

Sustainable development and EU integration of the Western Balkans

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**Tripartite High-Level Regional Conference
of Pan-European Trade Union Council:**

***Taxation, Informal Economy and Corruption
in the Western Balkans***

Sarajevo, 9 November, 2015

Western Balkans

Conference → Taxation, Informality, Corruption
Closely related & very important

Issues

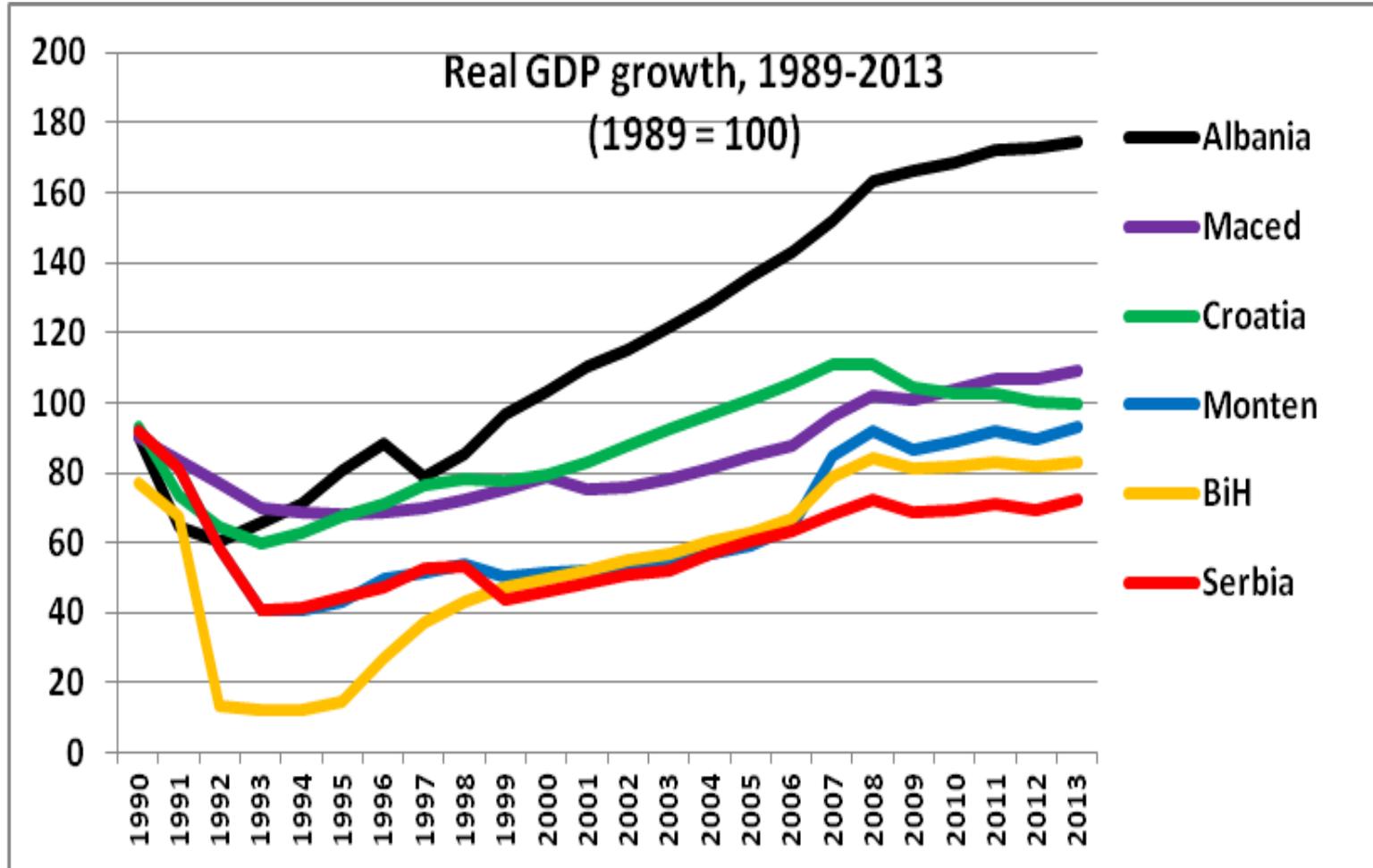
- 1. Western Balkans: where are they today?
- 2. Effects of global economic crisis
- 3. Taxation systems & investment policies
- 4. Prospects

1. Account of 25 years of transition

- **November 2014** : A quarter of a century since the fall of Berlin Wall
→ The overall account of transition, 25 years later?
- Branko Milanović (2014): *For whom the Wall fell? A balance sheet of the transition to capitalism*
→ Countries grouped according to level of development (GDP/cap) & income inequality (Gini coefficient)
- Worst off: 7 countries that by 2013 have still not reached GDP/cap achieved in 1990 & inequality highest → includes Bosnia & Herzegovina and Serbia; only Albania among the success cases
- Milanović : “The Wall fell only for some” → Only 1 out of 10 people have seen a successful transition to capitalism and more democracy

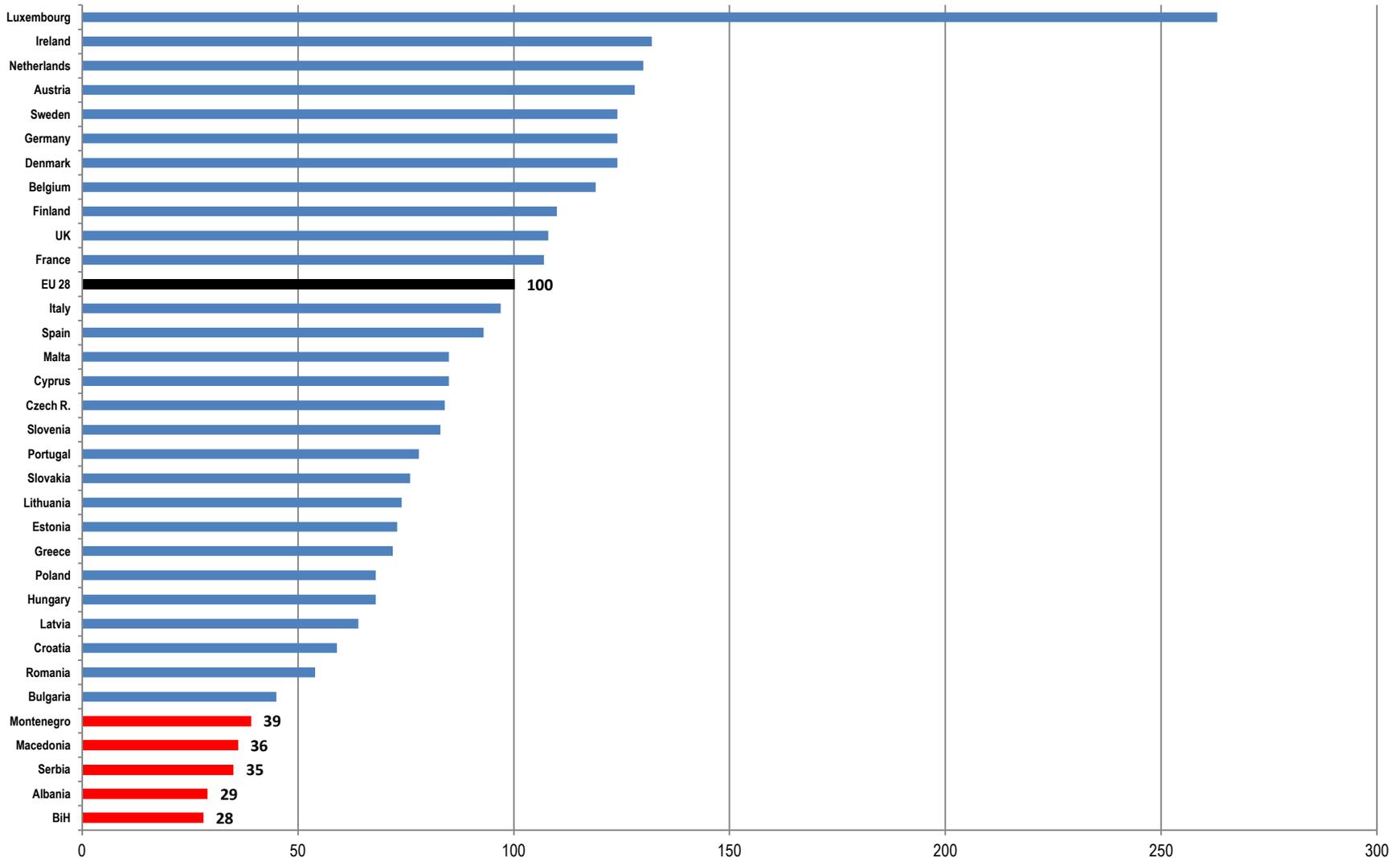
Account of 25 years of transition

By 2013 only 2 countries – Albania, Macedonia - have surpassed 1989 level of GDP



Account of 25 years of transition

2014: Western Balkan countries at 28-39% of aver. GDP/cap in EU28



Account of 25 years of transition

- **Increasing inequality:** not only because of income inequality, but also because of wealth inequality

Thomas Piketty: *Capital in the 21st Century* (2014)

- **Wealth inequality:** due to increasing income from ownership of capital, real estate, financial assets (profits, rents, interest, dividends)

Rate of return on capital > Rate of economic growth

→ Wealth has grown faster than output, concentration of wealth in the hands of owners of capital/real estate (rentiers)

- “A social state for the 21st century” → must include progressive taxation of not only income, but also of capital!
- Many arguments why inequality is not good for economic growth and development → Society is not using the full potential of all its citizens + Contributes to social tensions, instability ...

Extremely relevant for the Western Balkans

Account of 25 years of transition

Social differentiation in the Western Balkans

- Huge redistribution of income and wealth (since the early 1990s), through various channels:
 - Hyperinflation (State as main debtor: benefitted most)
 - Loss of citizens savings (freezing of bank accounts, financial pyramid schemes)
 - Illegal trade/underground activities, stimulated by wars and sanctions (“war profiteering”), benefitted those close to economic and political elite
 - Privatization (only some winners, many losers)
- Aggravated by: inadequate systems of taxation, inefficient judiciary, corruption... → Slow institutional change

2. Effects of the global economic crisis

- **Late 2008:** Western Balkans negatively hit by two external shocks
 - Sharp fall in foreign capital inflows (FDI, loans, remittances)
 - Reduced demand for exports on foreign markets
- **Western Balkans among the most vulnerable:**
 - *Current account deficits* → Covered by inflows of foreign capital
 - *Dependence on trade with EU* → Highly unbalanced (exp < imp)
 - *Banking systems* → Mainly foreign-owned, risk of capital withdrawals due to financial problems in parent banks (West)

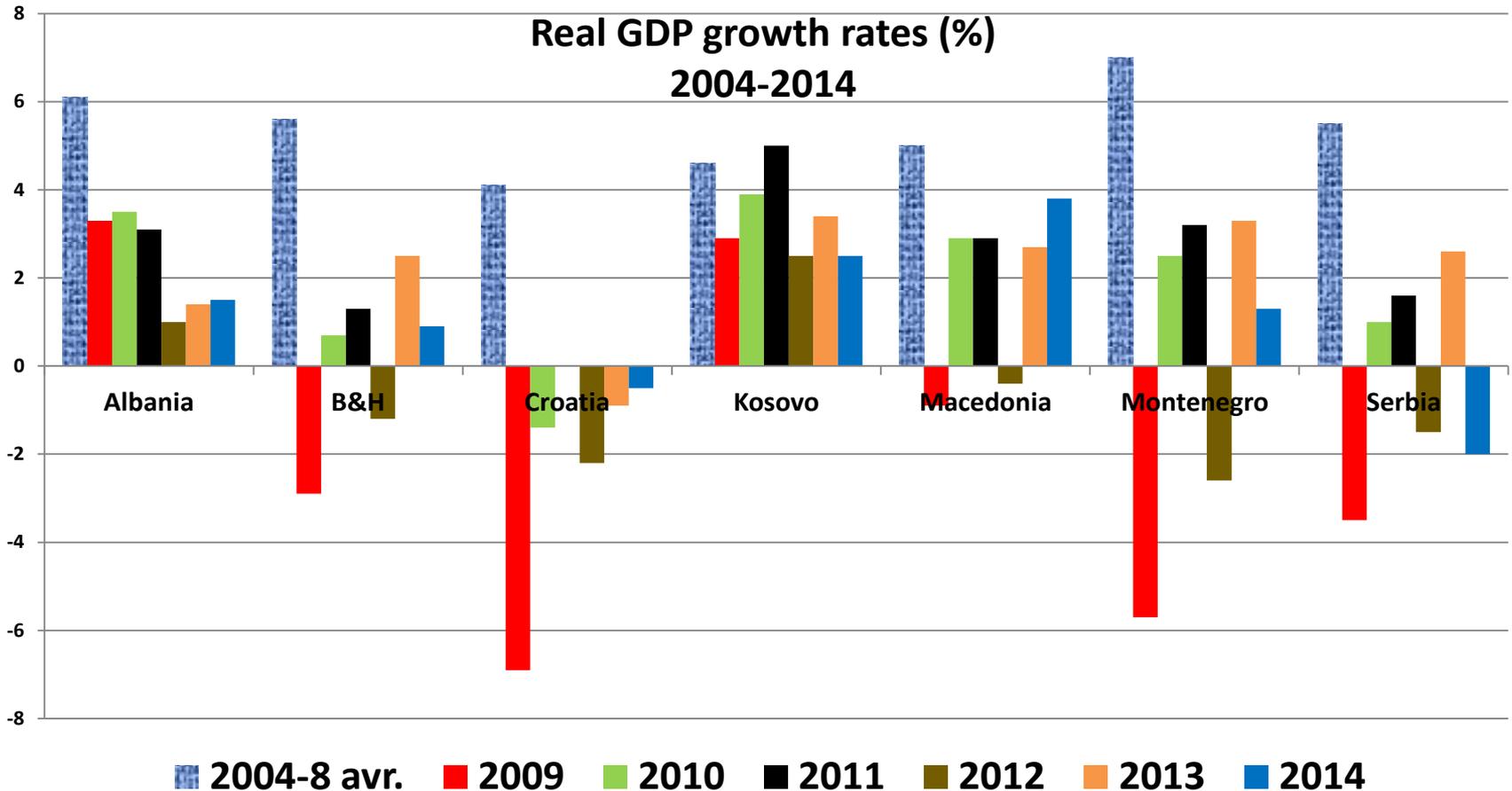
Effects of the global economic crisis

Global economic crisis (2009-2014): Many negative effects

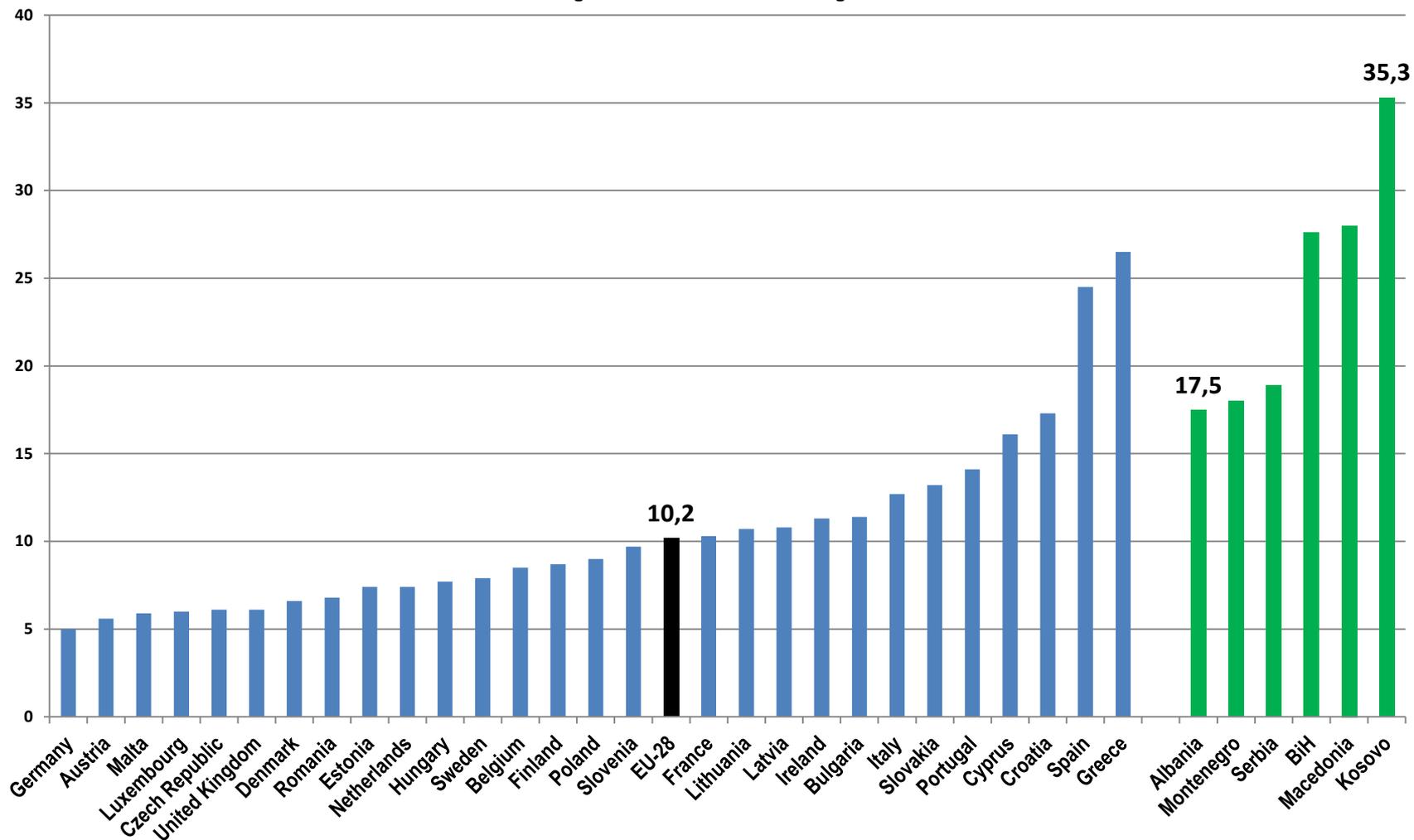
- ***Economic growth***: six years of slow (or no) growth of GDP
- ***Further increase in external debt***: foreign borrowing, IMF SBA, more flexible exchange rate policy (Serbia)
- ***Rise in public debt***: stimulus programs helped economic recovery, but increased public debt... → Austerity measures (negative effects on growth, government revenues)
- ***Labour market***: deterioration of main indicators → rise in unemployment, very low employment rates ...

Effects of the global economic crisis

2014: GDP growth rates *well below averages in 2004-8*

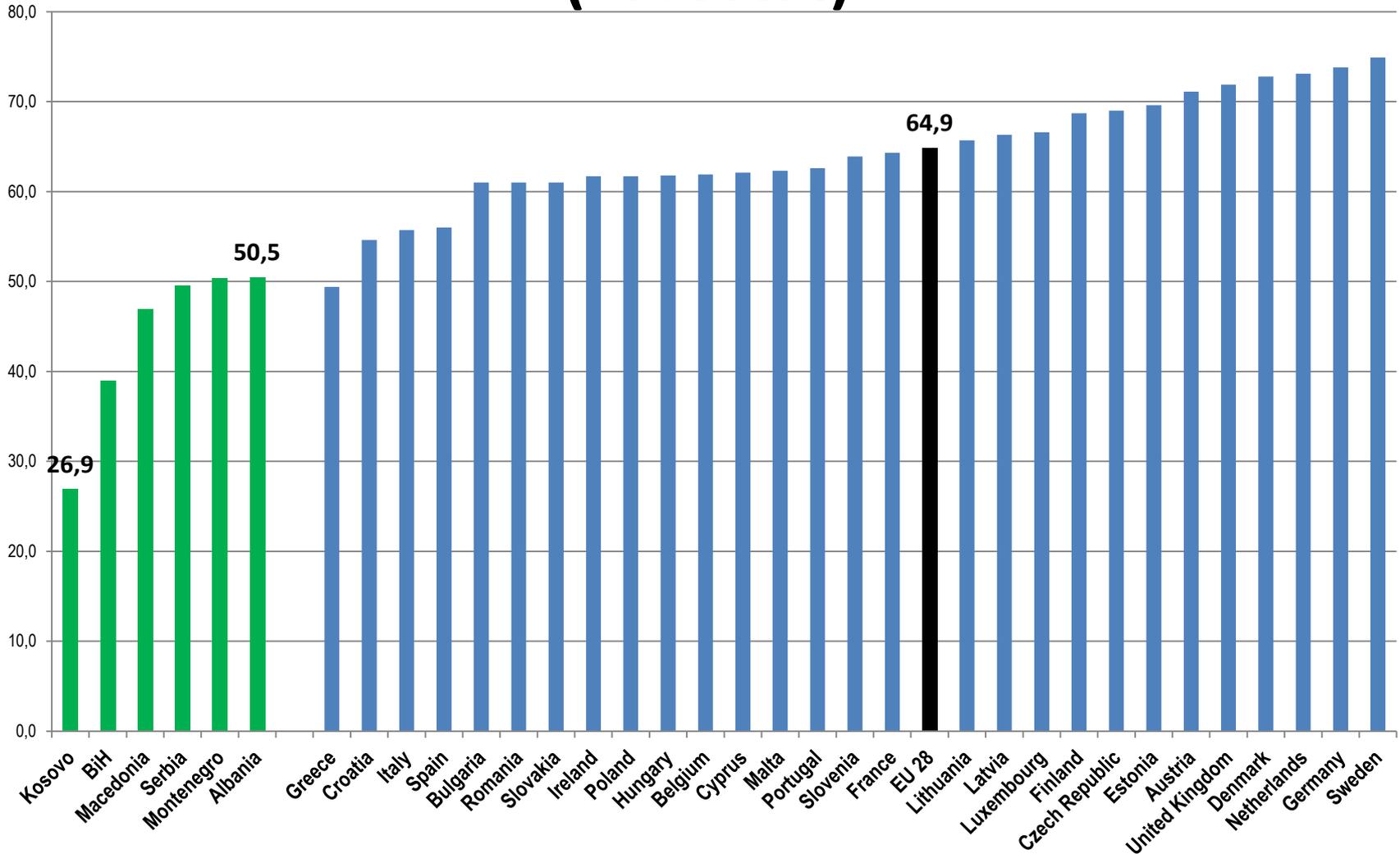


Unemployment rate (2014) (Eurostat)



Employment rate (2014)

(Eurostat)



Effects of the global economic crisis

- **Economic crisis** → brought to the surface many structural problems of Western Balkans (incl. labour market)
- ***Key features of labour market***
 - Phenomenon of “jobless” growth: high unemployment, low employment... → long-term problem
 - Widespread informal sector
 - Public sector wage premium (higher than in private sector)
 - “Brain-drain” → emigration, eroding the demographic base
 - “Brain waste” → inadequate occupations (“over-education”)
- Worrisome: these problems have persisted in time
- Among the causes: inadequate systems of taxation

3. Systems of taxation

Taxation systems in Western Balkans

- Very low personal income tax & corporate tax (flat tax)
- High social security contributions (only in Kosovo low)
- Dominance of indirect taxes (VAT and excises)
- Property tax: only since recently (low and inappropriate)

Some key features:

- *Unfair* (not sufficiently progressive) → ILO (2011): more progressive taxation
- *Inefficient*: revenues prevalently from indirect taxes → more direct taxes

Common assumption behind such taxation systems

- (1) Attract FDI (create jobs, increase wages ... spillover effects)
- (2) Create conditions for eliminating informality, thus accelerate preparations for EU accession → *Is this realistic?*

Systems of taxation

(1) Do fiscal incentives have a role in attracting FDI?

- UNCTAD (WIR, 2015): Redundancy of many schemes for attracting FDI, as they are often inefficient and ineffective
- Still, used worldwide → Tax incentives are one of the few available tools that can help overcome specific disadvantages + also steer investment into priority areas

Experience with FDI in W. Balkans?

- *Not sufficient* to reduce taxes/improve institutional environment to attract FDI
- Balkans may still face an “image problem” (Estrin and Uvalic, 2014):
- Investors often perceive the region as not sufficiently attractive
(Econometric model that takes into account standard determinants of FDI: shows that Balkans, in comparison with other transition economies, have received less FDI → there is a “negative Balkan effect”)
- Determinants of FDI: not only endogenous factors (= policies), but exogenous (= given)
→ *Even the best policies cannot eliminate some disadvantages* (such as smallness, fragmentation, lack of economies of scale, political risk ...)
- *FDI does not necessarily lead to positive spillover effects* (employment, exports) due to institutional weaknesses (low absorptive capacity) (Estrin and Uvalic, 2015)

Systems of taxation

(2) Can such taxation systems reduce informal activity/corruption?

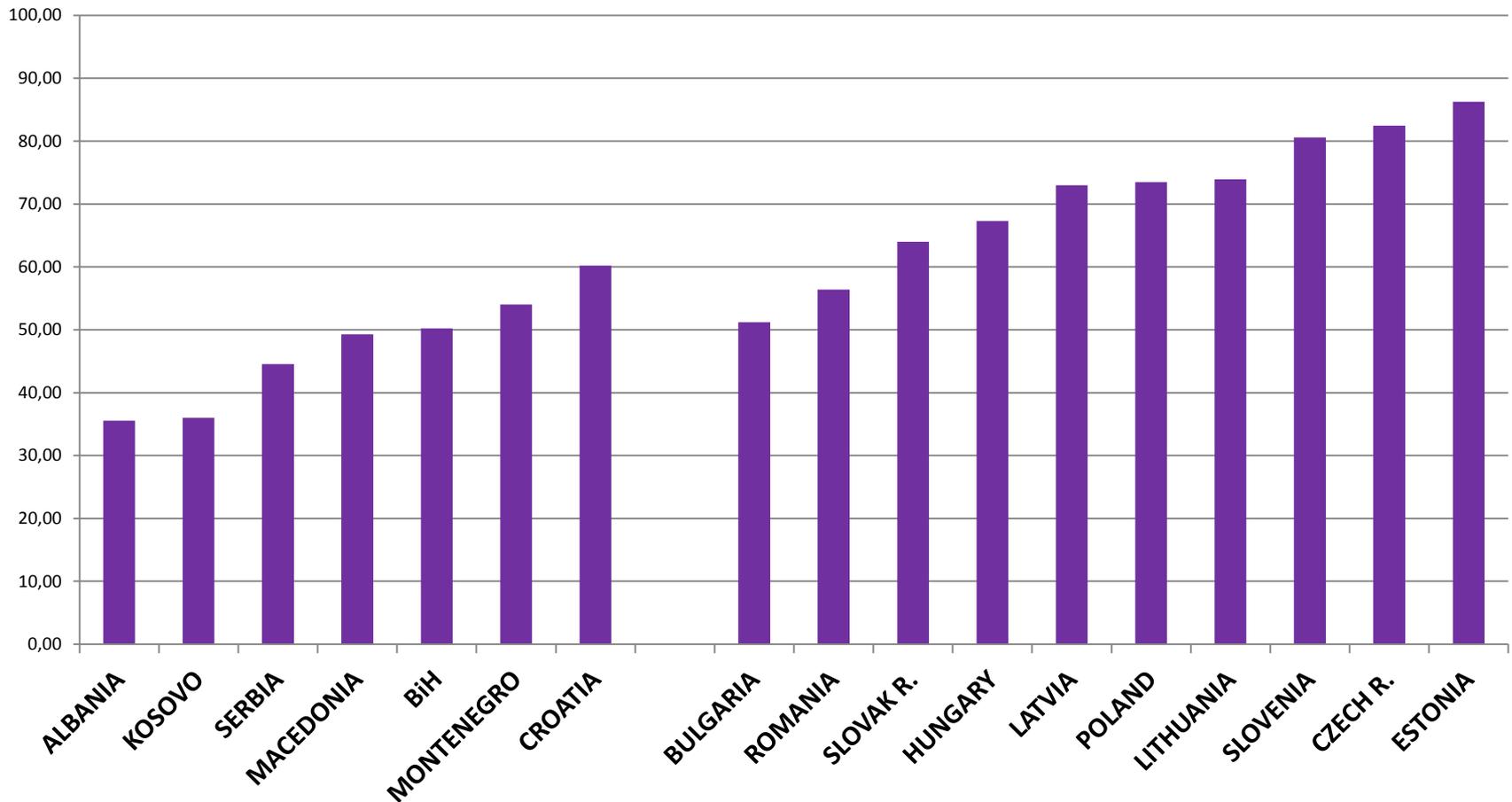
Not realistic, if other measures are not implemented:

- ***Rule of law*** → Efficient judiciary, effective implementation of laws ...
- ***Improvement of business environment*** (Doing Business Indicators)
- ***Better organization of tax administration***
- ***More efficient control of tax evasion*** → Improve financial control & system of collecting information on citizens income and property (sanctions)
- ***Better mechanisms of fighting corruption*** → Effective reforms of the public administration ...

- If there is no rule of law/financial control of firms → A key element of a firm's competitiveness becomes its ability to avoid paying taxes!

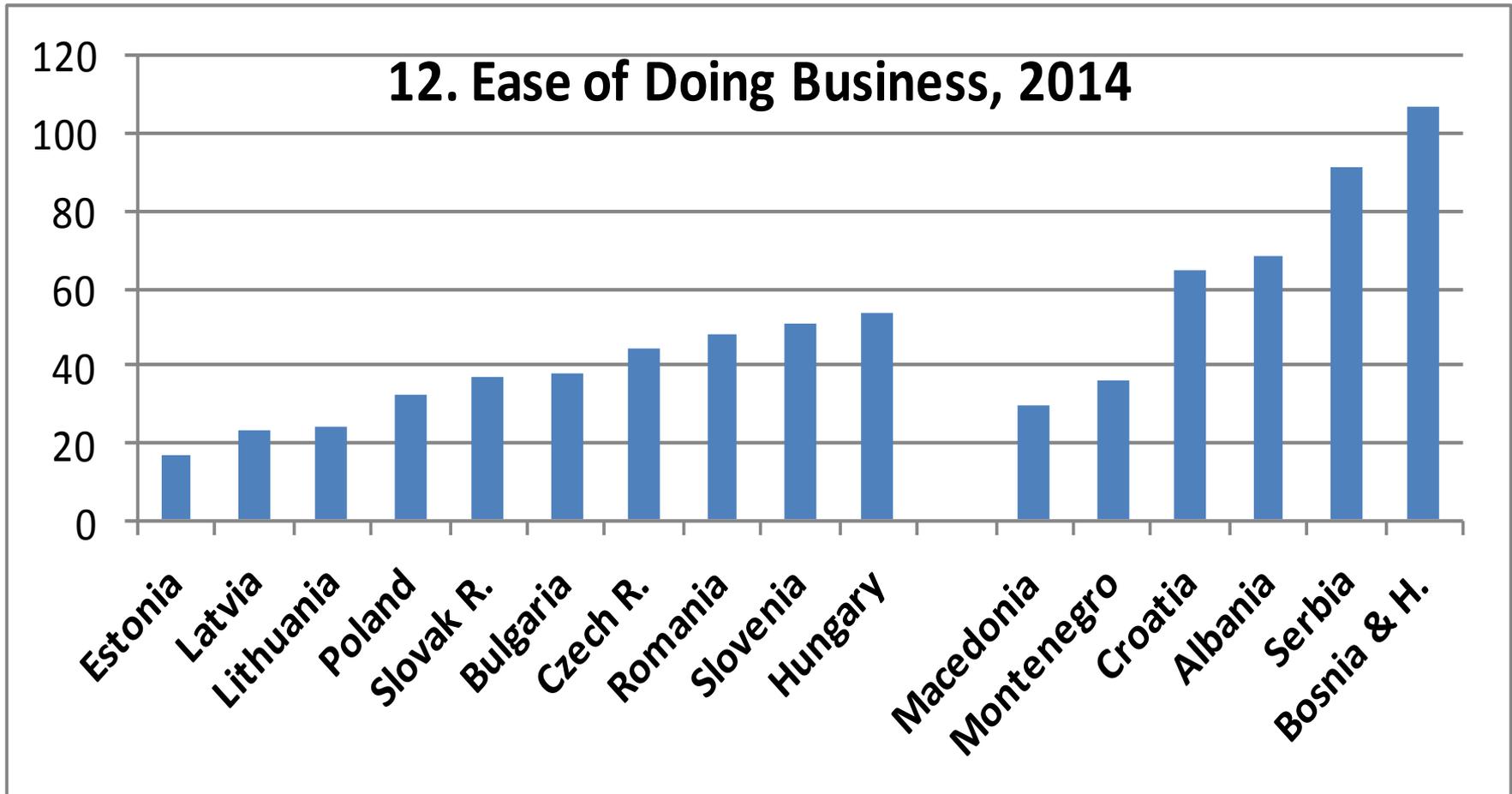
Rule of Law, 2013

(World Bank)



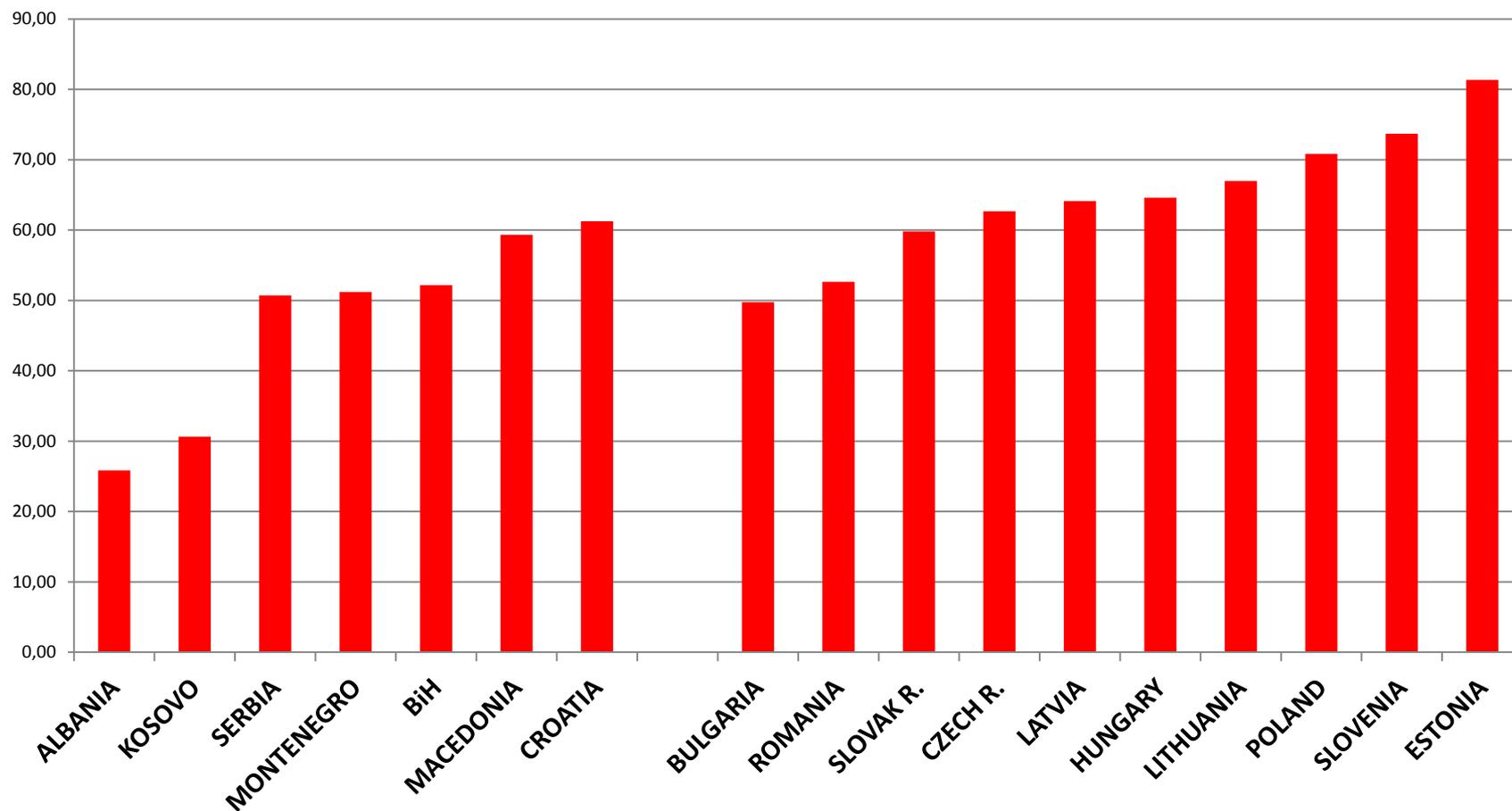
Doing Business Indicators, 2014

(World Bank)



Control of Corruption, 2013

(World Bank)



5. Prospects

Growth prospects after 2015? Uncertain, though improving ...

- ***Western Balkans:*** More permanent economic recovery still not in sight
- Strong economic dependence of WBs on EU → many issues beyond control of governments
- ***Policy-makers perceptions of FDI*** overly optimistic: improving the institutional environment is not enough to attract more and better quality FDI
- Despite some important deals in 2014, WBs cannot expect a large increase in FDI
 - Privatization opportunities have been mainly exhausted
 - Global FDI have not yet fully recovered (even drop in 2014)
- Governments need to rely much more on their own forces & policies
- ***More active government policies***
- ***How to influence the quality of FDI?*** Stronger link between investment promotion and industrial policy (more targeted industrial policy)

Prospects

Role of EU - Western Balkans integration process?

- **Current EU Enlargement Strategy** - New approach:
 - “Fundamentals” first, based on 3 pillars:
 - Rule of law
 - Economic governance
 - Public administration reform
- New EU approach → improvements also in areas discussed today...
 - Not necessarily through legal harmonization in taxation (EU member states: very different systems of personal income tax, corporate tax ...) – but: many lessons can be learnt from varied experience of EU member states
 - Accession negotiations → Rule of law, fight against corruption, reform of public administration...
- *Important role for trade unions*