

**Integrating the Balkans in the European Union:
Addressing social capital, the informal economy and
regional co-operation challenges in Southeast Europe**

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OP06.02

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EXECUTIVE SUMMARY

Significant progress has been made across the Balkans – both east and west – since the early 1990s. The improvements are remarkable yet there remains a substantial distance to cover. This is mainly due to the role of networks, the pervasive nature of informality, the kind of borders that cut across the countries and societies of Southeast Europe, and the still limited scope of regional co-operation.

In effect, transactions undertaken outside the scope of the formal economy, discretionary applicability of rules and regulations, corruption, particularistic social capital and emigration, continue to be highlighted as the region's main characteristics. In addition, regional co-operation across all sectors continues to be approached with caution and hesitation. These characteristics imply that there exist visible and invisible borders that cannot be easily overcome. Moreover, there exists a distance between formality and substance across the region. This distance breeds conditions of insecurity and unpredictability and, in turn, nurtures reliance on informal networks and practices. Thus, security - expanded in its definition and in all its dimensions - remains the main issue in the Balkans.

Efforts aiming at expanding the rule of law and facilitating the implementation of regimes and practices in a non-discretionary manner across formal and informal borders, must be concentrated and up-scaled. It is urgent to improve the quality of the services provided by state institutions in order to re-legitimise these and to improve levels of trust towards the main institutions, while strengthening civil society and specifically targeting conditions that act as incentives to informality. It is equally important to pursue regional co-operation, in spite of current obstacles mainly related to 'hard' borders and to the 'hub-and-spoke' relationship SEE maintains with the EU across all sectors. This is not only necessarily for its economic value but, rather, for its political implications.

It appears that until now and in spite of advances in specific sectors, regional co-operation has taken only a limited dynamic of its own within the region; the end-goal of all actors is EU accession thus all else takes on secondary importance. The role of the EU as a regional anchor and a promoter of regional co-operation are indispensable. The EU is instrumental and indeed for the time being, it appears that it is required to both push and pull this progress across the Balkans.

At present, the EU is confronted with a series of internal challenges, not least related to digesting enlargement and reflecting on what will follow the European Constitutional Treaty. Nevertheless, it is essential that the Western Balkans in particular do not cease to be a priority for the EU.

2006 is a milestone year for the Balkans. The future of Serbia and Montenegro has been decided via referendum, the talks on Kosovo are

underway to resolve the status issue, the EU Commission will give its ruling on whether Bulgaria and Romania have met membership conditions. At the same time, Croatia and FYROM have come farther along the EU membership path, while Bosnia, Serbia and Albania have also started treading on it. Enlargement fatigue ought not to risk compromising the EU's influence in the region, nor the region's prospects for co-operation, modernisation and security.

CORE RECOMMENDATIONS

- Efforts to extend the rule of law across formal and informal borders must be up-scaled so that regimes and regulations are implemented as much as possible in a non-discretionary manner;
- EU policies focusing on institutional efficiency need to be complemented by: social capital-building policies and 'perception-enhancing' policies;
- The focus of EU policies should not be limited to public sector management and public finance sector reform. In order to make recourse to informality less of an incentive, the institutional framework in place, the micro-economic level and the extra-economic causes of informality require more targeted attention;
- There remain many unexploited opportunities in SEE and the EU's role as a promoter of regional co-operation is indispensable. The Union must persevere in promoting multilateralism and co-operation across all sectors of trade and finance within the region. This is not only necessary for the Balkan countries' integration in the EU, it is just as important for the EU's influence and political leverage in region;
- The EU needs to be bold in maintaining the accession momentum and in continuing to provide push and pull factors to transform the domestic political agendas and economic strategies. Improved and wider access to pre-accession programmes for the entire region will avoid the creation of deeper disparities between regions, countries, economies and social groups and will support each country's route to the EU;
- The pace at which the countries of SEE are integrated in the transatlantic security community must be re-invigorated, and the countries of the region must maintain the highest level of political commitment to their integration in Euro-Atlantic structures.

I. THE SCOPE OF THIS PAPER

A. CHALLENGES ACROSS THE BALKANS TODAY

The next couple of years will be decisive for the Balkans. The status and borders of some of the political entities of the region may become more definite. The character and nature of the international military and political presence in the region will gradually evolve. Above all, it is anticipated that the timetable of their path to EU accession may become more clearly defined.

In effect, the coming couple of years will see Bulgaria and Romania accede to the European Union, while Croatia has already begun accession negotiations. FYROM's candidacy has received a positive recommendation by the Commission¹ and was granted candidate status by the Council in spite of growing uncertainty on behalf of certain Member States, and certain Commissioners, regarding the rate at which further widening should proceed. The state union between Serbia and Montenegro will be dismantled following the result of the May referendum in Montenegro, while their integration in the transatlantic community security framework will have to eventually proceed and Kosovo's future status will have to be addressed. Bosnia and Herzegovina will have to evolve from international protectorate and, Albania, already part of the Stabilisation and Association Process, aims at coming closer to its declared goal of EU membership.

This is quite a list, and, the outcomes of each of these elements will have far-reaching repercussions for the nature of the region's internal borders and for its borders with the EU. In purely geographical terms, current territorial borders among Balkan states will soon become the EU's external borders following the accession of Bulgaria and Romania. From a political and socio-economic perspective, the implications are extensive. It entails that more and more countries in this region will have fulfilled the Copenhagen political and economic criteria; and this is an impressive feat for the region's sustainable security.

In the meantime, the extent to which these borders will be increasingly 'functional' in benefiting from the advantages associated with lowering political and economic borders is not an easy call to make given the current challenges that the region's borders are up against. Still, the extent to which they make themselves 'porous' to formal and legal trade in goods and services, and the degree to which the countries of Southeast Europe (SEE) pursue cross-border co-operation, co-ordination and collaboration is linked to their EU accession course.

¹ COM (2005) 562, Commission opinion on the application of the Former Yugoslav Republic of Macedonia for EU membership, Brussels, 9 November 2005, http://www.europa.eu.int/comm/enlargement/report_2005/pdf/package_v/com_562_final_en_opinion_fyrom.pdf

The 'catch-22' in this situation is that the EU accession path and the rate at which the countries of SEE will move along this path, largely depends on their propensity to establish and consolidate functional borders.

In practical terms, this includes their capacity to engage in fruitful cross-border co-operation concerning infrastructure projects, trade policy, fiscal and exchange rate policies, energy, etc. It also involves their ability to manage borders that can address illegal migration and illegal trade challenges. Moreover, it involves prevailing over informal and even invisible dividing lines that may cut across these societies i.e., ethnic groups, socio-economic networks, privileged status groups or, in simple terms, between 'have' and 'have-nots.' These informal borders presently undermine the region's economic growth potential and the quality of its democratic consolidation.

It is commonly underlined that extensive non-compliance with rules and regulations, arbitrariness, discriminatory public services, corruption and what has been identified as 'particularistic social capital' are widespread phenomena in South East Europe (SEE). In effect, networks of economic and political agents work in parallel with markets. These networks operate as parallel, private systems of authority, advancing particularistic interests and influencing the state and the markets. Moreover, they create invisible borders of participation, often running along the lines of kinship, ethnicity or political affiliation. These cut across SEE societies and breed insecurity. The scale and nature of involvement of state agents in these networks, has spread non-compliant behaviour and has undermined social legitimacy of rules, thereby extending informality and weakening social consensus against it. As a result, state institutions become 'personalised' and processes become corruptible. For businesses and individuals, the 'informality trap' becomes a matter of opportunity as much as of necessity.

The declared objective of extending the European democratic security community to include the entire Balkan region and to integrate the countries of SEE in the EU is confronted with these challenges. It is these challenges that are explored in the present paper.

Most analyses and reports highlight the progress that has been undertaken in each country in the post-communist and post-conflict transition phases. By the same token, however, it is emphasized that reforms are slow-paced because corruption and informality are institutionalized while the core challenge obstructing their road to the EU lies with the 'implementation deficit.' The current situation in SEE includes a complex mixture of equally encouraging and discouraging factors that may be interpreted from either an optimistic or a pessimistic perspective.

The optimistic perspective estimates EU accession for the countries of SEE to be achievable between 2013 and 2015. Such an outlook² is encouraged by the steady political and economic progress that has been accomplished across SEE, by the fact that Slovenia is the second Balkan state to join the EU, and by the anticipation that after Bulgaria and Romania, the road for the other countries in the region will be more clearly defined. Democratic legislative frameworks have been set up (however slow), growth rates have been recovering, a climate of 'friendship' has pervaded the region. The gradual shift of security matters from military questions to issues that fall within the remit of justice and home affairs further underlines this progress. In addition, progress has been accomplished in ensuring a more equitable representation of ethnic communities even though thorny issues, such as the status of Kosovo, remain unresolved. This perspective urges for the 'Europeanisation' process of the Balkans to be speeded up in order for political compromises and mutually acceptable negotiated solutions to address vulnerable status issues. It equally emphasizes that the region has moved from a post-conflict situation to a phase of stabilization: frameworks that were set up to deal with conflict, warfare and ethnic violence have gradually been replaced by trade agreements, cross-border infrastructure projects, association agreements, etc. Increased regional trade and EU investment in key sectors, especially in infrastructure, is expected to push the region's economic growth potential, and economic growth.

In effect, there is good economic news to boast about in the Balkans. Inflation is declining, market oriented reforms are moving forward and, in some cases, public finances are improving.³ In 2004, the region appears to have recorded its fifth consecutive year of steady output growth, which has also outpaced growth in the leading reformers and new EU member countries of central Europe for the fourth year running. The maintenance of macroeconomic stability and progress in fiscal consolidation complement the favourable growth trends.⁴ The volume of Foreign Direct Investment (FDI) has also picked up and has even been described as being at 'historically high levels'⁵ (even though most has been associated with transactions linked to privatizations).

² EPC Event Report on "South East Europe five years on: can the Western Balkans make it to the EU?" 1 November 2004; ESI "Breaking out of the Balkan Ghetto: why IPA should be changed," 1 June 2005, http://www.esiweb.org/pdf/esi_document_id_66.pdf ; ESI "Recommendations – Wilton Park Conference", 10 June 2004, http://www.esiweb.org/pdf/esi_document_id_56.pdf

³ http://europa.eu.int/comm/economy_finance; EBRD Annual Report, 2004.

⁴ Kekic L, *Foreign direct investment in the Balkans, recent trends and prospects*, Athens, December 2004, paper presented at ELIAMEP and published in the *Journal of Southeast European and Black Sea Studies*, Vol.5:2, Taylor & Francis, London, May 2005

⁵ EBRD Annual Report 2004, p.39

Table 1. Comparing GDP growth in Central Europe and the Balkans

Real GDP growth (%)	GDP				Average annual
	2001	2002	2003	2004	2001-04
Central Europe	2.1	2.1	3.5	2.6	3.6
Balkans	4.6	4.7	4.2	4.6	4.7
Albania	6.8	4.7	6.0	6.0	6.6
Bosnia & Herzegovina	4.4	5.5	3.5	5.0	4.6
Bulgaria	4.1	4.9	4.3	5.0	4.7
Croatia	3.8	5.2	4.3	3.7	3.6
FYROM	-4.5	0.9	3.4	1.0	1.0
Romania	5.7	5.0	4.9	7.8	5.1
Serbia & Montenegro	5.5	4.0	2.2	6.0	4.7
Transition region	4.9	4.3	6.2	6.8	6.2

Source: Economist Intelligence Unit. Estimates for 2004.

Table 2. Economic snapshot of SEE countries in 2004

Country	GDP growth (%)	End-year inflation (%)	Net FDI (in USD millions)	Transition indicator⁶
Albania	6	2.2	350	2.81
Bosnia & Herzegovina	5	NA	420	2.52
Bulgaria	5.5	3.9	1,837	3.37
FYROM	2	3.3	150	2.96
Romania	7	9.3	5,020	3.18
Serbia & Montenegro	7.1	13	950	2.48

Source: EBRD Annual Report 2004

Improvements in the macro-economic indicators are by no means staggering, but in principle, the signs could be encouraging. According to the Economist Intelligence Unit's business environment assessment model, the Balkans is the sub-region within eastern Europe that is expected to see the greatest improvement in its business environment over the next five years. Of course, improvement is patchy depending on the country and depending on the sector. Bosnia and Herzegovina, for example, is still lagging behind, as is FYROM, which still appears to be recovering from its 2001 inter-ethnic conflict.⁷ Just as concerning are the current account deficits that are in the double-digit range in Serbia and Montenegro as well as in Bosnia, while

⁶ EBRD Annual Report 2004, p.38. This is based on an average of nine EBRD transition scores. The maximum score is 4.33.

⁷ Kekic L., op cit.

pockets of severe recession and deep disparities leave rural, peripheral and border regions lagging behind.

This leads us to the opposing end of the spectrum where lies the pessimistic perspective that stresses facts that obstruct the region's integration in the transatlantic security community. Among these, the most common concerns include the fact that co-operation with the Tribunal in The Hague is still far from optimal and that war criminals continue to effectively enjoy state protection. This suggests that 'post-conflict' politics continue to be very much influenced by the actors that provoked the conflicts during Yugoslavia's disintegration. In parallel, it is emphasised that the state and its resources are 'captured' by predatory elites and informal networks that promote their particularistic economic and political interests. This is done at the expense of their country's socio-political cohesion, of the quality of democracy and of economic growth. Indeed, it is argued that wide-spread arbitrariness breeds distrust, thereby negatively affecting the inflow of much needed foreign direct investment (FDI) and enlarging the scale and size of the informal economy. It is equally highlighted that SEE is experiencing transitional unemployment or underemployment, dual markets, market breakdowns, and macroeconomic imbalances. These market failures are severely pronounced in certain regions and the prospects for economic growth are hampered by institutional and normative obstacles. Regional co-operation remains extremely limited to specific sectors that have been practically imposed from outside agents, and the advancement of SEE-EU relation is significantly obstructed by organised crime, trafficking and illegal trade. In this context, forced migration, voluntary migration for economic reasons, and the brain-drain that has characterised the region's demographics over the past fifteen years, is not bound to be overturned in the foreseeable future, while quasi-international protectorates, unresolved status issues and tensions that continue to characterise ethnic relations make the region vulnerable to renewed outbursts of friction.

In short, progress has been accomplished, but it falls well short of what is necessary. The Report of the International Commission on the Balkans described the region as being 'as close to failure as it is to success.' It equally clearly underlined that the status quo – on all issues – is unsustainable and potentially precarious in the long-run. The Report identifies three major factors that render the current *status quo* deeply problematic:

- the '*expectations gap*' that characterises the people in the region who reject the status quo but fail to see a credible alternative;
- the '*development gap*', particularly in socio-economic terms between the winners and losers in the Balkans; and,
- the '*integration trap*' according to which stability, security and prosperity can only be achieved through EU integration that is blocked due to the region's dysfunctions.⁸

⁸ International Commission on the Balkans, Report on "*The Balkans in Europe's Future*," April 2005, pp.7-12.

The Balkans are often approached with a sigh of resignation. The perception that the region's problems and dilemmas are unsolvable, obstinate and bound to be perpetual, is hard to shed. And indeed, making progress on all these fronts is difficult.

Yet, by no means does difficult mean impossible.

Pointing out the strengths and weaknesses is important so as to ensure that the entire Balkan region remains a priority for the EU -- by far the most influential actor for the region, and to help identify some key areas that need to be targeted in order for functioning, democratic societies and sustainable, integrated economies to become consolidated throughout the whole of Europe. It is necessary to be aware of the vulnerabilities and challenges that (for some perhaps strangely) persist in Southeast Europe since this is the only way through which to address their causes. It is just as important to anchor the certainty that peace, wealth, prosperity and security can be tantamount to the 'Balkans.'

For the Balkans to be able to develop into a security community and gradually become effectively integrated with the European Union, the key lies with the nature of borders across the region, its societies and its economies. It is crucial that the rule of law can be extended beyond state and ethnic borders, and that borders serve as platforms for co-operation.

B. CORE AREAS OF FOCUS

In light of the above, this paper aims at outlining a number of policy-relevant issues relating to civil society and social capital, state institutions, economic practices and regional co-operation. These areas have been affected by the post-communist and/or post-conflict chronicle of the region over the past fifteen years. All have an impact, in different ways, on the region's path to EU accession, and all have been at the core of EU policies, EU interest and EU concern.

It does not intend to propose new instruments or approaches to integrate the Balkans in the EU. It argues in favour of concentrating and up-scaling co-ordination efforts aimed basically at expanding the rule of law and facilitating the implementation of regimes and practices in a non-discretionary manner across formal and informal borders. This involves improving the quality of the services provided by state institutions in order to re-legitimise the state and improve levels of trust towards the main institutions. It also entails strengthening civil society and specifically targeting conditions that act as incentives to informality. It requires the pursuit of regional co-operation, in spite of current obstacles mainly related to 'hard' borders, not necessarily for its economic value, but mainly for its political implications.

Bringing down borders, both official and invisible, is a core priority. This is the case for cross-border co-operation on infrastructure or trade related issues just as much as it is internally, through increasing social capital and limiting the influence of informal networks/agents on the economy, society and governance of the countries across SEE. Addressing these soft-security issues would significantly contribute to increasing legitimacy of the democratic political regimes and the quality of the market economies that are being consolidated; a necessary requirement for sustainable economic growth and regional stability.

The role of the EU as a regional anchor and a promoter of regional co-operation is, thus, indispensable to both push and pull this progress across the Balkans. This is principally due to the 'hub-and-spoke' relationship SEE maintains with the EU across all sectors (SEE countries are much better connected with the EU than between themselves)⁹. It is important that the EU maintains the same level of commitment towards the Western Balkans in spite of its current internal difficulties not least related to digesting enlargement and coming out of the period of reflection that has followed the rejection of the European Constitutional Treaty in France and the Netherlands.

For the necessary reforms to be implemented in this region, it is useful to understand how a particular society functions, what borders transcend it, and to what extent certain formal and informal behaviours and perceptions remain recalcitrant. It is against this background that this paper aims at contributing to a better understanding of the cleavages and insecurities that are present in the countries of Southeast Europe.

II. STATE AND SOCIETY IN SOUTHEAST EUROPE: SOME KEY CHARACTERISTICS

The question of whether the countries of Southeastern Europe (SEE) form a region has raised much debate. Regardless of their distinctive features, they share common traits that affect their individual development, the prospects for regional co-operation, and the region's relations with the European Union and its Member States.¹⁰ These characteristics include: *weak state institutions, economic hardship, widespread recourse to informal networks, and low social trust*. The combination of economic hardship with poorly functioning institutions leads to a recurring '*informality trap*' that is common across the Western Balkans and the accession countries. As a whole, the region is intersected by '*hard*', yet '*porous*' borders, and maintains a '*hub-and-spoke*' relationship with the EU. Each of these features is studied in the sections that follow.

⁹ Gligorov V., "Southeast Europe: Regional Cooperation with Multiple Equilibria," IBEU Working Paper 4.1., www.eliamep.gr

¹⁰ This is based on the results of the empirical research on social attitudes and economic practices conducted by the IBEU Consortium in the period 2002-2005. See the Paper's Annexes for details.

A. WEAK STATES, RECOURSE TO INFORMAL NETWORKS AND LOW SOCIAL TRUST

Individuals, groups, and even businesses in contemporary South-Eastern Europe live/exist in an environment of relative economic and institutional underdevelopment and they cannot count much on their weak state institutions. Such a particular environment leads individual actors to turn to particularistic or negative social capital in their social and economic relations, transactions and strategies.

Yet what does social capital actually involve, and why is it relevant?

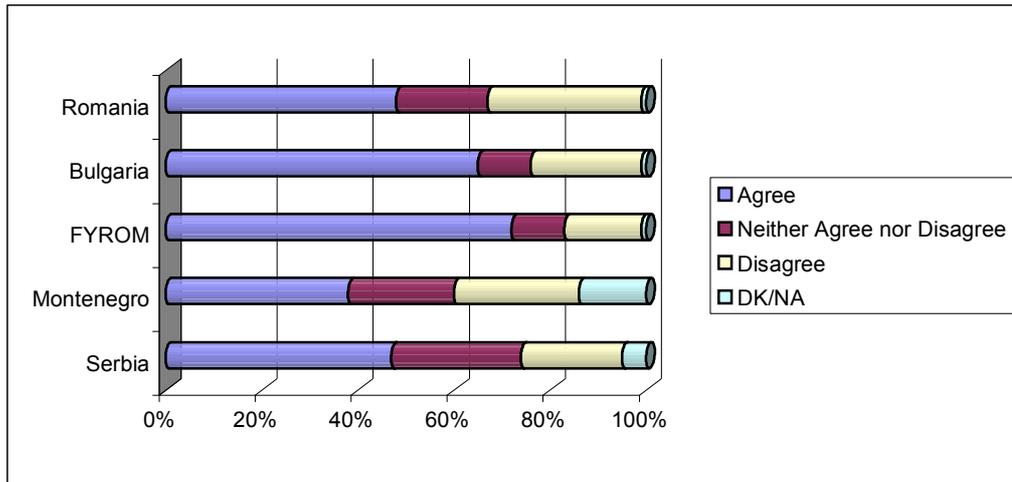
The concept of social capital is especially noteworthy for policy-makers in Southeast Europe. It has steadily paved its way into discussions on the Balkans to understand the effects of the post-communist and post-conflict transition phases and because signs of economic improvement do not yet appear to be translating into improvements in the social indicators.¹¹ Social capital involves relationships, shared knowledge, beliefs and patterns of interaction used by groups or actors. It is expressed in terms of interpersonal trust and trust towards civic and political institutions.

Positive and universalistic social capital are requisites for a strong civil society, the existence of which is widely considered to be strongly correlated with improved institutional performance, socio-political stability and economic growth. It has been approached as consisting of social networks and associated norms. The underlying foundations are that social capital facilitates co-ordination and co-operation through information sharing.

Negative social trust lies on the other end of the spectrum. It implies that trust is directed only towards members within a particular network or group. Consequently, this nurtures distrust towards other groups and is associated with low levels of trust towards the state and its institutions, thereby, breeding conditions of insecurity and hindering the development of civil society. This is expressed in the construction and operational processes of particularistic, closely-knit networks, which purposefully exclude non-members. Particularism is a main provider of social inequality and it is largely a legacy of communism. On the one hand, it is expressed in typical networks that include networks based on kinship, ethnicity, religious affiliation, linguistic ties, etc. Indeed, overall, people in SEE appear to trust their own ethnic groups and distrust others, while across the Balkans, the Roma score at the bottom of the social trust scale. On the other hand, it is also expressed in networks that have privileged accesses to services and markets, notably 'elites' that have 'captured' the state.

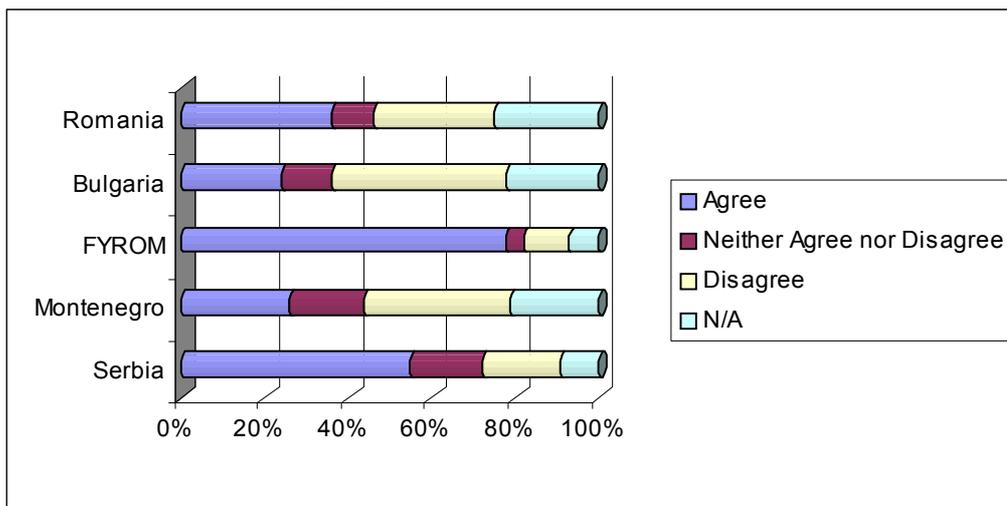
¹¹ See for instance, Kornai J. & Rose-Ackerman S. (Eds.), *Building a trustworthy state in post-socialist transition*, Palgrave Macmillan, 2004, London; Kornai J., Rothstein B. & Rose-Ackerman S (Eds.), *Creating social trust in post-socialist transition*, Palgrave Macmillan, 2004, London; Blue Bird Agenda for Civil Society in SEE, "In Search of Responsive Government, State Building and Economic Growth in the Balkans," Policy Studies Series 2003, Center for Policy Studies, Central European University, Budapest.

Graph 1. How much do you agree with the following statement: *Only your kin can be trusted*



Source: IBEU research

Graph 2. Are there ethnic groups within our borders that pose a threat to our sovereignty?



Source: IBEU research

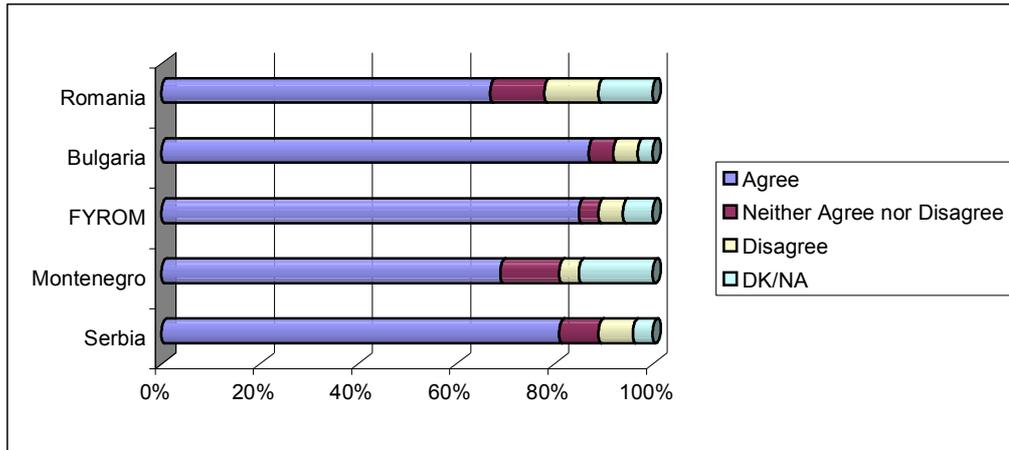
Social trust is relevant in this context for its implications at two levels. First, it is relevant in the way it influences the democratisation and modernisation processes in each country and the relationship between the state and its society. A fundamental constitutive element to a functioning and functional democracy is the existence of a civil society that can express its priorities, preferences and expectations. The conditions for this include pluralism, open and transparent participation, trust and co-operation. In these countries, 'universalistic' social capital is low and social trust as well as trust in political institutions is even lower. The second aspect that is discussed in greater detail below, is with regard to the way it affects the potential for regional co-operation.

Negative social trust nurtures recourse to informality and to non-compliant behaviour since people tend to consider that state institutions function in a discriminatory manner, persistently privileging certain groups and networks. One of the core questions that EU policy makers and national politicians are confronted with is how can the legitimacy deficit of the state and its institutions – that is wide-spread across SEE - be overcome? In effect, it is not sufficient to reform an institution in order to make it more efficient; it is equally necessary to make it more legitimate and this is where a core challenge for the Balkans lies.

The disproportionate access to and influence over state institutions and resources that certain individuals/groups/networks have, lead to generalised discriminatory behaviour, social frustration and lack of confidence in formal procedures (perceived as being corrupted). Research shows that throughout the region, this lacking trust tends to be based on predominantly negative stereotypes vis-à-vis the functioning of institutions – i.e. that some groups or networks have privileged access to the services of state institutions, that some are persistently discriminated against, and that some population and/or professional groups and networks are simply above the law regardless of regime change. This is identified as an 'experience gap' that is frequently very pronounced across the region.

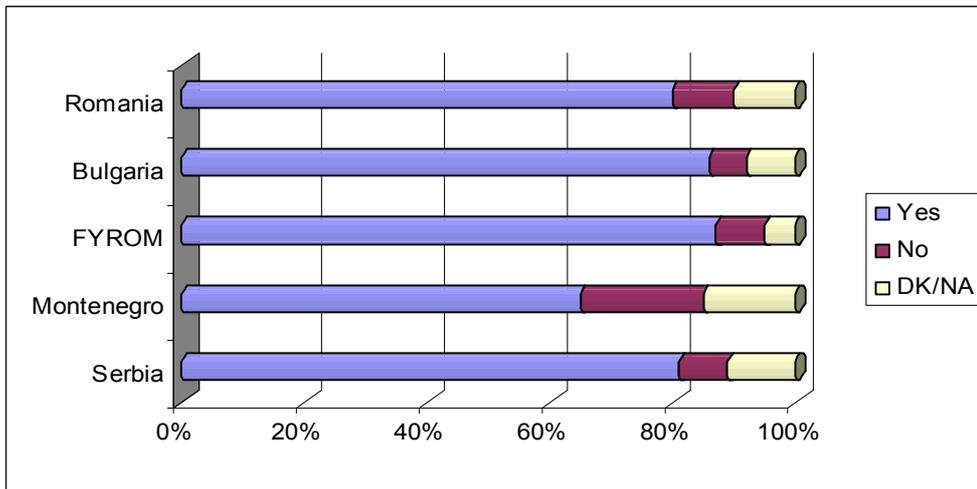
Regardless of whether social inequality is actual or perceived, it may equally support non-compliant behaviour. This basically involves deviation from the formal, legally established norms of conduct, that may impinge on the processes of privatisation, modernisation, liberalisation and democratic consolidation, and may even lead to subverting the rule of law. In any case, an evident impact of these low levels of universalistic social capital, of interpersonal trust, and of trust in state institutions/ agencies is in stressing the cleavage between 'have' and 'have-nots.'

Graph 3. How much do you agree with the following statement: *In this country some people are 'above the law'*



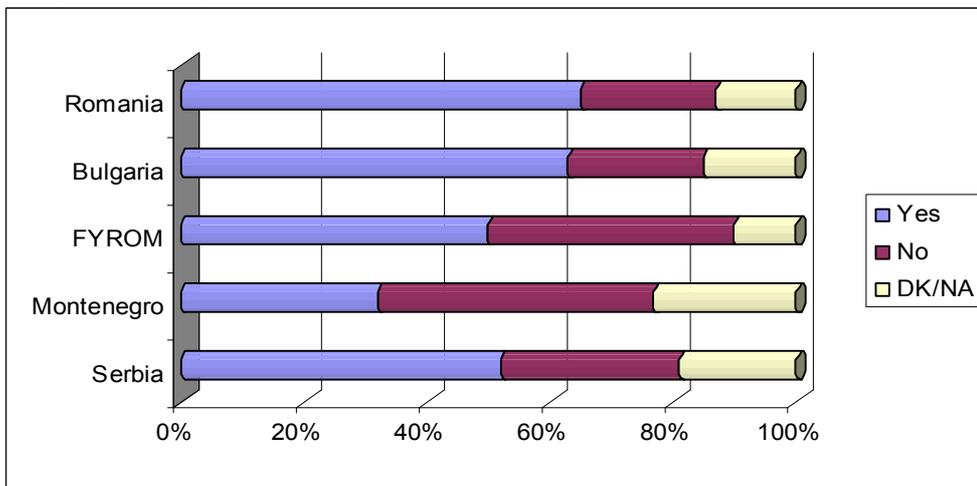
Source: IBEU research

Graph 4. Do you think politicians are 'above the law'?



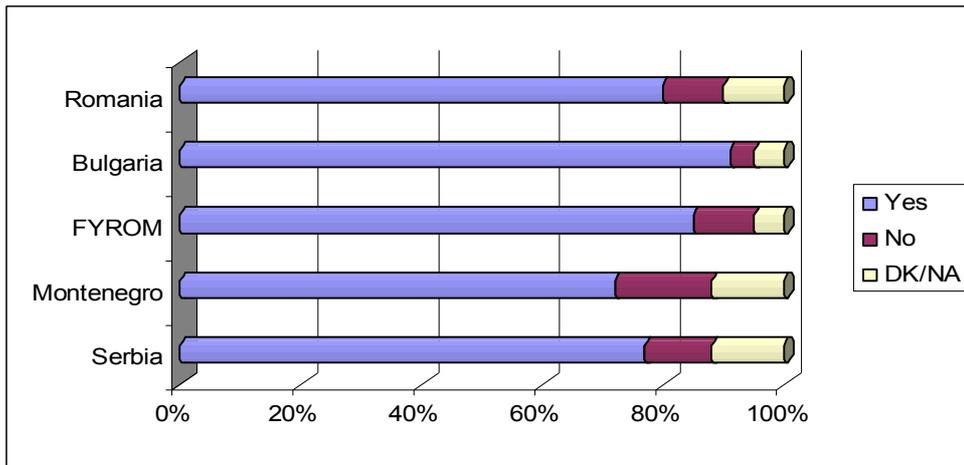
Source: IBEU research

Graph 5. Do you think policemen are 'above the law'?



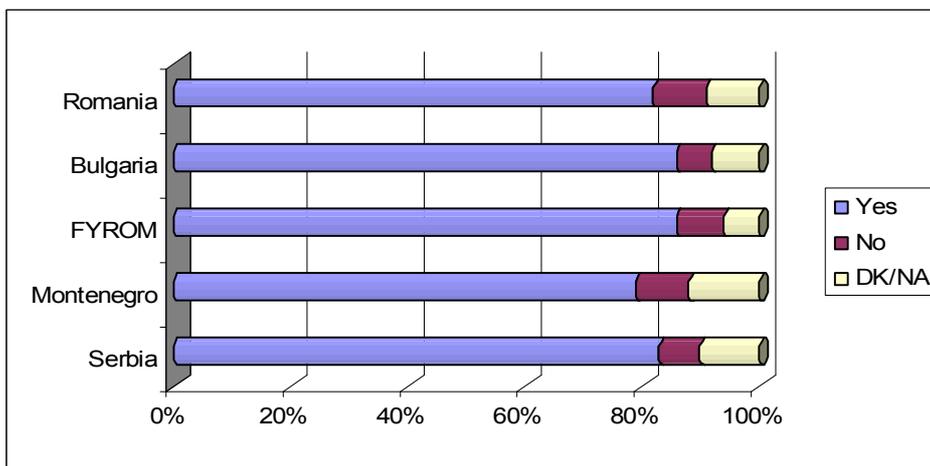
Source: IBEU research

Graph 6. Do you think the rich are 'above the law'?



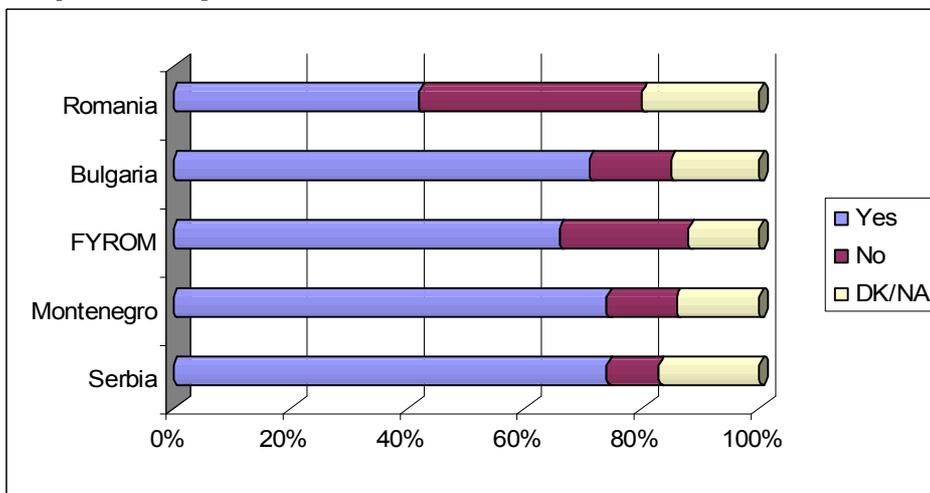
Source: IBEU research

Graph 7. Do you think that people with the right connections are 'above the law'?



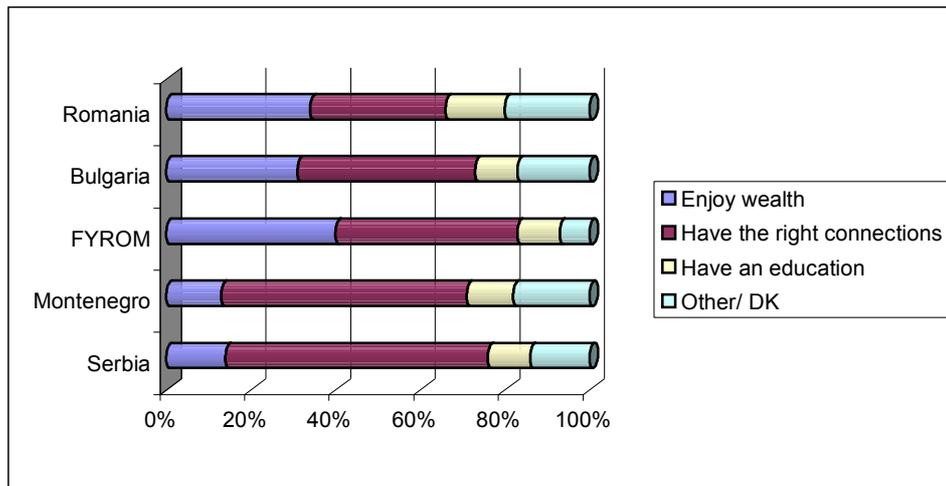
Source: IBEU research

Graph 8. Do you think that criminals are 'above the law'?



Source: IBEU research

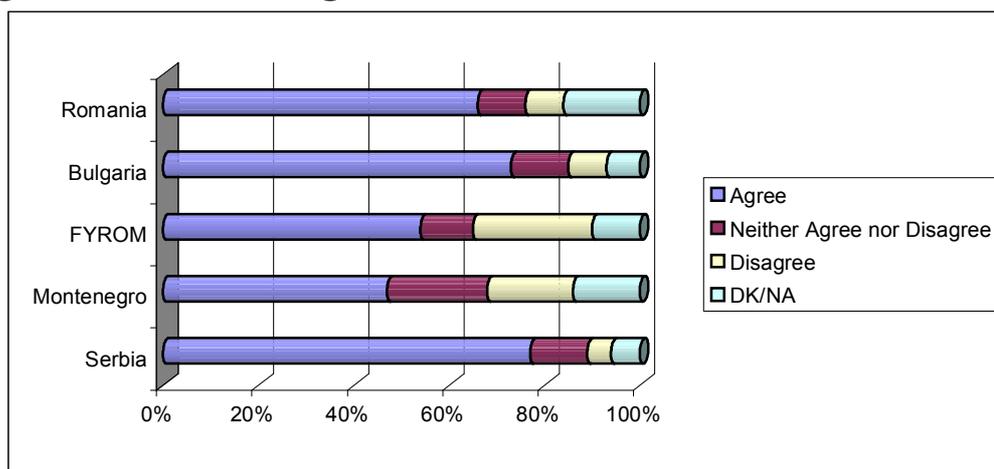
Graph 9. To get fair treatment from authorities nowadays, one has to:



Source: IBEU research

In this environment, particularism - also expressed as corruption - is not necessarily restricted to financial exchanges or gain. Corruption often manifests itself as favours granted to acknowledge superior status or to establish one's status in terms of 'influence.' Hence, this results in the population at large expecting to encounter discriminatory treatment, and in perceiving their society as unfair where some people enjoy disproportionate benefits.

Graph 10. The same people enjoy privileges regardless of changes of governments and regimes



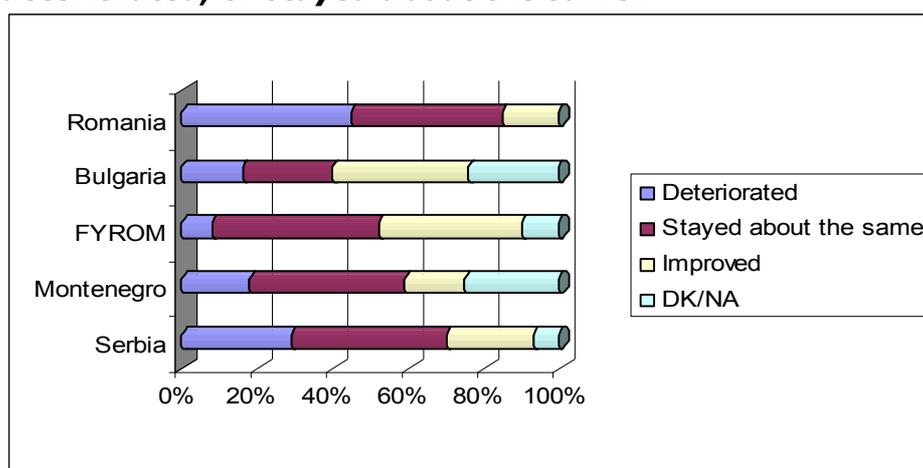
Source: IBEU research

Even if corruption, nepotism, state-capture by specific elites or networks is not as extensive and widespread as everyone might think it is, perceptions regarding it are widespread. In practical terms, this amounts to the same results in terms of perceptions not only on behalf of the domestic electorate,

but also on behalf of the international community. In effect, almost all EU documents referring to the region include a mention on organised crime and corruption and the overall conclusion that is repeatedly underlined is that there continues to be "little progress in the fight against organised crime and corruption."¹²

This constitutes a significant blow to the legitimacy of democratic institutions, procedures, and democratically elected elites that continue to be perceived as being 'the same people who enjoy privileges regardless of the regime.' It could thus be argued that externally-induced modernisation and liberalisation often translate in 'simulated change against the backdrop of structural, informal continuities'¹³ in societies that are undergoing transition. Overall, this may either lead people to try to gain access to these networks as a 'coping-mechanism,' in order to simply get their business done - thereby, in turn, further perpetuating particularism.

Graph 11. In general, compared to the transition period/ten/five years ago, has the honesty of local government improved, deteriorated, or stayed about the same?

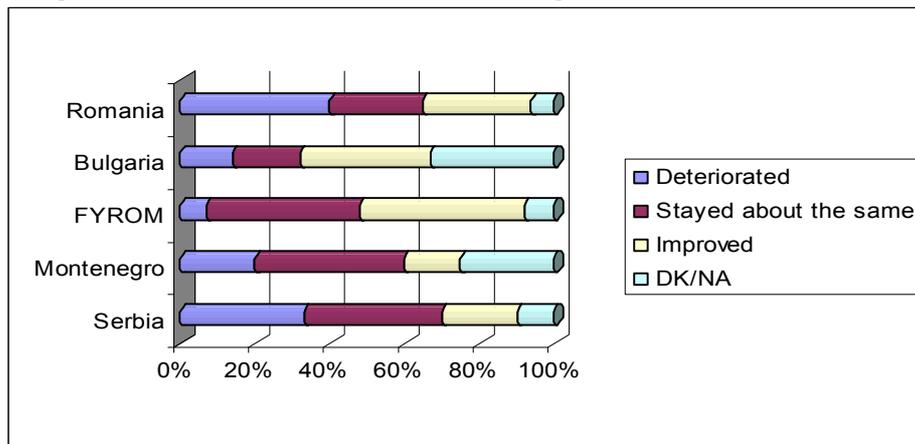


Source: IBEU research

¹² COM(2004) 202, 30.3.2004, p.12.

¹³ For more, please see Sotiropoulos D.A., "Positive and Negative Social Capital and the Uneven Development of Civil Society in Southeastern Europe" in *Journal of Southeast European and Black Sea Studies*, Vol.5:2, Taylor & Francis, May 2005; Mungiu-Pippidi A., "Deconstructing Balkan Particularism: The Ambiguous Social Capital of Southeastern Europe" in *Journal of Southeast European and Black Sea Studies*, Vol.5:1, Taylor & Francis, London, January 2005.

Graph 12. What about the central government?

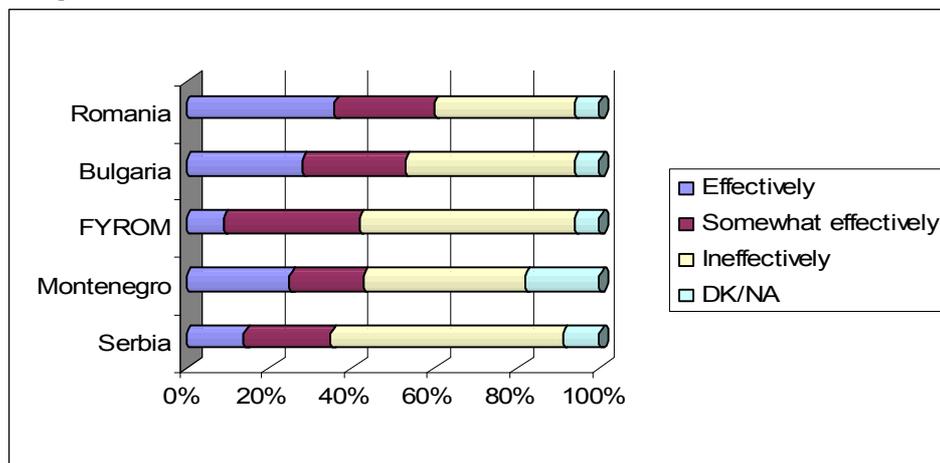


Source: IBEU research

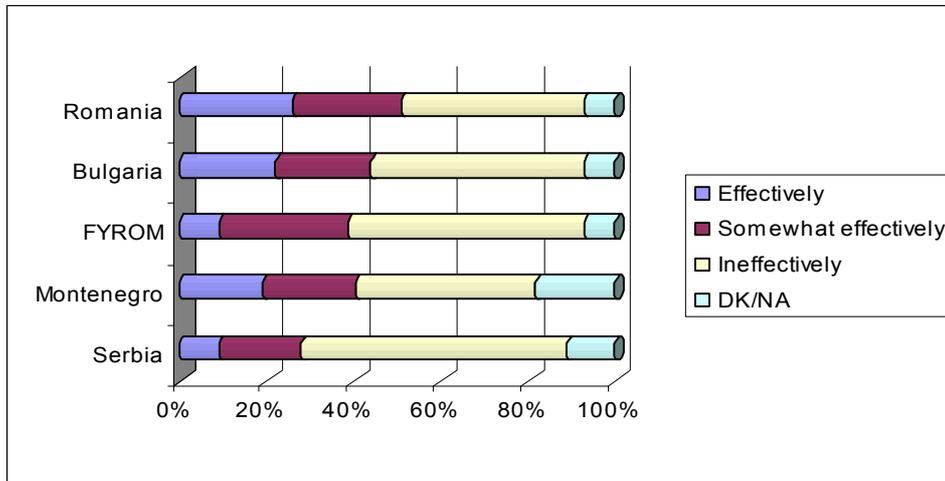
This distrust towards state institutions was apparent across all population and age groups according to the results of the social survey that was conducted by the IBEU Consortium in the five Balkan countries in the period 2002-2004. One set of questions asked the respondents to evaluate the performance of each main institution in their country in terms of serving the public interest in an effective manner.

Question posed: How do you evaluate the performance of the each institution in terms of serving the public interest effectively? (Source: IBEU research)

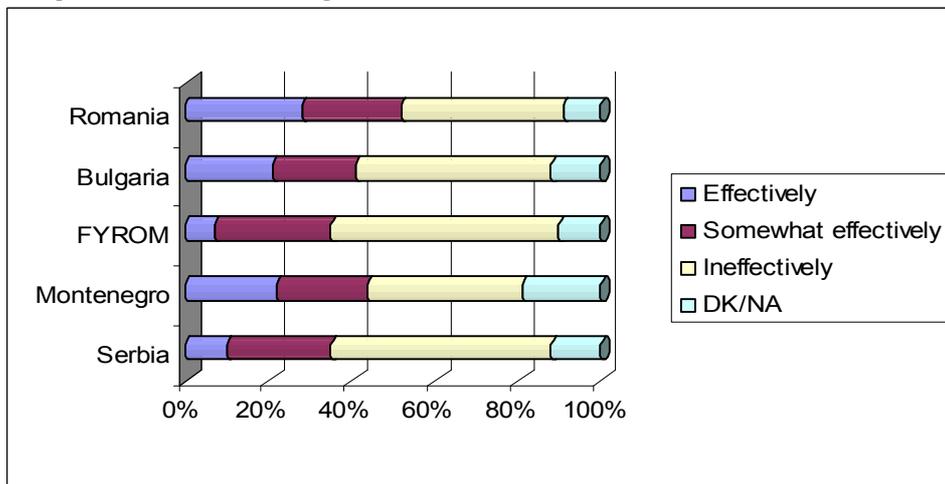
Graph 13. The Government



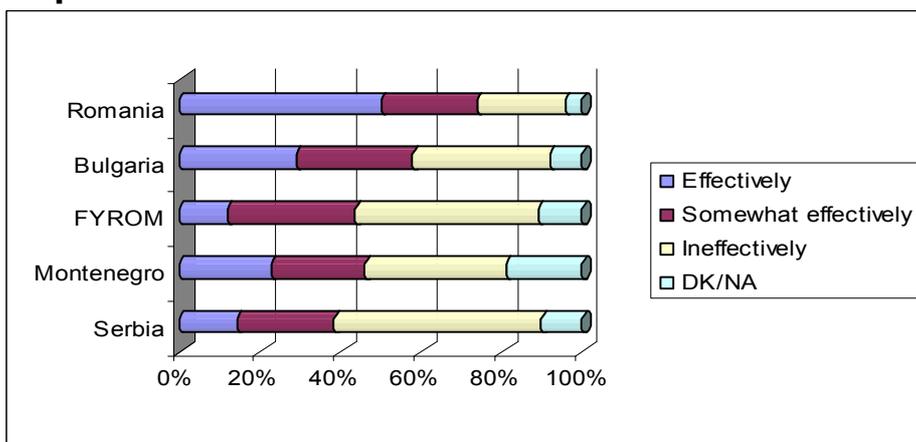
Graph 14. The Parliament



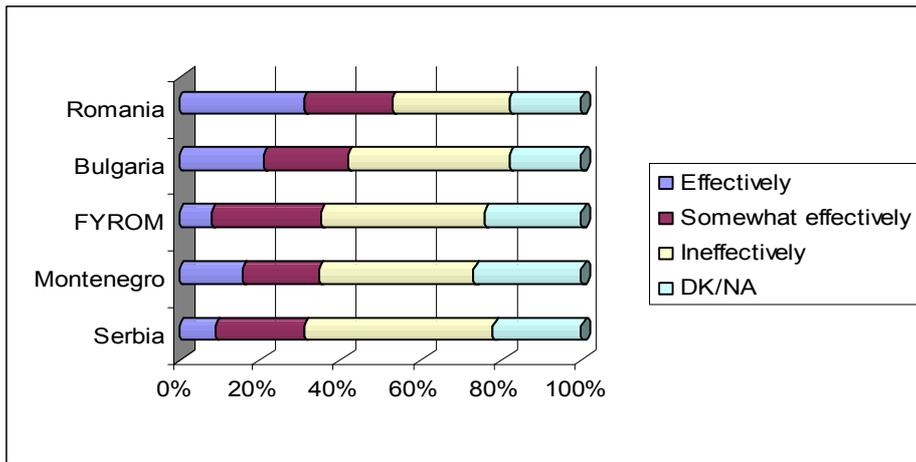
Graph 15. The local government



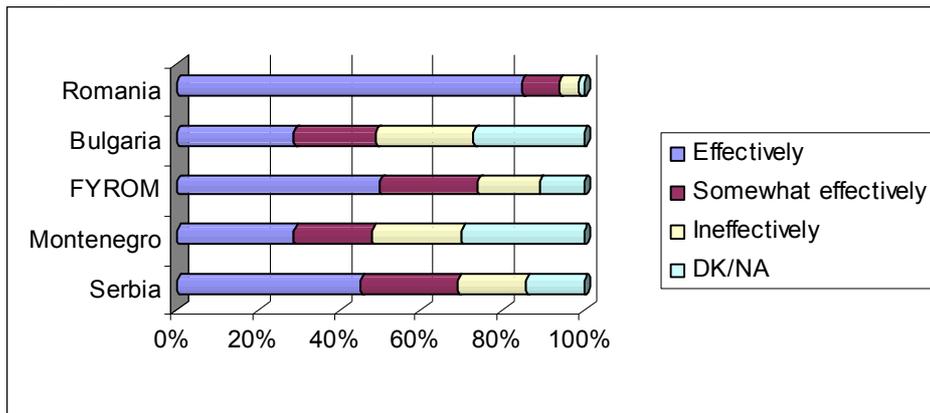
Graph 16. The courts



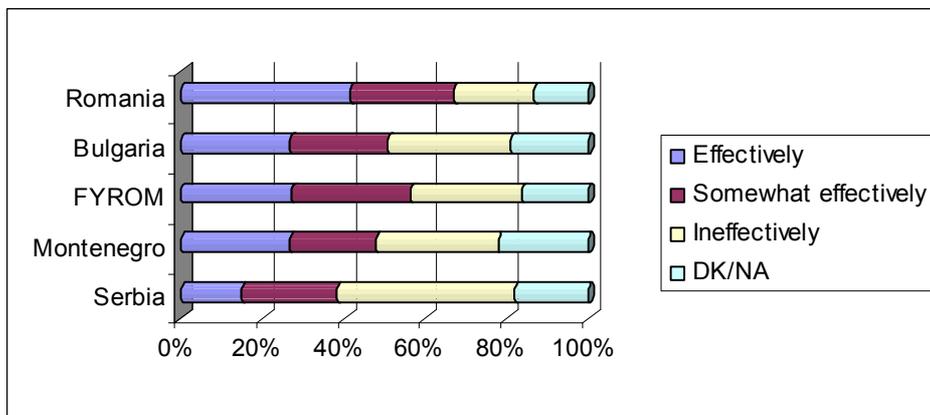
Graph 17. The Prosecutor



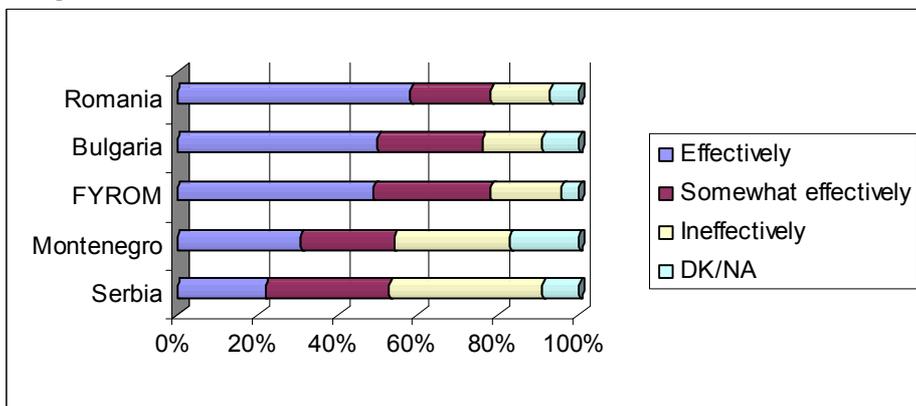
Graph 18. The church



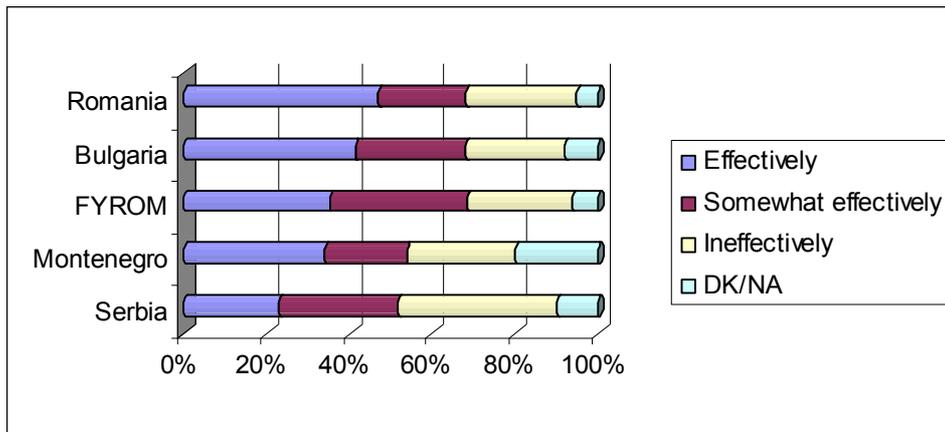
Graph 19. The tax office



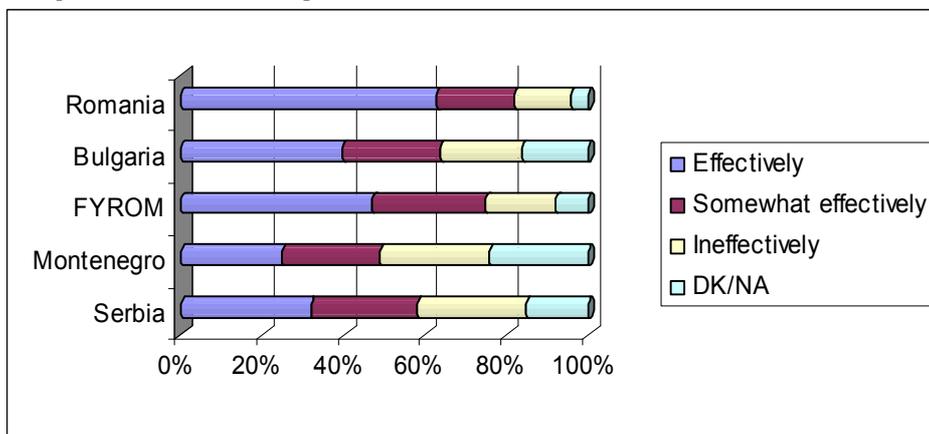
Graph 20. Public television



Graph 21. The Police



Graph 22. The Army



These low levels of trust toward the state and public sphere have 'knock-on' effects for the general levels of societal and individual optimism in the country's future and in personal socio-economic prospects. It almost works as a vicious circle since such a mentality provides fertile ground for further breeding a behaviour of non-compliance towards formal rules and regulations, and resorting to particularistic social trust. It may also be a determining 'push' factor for migration. This backdrop encroaches on the efforts of these countries to move further along the path of EU membership, since such 'invisible' borders hinder the administrative, political and institutional reforms that must be put in motion for adopting and implementing the *acquis communautaire* and for meeting the Copenhagen criteria.

B. THE 'INFORMALITY TRAP'

Informality involves non-compliance with rules regulating production and distribution of legal goods and services. Informal behaviour is characterised by arbitrariness and discretion in applying the rules. It also involves an element of rent seeking.

In the Balkans, informality has become pervasive and the conditions of state-economy relations are such that state institutions are heavily involved in informal practices. Naturally, this is not a phenomenon distinctive of the region, nor is it limited to the Balkans. Overall, it appears that informality is a rather diffuse post-communist phenomenon.

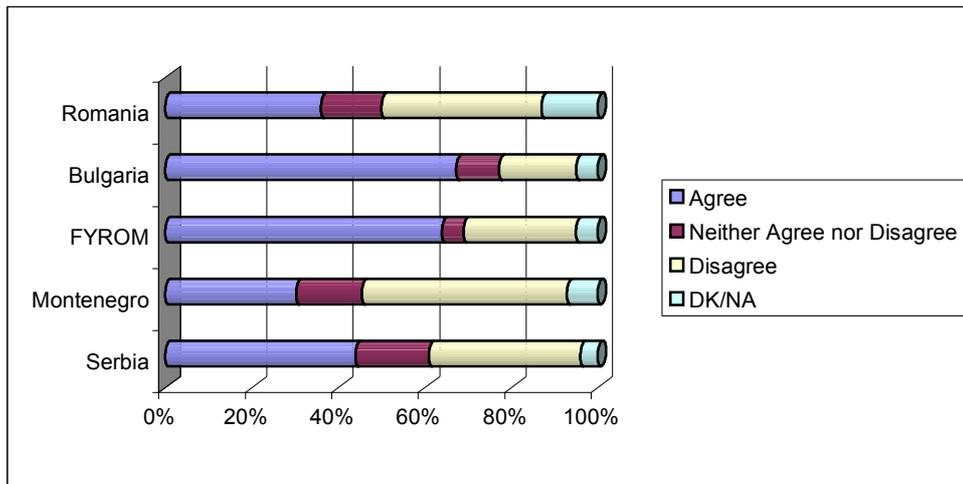
In any case, SEE continues to be widely characterised by enlarging zones of extra-legal activities that are growing and functioning at the expense of the formal economy. Networks of economic and political agents, rather than markets, are the dominant mechanisms determining economic exchange, the privatisation processes, the (non)enforcement of rules. These are functioning as parallel systems of authority that advance particularistic interests and may thereby undermine the legitimacy of formal institutions and regulations.¹⁴ Interference by political and economic groups in the implementation of administrative policies and in the application and co-ordination of regulations and legislation is commonplace. The civil and judicial services are not only lacking in infrastructure, efficiency and resources. More importantly, they are generally unable to carry out their responsibilities independently from the pressures and particularistic interests of influential political and economic networks/ actors; in short, of actors that have their fingers well in the 'honey pot.'

This has multifaceted consequences. An overall behaviour of non-compliance saps states' legitimacy and society's sense of security. It has resulted in loss of trust towards the state institutions on behalf of individuals, groups and firms. At the same time, it has led to reliance on parallel networks that come to operate as alternative means of resource allocation and that are able to respond to security needs. This has far-reaching consequences not only for a country's economic growth and the extent to which its markets are attractive to foreign investors and businesses. It also affects employment practices, fiscal revenues, the security of its labour markets. For businesses to remain competitive, this 'informality trap' is principally nourished by heavy tax burdens and by the high-level complexity in country tariff structures. Labour taxes, especially, are conducive to undeclared employment and/or under-reported wages. Even though the common strategy of under-reporting limits businesses' access to capital markets and foreign investors' interest in investment, nonetheless, most businesses are prepared, or even prefer to resort to tax evasion in order to reduce transaction costs.

Thus, informality becomes a matter of opportunity just as much as it is a case of necessity and eventually becomes self-sustaining.

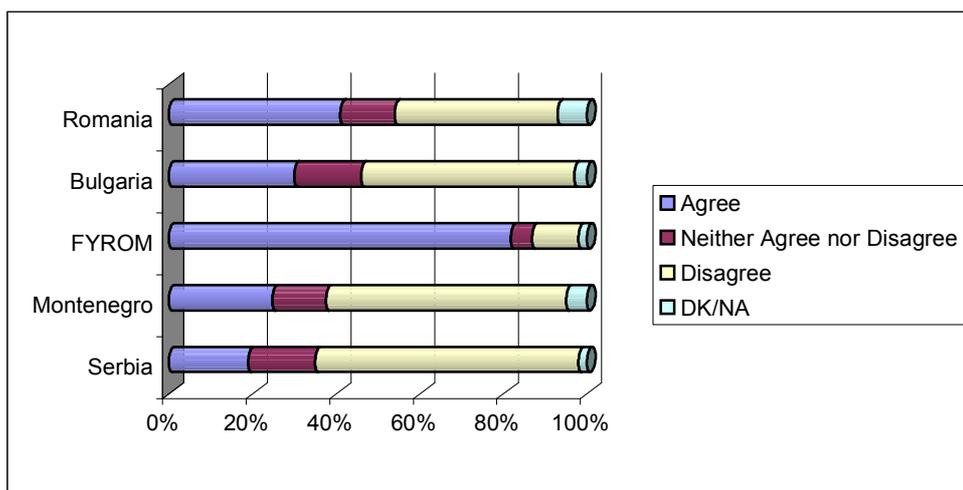
¹⁴ See Bojicic-Dzelilovic V. & Bojkov V., "*Informality in Post-Communist Transition: Determinants and Consequences of the Privatisation Process in Bulgaria*," in *Journal of Southeast European and Black Sea Studies*, Vol.5:1, Taylor & Francis, London, January 2005, 2004; Barrett E., IBEU Working Paper: *The Role of Informal Networks in the Privatisation Process in Croatia*, 2004; www.eliamep.gr

Graph 23. People cannot do anything to curb corruption



Source: IBEU research

Graph 24. People who work hard and are honest are better off in the end than those who cheat



Source: IBEU research

Though this is far from being distinctive of the Balkans and is present not only in the CIS, in eastern Europe but also in western and southern Europe, its scope is far more extensive here. With the exception of Croatia, the informal economy in SEE is approximately twice the size of most transition countries and shows no substantial decline over the years. War and armed conflict encouraged the prevalence of widespread informality in the economic and societal functioning in the Western Balkans, and equally affected this region's ability to attract foreign investors. For the other countries in the region that did not undergo the experience of armed conflict (such as Bulgaria and Romania), their unstable political environment, equally created conditions encouraging informality. In both cases, privileged networks (i.e. having access to government and/or state institutions) functioning on the basis of particularistic interests, were adept in exploiting informal procedures and

omissions in the institutional and regulatory framework, and in profiting from insider-operations and insider-trading.¹⁵

This environment impacts the region's attractiveness for foreign investors. Investment is still well below desired levels across most countries, while inadequate legal and supervisory frameworks and the underlying money-laundering problem have allowed the proliferation of unsound and speculative schemes that have led to acute financial crises. Across the Balkans, foreign direct investment (FDI) inflows have been mostly associated with large-scale privatization transactions in banking, heavy industry, telecommunications and the energy sector, whereas greenfield investments have been extremely limited. This has been even more restricted in countries where restructuring was delayed, such as in Albania, Bosnia and Herzegovina and Serbia and Montenegro.

FDI is influenced by basic objective criteria (such as the existence of natural resources, geographic proximity, etc), and by the general environment in place. This involves legislation, the regulatory frameworks, the degree of domestic market integration, business incentives, etc. The World Bank's good governance indicator incorporates six dimensions that concisely summarise the factors that hamper the much-needed flows of FDI across the region: (i) voice and accountability; (ii) political stability and absence of violence; (iii) government effectiveness; (iv) regulatory quality; (v) rule of law; and (vi) control of corruption.¹⁶ On the 'good governance' front, SEE overall scores quite poorly; property rights and contract enforcement are uncertain, corporate governance incentives are lacking, labour market legislation is rigid, infrastructure is under-developed, and the time and costs of setting up new business is lengthy. The fundamental elements that could attract investors to the region and contribute to its self-sustaining economic growth continue to be missing.

Informality and corruption exacerbate these difficulties as well as the ineffectiveness and the discriminatory services provided by public administrations and vice-versa. This results in business-related corruption, given that businesses require certain public services to be able to pursue their activities, and they end up become passive supporters of corruption. Corruption, and in particular the 'bribe tax' paid to public officials, constitutes a heavy cost on firms and has been identified as a further discouraging factor for region's economic development.¹⁷

¹⁵ For more, see Bojicic-Dzelilovic V. & Bojkov V., "*Informality in Post-Communist Transition: Determinants and Consequences of the Privatisation Process in Bulgaria*," in *Journal of Southeast European and Black Sea Studies*, Vol.5:1, Taylor & Francis, London, January 2005, 2004; Barrett E., IBEU Working Paper: *The Role of Informal Networks in the Privatisation Process in Croatia*, 2004; www.eliamep.gr

¹⁶ European Commission, DG for Economic and Financial Affairs, "*The Western Balkans in Transition*," Occasional Paper No.5, Brussels, January 2004, p.21

¹⁷ EBRD, "*Transition Report*," 2002, p. 27-28.

These practices are equally prevalent within all phases of the privatisation process, and in relation to public procurement, thereby, rendering many processes highly non-transparent. The absence of appropriate institutional and legal conditions to support the privatisation process permitted - or in certain cases provided - an environment which was fertile for informality to prevail and for privileged groups to 'personalise' the state. Furthermore, incomplete and/ or ambiguous regulatory frameworks facilitated networks that were connected with the political establishment to benefit in a disproportionate manner from the re-distribution of state assets.

In this environment, the informality trap also results in firms preferring, and in a sense even being driven into trading only with known partners and in avoiding official institutions for contract enforcement. Efforts to minimise contact with official institutions based on the expectation that the service will be ineffective, or that the 'right connections' will be required, are also at the root of the aforementioned 'experience gap.'

C. REGIONAL CO-OPERATION IN A REGION OF 'HARD,' YET 'POROUS' BORDERS

It has been repeatedly affirmed that regional co-operation is the only path towards the region's stability. It has been defined as "a practical means for promoting reconciliation and under-pinning reform."¹⁸ Yet, do the countries of the region perceive the benefits of regional co-operation? Regional co-operation continues to remain largely an externally imposed requirement and not necessarily a local preference.

Regional co-operation has been put forward as a major prerequisite for the Balkan states to become integrated in the EU and NATO's security structures. It tends to be approached as a list of initiatives and policies that, once put into place and then into motion, will help the economies of Southeast Europe to launch their growth potential. In parallel, it will develop a closer integration with the EU. The checklist of priorities usually involves: trade integration and the dismantling of tariff barriers; infrastructural improvement in the transportation, energy and communications sectors in particular; institutional capacity-building, with focus on reforming institutions and creating the required legal and administrative environment that facilitates trade, or in the case of the financial sector, the movement of capital, thereby providing the catalyst for investment.

The assumption is that the correct policies, combined with the appropriate incentives, or 'carrots' in EU jargon, will support growth in economic terms, which in turn will have a spill-over effect in the political and societal spheres. In addition, it will facilitate all sides in addressing common problems and challenges, thereby creating a stable environment within which the governments can focus on improving their citizens' standard of living.

¹⁸ COM(2004) 202, 30.3.2004, p. 6.

Ultimately, it is expected to contribute to a secure environment for investment, freer democratic institutions, political co-operation, and sustainable stability within its societies and in cross-border relations. In other words, it is anticipated that the spill-over will consolidate democratic processes and increase social trust and optimism for the future within the region's populations, and gradually, re-establish good neighbourly relations and reconciliation among the people and the countries in the area.

This rationale is the guiding force behind the EU's promotion of regional co-operation in Southeast Europe and is the backbone of the Stabilisation and Association process (SAP) that was launched back in 1999 and that was underpinned by the EU's Community Assistance for Reconstruction, Development and Stabilization (referred to as CARDS assistance) for the Western Balkans for 2002-2006.¹⁹ However, in spite of improvements in the Balkan countries at an individual level, regional co-operation is still stumbling and dragging its feet in the region. If we are to eventually see the desired results that are expected and that appear to be long-overdue, then efforts at the national level ought to be stepped up and, the Balkan countries are being strongly urged to do precisely so.

In practice, however, these efforts are up against a series of stumbling blocks, both real and perceived. 'Pockets of recession' and 'hard' (i.e. non-porous) intra-regional borders render the region's development more fragmented, more asymmetric and thereby limit its overall growth and the potential for regional co-operation. Much of the explanation to these difficulties and challenges lies in the nature of borders within this region.

Impediments to regional co-operation are inter-connected and include: the different levels of development between the components of this region; the infrastructural constraints to intra-regional connectivity (roads and rail tracks) inherited from Yugoslavia's economic structure followed by its disintegration; the incompatibility between the region's economies; and the non-tariff barriers to trade common across the Balkans.

For one, 'hard' (i.e. non-porous) intra-regional borders impede large infrastructure projects, which are necessary to strengthen communication and transportation within the region. At the core of this is rail and road transport infrastructure.²⁰ The current state of the Southeast European rail density is

¹⁹ The EU's regional approach to SEE dates back to 1996 with the Royaumont Process that aimed to support the implementation of the Dayton Peace Agreements. It was followed by the Regional Approach, adopted in December 1997 by the European Council, which established political and economic conditionality in EU relations with the Western Balkans. The SAP and the Stability Pact also fall within the EU's approach of promoting regional co-operation (modelled on the EU integration logic). See http://europa.eu.int/comm/external_relations/see/region/index.htm

²⁰ See IBEU Working Paper 4.2, Holzner M., "*Infrastructural Needs And Economic Development In Southeastern Europe - The Case Of Rail And Road Transport Infrastructure*", 2004, www.eliamep.gr

close to the European average but of rather poor quality. Road density is significantly below the European average with low levels of double track railway lines and only a few motorways in the region. In addition, just a brief glance at the region's maps testifies to the fact that most of the Balkan countries have better transport connections to the EU than with the other countries of the region. This is a legacy of the cold war and of the recent history of disintegration and conflicts that the European Union and the International Financial Organisations are trying to address by developing the region's infrastructure and connectivity.

In addition, insufficient liberalisation of the service sectors does not provide incentives for public and private partnerships (P&PP) to be set up. Though they may in fact be 'porous' to private businesses, they often prove to be quite 'hard' for public agencies. One reason for which inter-state co-operation may be difficult to engineer is the effect that cross-border investments may have on the national budgets. This may involve the loss of some direct sources of public revenues, such as tariffs. It is even more of a challenge in certain occasions to get the local public authorities to co-operate on common infrastructure projects. Here, more often than not, an outside actor able to trigger co-operation between the public sector and private sector actors that are necessary for a public and private partnership (P&PP) to be set up, is crucial, not only to set up the infrastructure project, but also to liberalise the services sector across borders. In setting up a P&PP the two guiding principles are that the public interest is involved in the investment aiming for the public good, while private interest is relied on to efficiently supply the private goods. For this partnership to work, it is important that proper procedures for competition are put in place, and for that to be the case across borders, it is necessary to further liberalise the services sector in the whole region. The recent experience of the Stability Pact, which has been especially active in procuring infrastructure projects,²¹ testifies to the fact that regional initiatives encounter the most challenges in being put together and in being implemented.

Improvements with regard to trade liberalisation on the other hand, have been undertaken within a network of twenty-four Free Trade Agreements that have been set up until now since the 2001 Memorandum of Understanding on Trade Liberalisation and Facilitation. With regard to the regional bilateral agreements most of the framework has been set up and the agreement are applied or in some case have been initialized, however, they still face implementation-related difficulties.²² FTAs do not imply free trade in the strict sense of no tariffs and no quotas as soon as the agreements come into force; rather they lift a range of tariffs on many commodities, progressively, over a number of years. Yet even the results of this progress remain restricted given

²¹ <http://www.stabilitypact.org/infrastructure/default.asp>

²² See Matrix in CEPS Policy Brief No.85/ November 2005, *An interim plan for South-East Europe. Customs Union with the EU and a regional Schengen for the free movement of people*, by Michael Emerson, www.ceps.be

that the EU has been the most important trading partner for each country in the region for over a decade, and will continue to be so. A number of different factors lead to this supposition: certain agreements, such as for instance between Albania and Bosnia-Herzegovina, cannot be expected to lead to massive trade flows; at the same time, one of the region's key players – not least because of its geographical position since it borders with almost all countries of the Western Balkans - Serbia and Montenegro, has still not set up the full range of potential regional agreements. It is difficult to talk of meaningful regional trade if the centrally located country cannot act as some sort of hub. Moreover, by the time all regional bilateral trade relations are truly free, it is likely that – at least as regards the remaining non EU-members - they will have been partly replaced by a revised set of bilateral agreements with the EU. It is, therefore, important to focus equally on other technical barriers and impediments to trade, such as: poor infrastructure, both tangible (in terms of transport, but also in terms of telecommunications) and intangible (speed and complexity of administrative procedures, of payment procedures, of clearing procedures, of insurance procedures and so on); reducing non-tariff costs to trade and transport;²³ reducing smuggling and corruption at border crossings, and strengthening and modernising the customs administrations and other border control agencies.

For this reason, initiatives which facilitate trade are encouraged. Among these, priority ought to be accorded to:

- Simplifying (and, where possible, eliminating) formalities and procedures, in particular those related to the import, export and transit of goods;
- Harmonising applicable laws and regulations;
- Standardising and integrating information definitions and requirements and the use of information and communications technologies so as to exchange this information efficiently.

Naturally, these measures need to be complemented with improvements in the transportation infrastructure so that the potential for regional co-operation and trade can really be built-up. Improving and standardising physical infrastructures and transportation facilities, including targeting long delays and queues at the customs are key to overcoming current obstacles to intra-regional trade growth. WTO membership for all countries in SEE is equally beneficial for tackling non-tariff barriers across the region.²⁴

Interestingly, these same borders that appear difficult to cross are particularly 'porous' to illegal trading activities. In effect, illegal trade in the Balkans is above the world average (particularly in certain goods such as textiles, petroleum, cars, electronics and medicine), while smuggling and transit smuggling is widespread.²⁵ It is difficult to estimate the size of this illegal

²³ <http://www.tfse.org>

²⁴ EBRD Report, "Spotlight on SEE," 2003, p. 45.

²⁵ See IBEU Working Paper 3.5, Holzner M. & Christie E., "Illegal Trade in the Balkans", 2004, www.eliamep.gr

trade in the region. Very tentative efforts to quantify the extent of over-invoicing or under-invoicing suggest that this may touch approximately 10 – 12% of imports among the SEE countries (specifically Albania, Bosnia and Herzegovina, Croatia, FYROM, Serbia, Montenegro, Bulgaria and Romania).²⁶ This is largely inherited from Yugoslavia's violent disintegration when conflict and sanctions led to wide-spread smuggling in order to meet the populations' needs. Another reason that contributes to such high levels of illegal trading also has to do with the fact that many border crossings are still not adequately policed. Finally, it is also because long delays at customs, heavy bureaucracies and corruptible legal requirements prove to be incentives to illegal trading and outweigh the benefits of legal trading. Indeed, it appears that there are substantial illegal trade flows particularly with products where high taxes are applied and between countries with tariff and non tariff barriers. Many of these countries rely on tariff revenues to finance important public goods, so reducing these is a difficult decision to take. Nonetheless, reducing these would eventually make illegal trade and smuggling less profitable and possibly less of an incentive, and would eventually bring benefits to the government budgets and to competitors in the formal sector.²⁷

The kind of contractual relations that each Balkan country (from west to east) has with the European Union is another factor that fundamentally influences the nature, scope, intensity and potential of regional co-operation. These relations range from Bulgaria's candidate country-status to EUFOR's mission in Bosnia and Herzegovina. In fact, the reality on the ground suggests the existence of two sub-regions – the Western Balkans on the one side, and the Southern Balkans on the other. It is not only the different status issues that differentiate the countries; the international community's approach towards the individual states is determined for some by the Dayton Peace Agreement, for others by the Partnership for Peace (PfP) and for others still by NATO. The economic indicators are just as telling. GDP levels range between Croatia's per capita, rather similar to the new EU member states, and Albania and Kosovo at the lowest ends of the spectrum. Moreover, the exchange rate policies that apply across the region are varied: Montenegro and Kosovo have unilaterally joined the euro-zone; Bulgaria and Bosnia-Herzegovina have introduced currency boards based on the euro; FYROM has a fixed peg and Croatia a narrow band; and Serbia has a managed float and is moving towards an undeclared crawling peg.²⁸ The differences in their formal relations with the EU determine not only how far ahead they are in the accession process, but the access to funds and support that they may have. For instance, Bulgaria and Romania, soon to be member states, will be able to access funds from the Common Agricultural Policy (CAP); the countries included in the Stabilisation and Association Programme (SAP) are being

²⁶ IBEU Working Paper 3.5, Holzner M. & Christie E., *"Illegal Trade in the Balkans"*, 2004, www.eliamep.gr, p. 21.

²⁷ EBRD Report, *"Spotlight on SEE,"* 2003, p. 45.

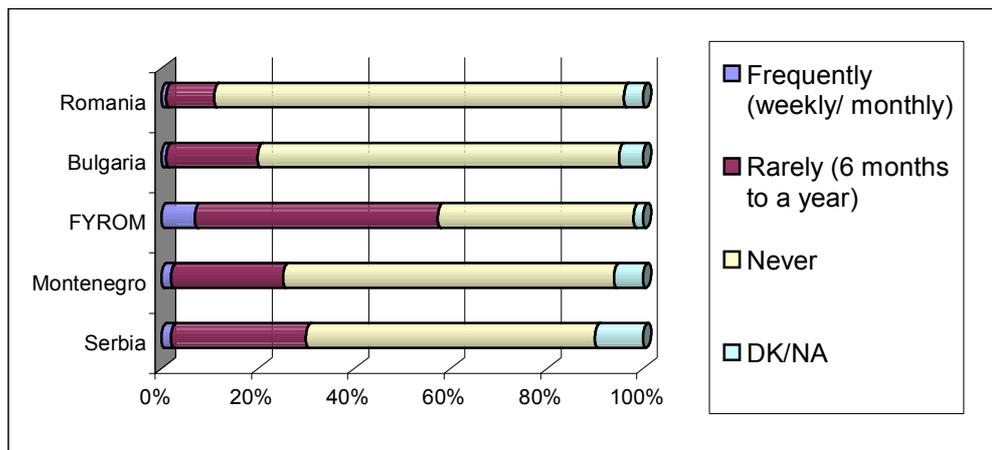
²⁸ The Vienna Institute for International Economic Studies, Special Issue on the Transition Economies, *"As East You Go, the More they Grow: Transition Economies in a New Setting,"* Research Report 308, by Vladimir Gligorov, Josef Poschl, Sandor Richter et al, July 2004.

increasingly eligible for funding from pre-accession programmes; and Serbia and Montenegro that have just opened SAA negotiations with the Commission are basically still constrained to the CARDS instruments, IMF macro-financial assistance, and humanitarian assistance. In any case, their relation with the EU will develop independently following the referendum result.

Although the spirit of regional co-operation has extended significantly across the Balkans, there exist also political and social obstacles, both perceived and real that continue to restrain the region's potential for a full-range of cross-border relations. In part, these are the result of wounds that have not yet been overcome, such as recovering from the psychological and practical effects of the wars and sanctions. They are just as much the result of continued instability and perceptions of uncertainty with regard to existing or future border configurations, and prevalent pessimism for the future.

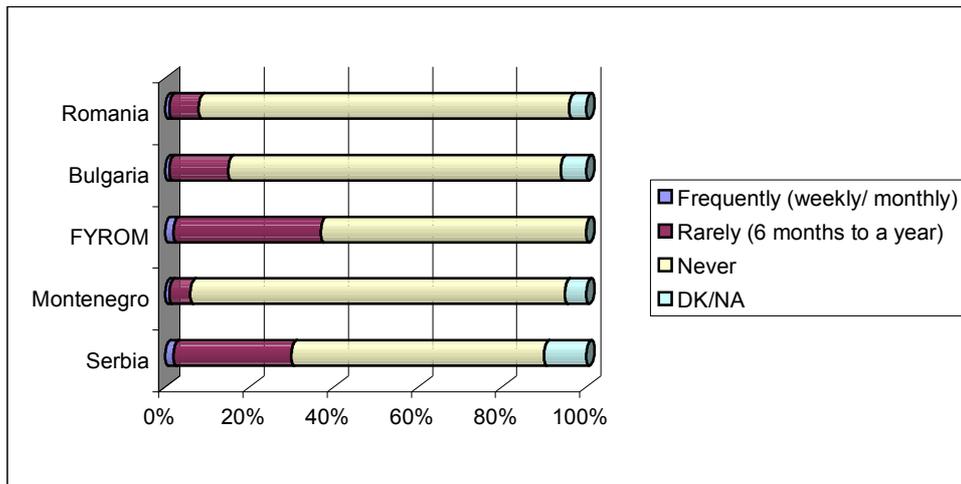
These political and social obstacles are linked with the limited contact that people in SEE countries have with other countries. Social surveys conducted in the context of the IBEU project suggest that travel to neighbouring countries in the region, and travel to foreign countries overall is rather limited.

Graph 25. How often do you travel to a neighbouring country?



Source: IBEU research

Graph 26. How often do you travel to a foreign country (not neighbouring)?



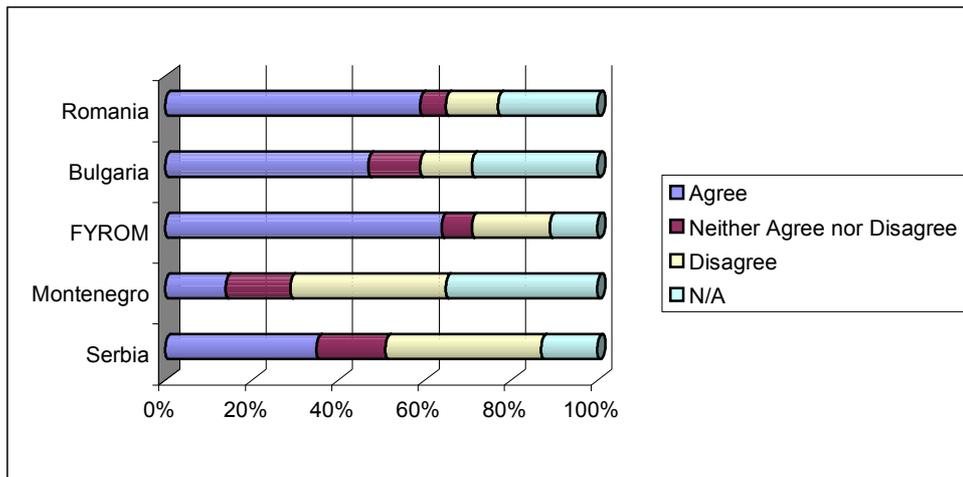
Source: IBEU research

In light of such travel patterns, regional co-operation and communication is necessarily affected. Initiatives that can encourage travel for business or leisure, student exchange programmes, and increased communication among neighbouring countries is most certainly needed.

This becomes even more pertinent when considering another obstacle to regional cooperation that has to do with people's perceptions of the neighbouring countries and of their country's borders. Particularistic social trust here leads to perceptions of a potential threat to their homeland's sovereignty and territorial integrity, or even irredentist claims. In effect, across the region, ethnic minorities are consistently perceived as constituting a threat to the country's territorial integrity. This highlights the relative newness of the nation-states in the region, underlining that national borders are still not fully accepted by some, making them fuzzy in certain cases and extremely hard in other. Against the background of the recent weight of national and inter-ethnic conflict in the region, these elements constitute an important hurdle for regional co-operation.

The table below provides some illustration as to the potential for cross-border tensions:

Graph 27. Are there parts of other countries that belong to us?



Source: IBEU research

D. THE 'HUB-AND-SPOKE' RELATIONSHIP WITH THE EU

The bilateral relations each country of SEE holds with the EU are more important than the intra-regional ones, and even more important than the relations the region as a whole has with the EU. In other words, SEE has a 'hub-and-spoke' relationship with the EU.

This relationship is characteristic across most areas and sectors.

The hub-and-spoke relationship is characteristic of the region's trading patterns. The European Union is by far the most important trading partner for both imports and for exports for practically all the countries of the region. The evolving trade relations that the economies of SEE have with the EU have greatly contributed to their integration into the global economy. If we consider each country individually, we can note that countries such as Albania and Romania which are the farthest from the geographical centre of Southeast Europe, have limited trade with regional partners and the bulk of their trade is with the EU and especially with new EU Member States such as Slovenia and Hungary. This is positive for their integration with the European single market and in comparison to other economies in the region, they enjoy better growth rates. On the contrary, the 'battered core', especially Serbia and Montenegro and Bosnia and Herzegovina, started their transition efforts much later due to a combination of military conflicts and trade sanctions with consequences for the size of the trade flows and their growth.

As noted above, the countries of the region have been progressively liberalising trade with one another through a series of bilateral trade agreements and the Memorandum of Understanding on the creation of a regional electricity market. However, this bilateral route is cumbersome and

slow, and the private sector's response has been rather sluggish in making use of new opportunities.²⁹ At the same time, given Bulgaria and Romania's upcoming membership, most likely to be followed by Croatia, means that the region has no prospect of becoming a regional free-trade area in any meaningful sense until all the countries are part of an enlarged EU.³⁰

Table 3. Imports from other SEE-7 countries as a percentage of total imports

Year / Country	Albania	Bosnia & Herzegovina	Bulgaria	Croatia	FYROM	Romania	Serbia & Montenegro
1998	6.3	43.4	2.8	2.9	20.4	1.1	14.1
1999	7	32.8	2.2	2.5	20.7	0.9	14.6
2000	6.1	21.4	4.4	2.0	19.8	0.7	20.9
2001	5.7	27.9	3.0	2.8	18.2	1.4	21.8
2002	6.1	22.8	2.5	2.7	11.1	1.1	15.3
2003	6.7	32.5	3.0	3.9	20.8	0.9	13.7

Source: IMF Direction of Trade Database, wiiw calculations

Table 4. Exports to other SEE-7 countries as a percentage of total exports

Year / Country	Albania	Bosnia & Herzegovina	Bulgaria	Croatia	FYROM	Romania	Serbia & Montenegro
1998	2.3	54.1	7	16	19.2	2.9	33
1999	2.1	42.9	8.6	14.7	20.4	2.9	33.8
2000	2.1	30.5	12.6	12	30.9	2.3	28.2
2001	2.8	31.2	9.8	17.4	38.3	3.1	28.7
2002	2.2	37.2	9.3	19.2	20	2.9	31.1
2003	4.0	32.0	9.4	19.5	32.6	3.1	30.7

Source: IMF Direction of Trade Database, wiiw calculations

Table 5. Imports from the EU-15 as a percentage of total imports

Year / Country	Albania	Bosnia & Herzegovina	Bulgaria	Croatia	FYROM	Romani	Serbia & Montenegro
1998	79	33.4	46.1	52.8	52.8	57.9	45.1
1999	77.6	37.6	50.9	56.7	50.7	62.7	38.3
2000	75.6	33.2	44.0	54.3	49.4	63.0	40.9
2001	77.4	37.2	49.8	55.9	46.1	63.0	49.1
2002	77.6	39.0	50.5	55.5	53.0	63.9	52.0
2003	73.1	35.9	56.4	56.0	50.7	62.7	49.7

Source: IMF Direction of Trade Database, wiiw calculations

²⁹ EBRD Report, op.cit, p. 39.

³⁰ IBEU Working Paper 4.2, Christie E., "Trade flows in SEE," 2004, www.eliamep.gr

Table 6. Exports to the EU-15 as a percentage of total exports

Year / Country	Albania	Bosnia & Herzegovina	Bulgaria	Croatia	FYROM	Romani	Serbia & Montenegro
1998	88.8	33.8	51.5	47.7	51.8	64.6	38.0
1999	89.9	42.3	53.3	49.4	50.9	66.0	34.3
2000	93.4	47.6	51.2	50.5	46.1	60.6	37.7
2001	91.8	46.3	55.2	55.0	41.4	65.1	47.0
2002	90.0	51.1	56.1	50.4	40.0	66.3	54.0
2003	88.5	55.9	53.2	52.9	53.5	67.1	54.3

Source: IMF Direction of Trade Database, wiiw calculations

The tables above illustrate that the overwhelming majority of the region's trade is with the EU. This is not only because of non-tariff trade barriers or because the transportation infrastructure in place across the region is set up in a way that facilitates access to EU Member States. It is also influenced by the fact that political elites tend to be much more eager to focus on their bilateral relations with Brussels than on relations with the other regional capitals; this necessarily influences the private sector's interest in intra-regional projects and trade. Nonetheless, steady growth in regional trade can be noted over the past years and there exists substantial scope for improvement due the implementation of the bilateral FTAs and Memorandum of Understanding on Electricity along with gradual infrastructural improvements underway.

The 'hub and spoke' relationship also exists in the banking sector. There exists a clear majority of foreign ownership in the region's financial sector with Austrian, Greek, Italian, Dutch and French banks owning significant shares of the financial sectors across all SEE countries. The privatisation process of local banks attracted foreign bank involvement and notable shifts in ownership structures. The foreign, and basically almost exclusively EU, participation in the banking sector has led to credit expansion and has improved banks' profitability and loan adequacy ratios.

Table 7. Market share of foreign-owned banks as percent of total assets

Country / Percent of total assets of the banking sector	2000	2001	2002	2003	2004
Albania	35.20	40	45	45	97.10
Bosnia & Herzegovina	50	60	<70	<75	<80
Bulgaria	71.50	70.60	72.40	82.20	74.60
Romania	50.90	55.20	56.40	58.20	62.10
Serbia	0.30	2.10	12.80	20	36.80

Source: RZB Group, *CEE Banking Sector Report – Part 1*, October 2005

Credit expansion is associated with easier access to credit because of regulatory and administrative changes within the banking systems and with a growing trust in banks. Household retail banking (consumer loans and mortgages) has grown significantly however, SME banking is still largely restricted. Among the principle causes of this, we can refer to the cumbersome regulatory frameworks still in place and the consequences of SME's informal practices. In effect, informal practices (especially the practice of consistently under-reporting trading, profits, etc) necessarily restrain the extent to which local firms can be identified as credit-worthy by the banks based on objective assessments of balance account sheets and profit and loss statements.

The third area fortifying the 'hub and spoke' relationship is related to human capital. Migration flows from the Balkans into the EU are fundamentally the result of an exit choice, mainly on behalf of a young labour force. These flows peaked during the 1990s with the disintegration of Yugoslavia and the end of Albania's isolationism, but continue steadily still today. This has resulted in significant remittances that helped provide a source of financing for the local economies and a financial support system throughout the transition phases for those who stayed behind. But it has also resulted in unbalances and gaps in the local workforce and society.

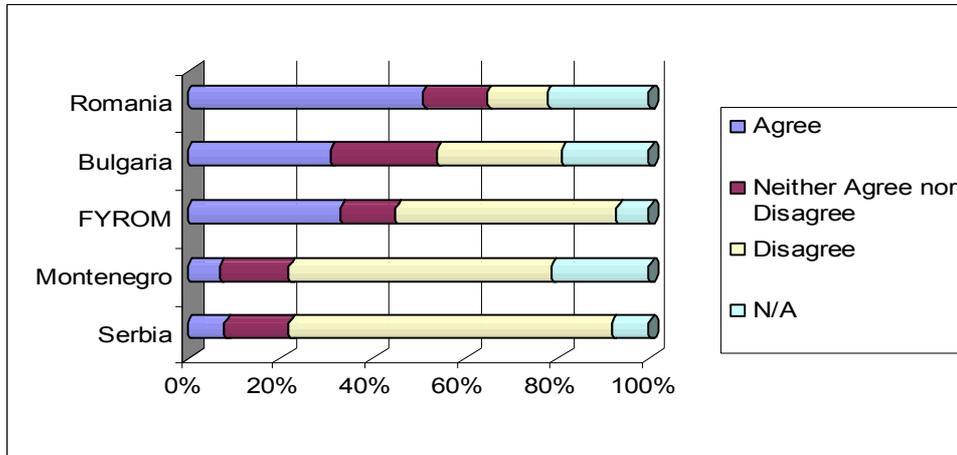
These migration flows were not only a result of push factors from the economic and socio-political situation across the region (conflict, unemployment, etc). They were also triggered by pull factors from the EU Member States that were able to take in this immigrant labour force not only in response to refugee and asylum applications but also because of the economic advantages associated with an inflow of an immigrant labour force.

In effect, a young immigrant labour force tends to contribute to an increase in jobs and to more efficient production solutions since it supplies a flexible labour pool. This migrant labour force contributes to growth and job creation in certain sectors in many EU Member States (Greece and Italy are illustrative of this), while raising an entirely different set of challenges mostly associated with inclusion, socio-economic cohesion and integration. Indeed, difficulties were raised with regard to the degree of their acceptance particularly in the new host migration countries exacerbated with an inefficient handling of the regularization processes. This has rendered migrants' legalisation difficult, time-consuming and very expensive, while it has frequently made their status and security in the host country vulnerable. Efforts have been made over the past couple of years to improve their regularisation and to address the restricted enjoyment of citizenship rights, but there is still a long way to go across most EU Member States.

This is not an exhaustive account of the hub-and-spoke relationship between SEE and the EU; it is merely illustrative of some of its important facets. The hub-and-spoke relationship is unlikely to change. On the contrary, after the EU accession of Bulgaria and Romania, the non-EU part of the Balkans will have shrunk significantly and the 'hub and spoke' relationship the region has with the EU will be intensified even further. From this perspective, it is a region that is being gradually integrated into the EU starting from the periphery and moving inwards.

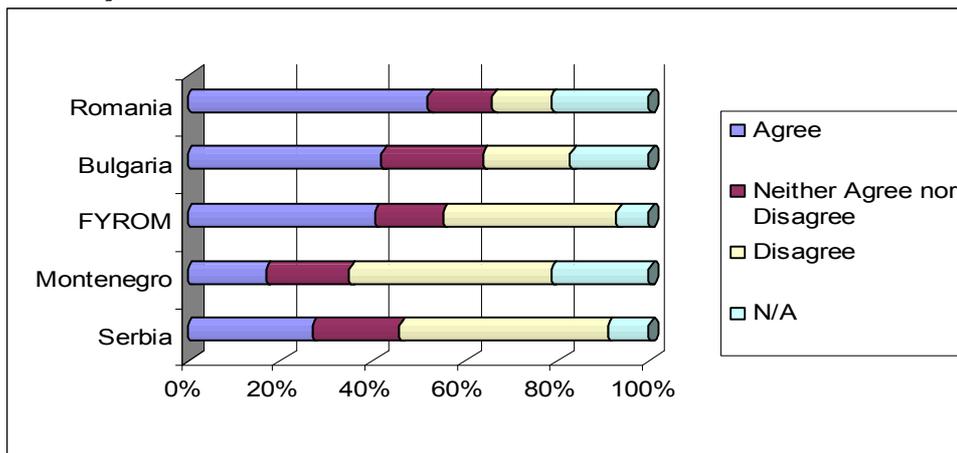
Although it is clear that EU accession is still long and difficult, and although Euro-optimism has been replaced by realism across the Balkans, the goal of EU membership remains unfaltering. There is common agreement across all countries of the region that their integration in the EU and in the transatlantic security structures is the way to consolidate and strengthen political stability and economic growth. In fact, research suggests that the closer a country is to the accession perspective, the higher the degree of trust towards the EU and NATO.

**How much do you agree or disagree with the following statements:
Graph 28. You can trust that NATO wants what is best for this country**



source: IBEU research

Graph 29. You can trust that the EU wants what is best for this country



source: IBEU research

On the basis of this, we could argue that the higher the degree of trust towards an institution, the stronger we can expect the influence, impact and ability to encourage reforms of an institution to be. In other words, higher trust in the EU translates in a stronger political leverage for the EU institutions and Member States to promote economic liberalisation, democratic consolidation and regional co-operation. This implies that the higher the trust in the institution promoting reforms, the greater the preparedness of the actor to undertake the necessary restructuring and changes. In these tired post-conflict and post-communist societies, maintaining and nurturing higher levels of trust towards the EU and the transatlantic security community will probably help in providing popular support and patience for the remaining necessary reforms. And in pushing the political elites in undertaking these reforms. For the necessary adjustments to be made, and for regional co-

operation to eventually start spilling over its benefits, the prospect of accession has to be made more tangible.

III. POLICY-RELEVANT IMPLICATIONS

EU policies focusing on institutional efficiency need to be complemented by social capital-building policies and 'perception-enhancing' policies.

- The Stabilisation and Association Process (SAP) is essentially built around a top-down approach that prioritises governance efficiency, the adoption of governance standards and institutional capacity building. For state agents and public institutions to fulfill their responsibilities in an efficient manner, independently from the pressures of privileged networks and groups, they require public support. At the very least, they require widespread compliance with regulations and formal procedures. This is necessarily underpinned by a generalised trust in state agents and institutions that are able to perform their functions on the basis of fair and equitable treatment. In these tired post-communist and post-conflict societies, where trust and patience are waning, it is important to complement the SAP with initiatives which will trigger popular consensus in support of the necessary reforms and adjustments;
- In part, this has been addressed by CARDS' focus on strengthening citizen participation, civil society at the local level and the municipal level of government. However, CARDS has limited resources and, by default, this has limited the scope and the results of its work. For the 'implementation' challenge to be met, it is not sufficient to expect that improved institutional performance will automatically generate increased trust and universalistic social capital;
- Priority needs to be accorded to strengthening open democratic political competition in parallel to 'revamping' the political institutions so that the individual institutions and the regime as a whole may be able to regain part of their lost legitimacy. The more competitive a system is, the less 'predatory' elites are capable of 'capturing' and disproportionately benefiting from state resources;
- In addition, those in favour of decentralization argue that empowering local governments is likely to increase the levels of social trust and civic participation. If national governments in the region are more decisive in transferring real resources and decision-making powers to the local levels, higher levels of social capital may be achieved (in addition to other potentially beneficial consequences associated with decentralisation). When empowering local levels of governance, however, there is a significant risk that must be taken into account: more power to local government may inadvertently increase the scope of corruption due to the higher degree of clientelistic relations between state officials/representatives and the local community;

- Improved institutional performance may increase social capital in the region. However, this is a very slow, gradual process that may not necessarily be easily identifiable. Thus, improved institutional performance must be complemented by perception-enhancing policies;
- Income-related and educational policies appear to be insufficient to increase social capital in Southeastern Europe. Therefore, explicit policies designed to address particularism are necessary to support the Balkan's 'Europeanisation' process;
- Strong external pressure for increased political pluralism and transparency is pivotal. The EU, along with other international organizations, can provide this external pressure/ motivation;
- International and EU support toward NGOs and civil society initiatives that are willing to press for higher accountability and transparency can be expected to further promote domestic mobilisation with positive repercussions on the political systems in the region.

The focus of EU policies should not be limited to public sector management and public finance sector reform. In order to make recourse to informality less of an incentive, the institutional framework in place, the micro-economic level and the extra-economic causes of informality require more targeted attention.

- Recourse to informality has to be made less of an incentive, both for local and for international firms. This is required in order to allow these markets to economically and institutionally grow closer to the EU standards;
- Regarding taxes: more moderate tax and quasi-tax rates along with simplified administrative levies may result in a significant increase in the tax base;
- In particular, research suggested that simplifying direct taxes (including mandatory social welfare contributions) eliminates incentives to informality. This was particularly noted when combined with the elimination of special exemptions and preferences;
- Efforts should also promote policies that: facilitate entry and business registration, separate inspection /controls from commencing activities, reduce the number of licenses and permits, and generally depersonalise the administrative process;
- The privatisation process tends to be better protected from the influence and/or 'capture' of informal networks if the banking sector is privatised before the other sectors of the economy;
- Other conditions that are necessary for the privatisation process include the following: the privatisation agency must be as immune as possible from political patronage considerations, and the necessary regulatory and institutional framework (i.e. bankruptcy law, corporate governance, regulation concerning mergers and acquisitions, etc) must be set up before embarking on large-scale privatisation projects;
- Extending EU competition policy and anti-monopoly measures to the region should be further pursued. This is particularly relevant in cases where the state and private monopolies (especially foreign firms or

banks), may have slowed down the integration process and exacerbated the misallocation and even misappropriation of resources;

- The integration process with the EU may have certain formalising effects. Experience in the (Bulgarian) pre-accession period suggests that foreign-investment friendly legislation may facilitate foreign entry into sectors in which informal practices were widespread, thereby, diminishing the size of the informal economy;
- EU accession is expected to affect the ways in which firms do business in these countries principally through external institutional shock. For instance, by significantly improving the judicial system and increasing the technical requirements (through the adoption of EU directives). The potential benefits of resorting to formal contract enforcement mechanisms may equally be increased. At the same time, up-scaling the costs of violating rules and regulations may eventually provide an incentive towards more formal behaviour (providing the firm can bear the compliance cost without losing the competitive advantage);
- In parallel, legislative reform should take into consideration the ability of national administrations to enforce new regulations and the ability of businesses to comply with these. A system able to assess the impact of new regulations would be useful in order to also avoid the risk of over-regulation and added bureaucracy.

There remain many unexploited opportunities in SEE and the EU's role as a promoter of regional co-operation remains indispensable. The Union must persevere in promoting multilateralism and co-operation across all sectors of trade and finance within the region. This is not only necessary for the Balkan countries' integration in the EU, it is just as important for the EU's influence and political leverage in region.

- As long as EU-SEE relations are defined in hub-and-spoke terms, regional co-operation can only be achieved through increased outside intervention. Thus, with respect to the individual countries and the region as a whole, the EU will have to alternate in its role as an anchor, a destination, a co-ordinator and an intervener;
- Co-operation in fiscal policies across the region should be encouraged for the following reasons: to simplify and render fiscal systems more transparent; to decrease the influence of local business lobbies and networks on tax policy aiming at retaining monopoly positions in the area/country; to reduce taxes where possible so as to lower the cost of 'doing business' and to limit 'preferential' exemptions;
- Equally, co-operation with regard to exchange rate policies across the region³¹, would be similarly useful. This is especially warranted given that exchange rate misalignments and shocks due to risks of devaluation affect intra-regional trade;

³¹ For instance through an indirect exchange rate co-ordination using the euro as an anchor.

- SEE is a transit region and there remain unexploited opportunities for trade and investment. Service sector liberalisation has to go hand in hand with convincing all sides that cross-border infrastructure and investment projects may be beneficial to all involved. The role of the EU in inducing local public actors to co-operate and in raising the necessary funds is, of course, pivotal;
- Given the choice between a multilateral free trade area and a customs union with the EU, the latter would be preferable since it is more in line with the prospect of EU integration. Regrettably, this is not an easy option at the moment primarily because the differences between the various Balkan countries are too varied (in terms of status of relations with the EU, economic indicators, etc), but also because the individual countries naturally give a higher priority to furthering their individual negotiations with the EU than those with the other countries of the region;
- In parallel, expanding intra-regional infrastructure (road and rail) is important to encourage and facilitate increased communication, business, travel and transportation between neighbouring countries in this region. This is necessary for trade and to bring neighbouring populations closer together in order to overcome the 'perceptions gap' and increase positive social capital across territorial borders.

The EU must be bold in maintaining the accession momentum and in supporting push and pull factors to transform the domestic political agendas and economic strategies. Improved and wider access to pre-accession programmes for the entire region will avoid the creation of deeper disparities between regions, countries, economies and social groups and will support each country's route to the EU.

- Although the relaxing of borders between the EU and SEE would not provide for an immediate boost to the region's economy, it would nonetheless have a significant soft-security impact and contribute to regional stability;
- The EU learning and socialisation process is suited to sharing information, experiences and expertise. The EU is now facing the huge challenge of 'reflecting' on its constitutional future, 'digesting' its recent enlargement and the future enlargement tests. At the same time, the new Member States have significant expertise to pass on and cannot become introvert. The countries of Central and Eastern Europe have faced similar post-communist (though naturally not post-conflict) trials and have recently undergone the accession experience. They have experienced the challenges of transition, notably of meeting the so-called EU standards, implementing the *acquis*, liberalising their markets, modernising their administrations, etc. It is important that this experience be shared. Just as important is the experience that older Member States (and especially Greece given its geographic position) can impart, particularly in addressing economic underdevelopment of certain rural regions, and absorbing cohesion and structural funds;

- On the EU side, EU efforts must equally focus on increasing the visibility of the positive aspects of immigration, particularly in the new host countries. Campaigns promoting immigration-friendly attitudes need to promote multi-cultural tolerance and cultural inter-connections. They must equally factor into their objectives measures aimed at easing the fears of potential 'losers';
- Restrictive immigration policies have been associated with an increase in illegal immigrants who frequently resort to informal networks (mostly by necessity). These networks facilitate the spread of informality, the growth of shadow economies and even the spread of organised crime within the region and within the EU. Visa requirements for SEE nationals ought to be reconsidered to encourage interaction, communication, legal travel and exchange (especially for some groups such as businesspersons, students, journalists, etc), thereby bridging the SEE countries among themselves and with the EU;

The pace at which the countries of SEE are integrated in the transatlantic security community must be re-invigorated, and the countries of the region must maintain the highest level of political commitment to their integration in Euro-Atlantic structures.

- Internal EU hesitancy to speed up the enlargement process is reasonable given current challenges. However, the EU is a core factor in providing the necessary push for further transforming the domestic political and economic agendas. Rendering candidate status tangible makes the prospect of eventual membership more realistic, more constraining and more of a catalyst for the much needed reform and co-operation throughout the region;
- The co-ordinated efforts of all the DGs and services of the Commission, and closer co-operation with the Stability Pact, in addressing the socio-economic challenges the Balkans face must be further supported. It is through this concerted effort that the EU's soft-power capabilities can best be put to use in nurturing a security community of integrated economies and stable democracies;
- Speeding up the NATO accession of Albania, Croatia and FYROM on the basis of their Membership Action Plans ought to also be a priority. For this, close co-operation between the EU and the US is essential;
- Integrating Bosnia and Herzegovina, Serbia and Montenegro in the transatlantic security community is just as imperative. These are still outside security structures, including the Partnership for Peace. There are reasons for this exclusion, namely that certain notorious war criminals are still at large, but security continues to be the key problem for the regions in all accounts and across all spheres. NATO is the only security umbrella that can induce local politicians to speed up transformation of local armies and the dismantling of paramilitary forces.

IV. CONCLUSION: INTEGRATING THE BALKANS IN THE EUROPEAN UNION

The real value of regional co-operation is certainly not limited to economic gains. It may largely be found in its socialising effects for SEE: in the re-learning of norms and behaviour of co-ordination and co-operation, and in the normalisation of relations that gradually results from this interaction. These are important 'training' exercises in terms of working together and acquiring experience in implementing agreements and projects – experience which will significantly contribute to their efforts towards EU membership. This is especially pertinent given that EU membership essentially involves co-operation, co-ordination and strengthening institutional capabilities. The accession process has been defined as serving as 'a catalyst for change, accelerating the implementation of complex and difficult political, institutional and economic reforms.'³² For this socialising effect to produce the desired security community we require more time, more effort and more funding. It appears that the region may be running thin on all three.

All the countries of the region have affirmed and reaffirmed their European vocation. The key challenge ahead for them now is to materialise the prospect of EU candidate status. The EU is and will continue to be the dominant partner for SEE. The region on its side is expected to show its aptitude to further normalise relationships within the region and with the rest of the EU and to address the infamous 'implementation challenge.' For the reforms and for regional co-operation initiatives to really take off, the long-term prospect of eventually joining the EU without additional incentives is insufficient. For a country or a region to put its long-term EU goal ahead of its internal problems, a clearly defined path toward EU membership is required to anchor expectations and provide incentives.³³ Equally, for the countries of SEE to avoid 'ghettoisation' and maximise their EU-accession potential, they need to enhance their institutional absorption capacity and their ability to adopt and implement the *acquis* in an efficient manner.

Over the past four to five years, there have been calls on behalf of the EU for more regional ownership, for a greater commitment on behalf of the countries of Southeast Europe to take on deeper reforms and meet the EU candidate criteria. On behalf of the SEE countries, there have been just as many calls for more political commitment on behalf of the EU, for improved instruments, for more targeted approaches, for less overlap and for greater consistency. It could be argued that both sides have come a long way, though granted, not far enough.

The EU's approach towards the region has made huge leaps in the right direction. Indeed, there is agreement in both the EU and in the region itself

³² COM (2004) 202/2 final, 30 March 2004

³³ See IBEU paper by Gligorov V., "Southeast Europe: Regional Co-operation with Multiple Equilibria," 2004, www.eliamep.gr .

that overall, significant progress has been accomplished both in the economic and political spheres. However, the challenges that now lie ahead are in the implementation of the legislation and of the *acquis* that has been/ is being adopted. On the path to EU accession, the devil is in the detail. For the countries of SEE to be able to take on this challenge, a clearer 'carrot' and a more solid support network ought to be provided.

On the EU side, the stakes are just as high and the challenges are just as testing. In effect, at the heart of EU policies towards the Balkans lies the fragile balance of managing between the regional approach that is necessary for constructing a prosperous security community, and the principle of evaluating the progress of each country on the basis of its individual merits. Moreover, the ratification process of the EU Constitutional Treaty illustrated the strong underlying tensions that exist within the EU on matters of deepening that have been accentuated by the recent enlargement fatigue. With the 'deepening' axis currently in disarray, it seems unlikely that any further steps along the 'widening' axis will be able to be taken swiftly. The EU internal developments, it seems, might necessarily delay the EU accession timetable of the Western Balkans. This will unavoidably have both political and economic implications for the region.

As the history of EU integration and enlargement clearly testifies, the most successful foreign policy instrument and catalyst for democratic consolidation and for sustainable security on the European continent has been the clear and unequivocal perspective of EU membership. The EU has provided this to all the SEE countries through its political declarations, through the modeling of the Stabilisation and Association process and the European Partnerships, and more recently, by including the Western Balkans in the portfolio of DG Enlargement of the European Commission. However, emphasis remains instilled in expanding and enhancing the pre- pre-accession process.³⁴ For the efforts and reforms that are associated with the perspective of EU accession to regain momentum and overtake the current fatigue that appears to be settling in on both sides, this process has to be revamped.

It is crucial that the Western Balkans do not cease being a priority after Bulgaria and Romania's accession. In part, the momentum can be found in making candidate status more accessible, more within reach. From there, the stepping-stones and the timetable to accession ought to be purely determined by the merits and the efforts of each state.³⁵ The timetable that tends to be

³⁴ See IBEU WP2 Andreev S. & Bechev D., "*Top-down v Bottom-up aspects of the EU institution building strategies in the Western Balkans*", 2004, www.eliamep.gr

³⁵ As the EU Commission itself has repeatedly stressed, each country will proceed towards membership on its own merits and at its own speed. This will be based on evaluations and assessments of the fulfillment of SAP and of the fundamental accession criteria. In other words, this is based on the political, economic and institutional criteria generally referred to as the Copenhagen criteria, the criteria specific to the Stabilisation and Association Process, and, where relevant, full co-operation with the International Criminal Tribunal for the former Yugoslavia, respect for human and minority rights, the creation of real opportunities for

proposed identifies 2009/2010 as the time at which accession negotiations could begin, with accession set for 2014/2015.³⁶ Though the current conjuncture is not favourable in identifying such time frames, given that the decision to integrate these states has been made, granting candidate status to the Western Balkans formalises the EU's commitment to not leave an enclave of insecurity and stifled economic growth within its midst. This political decision has to be considered in spite of the tenuous challenges that the EU and its institutions are up against in digesting the fifth enlargement, moving on to the sixth while addressing the hitches and glitches that surfaced during the ratification of the EU Constitutional Treaty.

EU accession is not only the wished-for prize for the Balkans; it has equal symbolic significance for the EU. For the EU, it will represent the successful accomplishment of the much-awaited integration of the entire European continent. It will mean the EU was successful in its role as a regional anchor and a promoter of regional co-operation, in its role as catalyst and facilitator in the inter-ethnic and inter-state reconciliation process, and in spurring institutional-capacity, economic reform and growth. For the region of SEE, however, it will represent the achievement of a successful transition from a post-communist, post-conflict environment to stabilisation and to democratic consolidation. It will mean that the descriptions 'frustrated societies', 'weak states', 'market failures' will be characterisations of the past.

Annex : Background information on the IBEU Project

This Occasional Paper stems from the research that was undertaken within the IBEU Research Project

<http://www.eliamep.gr/eliamep/content/Folder.aspx?d=11&rd=5565300&f=1314&rf=1182181778&m=-1&rm=0&l=1>

The IBEU project ran from December 2002 until January 2005. It has been principally funded by DG Research of the European Commission within the 3rd call for Targeted Socio-Economic Research (FP5).

The Consortium

The Hellenic Foundation for European and Foreign Policy (ELIAMEP) was the co-ordinator. The main partners involved in this project were the LSE

refugees and internally displaced persons to return, and a visible commitment to regional co-operation. To support this effort, the European Partnerships are the instruments that have been introduced by the EU through which to identify short and medium term priorities that each state needs to address and outline a timetable and support the adoption of the *acquis*. These Partnerships will also be the basis for programming assistance (within CARDS) and supporting the region's infrastructure and market development.

³⁶ For instance see: The Vienna Institute for International Economic Studies, Special Issue on the Transition Economies, "As East You Go, the More they Grow: Transition Economies in a New Setting," Research Report 308, by Vladimir Gligorov, Josef Poschl, Sandor Richter et al, July 2004; Report of the International Commission on the Balkans, "The Balkans in Europe's Future," April 2005.

(London), IECOB (Forli), WIIW (Vienna), CLS (Sofia), IME (Sofia) and SAR (Bucharest), as well as the Southeast European Studies Programme (Oxford University).

The scope of the project

The IBEU research project studied social capital, migration flows, the informal sector and the prospects for regional co-operation in different economic sectors within and across Southeastern Europe. It focused on these areas through the lens of the changing nature of borders and security. Through a more perceptive understanding of the cleavages in and within this region, IBEU's aim was two-fold. It aimed at contributing to a deeper understanding of the key factors and of the underlying mechanisms of the political economy and society of the Balkans. It also scrutinised the current state of relations with the European Union.

To this intent, the partners of the IBEU consortium carried out extensive empirical research. This research was principally carried out in Bulgaria, Romania, Serbia and Montenegro, FYROM, Croatia as well as in Italy and Greece. Our research combined sociological surveys, qualitative interviews, focus group analyses, literature review, economic and statistical analyses and ethnographic fieldwork, thereby bringing together the perspectives, the tools and the methodologies from various disciplines of the social sciences. Thus, the project's empirical research on the informal sector and regional co-operation along with our sociological surveys on social capital and migration flows have explored the influence of borders, both formal and informal, in shaping socio-economic developments in the Balkans.

The project's structure

WP1 consisted of elaborating the theoretical framework and of ensuring consistency in the theoretical background among the various workpackages. This involved a kick-off meeting that was organised in the first month of the project where the concepts of security and borders were discussed. In addition, the scope of each WP was more clearly defined. The State of the Art Report on the changing notion of borders and security was also published in an article form in the *Journal on Southeast European and Black Sea Studies* (Frank Cass, London) in January 2004.

WP2 concentrated on civil society in Romania, Bulgaria, Serbia and Montenegro and FYROM and explored the concept of social capital in order to understand the dividing lines that exist within these societies and the factors that determine these dividing lines. Social capital was studied in terms of trust among population groups within each country and towards the state institutions. The survey that was conducted through the IBEU in these countries shed light on the factors that influence positive and negative social capital. In addition, workshop meetings were held in Sofia and in Bucharest to derive comparative conclusions from the analysis of each country's data and to further develop the concept of particularism with respect to Southeast Europe.

WP3 studied informal networks and the informal economy in the Balkan region. Special emphasis was placed on Bulgaria and Croatia for the case studies on the role of informal networks in influencing the privatisation process. Bulgaria was also the principal case-study for the survey on factors that function as incentives for firms to operate 'in the shadows.' This empirical data provided concrete information on the factors and conditions that lead domestic and international firms to conduct parts of their activities in an informal manner. In addition, research conducted within the WP estimated the size of illegal trade in the region.

WP4 focused on regional co-operation. The region's rail and road infrastructure was studied in order to understand practical factors that may hamper or encourage cross-border trade and communication patterns. In addition, regional trade and trading patterns within the region and between the region and the EU were studied to identify the areas and sectors with potential within which co-operation at the regional level can be further pursued. The banking sector was also studied as a case-study of heavy foreign investment, illustrating the extent of the 'hub-and spoke' relationship that exists between SEE and the EU even further. In addition to the workshops, two conferences were held within the scope of this WP – one in Vienna and one in Belgrade – that provided the opportunity to discuss the challenges to regional co-operation with academics, policy-makers and officials from the countries of SEE.

WP5 explored migration trends within the Balkans and between the Balkans and the EU. With regard to internal migration trends, particular emphasis was placed on forced migration and rural-urban migration flows as a result of the disintegration of Yugoslavia. With respect to migration from this region and into the EU, our WP focused on Albanian migration into two relatively new EU host migration countries (Greece and Italy) that have been profoundly affected by the inflow of an Albanian workforce. This involved extensive surveys with Albanian immigrants and with employers of Albanian immigrants. A workshop and an edited volume on migration flows in Europe are among the key outputs.

WP6 brought together the conclusions and policy relevant implications of the research conducted by the IBEU research partners. In an interim meeting in Athens and in the final conference that was held in Brussels the final results of this inter-disciplinary research and of the empirical findings of the two major surveys that were conducted within IBEU were presented to a wider audience of policy-makers, EU officials, diplomats, journalists, economists and academics.

This paper essentially provides a synthesis of the IBEU project's key research. It also incorporates some of the issues discussed at the interim IBEU workshops and, references to the individual workpackage papers are duly

noted throughout. Intellectual debt to the entire IBEU research team and the participants of the workshops is herewith acknowledged.

The graphs presented here draw from the survey undertaken within WP2 in 2002-2003. The questionnaire was drawn up by the Romanian Academic Society (SAR) based on the World Bank projects on social capital organised the research in Romania along with the CURS (Center for Urban and Regional Sociology. Romanian sample of 1,600 random respondents was nationally representative. The Centre for Liberal Studies (CLS) was responsible for carrying out the questionnaire survey in Bulgaria, FYR Macedonia, Serbia and Montenegro), with the assistance of BBSS Gallup International. In Bulgaria and FYR Macedonia, country was stratified in regions and the random sample size was 1,021 respondents in both cases from across the countries. The same method was used in Serbia and Montenegro with 816 and 402 random samples respectively.

For further reading (available at www.eliamep.gr)

List of IBEU Papers per Workpackage

WP1: Introduction and theoretical framework

Gropas R., *"Functional borders and sustainable security: Integrating the Balkans in the EU and EU-Balkan relations,"* State of the Art Report

WP2: Civil society & social capital

Sotiropoulos D.A., *"Social Capital in Southeastern Europe: Conceptual, Empirical and Policy-Related Aspects."*

Ganev G., Papazova Y., and Dorosiev R., *"Social Capital in the Balkans: Are Socio-Demographic Factors Important? Can Policy Assumptions be Supported?"*

Mungiu-Pippidi A., *"Deconstructing Balkan Particularism: The Ambiguous Social Capital of Southeastern Europe."*

Bechev D. & Andreev S., *"Top-Down Versus Bottom-Up Aspects of the EU Institution Building Strategies in the Western Balkans."*

WP3: The informal sector

Bojicic-Dzelilovic V., *"Informal Sector in the Balkans."*

Stanchev K. (ed), *"Report: Study of Incentives, Characteristics and Strategies of Firms Operating 'in the Shadows'."*

Barrett E., *"The Role of Informal Networks in the Privatisation Process in Croatia."*

Bojkov V. & Bojicic-Dzelilovic V., *"Informality in Post-Communist Transition: Determinants and Consequences of the Privatisation Process in Bulgaria."*

Gligorov V. & Holzner M., *"Illegal Trade in SEE."*

WP4: Regional co-operation

Gligorov V., "Southeast Europe: Regional Co-operation with Multiple Equilibria."

Christie E., Gligorov V. & Holzner M., "Infrastructural needs and economic development in SEE: The case of Rail and Road Transport Infrastructure."

Christie E., "Trade flows in SEE."

Stubos G. & Tsikripis I., "Regional Integration Challenges in SEE: Banking sector trends."

WP5: Migration

Bianchini S. & Chiodi L., "The Borders of the Polity: Migration and security across the EU and the Balkans."

Lyberaki A. & Maroukis T., "Supply of and demand for immigrant labour: comparing Albanians in Athens and Emilia Romagna."

Sekulić T., "Forced migration and perception of borders: war-migrant associations as a resource of integration."

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