garbage which poses a health risk and, mixed with demolition debris, an expensive disposal problem. Damaged power generation, water supply, and wastewater collection and treatment facilities have increased pressure on natural resources and environmental contamination. The destruction of bridges on the Danube River has interrupted the main traffic route causing economic losses to the shipping and transport industries and contamination of the Danube River with debris. To a lesser degree, environmental conditions in human settlements were also affected in Albania and FYR Macedonia, mainly through the overuse and deterioration of infrastructure and services caused by the influx of refugees from Kosovo.
- **The refugees' struggle for survival** has also caused serious, though localized environmental damage in the vicinity of the major refugee sites, in Albania and FYR Macedonia. There has been accumulation of waste, and some destruction of forests as refugees have relied on fuel-wood for heating and cooking. Anticipated impacts in Albania are destruction of soil fertility and structure, and damage to national parks and protected areas.⁸³ There is not yet an assessment of the extent of this damage.
- **Destruction of cultural heritage:** Cultural heritage sites and town landscapes have been damaged in Croatia and Bosnia and Herzegovina in previous conflicts, and in FRY, including Kosovo, bombing damage has affected villages and towns. Land mines are one of the biggest obstacles to the return on displaced people in Croatia. This has affected both local community well being and potential tourism value.
- **Weakened environmental management:** Institutional impacts of the war include loss of environmental administrative control of Kosovo; a change in management priorities; a loss of income from normal sources, e.g., tourism; loss of linkages with other countries for transboundary environmental protection; curtailment of the national and transboundary activities of environmental NGOs. The threat is that environmental management systems may be so disrupted that environmental

⁸² In Croatia, the disposal of over 50,000 tons of expired pharmaceutical waste is a component of the World Bank Health II Project.

⁸³ "Assessment of the Environmental Impact of Military Activities During the Yugoslavia Conflict: Preliminary Findings". The Regional Environment Center for Central and Eastern Europe, June 1999.

problems cannot be adequately addressed.⁸⁴ The economic destruction and threats to human lives have inevitably absorbed the attention of public policy makers with environmental management and enforcement taking a back seat. This is not unexpected since environment tends to have a low priority in reconstruction processes, but it is of concern because reconstruction places heavy demands on raw materials for reconstruction (e.g., gravel, forests, and water) as has been demonstrated in Bosnia and Herzegovina.

D. NATURAL RESOURCE MANAGEMENT SECTOR

Coastal Zone, Forests, Land, Biodiversity

Coastal Zone Management

8.12 The countries' coastlines are a valuable asset (see Table 8.3 for tourism revenues). On the Mediterranean, Albania contains some of the most pristine and spectacular stretches of coastline in the northern Mediterranean. Uncontrolled urban and squatter developments, inadequate wastewater treatment and high soil erosion are damaging coastal water quality and reducing the potential of tourism. Croatia's coastline has been extensively developed for tourism; however land use planning institutions and policies are stronger than in Albania. Recognizing the importance of the environmental integrity of the coastline, investments in wastewater treatment have been undertaken in all coastal cities.

Table 8.3: International Tourism Receipts^a

<i>Country</i>	<i>International tourism receipts (US\$ millions) in 1996^b</i>	<i>GNP per head (US\$) in 1998</i>
Albania	11	810
Bosnia and Herzegovina	15 ^c	920
Bulgaria	450	1,230
Croatia	2,100	4,520
FYR Macedonia	na	1,290
Romania	20	1,390
FRY	43	n.a.

a. The Economist Intelligence Unit (EIU), Various Country Profiles, 1999-2000. London: The Economist, 1999.

b. The World Bank, "World Development Indicators: 1998." Washington, DC: The World Bank, 1998.

c. In 1997. The World Bank, "World Development Indicators: 1999." Washington, DC: The World Bank, 1999.

8.13 On the Black Sea, which is more heavily industrialized, dredging and deepening the channel at the mouth of the Danube has contributed to beach erosion further south.

⁸⁴ "Draft - Provisional Assessment of Environmental Policy and Management in Kosovo", UNEP/UNCHS Balkans Task Force, 8 November, 1999.

Pollution from the cities of Constanza in Romania and Burgas in Bulgaria has damaged water quality. Bulgaria has made good progress on participatory coastal zone planning and management, within its ongoing constraints of over-development of the coast and further development pressures that have arisen as a result of land privatization.

8.14 Economic recovery will increase environmental pressures on the coasts of both countries. Key strategies to correct the problems must deal with improved wastewater treatment, solid waste treatment, and the development of regulatory frameworks for coastal zone management in each of the coastal countries. It is particularly important for Albania to develop sound land use planning strategies, which are enforced, in order to secure the future tourism value of the coastline.

Forests

8.15 The SEE region contains some of the richest forestry resources in Europe. Forests are important to the economies of all countries, both directly as producers of timber and timber products (Romania, Bosnia and Herzegovina, Croatia, and Bulgaria) and indirectly because of their watershed protection, biodiversity and recreational values. Romania and the northern Balkan Mountain Range have a long tradition of sustainable forest management and well-established forest management institutions. In contrast in the southern Balkan Range there was degradation of forest lands until the Second World War. Since then there have been extensive programs to convert degraded oak coppice to high forest. Under pricing of forest resources continues to be an issue in most of the countries, but reasonably "tight" multi-use forest management plans assure good technical management.

8.16 All countries have faced new institutional and forest resource management challenges. In Albania, growing poverty and social unrest have led to increased illegal timber harvesting, overgrazing and uncontrolled cutting of timber for fuel wood. In Romania, restitution of 300,000ha of forestland to private individuals in 1991, in the absence of a sound regulatory framework, and in an atmosphere of uncertainty about the future, led to widespread destruction of these forests. In Bosnia and Herzegovina and Croatia, the forests were heavily landmined, reducing their economic and tourism value. Romania and Bulgaria are now embarking on much larger forestland restitution programs, which will require very careful management and support.

Land and Soil

8.17 Land management is a problem especially in Bosnia and Herzegovina, FYR Macedonia and Albania, the poorest countries of the region. Land and soil degradation are influenced by: (i) increasing poverty, and reliance of poor rural communities on livestock (mainly sheep and goats); and on fuel wood for heating, which has led to overgrazing and over-harvesting; (ii) the use of marginal lands for agriculture, some converted from forests and natural pasture and steppe; (iii) the management of fisheries stocks and their natural habitats (an issue in the Danube and its delta, the lakes and rivers as well as the seas); and (iv) measures to protect surface and groundwater resources. Land privatization has contributed to soil erosion in some cases because it resulted in a

decline in use of basic land conservation practices (contour plowing, vegetative barriers) that had previously been observed on state-owned land, e.g., Romania. In Bosnia and Herzegovina, the breakdown of the land use management system with the war, has led to exploitation of protected areas, soil erosion and loss of habitat.

Biodiversity

8.18 The SEE region contains some of the richest biodiversity in the Mediterranean and Black Sea Basins, largely occurring in natural marine, wetland, steppe, and forest ecosystems. Despite localized degradation, many of the mountain forests are relatively intact, supporting a diversity of indigenous flora and fauna. One of the primary instruments for preserving biodiversity on a national level, is the designation of protected areas which contain valuable natural resources. Croatia and FYR Macedonia are in the lead in terms of total land under protection (see Table 8.4). In the SEE region, many protected areas are situated on borders. Their ecological viability is reliant on maintenance of protected areas in neighboring countries; effective conservation is thus a regional issue. The region would benefit from collaboration among the countries to address regional environment challenges, including safeguarding trans-boundary resources (e.g., the Neretva Delta shared by Croatia and Bosnia and Herzegovina), and improving resource management (e.g., through better dissemination and application of best practices developed within the region, such as the forest management experience of Romania and Croatia).

Table 8.4: Protected Areas as a Percentage of Land Area

<i>Country</i>	<i>Protected areas as % of land area^a</i>
Albania	3.6
Bosnia and Herzegovina	0.5
Bulgaria	4.5
Croatia	7.0
FYR Macedonia	7.1
Romania	4.6
FRY	5.0 ^b

a. WB Web Environmental Data Sheets:

<http://eca/ecsre/envcopg/default.htm>, UN Protected Area List 1997.

b. Institute for Protection of Nature of Serbia:

<http://www.natureprotection.org.yu/areas.html>.

Potential Regional Natural Resource Management Programs

8.19 The environment presents several opportunities where a multi-country, regional approach could bring more benefits than the execution of individual projects. Biodiversity conservation, forest management, and water pollution control have been the topics of successful regional approaches such as the successfully completed GEF Trans Carpathian Biodiversity Project in which cooperation agreements between the Czech Republic, Slovak Republic, Poland and the Ukraine served as the basis for regional forest ecosystem management. Such an approach could be more broadly applied in the Balkan

mountains to preserve a unique ecosystem. Within South Eastern Europe, the GEF financed Danube Delta Biodiversity Project is utilizing a transboundary cooperative approach for both coastal zone and mountain ecosystem management. Both project have demonstrated that a regional approach leads to greater overall benefits and sustainability, helping to conserve unique ecological and tourist resources of a regional nature.

8.20 With regard to forest management, the region has the advantage of having well established institutions. Cooperation among these, and with Western European forest institutions, is already quite well established. Forest management demonstrates the need for both national and regional approaches, linked together, for effective natural resource management. On a national level, SEE countries need clear frameworks for land restitution, for forest management, resource pricing and taxation in order to recover forest industries and ensure sustainable forest management. The countries need further assistance in updating forest inventory and protection systems, and, for countries with forest land restitution programs, in developing regulations, taxes and incentives, extension systems and forest owners associations. Above and beyond national policies and practices, regional cooperation is essential to avoid the resource exploitation that can result from national policies and lack of incentives, e.g., log export bans, resource taxes, Regional agreement on basic natural resource policies would improve overall resource management. This issue is not limited to SEE countries. In northern Europe consumers of forest products are increasingly requiring certification that these products are produced from sustainably managed forests. Thus, improved management of natural/forest resources will increasingly be necessary in SEE countries in order to maintain access to markets elsewhere in Europe.

8.21 Regional cooperation could influence appropriate pricing of forest resources (as well as water and energy) to encourage more economical use. There is a substantial body of knowledge on how to introduce these higher charges. *However to do this* without imposing undue hardship on the poor will remain a difficult political issue.

E. POLLUTION CONTROL SECTOR: WATER, INDUSTRIAL, SOLID WASTE, NUCLEAR POWER AND SAFETY

Water Resource Management and Pollution Control

8.22 The SEE region is generally blessed with an abundance of freshwater resources (see Table 8.5), although there are spatial and seasonal distribution problems. Flooding is a serious problem in some countries, especially Croatia. In most SEE countries, water resource management is fragmented. Integrated water resource management approaches are not used. Albania has taken the lead in addressing these deficiencies by preparing a Water Resource Management Plan. Croatia is planning to utilize an integrated river basin management approach for water resources of the Sava River. Bosnia and Herzegovina is considering establishing river basin management authorities to manage their water resources.

8.23 Many of the water resources on which SEE countries depend are of a regional nature. Most of the SEE region lies within the Danube River Basin which supports the

supply of drinking water, agriculture, industry, fishing, tourism, power generation, and navigation, and is the recipient of most of the region's wastewater. Intensive agricultural, industrial and urban uses have created problems of water quality and quantity, and reduced biodiversity in the basin. Transboundary lake ecosystems face similar challenges. Lakes Prespa and Ohrid and their watersheds are shared between Albania and FYR Macedonia. Both are threatened by transboundary water pollution and require cross-country cooperation for solutions. FYR Macedonia has installed wastewater treatment plants to reduce water pollution of Lake Ohrid—the oldest lake in Europe with unique ecosystems. However, municipal wastewater and mining tailings are still discharged untreated from the Albanian shore.

Table 8.5: Water Resources

Country	Freshwater resources (m3 per capita) in 1996	Annual freshwater withdrawals			
		% of total resources used	% for agriculture	% for industry	% for domestic
Albania	13,542	40	76	18	6
Bosnia and Herzegovina	na	na	na	na	na
Bulgaria	2,154	77.2	22	76	3
Croatia	12,870	na	na	na	na
FYR Macedonia	na	na	na	na	na
Romania	1,637	70.3	59	33	8
FRY	na	na	na	na	na

Source: The World Bank, *World Development Report: 1998*. Washington, DC: The World Bank, 1998.

8.24 While water service coverage in most SEE countries is high (over 80 percent piped supply in most urban areas), service quality is generally unreliable. Infrastructure is deteriorating because of inadequate maintenance. Weaknesses in the policy and regulatory frameworks and in the management of water utilities are the main reasons for this deteriorating situation. Wastewater collection coverage is low, generally less than 50 percent in urban areas. Most countries treat only 20 percent of all wastewater produced. Investments are therefore primarily needed in the wastewater sector, but attention needs to be paid that institutional and financial capabilities of utilities be sufficiently strengthened so that investment are sustainable and operate efficiently.

8.25 The water sector has been affected by low institutional capacity to design and prepare reforms. The roles of local and central governments still need to be defined. The reform process is differently advanced in SEE countries. Bulgaria, Croatia, FYR Macedonia and Romania have high service coverage, but there remains a need for comprehensive and consistent reform programs. In Albania and Bosnia and Herzegovina, reforms have been slower and water systems are deteriorating. The key priorities for reform are:

- **Institutional weakness and lack of governance.** Water and wastewater utilities are overstaffed, inefficient, and lack modern management. Utilities have often little autonomy and insufficient control over management parameters. Maintenance and rehabilitation of existing facilities is often neglected, while resources are invested into new facilities that are often over designed and costly to operate.
- **Operational and planning inefficiencies.** Operational inefficiencies, poor planning and lack of maintenance increase costs and result in deterioration of infrastructure. Many systems were poorly designed, with low-quality materials, equipment and construction. Poor maintenance and operation results in inefficient plants, poor water quality, and excessive leakage (UFW of 50 percent and more are not uncommon). Given low level of tariffs, consumers have little incentive to conserve water consumption. Households and industrial units consume more water than their counterparts in Western Europe. This problem is particularly acute in countries where there are no meters.⁸⁵
- **Lack of financial viability.** Low tariffs, high operating costs and poor management have placed many water utilities into financial difficulties. Accumulation of payment arrears is particularly acute in water enterprises. Revenue collection is low, often constituting less than 50 percent of amounts billed. Disconnection of services for non-paying customers is uncommon.

8.26 Many water supply enterprises suffer from water shortages and poor water quality. The water utilities themselves are a major source of water pollution due to discharge of untreated wastewater. Existing institutions, legislation, and policies are not equipped to introduce modern principles of water resource management that would ensure cost-effective wastewater collection and treatment methods.

8.27 Increased private sector participation is an important avenue to improve the performance of utilities in the water sector. There has only been limited participation of the private sector in the water sector in the SEE countries. In larger cities, with more than 200,000 inhabitants, which have adequate regulatory frameworks, private sector participation should be possible, given revenue-earning potentials. For the smaller cities, where there is little possibility for private sector involvement or granting of management contracts to private operators, a policy of outsourcing should be pursued. Private sector participation requires the development of transparent criteria for the selection of providers, the establishment of technical, safety and environmental norms, which the private operators must follow and which can be monitored. It also requires a regulatory framework, which provides for price adjustments and penalties if agreed service standards are not delivered.

⁸⁵ Design standards for investments assumed consumption of more than 250 liters/day/capita in many ECA countries. The design norm in Western Europe is about 130 liters/day/capita.

Solid Waste Management

8.28 Several countries face serious problems with the collection and disposal of solid waste. In Albania, Kosovo, and Bosnia and Herzegovina collection is sporadic, and piles of garbage constitute health hazards. There is little or no adequate storage for hazardous waste, leading to continuous build-up. In Bosnia and Herzegovina medical waste accumulation is especially serious because it served as the depository for such waste in the FRY. Only Croatia has a hazardous waste incineration facility. Throughout the region, wastes are dumped in unsanitary landfills, dumpsites in ravines and valleys; or directly into water bodies. Given the karst nature of much of the region, indiscriminate disposal practices can have serious impacts on groundwater. In Romania, Croatia and Bulgaria progress has been made with developing a solid waste regulatory framework; however problems need to be tackled at a local level where municipalities face financial difficulties and shortage of adequate skills.

Industrial Pollution

8.29 Bosnia and Herzegovina, FYR Macedonia, Bulgaria, FRY and Romania were all heavily industrialized after the Second World War. Most development took place without adequate environmental safeguards or proper siting of the industrial plants; this has resulted in serious environmental degradation and had an adverse impact on health. The environmental impacts of industrial pollution are felt on both a regional and a local level. On a regional level, industrial air emissions, partly coming from northern Europe, are a cause of acid rain which damages forests and aquatic ecosystems. Forests at higher altitude, particularly in Slovenia and Bulgaria, have been damaged by SO₂ (sulfur dioxide) and NO_x (nitrous oxide) emissions from coal-fired power plants and vehicle emissions. There has also been localized damage to forests from copper smelters in Romania. Programs to address this problem (through reforestation with more resistant species and reduction of SO₂ emissions) have been developed in Germany and Poland but are costly.

8.30 Industrial air pollution is also a locally serious problem. Most of the emissions of organic micropollutants and heavy metals are linked to specific industrial enterprises—many of them now with reduced production and consequently reduced emissions. Some SEE countries are initiating air pollution monitoring, surveillance and industrial clean-up activities (Bulgaria, Croatia). The main atmospheric emissions (SO₂, NO_x, CO₂ and methane) have decreased by more than 20 percent in Bulgaria, and air quality monitoring has improved. Lead phase out programs are on going in Bulgaria and Romania.

8.31 With enterprise privatization, some countries have pushed forward with improved practices; in Bulgaria investments for improved environmental performance were agreed upon as part of privatization deals. In Romania progress has been made in the clean-up of fourteen pollution "hotspots", identified in the early 1990s, and since then there has been progress in developing a regulatory framework, in industrial restructuring and in "process" improvements. In Bosnia and Herzegovina, where heavy industry was reduced to 5 percent of its pre-war level, start-up of these antiquated, polluting industries without adequate environmental regulations and enforcement poses environmental risks. In Kosovo, the four BTF high priority "hot spots" as well as the other identified "hot spots"

in Obiliq, Trepca, Mitrovice, Glogovc and Elz Han should be the subject of environmental audits and possible "process" improvements.

8.32 CO₂ emissions, vehicle ownership and sources of electricity vary widely in the region (see Table 8.6). Heavily polluting coal accounts for 85 percent of electricity generation in FYR Macedonia, and one-third or more in Bulgaria, Bosnia and Herzegovina and Romania (Chapter 7 discusses the broader policy implications for energy). In the poorer countries increasing energy prices may be contributing to over-cutting of forests for fuel-wood, as discussed earlier.

Table 8.6: CO₂ Emissions And Vehicle Use

<i>Country</i>	<i>Per capita CO₂ emissions (per capita metric tons) in 1995^a</i>	<i>Motor vehicles (per 1000 people) in 1996^b</i>
Albania	0.6	31
Bosnia and Herzegovina	0.4	24
Bulgaria	6.7	234
Croatia	3.6	196
FYR Macedonia	4.5	142
Romania	5.3	124
FRY	3.63 ^c	163
CEE average	7.6	295
EU average	8.0	447

a. "Europe's Environment: The Second Assessment." Copenhagen: European Environment Agency, 1998.

b. The World Bank, "World Development Indicators: 1998." Washington, DC: The World Bank, 1998.

c. In 1992. The World Resources Institute, UNEP, UNDP, The World Bank, "World Resources: 1996-97." New York and Oxford: Oxford University Press, 1996.

Nuclear Power and Safety

8.33 Management of nuclear power and safety in the SEE countries has transboundary implications. The most serious concern is the management of the old units of Bulgaria's nuclear plant Kozloduy, on the Danube River. The plant includes four VVER 440/320 reactors which lack certain basic safety features. The plant produces nearly half of the electricity consumed in Bulgaria, and the closure of the four reactors would be extremely costly. The continued operation of Kozloduy has implications for Bulgaria's application for membership of the EU. It has been invited to start negotiations in 2000, conditional on agreeing to close the old units of the nuclear plant. The Government has agreed on early closure of units 1 and 2 before 2003, but against acceptable compensation measures for developing alternative sources of power for electricity and implementation of nuclear safety projects for decommissioning, including financial assistance from the EU for the period of 2000-2006. Part of the EU grant assistance is conditional on confirmation of the understanding for closure of units 3 and 4, which has to take place before 2006 at the latest. The Government will complete a time-bound program for decommissioning of units 3 and 4 by July 31, 2000.

Potential Regional Pollution Control Programs

8.34 Current pollution control efforts include the Danube Environment Program, initiated in the early 1990s. The Danube River Basin Program undertook analytical work in the major tributaries, and identified key industrial and urban pollution "hotspots" in the basin.⁸⁶ Improved municipal wastewater treatment capacity; reduction of industrial and non-point agricultural emissions; conservation of wetlands and floodplains; and integrated water resource management were elements of the recommended Program. The Danube Environment Program had only limited impact, in part because national and regional priorities frequently did not coincide, in part because of the large investment requirements (even with better policies) for improved industrial and municipal effluent. The real damage to human health and productivity from this pollution was also difficult to assess. For (mostly) financial and (partly) institutional and social reasons, municipalities and industries have not been able to invest in the clean-up activities. Without concessional funding large increases in utilities charges would be necessary, and few governments are politically ready to implement such increases. For investments, which are agreed to be of high priority, financing packages including concessional funding, will be necessary (Environmental projects in the Baltic countries, and the recent Agricultural Pollution project for Poland, are good examples).

8.35 Restoration of Danube wetlands and reduction of pollution from agricultural run-off and animal waste are less expensive strategies. Riverine and aquatic ecosystems conservation strategies also lend themselves well to transboundary cooperation. Existing programs such as the successful wetland restoration programs ongoing in the Danube Delta can provide guidance.

8.36 Regional coordination is well established in the Carpathians, with regular strategic and operational meetings among the Carpathians countries. A similar arrangement should be established for South Eastern Europe with concessional financing. This has the added advantage of improving communication and understanding. Regional cooperation regarding coastal zone management is also important. The "model" provided by the Lake Ohrid Conservation Project (LOCP), a GEF project now in implementation, between FYR Macedonia and Albania may be useful in this regard. The primary objective of the LOCP is to promote cost-effective solutions to transboundary natural resource management and pollution problems, thus providing a basis for the sustainable economic development of a regional watershed. A Memorandum of Understanding (MOU) between Albania and FYR Macedonia which established in 1996 the Lake Ohrid Management Board (LOMB) governs the conservation activities of the Lake. The LOMB provides a bi-national legal framework for the resolution of transboundary environmental problems. The LOCP project is proving to be successful in developing a regional environmental protection strategy for the watershed based on the principles of cooperation between the two countries and the joint management of the lake and its surrounding resources, e.g., fisheries.

⁸⁶ "Strategic Action Plan for the Danube River Basin 1995-2000," Environment Program for the Danube River Basin, 1995.

8.37 Projects should address improved management of wastewater and solid waste. The focus should be on improving conditions in the areas impacted by war, followed by addressing the areas with significant impact on human health and ecosystems. Restoration and reliable operation of basic municipal services (water, wastewater, refuse collection, electricity) will be necessary, and there will need to be a program linked to improving implementation of charging systems that cover costs. For tourism development, high standard municipal services (which can be fully paid for by the industry) are essential. Pricing policies are especially difficult to address. Adequate cost recovery for utilities is necessary in order not to strain scarce government budgets, to operate and maintain systems adequately and to attract private sector investment, but large sections of the population are now impoverished. So-called "life-line" tariffs may need to be applied to so many people in order to assure basic municipal services that some element of subsidy may still be necessary. This would in turn imply concessional financing of new investments for the coming years.

8.38 Programs to address environmental consequences of war should be based on the need to reduce risks to human health. The immediate priorities are:

- (a) Clearance of unexploded ordnance and land mines based on agreed upon priorities.
- (b) Restore basic municipal services of water supply, sewerage and solid waste collection/disposal.
- (c) Address hot spots of pollution of the Danube, and of reduced economic activity, caused by damage to infrastructure and industry.
- (d) Address environmental damage caused by the refugee crisis (solid waste, water pollution and destruction of forests).
- (e) Incorporate environmental considerations into reconstruction efforts. The reconstruction of industries will require careful environmental impact assessments and application of integrated pollution reduction techniques.

8.39 In terms of industrial pollution, programs to strengthen industrial regulations and pollution charges are well established in Europe; the difficulty will be to encourage these without increasing production costs unduly. Programs should improve environmental monitoring and measurement capabilities particularly in FRY and Bosnia and Herzegovina. Environmental audits of identified industrial "hot spots" should be conducted and clean technologies introduced.

8.40 The nuclear safety issue in Bulgaria needs comprehensive understanding, particularly of the real costs of closure and the support Bulgaria may need to develop alternative energy sources. Lessons from other countries attempting to address nuclear safety with financial assistance from European countries would be useful.

F. ENVIRONMENTAL POLICY, LEGISLATION AND INSTITUTIONS

8.41 Policy, legal and institutional frameworks in the SEE countries are similar to the ones in Central and Eastern European countries. There are environmental policy statements, constitutional recognition of the right to a healthy environment, a framework environmental law, environmental impact assessment legislation, and institutions for environment (usually ministerial level). Most SEE countries have ratified numerous international environmental protection treaties (see Table 8.7). Apart from bilateral agreements, several multilateral frameworks offer the SEE countries possibilities to cooperate in the environment sector including: Long Range Transboundary Air Pollution; Protection and Use of Transboundary Watercourses and International Lakes; Environmental Impact Assessment in the Transboundary Context; Transboundary Effects of Industrial Accidents; Access to Information, Public Participation in Decision Making and Access to Justice in Environmental Matters. Frameworks for regional environmental cooperation are also offered by the Central European Initiative (CEI), Black Sea Economic Cooperation (BSEC); the Convention on Cooperation for the Protection and Sustainable Use of the Danube River (DRPC).⁸⁷ (Table 8.8)

Table 8.7: Government Commitments/Treaties Signed ^a

<i>Country</i>	<i>Convention on Biological Diversity ^b</i>	<i>Climate change</i>	<i>Ozone layer</i>	<i>CFC control</i>	<i>Law of the Sea</i>
Albania	1994	1995	..	..	..
Bosnia and Herzegovina	..	..	1992	..	1994
Bulgaria	1996	1995	1991	1991	1996
Croatia	1997	1996	1992	1991	1994
FYR Macedonia	1997 ^c	..	1994	1994	1994
Romania	1994	1994	1993	1993	1997
FRY	..	..	..	..	..

a. The World Bank, "World Development Indicators: 1998." Washington, DC: The World Bank, 1998.

b. The World Bank, "World Development Indicators: 1999." Washington, DC: The World Bank, 1999.

c. The Convention has been ratified by all countries except FYR Macedonia and Romania. UNEP/UNCHS Balkans Task Force (BTF). "Assessment of the Damage to Biodiversity in Protected Areas of the Federal Republic of Yugoslavia." October 1999.

d. UNEP/UNCHS Balkans Task Force (BTF). "Assessment of the Damage to Biodiversity in Protected Areas of the Federal Republic of Yugoslavia." October 1999.

⁸⁷ A Framework on Environmental Recovery for South Eastern Europe in Support of the Stability Pact, ECE SECI Conference, Vienna, 4 October 1999.

Table 8.8: Participating Countries in Selected Multilateral Environmental Frameworks

	<i>ECE Air Convention</i>	<i>ECE Water Convention</i>	<i>ECE EIA Convention</i>	<i>ECE Accidents Convention</i>	<i>ECE Convent. Public Particip.</i>	<i>CEE</i>	<i>BSEC</i>	<i>Alpe- Adri a</i>	<i>DRPC</i>
Albania		Ratified	Ratified	Ratified	Signed	Yes	Yes		
BiH	Ratified					Yes			
Bulgaria	Ratified	Signed	Ratified	Signed	Signed	Yes	Yes		Signed
Croatia	Ratified	Ratified	Ratified		Signed	Yes		Yes	Ratified
Romania	Ratified	Ratified	Signed		Signed	Yes	Yes		Ratified
FYROM	Ratified					Yes			

8.42 Public participation in environmental matters has developed though difficulties remain in some countries. NGOs in FRY have had their activities curtailed, and some NGOs have had their cross-border activities halted by the conflict.⁸⁸ Elsewhere, new approaches to increase NGO and civil society participation in local and regional environment decision making are being demonstrated, e.g., the Lake Ohrid Conservation Project, and the Romania and Bulgaria environment movements more broadly, which can serve as models for the region.

8.43 Bulgaria and Croatia have made most progress in developing sound regulatory and institutional frameworks. Bulgaria has a well-established environmental monitoring system and environmental assessment system, with public consultation, in place. Croatia also has good technical capacity for monitoring and regulations, is pursuing environmental education and public awareness programs, and has established an "Environmental Label" system to promote clean technologies. In Romania there is still progress to be made in integrating and clarifying the responsibilities of the different agencies responsible for environmental monitoring and management. Improved consistency in environmental regulations, across the region, would assist countries with EU accession programs.

8.44 Governance and enforcement are issues in all countries, but particularly in Albania and Bosnia and Herzegovina. Until the political situation is more stable it will be difficult to make much progress. Public awareness programs and the increasingly active NGO movement are most likely, in the interim, to be successful approaches to improving environmental management.

Potential Regional Environmental Management Programs and Projects

8.45 A central objective of SEE environmental program and projects should be to promote institutional and policy frameworks which address environmental priorities within existing economic constraints, particularly those with high social values (e.g.,

⁸⁸ "Assessment of the Environmental Impact of Military Activities During the Yugoslavia Conflict."

human health and water resources) and high economic costs (e.g., deforestation and coastal management). In addition, clear, transparent and consistently applied regulatory frameworks are key, including clarity regarding responsibilities for environmental liability for industries which are privatized. There also needs to be clear and enforced land use-planning legislation, especially for tourist developments. Technical and financial support for the SEE countries is essential, as research indicates that generally significant improvements in environmental management are difficult to achieve at per capita incomes below US\$ 3,000. External support through concessional funding may, therefore, be necessary to improve environmental management in these areas over the near term. Improved environmental management also contributes to reduced poverty and increased opportunity (for natural resource management) and improved health and welfare particularly among lower income groups (for pollution management and improved water and sanitation).

8.46 There is scope for learning from "best practices" within the region regarding institutional management. Regarding development of regulatory frameworks and monitoring systems for environmental management, Bulgaria has much to share with the other countries of the region. It has also made good progress on developing programs for addressing environmental liability under privatization and investment programs. Croatia may be the regional "leader" in protected area management, while Romania has made good progress in developing community based approaches to natural resource management. The progress of Albania in these areas has been modest by comparison. Transparency is a key element in combating corruption, as is the development of NGOs and broader civil society. Romania, Bulgaria, and FYR Macedonia have the most flourishing NGO community.

G. CONCLUSION

8.47 This Chapter has outlined the environmental challenges facing the region that are regional in nature, or that have arisen as a result of conflicts and instability in the region. Regional issues arise in three main areas: natural resource management, pollution, and institutional and policy framework. Regarding natural resource management, the Chapter argues that forestry management and biodiversity conservation would benefit significantly from regional cooperation among countries in the SEE region, especially since many natural resources span more than one country. Water resource management and cooperation are also important, especially due to the special role the Danube plays in the region. Improved management of wastewater and solid waste are also essential, especially because of the deleterious effect that regional conflicts have had on the environment. Finally, as moving towards a closer integration with Europe will require substantial improvements in environmental management, institutions and regulations, there is a clear role for technical and financial support in these areas by the international community.

Table 8.9: Selection Criteria Matrix for SEE Regional Environmental Projects

	<i>Regionally Joint Project</i>	<i>Multi-Country Project</i>	<i>National/Bilateral Project with Regional Impact</i>
<i>Agreement among SEE countries, most concerned</i>	On location, ownership, project implementation, operation.	On cooperation, mutual control of supervision, peer pressure.	Commitment of the project government to share information with other countries in the region.
<i>Sectoral policy/institutional reforms</i>	The project fits into the national environment sectoral policy acceptable to IFIs.		
	<ul style="list-style-type: none"> • Introduction of European/international standards. • Economies of scale. 	<ul style="list-style-type: none"> • Regional and European legal harmonization. • Efficiency improvement. • Synergy effect. 	<ul style="list-style-type: none"> • Appropriate pricing policies for natural resources. • Pilot character. • Efficiency increase. • European/international standards. • European integration: EU compatible institutions. • “Polluter pays” principle. • Transparent regulatory procedures.
<i>Emergency character</i>			
<i>Bankability criteria</i>	<ul style="list-style-type: none"> • Improves people’s livelihood through sustainable use of natural resources. • Reduces risks to human health due to environmental factors. • Reduces vulnerability to environmental risks and natural disasters. • Enhances environmental quality and natural resource management. • Maintains the global ecosystem. 		
<i>Other</i>	Project conditions on a case by case basis.		
	<ul style="list-style-type: none"> • At least two countries. • Joint investment. 	<ul style="list-style-type: none"> • At least three countries. • Synergy from the harmonization of several national projects. 	<ul style="list-style-type: none"> • Sectoral reform with regionally demonstrative impact and/or part of a regional/Trans-European network.

**COMMON FRAME FOR COUNTRY ASSISTANCE FOR
ALBANIA, BOSNIA AND HERZEGOVINA, BULGARIA, CROATIA, FYROM AND ROMANIA**

ASSISTANCE OBJECTIVES	CURRENT STATUS AND PERFORMANCE					
	ALBANIA	BiH	BULGARIA	CROATIA	FYROM	ROMANIA
<p>1. Private Sector Development/Trade/Finance/Environment</p> <p>1.1 Ensure private sector environment conducive to growth, exports and employment.</p> <ul style="list-style-type: none"> ➤ Accelerate privatization and structural reform in the financial and enterprise sector. ➤ Develop effective commercial law legal framework. ➤ Reduce the tax burden on SMEs, foster development of SME financing vehicles. ➤ Alleviate constraints to FDI, including portfolio investment; ➤ Eliminate labor market inefficiency, reduce rigidity in labor market legislation. 	<p>“Strategic” enterprises (mining and fuels) continue to make losses, raising government contingent liabilities, SMSOEs not viable and not contributing to production, restitution poses bottleneck to privatization of enterprises. Foreign investment adversely affected because of the crisis in Kosovo. Legal framework not adequate and poorly enforced.</p>	<p>Mandated joint institutions have been established and economic legislation enacted, however, fundamental State and entity level governance structures require further development to ensure recovery and growth. The entities still need to establish sound revenue sources for the state and target number of enterprises to be privatized. The government also needs to prepare new labor laws limiting restrictions on hiring/firing. Implementation of effective legal framework for private sector development and privatization of enterprises is also crucial.</p>	<p>Legal obstacles to the privatization of SOEs in the oil, power, mining and gas sectors eliminated and privatization under way. Despite the progress privatization of SOEs should be accelerated using transparent and competitive privatization instruments. Legal and regulatory framework for securities was modified, SME development strategy formulated and adopted. Bankruptcy and liquidation proceedings remain to be streamlined by removing existing legislative, regulatory and procedural barriers. Adherence to commitments for further reductions is critical</p>	<p>Legislation for the privatization of 49 percent of large enterprises approved, however, progress has been slow in privatizing large public infrastructure and utility companies. State monopolies have no incentives for efficiency measures, explaining high tax and passed costs to the private sector. Strategy for privatization of state monopolies was developed, majority privatization in of telecoms to be completed and oil and gas conglomerate offered for privatization.</p>	<p>Privatization and restructuring in agriculture, industry and infrastructure should be accelerated and loss-reduction program of restructuring/ liquidation through bankruptcy adopted. Poor corporate governance, uncertain land and property rights, fragmented ownership, restrictions on share trading, small domestic market, lack of access to credit for SMEs, high real interest rates--all these issues need further attention. Legislation on investment funds needs to be adopted.</p>	<p>Continued compliance with IMF stabilization program. Adopt a legal framework enabling foreign portfolio investment, eliminate restrictions to medium and long-term CA transactions. Privatization of SOEs has to be accelerated to ensure swift transfer of control and ownership to private owners. Reduce losses through imposing financial discipline and closing down non-viable enterprises. Alleviate constraints to direct foreign investment, including portfolio investment. The availability of medium and long-term financing to SMEs should be further improved.</p>
<p>1.2 Promote further trade liberalization.</p> <ul style="list-style-type: none"> ➤ Reduce protection through lower, more uniform tariff rates and increase 	<p>Simple average tariffs in the range 12-16%. But, there is some differentiation across products, resulting in substantial effective</p>	<p>Low average tariff, but schedule is highly disaggregated. Need to make tariff regime more uniform. Also, need to harmonize</p>	<p>Trade regime relatively liberal. Import-weighted tariffs of 9% for industry and 21% for agriculture. Adherence to commitments to further reduction is</p>	<p>Simple average tariff is 12-16% but need to reduce tariff dispersion. Specific duties for agricultural products</p>	<p>Average tariff rate near 20% and should be lowered. Licensing still exits, as does surrender of export receipts.</p>	<p>Agricultural tariffs need to be lowered to the desired average. Tariffs and price regulations are limited by law to a short list of goods and</p>

ASSISTANCE OBJECTIVES	CURRENT STATUS AND PERFORMANCE					
	ALBANIA	BiH	BULGARIA	CROATIA	FYROM	ROMANIA
<p>transparency through reducing the number of tariff bands.</p> <ul style="list-style-type: none"> ➤ Eliminate non-tariff trade barriers, through the removal of licenses, quotas and other instruments. ➤ Strengthen trade-related institutional capacity. ➤ Harmonize existing intra-regional preferences which are not consistent with the WTO. 	<p>protection. There is a need to make tariff regime more uniform.</p>	<p>policies between entities and allow freer inter-entity trade.</p>	<p>critical. Export taxes and QRs (mainly agriculture) should be eliminated with a credible commitment not to re-impose them.</p>	<p>and licensing needs to be eliminated.</p>		<p>services. Foreign trade regime, however, should be further liberalized, made stable, predictable and equally applied to all economic agents.</p>
<p>1.3 Improve financial system safety, soundness and performance standards.</p> <ul style="list-style-type: none"> ➤ Improve lending policies/practices and risk management of banks. ➤ Efficiently manage foreign debt. ➤ Improve bank governance through privatization and strengthen supervision of banks and financial institutions. ➤ Improve accounting and auditing 	<p>Formal banking sector is non-functioning in terms of domestic credit because of poor management, state banks act as state agencies with soft budget constraints; all three state-owned banks are insolvent. High collection risks for private banks render them not active as credit facilitation intermediaries.</p>	<p>The banking sector needs restructuring, downsizing and privatization in order to attract strategic investment. The administration needs to revise and adapt legal and regulatory framework in order to support the continued development of private banks. With the legacy of war private foreign investment has not yet really begun, aside from some limited finance and suppliers' credits.</p>	<p>Capital adequacy ratio for banks was increased and program for banking supervision adopted, public sector banks are being privatized and new Deposit Insurance Law was enacted and implemented. There is a need to complete privatization in the banking system. Strengthening of the SSEC is being completed and international accounting standards adopted. Skills base for contractual institutions has to be upgraded, as well as long-term non-bank financing instruments.</p>	<p>Poor performance in the real sector put a squeeze on liquidity in the banking system. Insolvency in parts of the banking sector mounted causing a credit constraint, leading to contingent fiscal obligations, and weak banking supervision. Proceedings in bank asset resolution were improved in 1999, diagnostic studies for remaining insolvent banks completed,</p>	<p>High lending rates, high systemic risk and high costs and losses in the banking system. Lack of confidence in the banking system resulting from poor lending practices. NBM to introduce indirect instruments for monetary policy management. Lack of instruments and services to the private sector. Institutional/ market framework to be strengthened. Independence and capability of</p>	<p>Direct credit to be eliminated, savings mobilized and new financial instruments developed. Quasi-fiscal activities performed by the Central Bank should be eliminated. State-owned banks to be privatized and growth barriers to private banks removed. Regulation and supervision of banks and non-bank financial institutions to be strengthened. Most banks are using uniform international accounting standards, new instruments for monetary management have been</p>

ASSISTANCE OBJECTIVES	CURRENT STATUS AND PERFORMANCE					
	ALBANIA	BIH	BULGARIA	CROATIA	FYROM	ROMANIA
<p>practices, adopt international accounting standards.</p> <p>➤ Strengthen institutional/market framework, improve technology of financial intermediaries and markets and enhance information transparency.</p>				<p>and capital adequacy rules and accounting standards enforced. State ownership in the banking sector has yet to be reduced and deposit insurance scheme adequately funded. Deposit payouts need to be speedily implemented. Public finance management still needs streamlining.</p>	<p>commercial banks and enforcement of international standards of supervision and regulation in the banking system should be promoted.</p>	<p>introduced and collection performance of banks had improved. Risk management capabilities of banks to be improved and regulation and supervision of capital markets strengthened. Satisfactory deposit insurance scheme was implemented. Financial instruments for SMEs with no access to bank credit and venture capital to be developed.</p>
<p>1.4 Eliminate distortions in agricultural sector, complete privatization and improve its competitiveness.</p>	<p>Market-oriented incentive framework needs to be maintained including no distortion in prices. No transactions of privatized land because of restitution, inadequate legal and administrative procedures, and insufficient registration facilities. No clearly defined basis for ownership and responsibility for common land. Sub-optimal use of irrigated land because of deterioration and inappropriate management of water resources, drainage</p>	<p>The PRP restarted the domestic agriculture program, and very little food aid is now being provided. However, little progress has been made to address deep-seated institutional and structural constraints. The need for donor support for agriculture programs in the medium term will remain.</p>	<p>Legal and regulatory impediments to land transactions are removed, land restitution is to be completed. Agriculture pricing and incentives should be reformed by eliminating price and margin controls, other disincentives. Negotiated price system was eliminated, privatization program for all agricultural enterprises completed. Efforts are concentrated on improving the environment for private market development (plus external trade) and developing export-oriented agriculture. Medium-term goal is to promote sustainable intensification of</p>	<p>Collaboration with the Bank on agriculture sector policy study has brought revision of agricultural policies with particular reference to pricing, trade and subsidies. National agricultural development strategy to be adopted and implemented.</p>	<p>Collaboration with the Bank on agriculture sector policy study has brought revision of agricultural policies with particular reference to pricing, trade and subsidies. National agricultural development strategy to be adopted and implemented.</p>	<p>Prices for all agricultural products on all levels are liberalized. Subsidies are reduced in real terms and unilateral export quotas eliminated. Development of rural finance institutions should be promoted further. State grain marketing monopoly dismantled and successor companies privatized. Private sector entry into input markets facilitated, commodity markets established. All agricultural service companies privatized, licensing requirements for agricultural exports and imports were eliminated. Competitive</p>

ASSISTANCE OBJECTIVES	CURRENT STATUS AND PERFORMANCE					
	ALBANIA	BIH	BULGARIA	CROATIA	FYROM	ROMANIA
	and irrigation systems. Insufficient attention to livestock management resulting in low productivity and unsustainable production.		agriculture through improved infrastructure financing and management, and greater input access.			land market yet to be developed.
<p>2. Poverty Reduction and Social Development.</p> <ul style="list-style-type: none"> ➤ Support poverty reduction and address rising inequality. ➤ Promote access to quality education for all children which is suitable for the needs of a market economy, leadership, and democratic society. ➤ Reduce inherited inefficiencies in the health sector, through reorienting the health care system to lower levels of care, reforming health finance, updating clinical practices, and facilitating private sector provision. ➤ Increase the fiscal sustainability and impact of the social protection system, through reform of 	<p>Dramatic real wage collapse, with rural poverty much higher than urban. Sharp drop in upper secondary enrollment rates among the poor. Sharp decline in real public health spending, and high regional variations in health status. Inherited inefficiencies, weak governance, and management of health sector.</p> <p>Increasing out-of-pocket payments for health care.</p> <p>Social transfers are critical element of income for poor, with social assistance [reasonably targeted].</p>	<p>Limited, available social data indicate high regional poverty variation and inequality. Education system has fragmented governance, and legacy of conflict in curricula. Dramatic decline in real health spending, and structural inefficiencies exacerbated by fragmented governance.</p> <p>Severe compression of social assistance, and failure to adjust pension entitlements to available resources.</p> <p>Veterans' benefits dominate transfer spending.</p> <p>Critical role of NGOs in food aid and other programs.</p>	<p>Sharp increase in poverty in mid-1990s.</p> <p>Public spending on health and education as share of GDP amongst lowest in ECA.</p> <p>Divergence in enrollment rates in general education between income quintiles.</p> <p>Health indicators deteriorated in 1990s, despite real spending increase.</p> <p>Public spending on social transfers as share of GDP declining, though programs to improve social assistance and pensions approved.</p> <p>Social assistance mildly progressive.</p>	<p>Reliable social data not available for all regions, but poverty low, concentrated among elderly.</p> <p>Substantial increase in real wages during transition, and in registered unemployment.</p> <p>Access to health care adequate, but expenditures unsustainable and major need for rationalization in sector.</p> <p>Education enrollments steady, but spending share of GDP spending low. Governance and content unreformed to market needs.</p> <p>Despite low replacement rates, pension system running unsustainable deficit.</p> <p>Multi-pillar pension reform legislated.</p>	<p>Poverty and inequality increasing over transition.</p> <p>Sharp increase in registered unemployment of long duration.</p> <p>Disparities in enrollment rates by income level from secondary school upwards.</p> <p>Sharp decline in real health spending, but limited incentives for efficiency and quality.</p> <p>Social assistance and pensions have progressive incidence overall and significant poverty reduction impact.</p>	<p>Sharp increase in poverty and inequality in early transition.</p> <p>Significant increase in real health spending during transition, but management and governance need reform.</p> <p>Poor have lower enrollment rates in primary school and gap widens higher in system.</p> <p>Overall cash transfers are pro-poor, though social assistance being improved further.</p> <p>Pension system reforms approved.</p>

ASSISTANCE OBJECTIVES	CURRENT STATUS AND PERFORMANCE					
	ALBANIA	BIH	BULGARIA	CROATIA	FYROM	ROMANIA
pension systems, improving contribution compliance, and targeting social assistance more effectively.				Military and veterans' benefits remain non-transparent.		
<p>3. <u>Institutional Development/ Government and Public Sector/ Corruption.</u></p> <p>3.1 Maintain a sustainable and growth-promoting macroeconomic framework, reduce the size of the public sector.</p> <ul style="list-style-type: none"> ➤ Identify areas from which the state needs to withdraw and reduce overall level of public spending, ensure spending decisions are based on clear priorities. ➤ Define the responsibilities and competencies of government entities and equip them with technology and systems to improve efficiency. ➤ Enforce financial discipline, improve resource 	Reduction in the fiscal deficit is essential for curbing inflation, and important for inducing investment to generate growth. Reduction of fiscal deficit requires strengthening of tax and customs administration and efficiency of public spending.	As a result of the combination between donor concessional aid and strict monetary policies and balanced budgets the country has registered one of the best macroeconomic performances in the region. Inflation had fallen to single digits. Many of the basic political and economic institutions have been established (national currency, central bank). The present level of government spending, however, is excessive by most norms and in the near term will become unsustainable as donor funding phases down. Reform of the public finance system has begun. The Entities have made progress in harmonizing tax	Stabilization program currently implemented as agreed with the IMF, public expenditure systems and programs reviewed. Public financial management to be strengthened yet, effectiveness of public expenditures has also to be improved. New external liability and resource mobilization strategies are under implementation, modern public debt payment and monitoring system is operational. Comprehensive structure for tax administration is established. National Accession Action Plan for EU accession has to be adopted yet and macroeconomic measures therein to qualify for EU accession implemented.	Public investment is robust, public sector wage increases are planned, however, measures are taken to minimize the burden of the increase on the current state budget. Further budget transfers should be reduced, collection of payroll taxes should be improved. In the long run the enforcement of prudential regulations should be consolidated, CNB needs to ensure financial discipline.	Public expenditures are high, dominated by wages and transfers, public domestic debt – high and rising. Tax rates are high and tax evasion – rampant. Large loss-makers credited by the state should be liquidated, and arrears to state-owned public utilities eliminated. Flexible prices and markets should be maintained to promote competitiveness.	Measures implemented to strengthen tax administration and reduce tax evasion. New procedures to strengthen review of the public expenditure program and control adopted. Fiscal support for local authorities from the State to be reduced. Comprehensive budget management system under implementation, government liability management strengthened. Reform of civil service employment pay and training to be initiated yet.

ASSISTANCE OBJECTIVES	CURRENT STATUS AND PERFORMANCE					
	ALBANIA	BiH	BULGARIA	CROATIA	FYROM	ROMANIA
mobilization by broadening the tax base, improve tax administration and collection, reduce tax rates.		policies, debt management and transparency of budget management. This modest progress has been slow and difficult and pressure from the international community has been required.				
<p>3.2 Reorient state functions to meet the needs of market economy.</p> <ul style="list-style-type: none"> ➤ Adopt and implement effective legal and regulatory frameworks for the operation of private markets. ➤ Reorganize state institutions, streamline overlapping and outdated structures. ➤ Build local government management capacity and autonomy, strengthen municipalities and enhance devolution of powers to local administrations. 	Weak public administration not independent from partisan politics. Inefficient allocation of resources in public sector with overstaffing and low productivity versus understaffing and under-qualification in different areas. Local government is weak and inadequate in promoting local development. Public utilities and services need to be decentralized to promote local ownership and cost recovery.	Elements of private sector enabling environment are already in place but a healthy level of business activity will require a more conducive legal and institutional framework. Inconsistent and contradictory business laws and regulations are biased against small business, and in favor of large state-owned companies. Complicated tax structures and incomplete harmonization of custom and trade regulations between the Entities. In the Federation significant progress was achieved in establishing canton-	Legal obstacles to the privatization of SOEs in the oil, power, mining and gas sectors eliminated, GOB has withdrawn from ownership and operation of enterprises. New civil service law enacted, including a statute for civil servants and comprehensive civil service reform started. New procurement rules and guidelines adopted which are yet to be introduced in all central government agencies. The timetable for the transfer of identified responsibilities to regional and local governments is yet to be completed.	Public finance management needs streamlining and there is also need for institutional reform in support of an efficient payment system. Excessive government spending requires a fundamental review of public expenditures so the budget structure should be redesigned and system to monitor contingent liabilities created. Institutional and regulatory measures to allow fast-track bankruptcy proceedings should be adopted. Economic legislation to be strengthened to ensure enforcement	Ministerial policy units should be strengthened and/or new established. Regulatory and enforcement functions for private sector activities are underdeveloped. Institutional responsibilities are overlapping, civil service policies are outdated and performance incentives are poor. Large state ownership and lack of transparency in public procurement.	Decentralization policies in accordance with European Charter of Local Self Government under way. Local finances, local asset management and local public service management legislation enacted. Operational subsidies for local budgets eliminated, and investment subsidies restricted to sensitive sectors.

ASSISTANCE OBJECTIVES	CURRENT STATUS AND PERFORMANCE					
	ALBANIA	BIH	BULGARIA	CROATIA	FYROM	ROMANIA
		level fiscal administrations, however, coordination between Entity and local governments remains weak, and as a consequence, separate policies and practices continue in the fiscal structure. Despite increased credit availability banks remain weak and undercapitalized.		of commercial contracts.		
3.3 Enhance state role in long-term development planning, strengthen public administration and database management.	Weak public administration inadequate to perform basic functions of the state.	Prewar governance and economic management structures disintegrated with the war. The PRP aimed to rebuild the relevant and establish new ones where needed. Reforms in public administration, however, would take time and resources. The rebuilt capacities at this point cover basic spending requirements, including social assistance.	Guidelines for National Strategy for Accession to the EU agreed with the EU. Based on the Strategy and the EU Accession Partnership Agreement the state has to prepare time-bound program for meeting the Copenhagen accession requirements in the area of legal and administrative reform.	Identify areas from which the state needs to withdraw and in which policy-making and technical capacity need to be strengthened.	Need to develop work plan and access implications of EU integration. The state has to strengthen public investment programming and database.	Substantial administrative resources devoted to strengthening and rationalizing the role of the state, which will accelerate EU accession. The next SAL II likely to focus also on administration reform civil service operation and sizing.
3.4 Strengthen the judiciary, enhance judicial implementation capacity, provide basic resources for judges.	Weak judicial implementation capacity, including inadequate infrastructure, underqualified judges	Court system is viewed as slow and inefficient, skepticism regarding fair and just decisions. High taxes	Diagnostic review of current status and effectiveness of judiciary completed. Legislation required for implementation of the	The systems of property rights and contract enforcement are weak. Judiciary remains slow and	Weak judicial system. Legal framework should be simplified and the burden on judiciary reduced.	N/A

ASSISTANCE OBJECTIVES	CURRENT STATUS AND PERFORMANCE					
	ALBANIA	BIH	BULGARIA	CROATIA	FYROM	ROMANIA
	and lack of security for judges.	on civil suits discourage bringing claims to court. Unclear ownership rights.	reform identified in it was enacted, implementation is underway. Still factors contributing to failed enforcement of judgements are to be identified and prioritized, and appropriate COM decisions, legislation, and other actions adopted and implemented in order to address these factors.	ineffective in enforcing the commercial code and laws pertaining to economic activity. Judiciary should be improved and appropriate economic and commercial legislation promoted.		
3.5 Reduce corruption through identifying areas of public administration most prone to corruption, streamline and rationalize legal and administrative procedures to eliminate corruption encouragement, introduce transparency.	Public administration and civil service is underpaid and there is severe corruption. Judiciary is subject to political influence and corruption.	Inconsistent and contradictory business regulations make following them difficult. This creates favoritism and encourages corruption.	Key causes for proliferation of unrecorded economic activity are yet to be identified. Measures to eliminate opportunities for corruption through streamlining and rationalizing legal and administrative procedures and to introduce transparency are being considered.	Law enforcement of financial and business practices is very weak with recurrent accusations of bias and corruption.	Limited transparency and weak enforcement of legal protections encourage favoritism and corruption.	Government has demonstrated commitment to fighting corruption, however more decisive measures are necessary.
4. Infrastructure. ➤ Rehabilitate and strengthen existing infrastructure systems through least-cost investments reduce infrastructure system losses through improved management.	Power transmission and distribution systems are overloaded because of rapid growth in demand. The state is delinquent in paying bills and does not enforce payment of bills. Tremendous bottlenecks in power,	The PRP set out to quickly resolve major transport bottlenecks by repairing the most essential road corridors and bridges, restore electric power generation, transmission and distribution, and to restore telecom	Main goal – infrastructure to be upgraded to EU accession standards. The legal framework in infrastructure sectors is strengthened. Operational efficiency, financial viability and limiting the need for public finance are still to be pursued. Upgrade and rehabilitation	Inadequate regulatory framework, low efficiency and highly integrated utilities and energy enterprises. Regulation legislation adopted and privatization of utilities to be	Sub-standard East-West connections, lack of road-planning capabilities, cumbersome customs operations. Inadequate municipal institutional capacity in water sector,	Continue rehabilitation and modernization of existing supply infrastructure. New pricing structures based on economic costs were adopted. Sectoral restructuring to demonopolize power generation is being carried out. Full

ASSISTANCE OBJECTIVES	CURRENT STATUS AND PERFORMANCE					
	ALBANIA	BiH	BULGARIA	CROATIA	FYROM	ROMANIA
<p>➤ Improve billing and fee collection systems for infrastructure services, insure financial viability of the different sectors, modernize and streamline operations.</p> <p>➤ Open up major infrastructure units to competition, establish legal and regulatory framework for price liberalization.</p>	<p>water and roads, presenting a major barrier to private sector growth. Water service provision is irregular, thrash remains uncollected. Assets are old, cost recovery is insufficient and there are no sewage treatment plants. Acute shortage of urban infrastructure due to massive recent urbanization. Transport facilities are far from adequate, many rural areas are not accessible thus constraining further development of the rural sector. Railway is running significant losses because of underutilization as freight, port facilities are inadequate.</p>	<p>services. Most of the infrastructure was reestablished close to pre-war levels, however critical institutional bottlenecks to fully efficient use still remain. Infrastructure sectors will also need to increasingly shift policy and institutional focus to meet the demands of a market oriented economy and facilitate private sector-led growth.</p>	<p>of the existing network, restructuring and corporatization of infrastructure companies yet to be completed.</p>	<p>initiated, starting with telecoms and power. The oil and gas conglomerate to be also restructured and unbundled as precondition for privatization.</p>	<p>inefficiencies in water supply, electricity distribution. Uneconomic oil refinery. System losses to be reduced through improved management and rehabilitation, electricity generation to be opened to competition. Need to increase electricity prices and develop a long-term power plan.</p>	<p>liberalization of the petroleum sector, from exploration to retail distribution carried out, cost-efficiency to be improved. Monitoring capacity of national regulatory agencies strengthened. The transport infrastructure and equipment yet to be modernized to meet economic and technical levels of Western Europe. Restructuring Action Plan for railways was implemented, including employment targets. The state telecom company converted into a joint stock company and sold to a strategic investor. The connectivity of the newly installed digital transmission network to be expanded and the financial position of the telecom company to be improved.</p>
<p>5. Environmental Management. Improvement of national resource management and environmental standards.</p> <p>➤ Strengthen institutional capacity</p>	<p>Inadequate public sector response to widespread resource degradation due to lack of information, obsolete forestry management. Inadequate public sector management</p>	<p>Mine pollution was pervasive following the war. Landmine hazard is a significant obstacle to the reestablishment of normal development activities. The country has to</p>	<p>Strategy for environmental implications of EU accession with priority list of activities prepared. GoB/Swiss agreement on Debt for Environment Swap deal enacted. Capacity of the National Eco-Trust Fund</p>	<p>High levels of air pollution in industrial areas and limited water treatment need government action. Main issues and cost-effective interventions are</p>	<p>Pollution due to discharge of untreated wastewater. Underexploited natural and cultural tourism potential. Abundant but poorly managed national</p>	<p>Legislation for environmental liability passed and compliance schedules for pollution sources developed and enforced. Training for central and regional environmental staff provided. The</p>

ASSISTANCE OBJECTIVES	CURRENT STATUS AND PERFORMANCE					
	ALBANIA	BIH	BULGARIA	CROATIA	FYROM	ROMANIA
<p>of the environmental protection institutions at the central (policy issues) and regional (better enforcement and monitoring) levels.</p> <p>➤ Develop or enhance systems for environment monitoring and assessing environmental degradation.</p> <p>➤ Create national strategy for environment priorities and resource management.</p>	<p>and policy for ensuring environmentally sustainable growth.</p>	<p>provide donor support to develop new environmental legislation, formulate environmental standards and controls, and develop a national resource management and environmental action plan.</p>	<p>strengthened. Still past environmental damages in heavily polluting industrial enterprises have to be cleaned up, air and water pollution in selected priority areas reduced.</p>	<p>identified. Sound conservation methods and efficient business practices w.r.t. cultural heritage also needs to be introduced as a large part of Croatia's cultural heritage was destroyed during the war. Currently the maintenance and conservation practices are qualified as inadequate.</p>	<p>resources and bio-diversity. National environment preservation strategy needed.</p>	<p>institutional capacity of the environmental protection agency to be strengthened. Regulation for bio-diversity conservation and protected area management developed. Environmental partnerships with NGOs to be developed.</p>

**EXISTING COUNTRY ASSISTANCE FOR
ALBANIA, BOSNIA AND HERZEGOVINA, BULGARIA, CROATIA, FYROM AND ROMANIA**

ASSISTANCE OBJECTIVES	PARTNERS					
	ALBANIA	BiH	BULGARIA	CROATIA	FYROM	ROMANIA
<p>1. <u>Private Sector Development/Trade/Finance/Environment.</u></p> <p>1.1 Ensure private sector environment conducive to growth, exports and employment.</p> <ul style="list-style-type: none"> ➤ Accelerate privatization and structural reform in the financial and enterprise sector. ➤ Develop effective commercial law legal framework. ➤ Reduce the tax burden on SMEs, foster development of SME financing vehicles. ➤ Alleviate constraints to FDI, including portfolio investment. ➤ Eliminate labor market inefficiency, reduce rigidity in labor market legislation. 	EU, IMF, USAID, Italy, CEB (SME) Canada	UST/USAID, OHR, EC EBRD, others Canada, Bank	Japan PHRD/TA, EBRD, JEXIM/FESAL, EU EBRD (grant for SME), CEB (SME), Canada	Bank, IFC/TA&ESW CEB (SME)	IFC, MIGA/TA & ESW USAID/TA&ESW EBRD/F EU PHARE/TA Know-how Fund, Dutch Govt./TA CEB (SME), Canada	USAID/TA&ESW EU PHARE/TA&ESW CEB (SME) WB/CEB (microcredit), Canada
<p>1.2 Promote further trade liberalization.</p> <ul style="list-style-type: none"> ➤ Reduce protection through lower, more uniform tariff rates and increase transparency through reducing the number of tariff bands. ➤ Eliminate non-tariff trade barriers, through the removal of licenses, quotas and other instruments. ➤ Strengthen trade-related institutional capacity. ➤ Harmonize existing intra-regional preferences which are not consistent with the WTO. 	EU, Bank, SECI, UK, USG/USAID (SEED)	EU, Bank, SECI, UK, USG/USAID (SEED)	EU, Bank, SECI, UK, USG/USAID (SEED)	EU, Bank, SECI, UK, USG/USAID (SEED)	EU, Bank, SECI, UK, USG/USAID (SEED)	EU, Bank, SECI, UK, USG/USAID (SEED)
<p>1.3 Improve financial system safety, soundness and performance standards.</p> <ul style="list-style-type: none"> ➤ Improve lending policies/practices and risk management of banks. ➤ Efficiently manage foreign debt. ➤ Improve bank governance through privatization and strengthen supervision of banks and financial institutions. ➤ Improve accounting and auditing practices, adopt international accounting standards. ➤ Strengthen institutional/market framework, improve technology of financial intermediaries and markets and enhance information 	EU, IMF, USAID, Italy, Canada	IDA, MIGA, Canada, Bank	EU, USAID/TA, Canada, KFW/ESW	Bank/TA&F	USAID/TA&ESW EU PHARE/TA, EBRD/F Know-how Fund/TA, Canada	USAID/ESW EBRD/ESW EU PHARE/ESW EIB/ESW, Canada

ASSISTANCE OBJECTIVES	PARTNERS					
	ALBANIA	BIH	BULGARIA	CROATIA	FYROM	ROMANIA
transparency.						
1.4 Eliminate distortions in agricultural sector, complete privatization and improve its competitiveness.	USAID – Immovable Property Registration Project	Bank	USAID/TA, EU PHARE/ESW, Netherlands/TA	Bank/TA	Netherlands&WB/ESW USAID/ESW EU PHARE/ESW Germany/TA	USAID/ESW EU PHARE/TA EBRD/TA Japanese PHRD/TA, Canada
2. Poverty Reduction and Social Development. ➤ Support poverty reduction and address rising inequality. ➤ Promote access to quality education for all children which is suitable for the needs of a market economy, leadership, and democratic society. ➤ Reduce inherited inefficiencies in the health sector, through reorienting the health care system to lower levels of care, reforming health finance, updating clinical practices, and facilitating private sector provision. ➤ Increase the fiscal sustainability and impact of the social protection system, through reform of pension systems, improving contribution compliance, and targeting social assistance more effectively.	EU-Social Safety Net, Rehabilitation Credit (98), Soros-School Rehabilitation CEB (health)	Bank, UN, NGOs, bilateral, IMF CEB (health), Canada	CED/TA, Japan PHRD/TA USAID/F, UNDP/F EU Phare/TA Open Society (Soros)/F CEB (health)	Bank/TA CEB (edn, health)	EU PHARE/TA&ESW, USAID/ESW, Netherlands, Switzerland/F UNICEF, WHO/ESW USG USAID/ESW Japan/ESW	USAID/TA&ESW EU PHARE/TA BEI/CEB (health), Canada
3. Institutional Development/Government and Public Sector/Corruption. 3.1 Maintain a sustainable and growth-promoting macroeconomic framework, reduce the size of the public sector. ➤ Identify areas from which the state needs to withdraw and reduce overall level of public spending, ensure spending decisions are based on clear priorities. ➤ Define the responsibilities and competencies of government entities and equip them with technology and systems to improve efficiency. ➤ Enforce financial discipline, improve resource mobilization by broadening the tax base, improve tax administration and collection, reduce tax rates.	IMF/TA recovery program	IMF, OHR, EU, UST/USAID, Bank	IMF, EU, EU PHARE, Open Society Foundation, Japan PHRD, US Treasury, EU-Bank Consultations/all TA	Bank/TA&F	IMF/TA, USAID/ESW, EU PHARE/TA	USAID/TA

ASSISTANCE OBJECTIVES	PARTNERS					
	ALBANIA	BIH	BULGARIA	CROATIA	FYROM	ROMANIA
<p>3.2 Reorient state functions to meet the needs of market economy.</p> <ul style="list-style-type: none"> ➤ Adopt and implement effective legal and regulatory frameworks for the operation of private markets. ➤ Reorganize state institutions, streamline overlapping and outdated structures. ➤ Build local government management capacity and autonomy, strengthen municipalities and enhance devolution of powers to local administrations. 	Italy, Switzerland, France, IFAD, Islamic Development Bank, EU, Soros	Bank, IFC and MIGA, UST/USAID, OHR, EC EBRD, others, Canada	TA: EU PHARE, USAID	Bank/TA&F	EU PHARE, OECD/TA USAID/ESW EBRD/ESW	USAID/TA, EBRD/ESW EDI/OECD/TA Council of Europe/TA, Canada
<p>3.3 Enhance state role in long-term development planning, strengthen public administration and database management.</p>	EU	The Netherlands (EU), Canada	EU/TA	Bank/TA&F	EU PHARE/TA&ESW	EU, bilaterals/TA
<p>3.4 Strengthen the judiciary, enhance judicial implementation capacity, provide basic resources for judges.</p>	EU, Italy, Council of Europe, CEELI	EC, USAID, Japan	USAID/TA Japan PHRD/F	Bank/TA&F	EU PHARE, OECD/TA	
<p>3.5 Reduce corruption through identifying areas of public administration most prone to corruption, streamline and rationalize legal and administrative procedures to eliminate corruption encouragement, introduce transparency.</p>	EU, Italy, Council of Europe, CEELI	Bank/OHR	Center for Democracy/TA, Canada	Bank/TA&F	N/A	N/A
<p>4. Infrastructure.</p> <ul style="list-style-type: none"> ➤ Rehabilitate and strengthen existing infrastructure systems through least-cost investments reduce infrastructure system losses through improved management. ➤ Improve billing and fee collection systems for infrastructure services, insure financial viability of the different sectors, modernize and streamline operations. ➤ Open up major infrastructure units to competition, establish legal and regulatory framework for price liberalization. 	OECF-Japan, EBRD, Switzerland, Italy, Austria, EIB, EU Phare, USAID, KFW, OPEC Fund	EBRD (power, transport and telecom), WB (transport, power, gas), EIB, bilaterals CEB (housing)	EIB/ESW, EBRD/ESW, EU PHARE/ESW, TA, USAID/ESW, Japan PHRD/TA	Bank/TA&F (EFSAL, TAL&TAL II) CEB (housing)	EU/ESW, EU PHARE, EIB/F, Germany, EBRD/ESW EU PHARE/TA, Japan/TA&F CEB (housing)	EBRD/ESW Japan EXIM/ESW EU PHARE/TA, EIB BEI/CEB (housing), Canada

ASSISTANCE OBJECTIVES	PARTNERS					
	ALBANIA	BIH	BULGARIA	CROATIA	FYROM	ROMANIA
<p>5. <u>Environmental Management.</u> Improvement of national resource management and environmental standards.</p> <ul style="list-style-type: none"> ➤ Strengthen institutional capacity of the environmental protection institutions at the central (policy issues) and regional (better enforcement and monitoring) levels. ➤ Develop or enhance systems for environment monitoring and assessing environmental degradation. ➤ Create national strategy for environment priorities and resource management. 	GEF-Lake Ohrid Conservation Project CEB (env.)	N/A	Switzerland/TA BEI/CEB	Bank, GEF/TA	Germany, Switzerland, Netherlands, USAID/ESW Japan/TA CEB (env.)	EU PHARE/TA&ESW USAID/ESW CEB (env.), Canada