Reaching political and social stability in the WB6 region through unlocking higher economic growth

Fostering reforms that would increase economic freedoms in the area of Property Rights and Business Regulation would substantially boost economic growth. If implemented, these reforms would make WB6 countries more affluent and stable in 2025, with their GDP per capita surpassing the threshold of 40% of the EU average, and 50% of the New Member States, making them more prepared for the EU accession.

How would WB6 economies (Serbia, Montenegro, Macedonia, Albania, Bosnia and Herzegovina and Kosovo) look like in 2025? This is a very important question since it openly questions the economic capacities of the WB6 countries to join the EU. There are several reasons why the level of economic development of the WB6 countries is important:

1) Countries that aspire to EU accession must have a ’’functioning market economy’’, according to the Copenhagen criteria, in order to be able to be a part of the single market.
2) A growing and prosperous economy would alleviate many current internal social and political tension within WB6 societies, providing more opportunities for their citizens. This would lead to the greater political stabilization of the entire region and lower ethnic and national tensions.
3) WB6, as a region with a vibrant economy, would be more attractive in political terms for the EU than as a region with low income and prevailing poverty. Voters in many EU countries are not too keen on new EU members whose citizens would potentially emigrate in high numbers to their countries, as the populist surge in some of the EU countries (the UK, Slovakia, Hungary etc.) show.

The most optimistic scenario[1] for the WB6 economies show that, although the region will continue to grow, in 2025 it would still be substantially below the EU level when GDP PPP per capita is considered. The WB6 countries will on average have a GDP per capita of just 17 200 international USD, which would be lower than even the current level of Bulgaria, the least prosperous EU country, whose GDP stood at 19 800 international USD in 2017.

Table 1: GDP PPP per capita of selected countries in 2025, in international 2011 USD

Country	GDP 2025	As weighted EU 27 average
Austria	49,954	1.11
Belgium	46,540	1.03
Bulgaria	25,843	0.57
Croatia	27,634	0.61

[1] The data for GDP growth until 2023 were taken from the World Economic Outlook database of the International Monetary Fund; for 2023-2025 growth rates are estimated as the average of the previous three years.

Cyprus	40,176	0.89
Czech Republic	39,735	0.88
Denmark	50,106	1.11
Estonia	37,573	0.84
Finland	44,639	0.99
France	44,524	0.99
Germany	52,002	1.16
Greece	29,668	0.66
Hungary	33,479	0.74
Ireland	84,066	1.87
Italy	37,429	0.83
Latvia	33,090	0.74
Lithuania	39,998	0.89
Luxembourg	109,502	2.44
Malta	49,327	1.10
Netherlands	56,942	1.27
Poland	34,374	0.76
Portugal	31,759	0.71
Romania	30,268	0.67
Slovak Republic	40,010	0.89
Slovenia	38,510	0.86
Spain	40,891	0.91
Sweden	51,650	1.15
EU 27	44,967	1.00
EU 11	34,254	0.76

Calculations according to the IMF WEO 2018 data; EU 27: all EU countries minus the UK; EU 11: transition countries that joined the EU in 2004, 2007 and 2013.

Table 2: GDP PPP per capita of selected countries in 2025, in international 2011 USD

Country	GDP 2025	As weighted EU 27 average
Albania	15,569	0.35
Bosnia and Herzegovina	15,716	0.35
Kosovo	11,987	0.27
FYR Macedonia	17,515	0.39
Montenegro	20,391	0.45
Serbia	18,970	0.42
WB6 weighted average	17,206	0.38

Although this WEO data are considered to be among the best macroeconomic forecasts available, they can still be regarded as optimistic. Macroeconomic forecasting is prone to many errors, so economists are often aware that they are more likely to guess more the underlying trends than actual numbers.

However, very big errors are often made: for example, the WEO in 2008 did not predict the financial crisis and the recession following it. In several cases in the Balkans, exogenous shocks were also not predicted, such as in 2012 and 2014. Since the economic data from advanced countries currently show performance above the trend (unemployment below the 2008 pre-crisis benchmark, financial markets activities above their 2008 peak etc.) and there has not been a recession for almost a decade, strongly point out to the high probability that future economic trends can be less optimist than currently evaluated. Any recession would strongly hit the WB6 countries due to their close connection to the European core, through financial and trade channels, which would considerably worsen their economic performance. Therefore, the WEO data above should be considered to be on the optimistic side.

The data used show that, if macroeconomic assumptions hold, the WB6 countries will in 2025 still be lagging behind not only the EU as a whole, but also the less developed EU11 countries. In fact, with the projected GDP per capita of just 17 200 2011 USD PPP, the WB6 countries will be below even the development level of these countries when they joined the EU. Only Montenegro and Serbia would be near the EU11 accession year GDP average, while Kosovo, Bosnia and Herzegovina and Albania would be on the level of the worst well off Bulgaria and Romania. This would mean that WB6 economies would even in 2025 struggle with providing enough employment opportunities and a higher standard of living than today. The level of economic convergence with the EU among the WB6 countries with this projected level of growth is not high since they will still be well below 40% of the average EU income (Montenegro being the only exception). Furthermore, the WB6 economies will only reach half of the EU11 income. Therefore, more robust economic growth would be a prerequisite for stabilization of these societies, which would further provide support for their EU accession path.

Table 3: GDP PPP per capita of selected countries, in international 2011 USD, in their EU accession year

Country	GDP per capita
Bulgaria	15,170
Croatia	20,000
Czech Republic	24,000
Estonia	20,190
Hungary	21,550
Latvia	15,710
Lithuania	16,840
Poland	16,400
Romania	13,300
Slovak Republic	18,680
Slovenia	25,910

EU accession year: Poland, Hungary, Slovakia, Czech Republic, Slovenia, Estonia, Latvia and Lithuania 2004; Romania and Bulgaria 2007; Croatia 2013.

The question of how to reach higher economic growth rates could be quite literally the million dollar question. The current economic theory of growth is vast, but there is a renewed interest among the economists for the role of the institutional framework for fostering economic growth. But what institutions foster growth? Institutions can be of open or restricted order (North) / inclusive or exclusive (Acemoglu and Robinson). The former foster competition and creative destruction through innovation and are open to participation to the majority of people, while the latter focus on rent-seeking and redistribution, closed to participation of the wider audience. Good examples of this open / closed dichotomy in the political arena are democracy and authoritarianism, while in the economic arena those are the lack of or existence of barriers to market entry. The best existing tool to measure the institutional quality in the economic arena is the Economic Freedom in the World Index by the Fraser Institute, methodologically derived by a group of prominent economists, jurist and political scientists, including several Nobel prize laurates in economics, such as North, Stigler, Becker, Friedman etc.

''Individuals have economic freedom when property they acquire without the use of force, fraud, or theft is protected from physical violations by others and they are free to use, exchange, or give their property as long as their actions do not violate the identical rights of others.' (Gwarntey, Lawson, and Block, 1996). Economic freedom is measured through 5 subindexes: Size of Government, Property Rights, Sound Money, Freedom to Trade Internationally, Regulation of Credit, Labour and Business. The final score is the average of all subcomponents, ranging from 0 (least free) to 10 (most free).

The data show that WB6 countries are lagging behind the EU countries on economic freedom. However, the situation is not the same across the whole set of subcomponents. It is clear that the WB6 countries are most lagging in the field of Security of Property Rights. The Freedom of Trade score follows closely the EU average, and Size of Government is actually higher than in the EU27. The Sound Money seems lower, but this is mostly due to high past data on the monetary situation in Serbia, which will be improved in the future editions of the Index due to currently low inflation rates.

Table 4: Level of Economic Freedom in selected countries, Economic Freedom of the World 2017.

	Final Score	Size of Government	Property Rights	Sound Money	Freedom of Trade	Regulation
Albania	7.54	7.96	5.00	9.59	8.11	7.05
Bosnia and Herzegovina	6.61	5.33	4.24	8.44	7.78	7.24
Macedonia	7.17	6.25	5.07	8.31	7.95	8.27
Montenegro	6.77	5.14	4.83	8.40	8.14	7.32
Serbia	6.75	6.43	4.89	7.85	7.57	7.01
WB6	6.97	6.22	4.81	8.52	7.91	7.38
EU11	7.47	5.87	6.09	9.51	8.19	7.70
EU27	7.53	5.28	6.84	9.55	8.23	7.74

However, the situation in the area of Regulation needs some elaboration. It consists of three further subcomponents: Regulation of Credit, Labour Regulation and Regulation of Business. Labour codes in WB6 are mostly more flexible than those of EU27 on average. However, the Business Regulation in WB6 scores are much lower. Also, the data for calculation of this score come from different resources, most notably the Doing Business of the World Bank and the Global Competitiveness Report of the World Economic Forum. These resources are designed to be used as proxies or approximations of the regulatory situation in the countries concerned. However, since the Doing Business has a transparent methodology of narrow objective measures, it is easy to implement reforms in these areas. This would mean that reforms are also very narrow, covering only the areas used by the Doing Business report. Therefore, its data show that Macedonian regulatory environment is more business-friendly than that of Germany, which can hardly be the case. This problem also masks the real situation in the Regulation subcomponent of the Index, so one should have in mind that Regulation segment of the Index is to some degree biased and that the real situation is less positive among the WB6 countries.

Apart from its moral value, economic freedom also has an important instrumental value. There were many attempts to evaluate the importance of economic freedom and economic growth. A recent survey by Libek (forthcoming), using Google Scholar engine, identified 2428 studies focusing on economic freedom, and 92 of them focusing on economic growth. Out of this sample, 86 established a significant positive relationship between economic freedom and growth, while only 5 were less conclusive. Regression analysis reported in Gwartney and Lawson (2004) show that an increase in economic freedom score of 1 (on a 0-10 scale) would boost the long-term growth rate of 1.24% of GDP.

Therefore, reforms among WB6 countries that would increase economic freedom would significantly raise the economic dynamic of the whole region, leading to a faster income convergence with the EU, and providing more political stability within the region. Major improvements are necessary in the field of Property Rights and Business Regulation. If WB6 countries increased their scores in this sections to the half of the distance to frontier towards the EU11 countries (meaning, reaching the level that now lies in between their current score and the current EU11 scores), from 4.81 to 5.45 in the Property Rights and from 7.38 to 7.54 in the Regulation segment, this would increase their economic growth rate for 1 percentage point annually. This may not seem much, but this difference, in the long run, can have great effects. Furthermore, due to the low economic growth in some of the countries in the region during the previous decade, such as Serbia and Bosnia and Herzegovina, this 1 pp seem a lot.

The projected scenario is conservative since it takes into account the fact that these reforms take time. But if the reform steps are taken seriously, they can soon give results. The model envisages the distance frontier to EU11 countries in the Property Rights and Regulation subcomponent be cut in half in 2020, after which the growth would be enhanced for 1 percentage points compared to the current WEO projections. If this scenario is fulfilled, then the WB6 countries will have stronger economic performance, being able to surpass one half of the EU11 income and reach the magic 40% EU27 threshold.

Table 5: WB6 GDP per capita in 2011 USD, with reforms enhancing economic freedoms

	GDP per capita	Net gains: WEO projections = 100
Albania	16 390	105.3
Bosnia and Herzegovina	15 620	105.3
Macedonia	18 610	106.2
Montenegro	21 670	106.3
Serbia	19 770	104.2

Kosovo	13 470	112.4
WB6 weighted average	17 950	106.2
WB as a percent of EU11 average	0.53	-
WB as a percent of EU27 average	0.41	-

It is important to stress that many objections to higher economic freedom come from the egalitarian perspective, but this is a false dichotomy. Societies with higher economic freedom have lower poverty rates, and higher income of the poorest 10% of the population, than those with lower economic freedom. Also, countries with lavish welfare state and redistribution programs, such as Sweden, Denmark, Finland, the Netherlands, Germany and Canada score very high on the economic freedom scale. Therefore, an increase in economic freedom does not have to entail cutting existing redistribution programs, or the level of taxes.

Policy Recommendations

- National platforms for policy discussion between professional and business organizations, CSOs and political parties within the National Parliaments should be established or strengthened through formal and informal fora, which would provide a place for policy deliberation and learning, as well as communication between members of parliament across political divisions.
- The EU representatives should insist on deep reforms within the judiciary, through the creation of a clear strategy of reforms, and evaluate thoroughly its implementation in practice. The implementation should be the conditio sine qua non of the integration process: without clear positive signs, no further accession negotiation would be open or closed.
- The process of ’’gold plating’’ during the introduction of EU directives should be discouraged through publicizing in English different solutions coming from a range of European countries. The current situation is that the Serbian administration is focusing on solutions implemented in Croatia and Slovenia, due to linguistic proximity and technical assistance experts. However, their legislation is mostly very burdensome in the European perspective, much more than those of Scandinavian countries or the Netherlands.
- Insisting on the introduction of fiscal rules to the Constitution of the WB6 countries would provide a strong safe haven on public finances from possible fiscal downturns due to a prolonged recession. Solutions from Bulgaria and Slovakia are very illustrative and relatively easy to implement in the WB6 context.