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IMPACT OF NON-PERFORMING LOANS ON BANKS' LOAN PORTFOLIO AND ECONOMIC GROWTH IN THE REPUBLIC OF CROATIA AND BOSNIA AND HERCEGOVINA

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Abstract

Bank loans are the most important source of the banks' income and profitability. The structure of loan portfolio, such as maturity, currency, type of interest rate or credited sector, is also highly significant for banks' business performance. In the latest global financial crisis, quality of the loans sharply deteriorated, thus increasing the percentage of non-performing loans in banks' balance sheets and causing major problems in business activity for many banks. The events emphasized the importance and potential impact of non-performing loans not just on banks, but on the whole economy and society.

The aim of this article is to analyse determinants of non-performing loans, future challenges and possible solutions of high NPL ratios in Bosnia and Herzegovina and Croatia. Multiple regression analysis was conducted to determine strength and coefficient of the independent micro and macro variables (GDP growth rate, unemployment rate, Consumer Price Index, amount of bank loans and value of stock exchange indexes) on the level of non-performing loans. Obtained results indicate that GDP growth rates are significant in both countries but with opposite impact. Additionally, unemployment rate is significant in Bosnia and Herzegovina and amount of loans in Croatia.

Despite current economic expansion, banks are still slightly reluctant in

approving loans, alert of the potential growth of the non-performing loans and its effect on banking performance. In recent years, the level of NPL ratio started decreasing in both countries, mostly due to the selling or writing off loans by the commercial banks, but this level is still higher than in the comparable countries. Therefore, more effort is needed to further improve loan portfolio and enforce economic growth, with possible measures being better banks' NPL management, improvement of insolvency procedures and more transparent justice system.

Keywords: *Non-performing loans, banks, banking loans, Croatia, Bosnia and Herzegovina*

JEL: E44, G21

1. INTRODUCTION

Quality of the commercial banks' assets is an exceptionally important determinant of the entire economy. Not only does it show the business success and performance of the financial sector, but it can determine the speed and dynamic of the development at the level of entire economy by providing support and the most important source of funds, i.e. bank loans for various sectors of the economy. The well-regulated financial sector is one of the key driving wheels of a modern and successful economy, which is certainly confirmed by the development trend of the financial sector. Therefore, it is imperative for the successful economic growth that the commercial banks maintain liquid and are prepared for global shocks in challenging times, as it was the last economic crisis stemming from the US real estate business model and related securities.

Above mentioned goal can only be achieved through efficient supervision and regulation of commercial banks. In the context of the Bosnia and Herzegovina and Croatia, the supervisory and regulatory bodies were built from the ground up, mostly by adoption of the good foreign practices, after the transition to the market based economic system. Also, the lack of the qualified staff in the system of planned economies was another challenge. The very fact that Croatia is a member of the European Union (EU) and strives to join European Monetary Union and that Bosnia and Herzegovina is on its way to EU accession shows the success of adjusting national bodies to contemporary regulatory and supervisory standards.

Regarding bank loans, they are still the most important component of banks' balance sheets and a key source of their income. Their quality and profitability determines the efficiency, profitability and business success of each institution, but also of the whole banking sector. But, due to the importance of banks and their role in the financial intermediation, the low quality of banks' loan portfolio, i.e. high level of non-performing loans (NPLs) triggers much wider macroeconomic

challenges, such as increase of the systemic risk, higher funding costs, lower supply of loans and finally lower potential GDP growth or even recession (European Systemic Risk Board, 2017, 12).

As in most countries worldwide and especially in Europe, banks and banking loans are the most important sources of funds for the economic development in the Bosnia and Herzegovina and Croatia. Consequently, the quality of banking loan portfolio and percentage of the NPLs is a key prerequisite for the economic success, but also for the banks' profitability and liquidity. Preliminary data and analysis for both countries indicate much higher levels of the NPLs than the EU average, but also higher level than the other Central and Eastern European Countries (Raiffeisen Research, 2017, 19).

The aim of this article is to analyse determinants of non-performing loans, future challenges and possible solutions of high NPL ratios. Multiple regression analysis with the ratio of NPLs to total loans as a dependent variable and five independent variables (GDP growth rate, unemployment rate, Consumer Price Index, amount of bank loans and value of stock exchange indexes) were used to determine this effect. Main hypothesis of the article is that macroeconomic variables, especially GDP growth rate due to the cyclicity of banks, are key in determining the level of banks NPLs.

The rest of this paper is organised as follows. Second section reviews literature regarding levels of NPLs and their effect on the broader economy worldwide and in countries of interest. Data and the methodology are described in the third section, while section four presents the results of the model. Section five contains future challenges, possible solutions to the high NPL ratio and study limitations. Section six contains main conclusions of this paper.

2. LITERATURE REVIEW

Recent global financial crisis raised the importance and awareness of the NPL ratio on performance of the banking sector, but also on the whole economy due to the bank size and availability of funds for economic growth. This interaction between the economic performance and financial systems is in the focus of researchers for long time. Main theoretic studies in this field demonstrated the procyclicality of the financial systems, i.e. in the good time quality and strength of the borrowers balance sheets increases investments and growth, while the opposite occurs in the case of financial crisis (Bernanke and Gertler, 1989, 28; Bernanke et al., 1999, 1342). The authors also emphasize the importance of small and temporary shocks on the business cycle fluctuations (Kiyotaki and Moore, 1997, 211).

Many studies have researched the determinants influencing NPL ratios on the level of individual countries. In Greece, country severely affected by the financial and

sovereign debt crisis, macroeconomic variables (GDP growth rate, unemployment, the lending rates and public debt) and quality management could have a significant impact on levels of NPLs (Louzis et al., 2012, 1025). Research for Italy demonstrates that the business cycle has a key effect on loan losses which are significant and long lasting in the recession times (Quagliariello, 2007, 137). In the US, market based financial system, analysis of the NPL determinants highlights several bank specific (capitalization liquidity and profitability) and macroeconomic (GDP growth rate, unemployment, real personal income) indicators which determine the NPL ratio (Ghosh, 2015, 93). Author also emphasizes that the state-level economic conditions as a variable should be taken into account for the conduction of the stress test and also that non optimal levels of capital, i.e. overcapitalization enhances NPLs. On the other hand, in Spain the importance of the microeconomic individual bank level variables, such as the growth policies and managerial incentives, is proved even after the control for macroeconomic conditions (Salas and Saurina, 2002, 221). Certain authors emphasize the importance of the moral hazard of lending decisions and management risk tolerance which can cause a significant variation of loan losses across similar banks and economic conditions (Keeton and Morris, 1987, 19; Zhang et al., 2015, 58).

Studying the case of the advanced economies, analysis demonstrates that adverse macroeconomic developments, such as a GDP decline or rise of the unemployment, result in rising level of the NPL ratio (Nkussu, 2011, 20). Author also argues that high levels of NPL tend to have a negative effect on the economic growth, thus deterioration in economic activity and banking performance reinforce each other and intensify negative trends. Similarly, research that focuses on the macroeconomic determinants of NPLs across 75 countries shows that the GDP growth rates are the main driver of non-performing loans (Beck, 2011, 546). Additionally, in countries with a high degree of foreign currency lending, exchange rate depreciation may lead to the increase of NPL ratio, while a drop in stock prices could be important for stock oriented countries and markets.

In Eurozone, the importance of the macroeconomic conditions on the bank performance and level of NPLs is emphasized with the conclusion that GDP growth rates and unemployment have a strong influence on loan losses (Makri et al., 2013, 203; Dimitrios et al., 2016, 119). Authors also emphasize the importance of the management skills, risk preferences, ROE and capital adequacy ratio as an important bank specific variables determining the NPL ratio. Recently conducted meta analysis of 37 studies indicates that economic growth has a negative, while unemployment rate, inflation and interest rate mostly have a positive effect on the NPL ratio (Macháček et al., 2018, 354).

The sources and impacts of NPL ratios were also studied in Central and Eastern Europe. A study focused on the period 1998-2011 concluded that macroeconomic factors have a higher impact on the NPL ratio than the bank specific factors, thus rise of the unemployment, exchange rate depreciation and higher inflation tend to

increase NPL ratio (Klein, 2013, 20). Similar results were obtained by a research from 2007 to 2012 in which GDP, unemployment rate and inflation have a key impact on the NPL ratios in Central and Eastern Europe, with the highest and negative coefficient observed by the GDP growth rates (Škarica, 52, 2014).

Analysis of the NPL ratio in Bosnia and Herzegovina, Croatia and Serbia indicates significant and long-lasting connection between NPLs and macroeconomic factors (Kozarić and Žunić, 2017, 101). Especially emphasized contributing factors are GDP growth rate, inflation and unemployment. In Bosnia and Herzegovina, research focusing on the bank specific factors demonstrates that the increase of the risk weighted assets increases, while the increase in ratio of liquid asset to short-term liabilities decreases NPL ratio (Kozarić and Žunić, 2015, 138). Interestingly, researches indicate contrary significance of the GDP growth ratio on NPL ratio, with the significant and insignificant impact observed for the different time periods (Agić and Jeremić, 2018, 56; Pašić and Omerbegović-Arapović, 2016, 81). In Croatia, the increase of the GDP growth rate and industrial production index have a significant effect in reducing the level of NPLs (Benazić and Radin, 2015, 85; Žiković et al., 2015, 22). Additionally, both papers conclude that effect of the macroeconomic determinants on the level of NPL is more evident in the longer periods and rather mixed in the short run.

3. DATA AND METHODOLOGY

3.1. Data

The data for this model is collected from multiple sources. Databases from the International Monetary Fund were used to obtain data for the ratio of NPLs to total loans, Consumer Price Indexes (CPIs) and GDP growth rates. All other variables were retrieved from national sources, i.e. from national central banks (amount of total loans), national stock exchanges (value of stock exchange indexes) and bureaus of statistics (registered unemployment rates - a ratio of unemployed persons to the total active population). Data was collected on the quarterly basis covering the period of 11 years from Q12007-Q42017.

All data, except the GDP growth rates, were calculated as an annual percentage changes on the quarterly levels. Therefore, the variables in the model are: *npl* (annual percentage changes in NPL ratio), *cpi* (annual percentage change in Consumer Price Index), *gdp* (real GDP growth rate), *loan* (annual percentage change of the amount of total banks' loans), *share* (annual percentage change of key stock exchange index for each country) and *unpl* (yearly percentage change of registered unemployment rates).

The complexity of the NPL ratio and issues is evident from the various classifications, definitions and number of days used to classify loans as the non-

performing ones. According to the IMF, whose databases were used to obtain NPL ratios in this study, loan is classified as non-performing if payments of principal and interest are past due by at least 90 days or if interest payments equal to 90 days interest or more have been capitalized or rolled over (International Monetary Fund, 2006, 46). European Banking Authority defines non-performing exposures as exposures that have a material exposures which are more than 90 days past-due or where the debtor is assessed as unlikely to pay its credit obligation in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due (European Banking Authority, 2013, 13).

Recent global financial crisis exposed certain weakness in the accounting standards, especially regarding credit losses of the banks which were taken into consideration during set up and implementation of recent regulatory measures. For instance, IRFS 9, effective from January 2018, takes into consideration a more forward looking approach where model requires credit institutions to take into account the amount of expected credit losses and a trigger event is not needed to recognise credit losses (International Financial Reporting Standards, 2014, 14). Framework Basel III, beside defining default and exposure, sets up classification of exposure into grade A, B and C depending on the exposure to the risk of banks' counterparty (Bank for International Settlements, 2017,13). Similar classification of exposures is adopted in Croatia with the definition and classifications of A (A-1 and A-2 sub-categories), B (B-1, B-2 and B-3 sub-category) and C risk categories in order of better estimation of the possible credit risks (Croatian National Bank, 2017, 5).

Regarding the number of days needed to classify the loans as non-performing, the Croatian National Bank in its reporting uses a ESA2010 accounting framework that defines the loan as uncollective after the last 90 days of the maturity day, while Bosnia and Herzegovina in its statistical reporting and guidelines also highlights the time limit of 90 days (Croatian National Bank,2014, 10; Central bank of Bosnia and Herzegovina, 2017, 8).Despite this similarities, data regarding NPL ratio, its possible standardization and the results of the analysis should be taken with consideration due to the possible difference in classification and coverage, especially taking into account period of 11 years when regulatory changes and various guidelines are inevitable. Certain researches indicate various sources of heterogeneity regarding the NPLs definition in Central, Eastern and South Eastern Europe, with the more prominent ones being dealing with collateral, sub-categories of NPL and used approaches (customer vs productive) which are followed by the definitions (European Banking Coordination "Vienna" Initiative, 2012, 14).

3.2. Methodology

In order to observe the impact and strength of the various variables on the ratio of NPLs to total loans, multiple linear regression models (OLS) for each country were

constructed, with the NPL ratio as an independent and all other variables as a dependent variables. The regression was carried out for Croatia and Bosnia and Herzegovina separately and obtained results were compared.

Firstly, in order to ensure stationarity of the observed variables, Augmented Dickey-Fuller Test presented in table 1 was conducted for each country. Since most of the variables were not stationary at the original level, transformation of the variables using first difference, one of the possible methods to resolve non-stationarity issues, was used in order to obtain variable stationarity (Chatfield, 2003, 49). After transformations, one variable for each county was not taken into models due to the unachieved stationarity using first differences.

Table 1. Augmented-Dickey-Fuller unit root Test for the Bosnia and Herzegovina and Croatia

Variable	Bosnia and Herzegovina		Croatia	
	Original	First difference	Original	First difference
NPL	-1.817476	-3.584539*	-0.686768	-3.670029
CPI	-4.610152	-3.526464*	-2.136103	-2.528127**
GDP	-3.152143	-7.345888	-2.034755	-5.734954
LOAN	-7.65918	-1.912752**	-1.991981	-5.441548
SHARE	-2.334611	-4.894418	-4.494629	-3.597489*
UNPL	-3.262735	-5.702052	-1.692031	-3.138222*

First difference values without * or ** are stationary at the 1% significance level.

* Stationarity at the 5% significance level

** Not stationary at the 10% significance level

Source: Authors' calculation

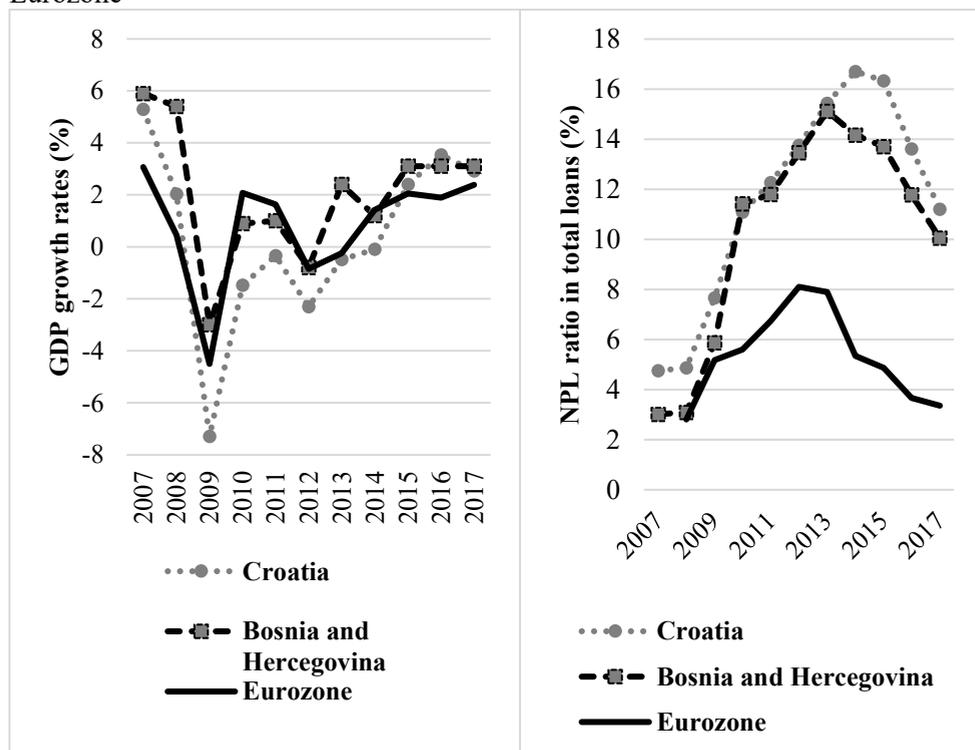
Due to the fact that certain macroeconomic factors do not immediately impact NPL ratio and number of days needed to classify loans as non performing, lags of the dependent variables were used in the model based on the Akaike, Schwartz and Hanan-Quinn information criteria. By applying this approach, historical factors causing existing differenced in the NPL ratio are taken into account (Wooldridge, 2016, 283). Additionally, AR(1) process was used in the model to consider the effect of past value (t-1) on current value (t) of NPL ratio (Bahovec and Erjavec, 2009, 211).

4. RESULTS

The GDP growth rates and NPL ratios of both countries and Eurozone are presented in figure 1. Global financial crisis hit Croatia more sharply than Bosnia and Herzegovina and this, together with the weaknesses of the local economy,

resulted with the economic downturn in 6 years (only 2 in Bosnia and Herzegovina). Comparing the economic trends with the Eurozone, data indicate higher growth rates of Bosnia and Herzegovina than the average of the Euro area for the period observed, while Croatia achieve higher growth only in the 2016 and 2017. Despite difference in the GDP growth rates, trend regarding the NPL ratio is similar for both countries. Firstly, at the beginning the financial crisis, NPL ratio rose significantly in both countries, much higher than in the Eurozone. With the start of the economic recovery, ratio of NPL started decreasing (from 2013 in Bosnia and Herzegovina and 2015 in Croatia), but the level of NPLs is still much higher than in the pre-crisis period and in the Euro area.

Figure 1. GDP growth rates and NPL ratio in Bosnia and Herzegovina, Croatia and Eurozone



Sources: Prepared based on the database Financial Soundness indicators of the IMF

Regarding statistics of the banking sector, the growth of the banks' assets and loans is much higher in Bosnia and Herzegovina than Croatia (39% and 56% in Bosnia and Herzegovina, 13% and 5% in Croatia respectively). Therefore, the loan to deposit ratio (LTD) is declining continuously in Croatia since 2008 and is lower by 17% than at the beginning of the period while in Bosnia and Herzegovina, despite decline in most years, is slightly lower at the end of the observed period. Presented

data indicate that banks, especially in Croatia, despite high liquidity and capitalization levels, are not eager for intensive lending, with the fear of re-growth of the NPL ratio and the profit losses being one of the key factors. In spite of higher NPL ratios, the Croatian banks are more profitable in the most observed years.

Table 2. The descriptive statistics of banking sectors

Country	Variable	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Croatia	Assets*	47.0	51.2	51.6	53.7	54.7	53.2	52.5	51.8	51.7	51.6	52.5
	Loans**	63	67	67	68	69	67	66	64	63	61	58
	Capital**	13	14	14	14	14	14	14	14	13	14	15
	LTD***	0.93	1.00	0.98	0.99	0.99	0.97	0.93	0.88	0.84	0.80	0.76
	ROA**	1.6	1.6	1.1	1.1	1.2	0.8	0.2	0.5	-1.3	1.6	1.0
	ROE**	10.9	9.9	6.4	6.5	6.9	4.8	0.8	2.8	-8.8	9.6	5.9
Bosnia and Herzegovina	Assets*	10.0	10.6	10.5	10.4	10.7	10.8	11.3	11.6	12.1	12.8	13.9
	Loans**	59	67	65	68	70	72	71	70	69	67	66
	Capital**	-	-	10.7	11.8	13.6	14.2	14.4	14.4	14.1	14.4	14.0
	LTD***	0.97	1.22	1.17	1.16	1.18	1.19	1.15	1.08	1.03	0.98	0.95
	ROA**	0.8	0.4	0.1	-0.6%	0.7	0.7	-0.1%	0.8	0.3	1.1	1.5
	ROE**	8.6	4.2	0.8	-5.5%	5.8	5.1	-0.5%	5.4	2.0	7.3	10.2

* Value in billion €

** Percentage of total assets (capital, loans, ROA) or capital (ROE)

*** Loan to deposit ratio

Source: Authors' calculation according to the statistics and publications of the central banks and International Monetary Fund

The results of the regression model for both countries are presented in table 3. For Bosnia and Herzegovina results indicate that, at the significance level of 10%, GDP growth rates and unemployment rates are significant variables for the NPL ratio. Surprisingly, the variables tend to show opposite interactions than one should expect by the literature review and intuition: negative effect of the GDP growth rates and positive effect of the rise of the unemployment rates. In the Republic of Croatia, two independent variables, GDP growth rates and amount of loans, are proved significant at the 10% level. Both variables tend to have negative effect on the NPL ratio, i.e. increase of the GDP growth rate and loans decreases the NPL ratio levels.

Table 3. OLS results for Bosnia and Herzegovina and Croatia (Q12007-Q42008)

Dependent variable: NPL (Bosnia and Herzegovina)			
Variable	Coefficient	Std. Error	t-Statistic (Prob.)
Constant	-0.772721	4.100149	-0.188462 (0.8519)
CPI ₂	-0.466959	2.415188	-0.193343 (0.8481)
GDP ₃	1.731091	1.002094	1.727473 (0.0955)
UNPL ₅	-2.61862	1.316895	-1.988481 (0.057)

SHARE	0.237917	0.191484	1.242490 (0.2247)
AR(1)	0.383458	0.185833	2.063452 (0.0488)
Adj. R ² = 0.224886, AIC = 8.187075, SC = 8.501326, HQC = 8.294243, DW= 2.146892, Prob (F-statistic) = 0.04069			
Dependent variable: NPL (Croatia)			
Variable	Coefficient	Std. Error	t-Statistic (Prob.)
Constant	-0.391836	2.428672	-0.161338 (0.8730)
GDP ₋₄	-1.183203	0.530338	-2.231035 (0.0339)
LOAN	-0.577362	0.331501	-1.741661 (0.0925)
UNPL ₋₁	0.425954	0.054466	-1.187707 (0.2449)
SHARE ₋₄	-0.064689	0.191484	1.242490 (0.2247)
AR(1)	0.583106	0.15061	3.871638 (0.0006)
Adj. R ² = 0.415078, AIC = 6.529853, SC = 6.840923, HQC = 6.637234, DW= 2.170761, Prob (F-statistic) = 0.00132			

Subscripts represent number of lags for each variable.

Source: Author's calculation

5. DISCUSSION

This study estimated the impact of certain macroeconomic and banking variables on the NPL ratio in Croatia and Bosnia and Herzegovina. Calculated results indicate that GDP growth rate is the only significant variable in both countries. However, the variable has a contradictory effect, where increase of the GDP growth rate is decreasing NPL ratio in Croatia and increasing it in the Bosnia and Herzegovina. This can be partially explained by the chosen variables and model representation which is, according to the Adj. R² and Prob (F-statistic) much higher and comprehensive in Croatia. Secondly, despite positive GDP growth rates and decrease of the unemployment rates in most observed period in Bosnia and Herzegovina, the NPL ratio grew in the most quarters, similar to the levels in Croatia, country with the worse economic indicator in the observed period. Thus, the results could emphasize the possible impact of additional variables on NPL ratio.

In recent years, the NPL ratio started decreasing in both compared countries. For Bosnia and Herzegovina, this process in 2017 is mostly result of a permanent write off of NPLs, resulting with the reduction of NPLs by 80.5 million € (Central bank of Bosnia and Herzegovina, 2017, 60). The most contributing factor in recent years was a quality of the GDP growth, although better management of the NPLs should not be neglected. To further decrease the NPL ratio, regulatory changes in the current tax law and debt collection and execution are needed which would enable secondary market and speed up court proceedings (Central bank of Bosnia and Herzegovina, 2017, 61).

Similarly to Bosnia and Herzegovina, the decrease of the NPL ratio in Croatia is mostly the result of NPL sale in the secondary market which amounted

approximately 3.6 billion € from 2010 onwards (Croatian National Bank, 2018, 30). This process was boosted in 2014 onwards by the Croatian National Bank with the Decision on the classification of placements and off-balance sheet liabilities of credit institutions (OG 41A/2014)'which forced banks to progressively adjust values of exposures depending on the number of delinquency days and motivated sale of NPLs (Croatian National Bank, 2017, 8). In both countries, the NPL ratio is still higher than the average of CEE countries and further effort is needed to resolve the issue, with possible measures such as better banks' NPL management, improvement of insolvency procedures and more transparent justice system.

Despite much lower NPL ratio than countries in this paper, the NPL ratio is also a great challenge at the level of the EU. Recent global financial crisis and sovereign debt of certain European countries deteriorated banks' balance sheet with the current level of NPLs at 900 billion € and unlikelihood to reach pre-crisis levels in near future (European Banking Authority, 2017, 36). In the EU, as in Croatia, secondary NPL market proved especially important in reducing NPL levels, although with certain market failures, such as not lower bid-ask spreads, which could be resolved with the European Council's NPL Action Plan expected in 2018 and national reforms (European Central Bank, 2018, 100). Recently, in March 2018 European Banking Authority published the 'Draft Guidelines on management of non-performing and forborne exposures' in which it especially emphasises the importance of adequate NPL framework and strategy at the level of individual credit institution (European Banking Authority, 2018, 18).

The model conducted in this research has certain limitations. Firstly, the variables included in the regression and inclusion of additional variables can change the result of any regression analysis. Due to data limitations or unavailability, certain variables which could be significant in determining NPL levels were not included in the model (e.g. currency exchange rates, lending rates). Secondly, despite using quarterly data, initial number of periods in the model is 44, but is further decreased after the calculation of annual percentage changes and by lagging the independent variables. Regarding lags of variables, different lags yield different results in all regression analysis, although this issue was reduced by using usual criteria to determine relevant number of lags. Finally, more detailed NPL division, i.e. separate ratio of retail and corporate ratios should also be considered in order to better observe and analyse differences between these two sectors and their separate trends. Based on the above mentioned, this research is a base for further more detailed and sophisticated paper.

6. CONCLUSION

The ratio of NPLs to total loans is one of the key determinants of banks' business performance, but also its level is one of the key prerequisites for economic stability and growth. The main hypothesis of this paper is that macroeconomic factors,

especially economic growth, have a key impact on NPL ratio in Bosnia and Herzegovina and Croatia. Results indicate that GDP growth rate is significant in determining NPL ratio in both countries, but with opposite effect. Since both countries in this research have a higher level of NPL ratios than average of the EU or CEE and SEE, better management of banks' loan portfolio and consequently NPLs is one the key challenges in increasing the amount of loans and improvement of the financial intermediation of the banking system. Further research should focus on inclusion of more variables which could impact NPL levels, covering of the longer time period and inclusion of more similar countries in the research.

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EU PROSPECTS FOR BOSNIA AND HERZEGOVINA: BETWEEN STAGNATION AND GROWTH

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Abstract

The aim of this paper is to point to the specificities of economic and political transformations in Bosnia and Herzegovina (B&H) and the Western Balkan in the context of economic and political changes in the global environment that can significantly affect the EU accession process. An analysis of the position of B&H in the group of Western Balkans countries and the perspective of economic growth was conducted by focusing on the political and economic criteria as well as on the current obstacles these countries are facing, specifically, based on their political and economic background and in conditions where external risks are growing.

All these countries are committed to implementing structural reforms because the commitment of all the countries towards Europe, which means convergence towards the European countries and a reduction in the size of the GDP per capita. In order to achieve such long-term goals, it is necessary to implement structural reforms that will result in stimulating production, trade, financial flows and reforming the labor market and the public sector. That is why growth of investment and exports is the main determinant of long-term growth. This paper gives an overview of the basic economic features of B&H compared with the other countries that belong to Western Balkan region, as well as projections on the certain macroeconomic indicators in the forthcoming period.

Keywords: *European Union, Bosnia and Herzegovina, Western Balkan, Association, integration, structural reforms, investments, competitiveness, risk, prospects.*

JEL: 052

1. INTRODUCTION

Bosnia and Herzegovina is a country that has been for long in the process of political and economic transition towards a market economy with a view to becoming a full member of the EU. However, the process is taking place very slowly and with constant political tensions that make it difficult to implement the necessary structural reforms. In such conditions, the priority is to build a legal state that can ensure political stability and economic growth. A legal state is the main condition, and at the same time it is the backbone of every democratic society. Its main task is to provide legal security with a view to the functional maintenance of the constitutional order, internal security, functional values of the democratic order and fundamental human rights and freedoms on which the EU is built.

The European prospect of B&H is not possible without a new constitution, fully harmonized with the European Convention on Human Rights and Fundamental Freedoms. Only such B&H will enable the establishment of functional and efficient state institutions with powers that will allow accelerated accession to the European and Euro-Atlantic integration. In the Western Balkans, B&H is, alongside Kosovo, the worst positioned in the context of the EU accession.

The degree of development of the economic system directly influences political stability, the standard of citizenship, the effectiveness of legal mechanisms, and the quality of relations with the environment. The rule of law system ensures freedom of the people and the individual and their participation in political life, and thus makes the precondition of an economic prosperity. Economic development for the core objective is to ensure self-sustainability, competitiveness, flexibility and ecological sustainability of the economic system of Bosnia and Herzegovina. The achievement of such an emphasized fundamental economic goal is in principle a complex process whose successful implementation depends on the achievement of a large number of smaller and interrelated and dependent sub-goals.

The concept of an open market and export-oriented economy of small countries such as B&H in the long run can ensure its balanced and sustainable development. We must, therefore, be aware that external constraints on the development of B&H economy are great because B&H can not in any sense affect the conditions that govern its environment and the world economy, but can only constantly adapt. This means that it is necessary to achieve the high efficiency of production of B&H economy with the aim of achieving its competitiveness on the world, especially in the European market. Of course, high efficiency is only possible in the market economy.

Many authors dealing with the determinants of economic growth emphasize the importance of strengthening democracy and the rule of law. Thus Barro in his research (1996) argues that the growth rate of real GDP per capita is higher in

countries where a legal state has been built and with lower national consumption and lower inflation. Strengthening democracy and political rights initially increases growth but accelerates growth when a moderate level of democracy is achieved. Of course, other public policies such as tax policy, pension and other transfer programs and the legislative framework affecting financial markets, labor markets and other markets are important. Significant growth determinants are infrastructure investments, R & D expenditure, quality of education, and revenue and wealth distribution.

2. THE MAIN CHALLENGES FACING B&H TOWARDS THE EU

Special accession criteria need to be met for the accession process of B&H and the Western Balkans countries to the EU. The three fundamental criteria that are required for accession refer to the Copenhagen criteria set at the Copenhagen European Council meeting in 1993. These are: political, legal and economic criteria. Political criteria imply the stability of institutions guaranteeing democracy, the rule of law, respect for human rights and the protection of minorities. Legal criteria imply the ability to assume membership obligations, including the commitment to the goals of the political, economic and monetary union. Economic criteria imply the existence of a functioning market economy, capable of cope with competitive pressure and market forces.

In addition to the Copenhagen Criteria, potential EU member states have to fulfill the additional criterion (Madrid criteria) set at the Madrid European Council meeting in 1995. This criterion concerns adapting the administrative structure to create conditions for gradual and harmonious integration, skills and the creation of an effective state administration system for the implementation of the *acquis communautaire* and other obligations deriving from membership in the European Union. The criterion from Madrid is called an administrative criterion.

Western Balkans countries are more advanced in economic reforms than in the rule of law. Based on a new assessment methodology, most countries have only “some level of preparation” in the three areas of the rule of law, including functioning of the judiciary, fight against corruption and fight against organised crime. This is a long way from the “well advanced” state of progress needed for the EU accession. The situation is a bit better with regard to economic reforms, where most countries are “moderately prepared”. Bosnia and Herzegovina and Kosovo are lagging behind, being assessed at “an early stage” in this area¹.

Comprehensive reforms are needed to promote a dynamic private sector. The state must play an important growth-enabling role by providing the rule of law, a stable

¹ EBRD, *The Western Balkans in transition: diagnosing the constraints on the path to a sustainable market economy*, February 2018, pp. 10.

macroeconomic environment and clear rules of the game for businesses. Bosnia and Herzegovina and whole region of Western Balkans lies at the heart of Europe and is surrounded by European countries. However, weak economic performance, combined with political instability and upheaval over recent decades, has left the region lagging behind the EU indicators in terms of prosperity and living standards. GDP per capita in the Western Balkans is on average just one-quarter of the level in the richest EU members in Western Europe.²

2.1.The challenges of convergence towards the EU

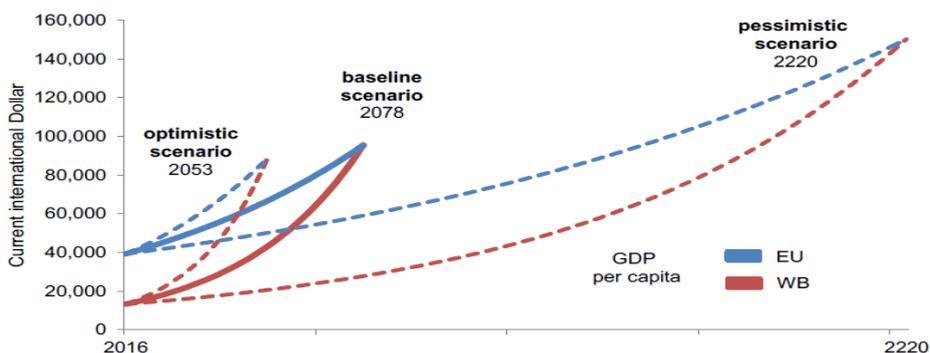
Bosnia and Herzegovina faces high import dependence problems and low export competitiveness, which contributes to a high trade deficit. Inadequate export growth is the result of poor industrial policy and restructuring of the industry sector. That is why economic policies are needed to ensure the restructuring of the real sector of the economy with the aim of strengthening competitiveness. The key objectives of such an industrial policy would be to ensure some reindustrialization of the strongly de-industrialized economy. This could be done through measures that would facilitate the development of new industries and strengthen those sectors that, presently, contribute the largest part of exports. As a result of such movements, the process of the income convergence and catching up with the more developed EU has been extremely slow and has still not reached pre-transition levels of real GDP.

In the exploration of convergence / divergence, Barro has come to the conclusion of convergence, provided that developing countries have the same level of education as developed countries.³ Countries in the Western Balkans face a major convergence challenge. Current average GDP per capita for the six countries is only half the average in the 11 EU member states of eastern Europe (EU-11), and just one-quarter of the most advanced western European countries (Chart 1.). The main reason behind this prosperity gap is the lack of appropriate factors and institutions needed for high levels of long-term productivity growth.

² EBRD, The Western Balkans in transition: diagnosing the constraints on the path to a sustainable market economy By Peter Sanfey and Jakov Milatovic February 2018, pp.3

³ Barro, R. and X. Sala-I-Martin, 1992. Convergence. Journal of Political Economy, 100(2): 223-251.

Chart 1. Convergence scenario



Source: EBRD, *The Western Balkans in transition: diagnosing the constraints on the path to a sustainable market economy*, February 2018.

Consequently, full convergence with average EU living standards could take many decades. After the global financial crisis, B&H has significantly lower GDP growth rates compared to the period before the global financial crisis. As a consequence of the slowdown in economic growth, the assumptions for convergence towards the EU countries are worsening. If the economy continues to grow by the current rates of economic growth, it will take more than a decade to reach the EU.

Analyzing the convergence opportunities of the Western Balkans countries towards the EU countries, EBRD has developed several possible scenarios. A baseline scenario, which uses the average growth rates for the period of 2001-16, implies that the WB-6 region, on average, could achieve the average GDP per capita in the EU in about 60 years. An optimistic scenario, which uses pre-crisis growth rates, would yield catch up with EU living standards in just under 40 years, while a pessimistic scenario, which uses the post-crisis average growth rates, means that catching up takes place after 200 years. The speed of catch up would depend on the pace of addressing the challenges that hamper the region from developing its full potential.⁴ A large number of factors may affect the convergence rate of B&H and other Western Balkan countries towards the EU. The most important are however policies that will support faster development of the private sector of the economy, ie a higher level of private investment and job creation, and growth of exports. More efficient policies are needed to stimulate R&D and innovation, along with better quality reforms of the system of education, that are essential for reducing the present mismatch between demand and supply of specific labor skills. These policies are also closely related to the current EU objectives of a knowledge-based economy. More intensive regional cooperation among the Western Balkan countries – including better coordination of national policies in various areas and

⁴ EBRD, *The Western Balkans in transition: diagnosing the constraints on the path to a sustainable market economy*, February 2018, pp. 4.

implementation of regional initiatives – is another highly desirable priority for stimulating growth in the medium term. Although the benefits of regional cooperation have been emphasized for a long time, its potentials have not been sufficiently utilized. In addition to increasing intra-regional trade, which, for the most Western Balkan countries, still remains quite important, other forms of regional economic cooperation could also contribute to growth in the areas of R&D, energy, transport or other specific industries.

Bosnia and Herzegovina has made some progress, but is still at an early stage of establishing a functioning market economy. Some improvements of the business environment have been achieved and the financial sector has been strengthened. Key remaining issues are a weak rule of law, a still poor business environment, a fragmented and inefficient public administration and major labour market imbalances, related to a poor education system, weak institutional capacities, and an unsupportive investment climate. In order to support long-term growth, Bosnia and Herzegovina should pay particular attention to: strengthen the political ownership of reforms and the cooperation and coordination among different levels of government; improve the quality of public finances by strengthening its growth-friendliness and improving the targeting of social spending; improve the provision and quality of timely and exhaustive statistics, increasingly applying European and international standards.

Western Balkans countries lag behind the EBRD regional average in terms of progress towards a sustainable market economy. The six qualities are: competitive, well-governed, green, inclusive, resilient and integrated. The results show that the most Western Balkans countries are lagging behind in competitiveness and governance, in common with the rest of the EBRD region. The difference in relation to the EU countries in central and Eastern Europe is much more pronounced, with gaps ranging from 1.3 to 2.0 points.

Table 1. Transition scores for six qualities of a sustainable market economy

	Competitive	Well-governed	Green	Inclusive	Resilient	Integrated	Average
Albania	4.4	4.3	4.9	5.1	4.9	5.8	4.9
Bosnia and Herz.	4.7	3.7	4.8	4.8	5.3	5.5	4.8
FYR Macedonia	5.4	5.2	4.9	4.7	5.3	6.0	5.3
Kosovo	3.4	3.7	3.8	4.7	5.1	4.9	4.3
Montenegro	4.9	5.1	5.2	5.6	5.9	5.6	5.4
Serbia	4.9	4.4	5.8	5.2	5.6	6.4	5.4
WB-6	4.6	4.4	4.9	5.0	5.3	5.7	5.0
EU-11	6.5	5.7	6.3	6.3	7.3	7.5	6.6
EBRD	4.9	4.8	5.4	5.4	5.7	6.0	5.4

Source: EBRD, The Western Balkans in transition: diagnosing the constraints on the path to a sustainable market economy, February 2018, p. 20.

3. STRUCTURAL WEAKNESSES OF THE B&H

In order to implement a more efficient industrial policy, B&H could learn from the current EU measures that aim at the reindustrialization of the EU economy. The Strategy for the Reindustrialization of Europe, launched in 2012, aims at increasing the share of manufacturing from the current 15% to 20% of GDP by 2020. The share of the manufacturing industry in GDP is about 13% in 2017. The public sector share of GDP is large and it is about 20%⁵. Such a high share of public administration in the B&H economy reflects the multiple layers of the country's government, including the central government, governments of two entities and the Brčko district, cantonal governments in the Federation of Bosnia and Herzegovina, as well as local administration across the country. It is therefore necessary to take measures to change the structure of the economy. Since the 1990s, deindustrialization has been highly expressed in B&H, which is one of the main causes of poor economic structure.

De-industrialization is characteristic of all Western Balkan countries as the logical consequence of changes in countries that have left the socialist system and have begun to build the institutional framework for building a market economy and civil society. The experience of other countries has shown that production, employment, productivity and competitiveness, aggregate demand, real wages and living standards as a whole are inevitably the result of the changes being made. Privatization of state-owned enterprises has led to the dismissal of a number of workers in all countries in order to open up the space for restructuring. In B&H, this problem in the context of privatization is less pronounced because of the fact that during the war a large part of the industrial caucus was destroyed.

Even before the war in B&H, there was a question of justifying the work and the need for restructuring some of the major industrial systems, such as ironworks, coal mines, chemical combines and others that were built in the former Yugoslavia as a raw material for the development of other republics. As a result of war destruction, market loss and obsolete technology, and later privatization, major industrial systems have ceased to exist. In post-war reconstruction, there was no cost-effective investment in their revitalization due to obsolete technology and the need for their transformation, both in organizational terms and in terms of orientation to new production and new technologies. On the other hand, it was necessary to redirect the economic structure to other production, which have the potential for market valuation.

However, B&H has failed to define clear industrial policy and institutional support for industry development. Clear industrial policy is needed to ensure economic

⁵ Agency for Statistics of Bosnia and Herzegovina

growth that can be achieved thanks to the inherited industrial base and tradition in industrial production. In the real GDP structure, expenditures on household final consumption have an impact on the overall economic activity, and average of 79.3% of GDP, although there has been a recent trend of decreasing the share of this consumption. Expenditure on government final consumption averages 21.5% of GDP, with the share of this category declining in GDP as a result of more rational public spending. Average gross investment expenditure is 18.6% of GDP and relates mostly to investments in new fixed assets. Exports in the mentioned period in the structure of GDP are 32.3%, while imports represent 51.6%. The more positive structure of GDP has been recorded in previous years as a result of the increase in the share of gross investment and exports so that their share at the end of the third quarter of 2017. amounts to 20.8% and 37.0%, respectively⁶.

4. SME SECTOR AS THE DRIVER OF THE GROWTH OF THE ECONOMY OF B&H

SMEs should be one of the pillars of B&H's economic development. In this sense, it is necessary to define the overall SMEs development policy in the context of regional and local specificities. Policy development of SMEs should be focused on removing barriers and encouraging environment for the emergence and development of new enterprises. The main question is: how to improve competitiveness of SMEs? The positive business environment and efficient public business support at all levels are the most important factor in the competitiveness of SMEs. Further improvement of economic policy that should be in function of faster economic development and better competitiveness position of B&H economy is necessary. Special attention should be focused on:

- Improving administrative efficiency at the national and regional level,
- Improving business competitiveness through e-business services,
- Providing advisory services to SMEs,
- Creating incentive investment climate,
- Supporting cluster development.

A key factor for SMEs development in specific industries in the developed economies are clusters. They offer a new way of thinking about economic development, giving the new role of business to the governments and institutions. They are development tool that should be recognized by state, entities and local authorities in B&H, who should encourage their formation and growth. Clusters are binding factor with similar companies in a particular field and they have to become widely accepted component of national and regional development plans. That process involves a partnership of governments, business and academic communities. That is why B&H need new policies for the development of SMEs,

⁶ Central Bank of Bosnia and Herzegovina, Annual Report 2017., pp. 30.

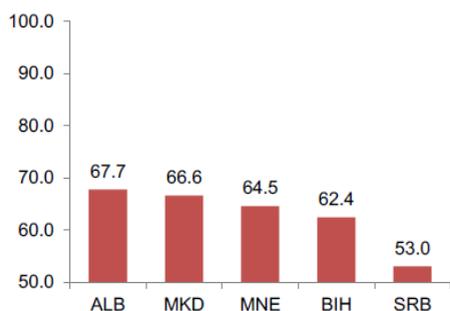
aimed at removing barriers and creating an enabling environment for their establishment and development. Effective policies must take into account all the specifics of B&H. In this way it is possible to ensure sustainable economic development in which SMEs should be one of the pillars of creating a growing competitive economy.

As a consequence of de-industrialization in the post-war period, SMEs dominate the economies of the Western Balkans: SMEs make up about 99 per cent of businesses in all countries of the Western Balkans. On average, SMEs provide jobs for around three-quarters of the total number of employed, ranging from just below 70 per cent in Bosnia and Herzegovina to more than 80 per cent in Albania (Chart 2. a.)⁷.

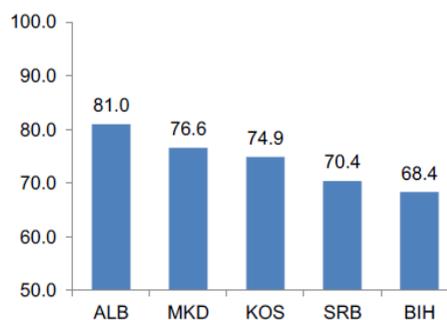
At the same time, on average, SMEs add an estimated two-thirds of the countries' total annual value added, a proportion similar to the EU average, ranging from just above 50 per cent in Serbia to just below 70 per cent in Albania (Chart 2.b.).

Chart 2.

a) SMEs sector employment, share of total of total b) SMEs sector value added, share of total



Source: OECD.



Source: OECD.

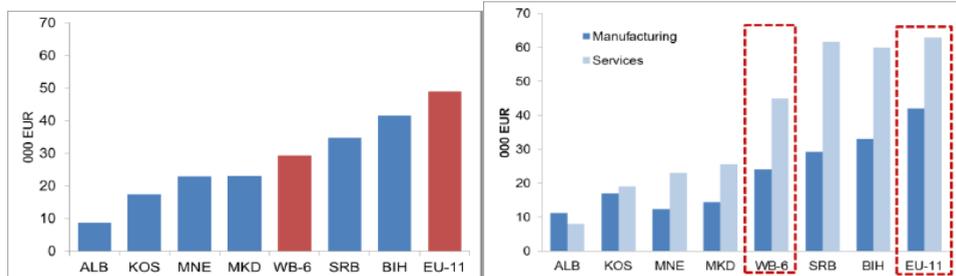
Productivity in the private sector lags well behind EU standards. The data highlight the labour productivity gap between Western Balkans countries and the EU-11. Chart 3.a. shows that, on average, aggregated firm level labour productivity in WB-6 companies is about 60 per cent of that of the EU-11. Chart 3.b. demonstrates that this gap is driven by the manufacturing sector; the productivity of this sector in the WB-6 is around 55 per cent of that of the EU-11. In the WB-6 region, manufacturing is most productive in Serbia and Bosnia and Herzegovina, with both countries having a strong industrial basis. Services (wholesale, retail, transport, accommodation and food services) are more productive than manufacturing in all

⁷ EBRD, The Western Balkans in transition: diagnosing the constraints on the path to a sustainable market economy, February 2018, pp.12.

WB-6 countries, except in Albania, but still on average only 70 per cent of EU-11 levels.⁸

Chart 3.

a) Labour productivity, overall b) Labour productivity by sectors



Source: OECD

5. COMPETITIVENESS OF ECONOMY

Competitiveness plays a key role in the economic development of modern economies that are highly integrated into the global economic system. The core of competitiveness are the most important: knowledge, infrastructure, technology and innovation. Modern approach to economic development and new theories that emerge in response to the problems of the economy are increasingly attributed to factors such as: a favorable macroeconomic context, cheap labor, abundant natural resources, economic policies and the promotion of development with the protection of industrial branches and the promotion of exports. The modern approach to economic growth and the development of demand is the answer to the question of how to ensure sustainable quality of life, the answer lies in sustainable competitiveness that is focused on enterprises and industry rather than the economy as a whole.

Competitiveness of the economy implies a sustainable growth of productivity and business operations, influenced by the macroeconomic and microeconomic, business environment as well. Competitiveness of the economy and social productivity determine the standard of living of the state or region and its inhabitants. The basis of competitiveness lies in the nature of the environment in which businesses operate, which means that the business environment should be stimulated, invested, transparently and efficiently in providing the necessary information, natural and human resources, physical infrastructure, financial resources, scientific, information and technology infrastructure.

⁸ EBRD, The Western Balkans in transition: diagnosing the constraints on the path to a sustainable market economy, February 2018, pp.14.

The ability of firms to achieve competitive advantages depends not only on their strategy, innovation, and business but also on external factors and institutions. Macroeconomic reforms are necessary, but not a sufficient prerequisite for increasing social productivity and competitiveness. Microeconomic reforms are also important, and they take place at the enterprise level. That is why joint action by government and business is needed to create an incentive-friendly environment. The process of improving competitiveness in B&H implies a partnership between governments, business and academia; all must work together on the challenges that the global market poses to B&H.

According to research conducted by the World Economic Forum, the state of competitiveness of the economy of Bosnia and Herzegovina is bad. This assessment shows that much more needs to be done to achieve the average level of competitiveness in the near environment. A satisfactory level of country competitiveness is one of the conditions to be met for EU membership. Capacity needs to be built that will enable B&H to face competition and the European Union market, which is a critical component of Copenhagen's economic criteria for EU accession.

According to the World Economic Forum (2017/2018), B&H is ranked as 103rd and it is the most vulnerable of the countries of the Western Balkans. According to this report, Global Competitiveness Index for Serbia is 78, for Montenegro 77; for Albania 75, for Macedonia 68. On average, the GCI for the Western Balkans is 80, while the 11 EU countries⁹ have an index of 50. This indicates a large gap between the Western Balkans and the EU 11.

The most problematic areas in the GCI:

- labour market efficiency related –capacity to attract talent from abroad and the “brain drain” problem,
- weak business sophistication, the reliance on informal (family and friend) relationships rather than on professional management,
- the lack of well-developed business clusters, and
- shallow value chains.

The largest difference in ranking between the WB-6 and EU-11 is in the areas of macroeconomic environment (particularly emphasising the challenging fiscal situation in the region compared with the EU-11), market size, business sophistication, infrastructure development, innovation capacity and labour market efficiency.

⁹ The EU-11 refers to the 11 former socialist countries from central Europe, the Baltic states and south-eastern Europe that joined the EU in 2004 or since then, namely: Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.

The World Bank's annual Ease of Doing Business rankings vary widely in the region. FYR Macedonia is ranked at 11th position out of 190 countries in the 2018 report, the highest ranking in the region and the second highest among all EBRD countries of operations. Kosovo, Montenegro and Serbia are ranked between 40th and 43rd position, Albania is 65th, while Bosnia and Herzegovina is ranked the lowest in the region at 86th position.¹⁰ Common problems across the region include dealing with construction permits and getting electricity.

Table 2. Ease of Doing Business, Rankings out, of 190, 2018.

Economy	Ease of doing business rank	Starting a business	Dealing with construction permits	Getting electricity	Registering property	Getting credit	Protecting minority investors	Paying taxes	Trading across borders	Enforcing contracts	Resolving insolvency
Albania	65	45	106	157	103	42	20	125	24	120	41
B&H	86	175	166	122	97	55	62	137	37	71	40
Macedonia	11	22	26	53	48	12	4	29	27	35	30
Montenegro	42	60	78	127	76	12	51	70	44	42	37
Serbia	43	32	10	96	57	55	76	82	23	60	48
Kosovo	40	10	122	106	34	12	89	45	48	49	49

Source: World Bank Doing Business 2017 survey, <http://www.doingbusiness.org/Rankings>.

6. THE ROLE OF FOREIGN DIRECT INVESTMENT

Bosnia and Herzegovina, as a small, still insufficiently developed country, has no special advantages over the country's environments or other destinations, which would be a strong motivation for entry of foreign investors. Infrastructure and communication are insufficiently developed, but these activities may be most interesting for foreign investors; they are the space in which the global strategy of foreign companies can be realized for mutual benefit. Although legal regulation provides sufficiently liberal status to foreign investors, the political and economic system has constraints on their entry. The general view is that the most important factor influencing foreign investment is domestic economic and political stability. The political and economic environment in B&H is disadvantageous, so the state and its overall policy, and in this context, and foreign investment policy, are the main determinants of the influence that foreign investments may have on economic development.

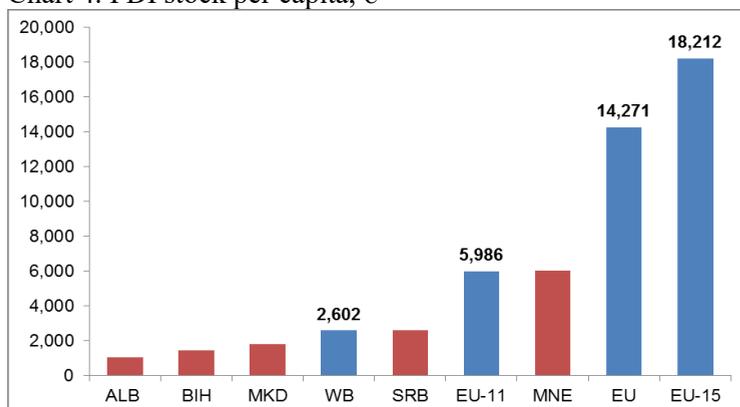
Foreign direct investment (FDI) in all Western Balkan countries has lagged well behind levels in the EU. Still, the region lags significantly behind the European Union in terms of FDI stock per capita received; average FDI stock per capita in

¹⁰ Doing Business 2018, Reforming to create jobs, A World Bank Group Flagship Report

the Western Balkans is around €2,600 while in the European Union it is around €14,300.¹¹ Even compared with the EU-11 average, the Western Balkans region's average FDI stock per capita is less than half that of the EU-11. However, over the past five years, Albania, Kosovo and Serbia have all experienced annual FDI inflows at a rate above the OECD average of 4.1 per cent of GDP, which is encouraging.

According to the data of the Central Bank of Bosnia and Herzegovina, the total direct foreign investment on 31 December 2017 amounts to 6.9 billion euros in B&H. Within the UNCTAD Annual Report on Global FDI B&H is ranked second in the Southeastern European countries. FDI for 2017. amounted to 397.6 million euros. Data for the period January-December 2017. indicate an increase in FDI by 37,9% in relation to the amount in 2016. Or by 28,8% in comparison to the five-year average (2012-2016). Based on the first preliminary data for period January – Jun 2018. We can expect FDI to maintain a positive trend.

Chart 4. FDI stock per capita, €



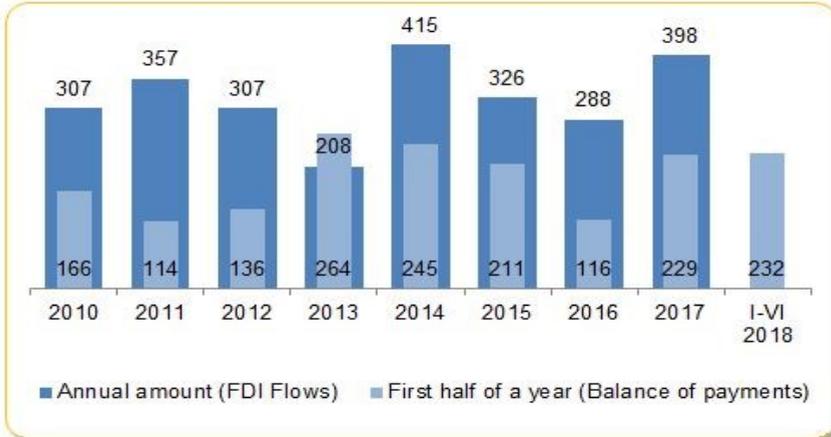
Source: The Western Balkans in transition: diagnosing the constraints on the path to a sustainable market economy, February 2018, pp. 39.

In 2007 B&H attracted 1.3 billion EUR which is absolutely the highest amount recorded till now, mainly thanks to the privatization of certain large state-owned enterprises. In 2008 FDI inflow (684 million EUR), without the expected privatization, can be considered as satisfied, especially if we take into account its positive structure (investment in production sector and high contribution of Greenfield investments). In 2009 the global economic crisis hit the inflow of FDI. Slight progress was achieved in 2010 and 2011. Unfortunately, despite promising expectations, foreign direct investment in 2012 and 2013 did not have a positive trend, mainly caused by slow economic recovery globally, which also reflected on

¹¹ EBRD, The Western Balkans in transition: diagnosing the constraints on the path to a sustainable market economy, February 2018, pp 38.

investment worldwide. In 2017, with a 37.9% increase in foreign investment, the negative trend has stopped and we hope that investment growth will continue in the future.

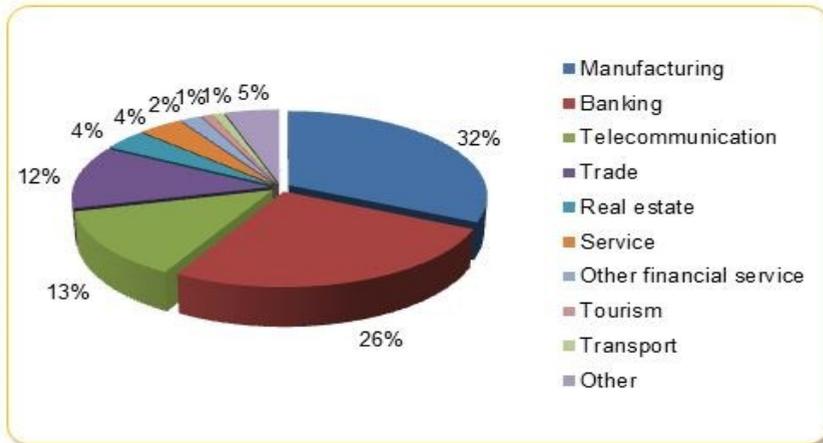
Chart 5. Flow of FDI in Bosnia and Herzegovina, by years, million EUR



Source: Central Bank of B&H (CBBH), 2007-2017 Flows of FDI, 2018.

Due to the good reputation and long industrial tradition of Bosnia and Herzegovina, the manufacturing sector received the largest amount of FDI (32%). A significant share of investment has been in banking sector (26%).

Chart 6. FDI Stocks by Industry, May 1994 - December 2017



Source: Central Bank of B&H

For example, the region’s banking sector is owned largely by foreign investors, predominantly from the EU. The competitiveness of B&H economy and its capacity to attract foreign direct investment depend on a number of factors, including the regulatory environment, the skills base, the market size, the resource endowment, and

the quality of its infrastructure and investment promotion efforts. The most important policies that affect FDI are: the FDI-specific legal framework, international investment agreements, business facilitation, the tax regime, labour policy and skills, and the competition regime.

7. THE OPPORTUNITIES FOR GROWTH OF THE ECONOMY

Bosnia and Herzegovina and Western Balkans countries lag behind EU standards, whether in terms of overall competitiveness, weak institutions and low standards of governance or barriers to trading across borders. However, the prospects for economic growth are positive, of course only assuming the planned structural reforms are achieved.. Bosnia and Herzegovina has maintained a stable 3 percent annual growth rate for the last few years. Growth in 2018 is projected at 3.2 percent, driven primarily by consumption. In the medium term, it is expected to pick up as structural reforms supported by new investment in infrastructure get underway. Real GDP growth is therefore projected to build gradually to 3.9 percent by 2020.

The potential danger to realizing any projection may be delays in forming the new government after the October general election. Delay in forming new governments could slow reform efforts and drag down growth

Table 3. Movement of basic macroeconomic indicators shows moderate growth

Bosnia and Herzegovina	2014.	2015.	2016.	2017.	2018.*	2019.*	2020.*
Real GDP growth (%)	1,1	3,0	3,1	3,0	3,2	3,4	3,9
Consumption	n.a	n.a	n.a	3,0	3,5	2,6	2,7
Investment	n.a	n.a	n.a	0,6	0,8	1,0	0,8
Net exports	n.a	n.a	n.a	-0,8	-1,1	-0,2	0,4
Consumer price inflation (%period average)	-0,9	-1,0	-1,6	0,8	1,1	1,4	1,4
Public revenues (% of GDP)	44,2	43,2	43,1	43,7	44,5	42,9	42,7
Public expenditure (% of GDP)	46,2	42,5	42,1	41,4	45,0	42,6	41,5

*World Bank estimates and projections

Source: World Bank Group, Western Balkans Regular Economic Report No.14, 2018, pp. 50.

Table 4. suggests that B & H in the Western Balkans group achieved a somewhat higher growth rate than the average of the WB6 countries, and that growth will continue until 2020.

Table 4. Real GDP growth in Western Balkans, %

Real GDP growth (%)	2014.	2015.	2016.	2017.	2018.*	2019.*	2020.*
Albania	1,8	2,2	3,4	3,8	4,0	3,6	3,5
Bosnia and Herzegovina	1,1	3,0	3,1	3,0	3,2	3,4	3,9
Kosovo	1,2	4,1	4,1	3,7	4,0	4,5	4,5
Macedonia, FRY	3,6	3,9	2,9	0,0	2,5	2,9	3,2
Montenegro	1,8	3,4	2,9	4,3	3,8	2,8	2,5
Serbia	-1,8	0,8	2,8	1,9	3,5	3,5	4,0
WB6	0,3	2,2	3,1	2,4	3,5	3,5	3,8

*World Bank estimates and projections

In 2017, the labor market in the EU countries registered lower unemployment rates compared to 2016. The average unemployment rate in the EU 28 has been the lowest since 2009 and gradually reaches the level just before the economic crisis (in 2008 it was 7%). The unemployment rate in B&H was 20,5% in 2017. And it is lower in relation to 2016. by 4,9%, continuing the downward trend.¹² However, it is evident that the unemployment rate in B&H remains one of the largest in the region. The problem of high unemployment in B&H can only be solved by the implementation of the necessary reforms, which ultimately should lead to convergence of the economy towards EU economies. To achieve this goal it is necessary to reform the education system with the aim of establishing stronger links with the labor market. The reform should include support for first-job seekers, with active discouragement of work in the informal economy, and a significant reduction in social security contributions.

Reform means to protect workers' rights in accordance with the standards of the ILO and the EU directives on the work. The reform of social security and pensions Social protection systems should involve the protection and increase social assistance to those who need.

8. CONCLUSION

The long-term and sustainable development of Bosnia and Herzegovina depends in a large extent on the success of the entry into the Western European market because the country is heavily dependent on exports, especially in the European Union countries. That is why building up national competitive advantages is the only way to overcome this obstacle; the growth of the competitiveness of local businesses creates the preconditions for entering the European and world markets.

¹² CBB&H, Annual Report for 2017., 2018.

Integration of the economy into the EU creates conditions for the internationalization of economic activities and the arrival of foreign investors, which, with the establishment of new enterprises or by taking local ones, significantly affect the quality and volume of employment as well as the growth of competitiveness of the economy at the international level. To close the gap with advanced Europe faster, B&H need stronger policies to improve labor supply, boost investment, and increase efficiency.

European Union through the strategic objectives (Europe 2020) put a smart, sustainable and inclusive growth at the center of its activities, with five main objectives (employment, research and development, climate change and energy, education and the fight against corruption). Given the high degree of integration with the EU economy, the immediate growth prospects are in part beyond the direct control of their respective governments, as economic recovery to a large extent depend on future growth in the European Union. At the same time, FDI is unlikely to return in larger amounts soon, since privatization opportunities have been mostly exhausted, while FDI at the global level has not yet fully recovered.

From today's perspective it may be possible to grow faster, smarter and better, but the B&H will need to radically change economic development strategy at both the regional and national level. However, the key instruments for achieving the objectives of the SEE 2020 Strategy and for resolving the crucial economic problems are in the hands of the national governments, that need to devise their own development strategies in line with specific priorities. After election, this may be a key challenge for the new government in B&H.

In view of the extreme deindustrialization that has taken place in the region, the new growth model has to ensure one common objective: the strengthening of the real sector of the B&H economy, as this is a crucial element for improving export performance and increasing competitiveness on global markets. This will require a more targeted industrial policy that would strengthen key manufacturing industries, stimulate diversification and upgrading of the industrial base and facilitate reindustrialization. The reindustrialization of the B&H would be in line with recent EU objectives that aim at increasing the share of manufacturing value added from 15 per cent to 20 per cent of GDP by 2020.

It is necessary to implement structural reforms that will result in:

- stimulating production, trade, financial flows,
- reforming the labor market and the public sector,
- that is why growth of investment and exports is the main determinant of long-term growth,
- significant convergence towards EU living standards requires a major and sustained boost to productivity and investment.

The ability to turn adjustment of the economy is reflected in the speed with which the economy responds to changing market conditions and recognize new possibilities and opportunities that can not be covered by one macroeconomic indicator.

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**CROATIAN DEVELOPMENT INDEX AND REGIONAL
DISPARITIES IN SPATIAL DISTRIBUTION OF EU FUNDS FOR
RURAL DEVELOPMENT**

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Abstract

The EU funds are an important factor in the development process of any new member state of the European Union. As such, EU funds support modernization and help facilitate further economic development in a member state, including its rural regions. The Republic of Croatia, based on NUTS3 classification, is predominantly rural with 79.01% of its territory being rural and 56.07% of population living in rural areas. Therefore, rural development is an integral part of overall economic development of the country. In order to improve competitiveness of Croatian agriculture sector, especially its small family farms, it is crucial to invest in their means of production and modernization of their assets. Funds awarded within the EAFRD framework in The Republic of Croatia tend to facilitate this process and further aid rural development. Croatian Development Index has a very important role in allocation of before mentioned funds. Its values are taken as criteria for state-aided areas, scoring projects (including EAFRD and other EU funds applications) and other aspects of public development policies. As one of the primary goals of Rural Development Programme in the Republic of Croatia, it is especially important to achieve a more balanced territorial development of rural areas given the fact that Croatian rural regions (counties and municipalities) are not equally developed, ensuring job creation and job retention in the process. The existence of disparities in the level of development is not a characteristic that can be found only in the Republic of Croatia, but it is an issue that should be taken into

account when devising or reconsidering criteria for allocation of future EU funds in the Republic of Croatia, in order to further reduce regional disparities in the level of development. The aim of this paper is to provide empirical evidence on associations between the indicators of Croatian Development Index and spatial distribution of EU funds awarded within the Rural Development programme in The Republic of Croatia based on available data for the most recent invitation to tender for EAFRD funds.

Keywords: *Croatian Development Index, EU, funds, EAFRD, rural development*

JEL: F15, O13, Q18

1. INTRODUCTION

Rural areas in the Republic of Croatia are facing serious challenges at this moment. Most of these challenges are coming from globalization trends, demographic changes and migration from rural areas of young people (mostly to bigger cities in The Republic of Croatia and other EU countries for job opportunities) thus bearing a consequence of possible depopulation of rural areas and an overall socio-economic decline in those areas. Implementing rural policies is intended to prevent or decrease further decline of rural areas and promote and aid subsequent development of those areas as a vital part of improving overall economic development of any country. These rural policies intend to aim to contribute to recognizing and making use of particular strengths and opportunities of these rural areas, which is not irrelevant, given that rural regions cover 44% of the EU territory, intermediate regions another 44%, while urban regions only represent 12% of the territory (DG Agriculture and Rural Development: Unit Farm Economics, 2018).

2. RURAL DEVELOPMENT POLICY IN THE EU AND THE REPUBLIC OF CROATIA

The definition of rural development changed over time, and can be now considered as (Anríquez & Stamoulis, 2007): “development that benefits rural populations; where development is understood as the sustained improvement of the population’s standards of living or welfare.” However, rural development should be further analyzed and explained, as rural development first predominantly focused on agriculture and today the importance of agriculture in rural development is less prominent (Anríquez & Stamoulis, 2007), as rural development can be attributed to tourism activities as well. As such, rural development makes a very important part of the CAP (Common Agricultural Policy) in the EU. Rural Development policy is referred to as the ‘second pillar’ of the EU’s Common Agricultural Policy (CAP),

complementing the system of direct payments to farmers and measures to manage agricultural markets ('first pillar') (enrd.ec.europa.eu, 2018).

After the 2003 Reform of the CAP (which decoupled direct payments from production and introduced single farm payments), EU decided to reform rural development policy in 2005 and from 2007 onwards, a new policy is administered. Today's EU rural policy has many measures that can comply with four main axes (FAO/WB, 2011): improving the competitiveness of agricultural and forestry sector, improving the countryside and the environment, improving the quality of life in rural areas and diversifying the rural economy and LEADER. The EARDF is, along with the EAGF (European Agricultural Guarantee Fund), one of the two financial instruments of the Common Agricultural Policy (CAP) established by Regulation (EC) No 1290/2005. From 1 January 2007, these two funds replace the EAGGF Guidance section and the EAGGF Guarantee section respectively (eur-lex.europa.eu, 2018). The EAFRD (European Agricultural Fund for Rural Development) is a key tool for implementing EU rural development policy. The Fund complements national, regional and local actions, which contribute to Community priorities. The Commission and the Member States are also to ensure that the Fund is consistent and compatible with other Community support measures (eur-lex.europa.eu, 2018). The EAFRD has a total budget of over €99 billion for the period 2014-2020. This support is provided to agriculture, forestry and environment or natural resources management as well as to the sustainable development of rural economy (cohesiondata.ec.europa.eu, 2018). Furthermore, The Republic of Croatia has a total budget of ESIF funding of over €10 billion in the period 2014-2020, through 4 national programs. The planned EAFRD financing for The Republic of Croatia in the period 2014-2020 is over €2 billion (cohesiondata.ec.europa.eu, 2018). Implementation of before mentioned EAFRD funds until the end of 2017 accounted for 25% spent (€591 512 859) out of 48% financing decided (€1 137 522 211) (cohesiondata.ec.europa.eu, 2018). The past century was marked by wars that led to many changes that directly affected the standard of living of the population in rural areas. Croatian villages throughout history had passed through 3 big stages (Župančić, 2000). The first stage marks the period until the end of World War II, the second stage until the 1990s and the third stage represents the transitional period since the 1990s. In the Republic of Croatia, on the basis of data from the Register of Agricultural Holdings/Farms it is evidenced that there is a continuous depopulation of farmers and agricultural holdings/farms. From 2010 to 2016, the total number of agricultural holdings/farms decreased from 198,029 to 170 515. In addition to the persistent depopulation trend, the structure of the agricultural holdings/farms was marked by the aging of the population engaged in agriculture. Most of the farmers are older than 65 yrs, while the share of farmers under the age of 40 is less than 10 percent of total number of agriculture holdings/farms (APPRRR, 2018).

Summarizing all the before mentioned, rural areas in The Republic of Croatia face very difficult times. Therefore, enticing project applications for EAFRD funds among agricultural holdings/farms is of crucial significance for further rural development in The Republic of Croatia. By efficiently using these available allocated funds rural areas in The Republic of Croatia could prevent or reverse the depopulation and migration trends thus keeping people, especially young people in rural areas giving them a stimulus to stay and further develop their farms or other rural based projects, basically, providing them a sustainable future. As a new member of the European Union, in 2013, The Republic of Croatia decided on 16 implementation measures intended for rural development within the Rural Development Program (RDP) in the period 2014-2020 (Ministry of Agriculture of RH, 2018). The main objective of the RDP is to restructure and modernize agricultural holdings/farms and food sectors. It is expected that nearly 2 000 holdings will receive investment support, more than 5 000 farmers will receive start up aid for the development of small family farms and around 1 000 young farmers will get support to launch their businesses during the 2014-2020 period. The program also puts emphasis on the restoration, preservation and enhancement of biodiversity (EC Factsheet on 2014-2020 RDP for Croatia, 2018).

2.1. Potential for Rural Development and Key Challenges in the Republic of Croatia

The Republic of Croatia saw a significant decrease in the share of rural population in the total population over the years. There was 68.4% of rural population in 1961 compared to 31.6% of urban population in that year. The percentage of rural population was 58% in 1971, 48.5% in 1981, 43.8% in 1991, and 42.7% in 2001, and in the last census that number dropped to 39.1% (Župančić, 2000). Deagrarization and deruralization have led to a large number of stateresidents that live in rural areas but do not engage in agricultural activities or agriculture-associated activities. It can be stated that this condition is a significant “*deal-breaker*” in the development of the rural areas and has an effect that 77% of the rural areas of the Republic of Croatia have a characteristic of significant lagging in terms of demographic, socio-cultural and spatial planning (Strategy of Rural Development of Croatia 2008-2013, 2008). Lack of permanent income, old average age of population, low level of education, neglect of architectural heritage, insufficient basic services and infrastructure combined with unresolved ownership issues have resulted in a neglect of rural areas and the loss of youth labor (Rogošić, 2011). The large negative rate of rural population growth is a trend that has several reasons: a low percentage of woman under 45 lives in rural areas, unfavorable living conditions for young families, the preference for a smaller number of children, the decisions of young families to live in urban environments etc. Overall, there is a big difference between the rates of economic growth and the rate of population growth in rural and urban areas and / or between less prospective and more perspective rural areas region. A strong negative growth rate of population

living in rural areas is the result of relative and / or absolute deterioration of the living conditions for young families and the growing trend of migration in urban centers or in more perspective rural / tourist regions (Strategy of Rural Development of Croatia 2008-2013, 2008).

According to Eurostat (2018), the working-age population in 2017 was 3.1 million, of which 1.8 million were active and 1.3 million were inactive. Around 1.6 million were employed and around 205 000 were not. Agriculture provides 7.54% of employment in 2017, industry employment distribution occupies 27.04% and 65.41% of total working population work in services. Average farm size is 5.6 ha. This is considerably less than the average size in the rest of the EU (14.4 ha). Half of all farms are under 2 ha and the vast majority is below 10 ha (89.4%) (Eurostat, 2018). The average economic size of a farm, calculated on the basis of total production value, is € 9 064. Based on this criterion, 40 % of farms are below € 2.000. Average crop yields are lower than in other EU countries due to outdated technologies and frequent droughts. There is a serious structural challenge in some sectors, including fruit, vegetables and livestock sector, because there is a need for investment, modernization, preparation of products for the market and the promotion of production and market organization of farmers, all with the common aim of ensuring stronger productivity growth and creation of new jobs. Croatia is increasingly exposed to extreme weather conditions causing droughts and floods. This is attributed to climate change. However, only around 1 % of agricultural land is irrigated, significantly affecting productivity. Due to the conflicts between 1991 and 1995, 11 000 ha of agricultural land currently contain land mines. Natura 2000 sites cover nearly 37% of the country. The production of renewable energy is quite low. For example, the production of electricity from renewable energy resources accounted for 4, 9 % of total production, with the exception of large hydro plants. Only 2.4 % of the total agricultural land is currently used for organic farming. Due to inadequate management in the past, forest fires or other factors, degraded forms of forest stands now cover 44 % of the total forest land. Due to depopulation, the impact of the war and the long-term economic crisis, there has been low maintenance of infrastructure, social and cultural facilities resulting in a poor availability of basic services for the local rural population (EC Factsheet on 2014-2020 RDP for Croatia, 2018). In addressing these challenges, the Croatian RDP will fund actions under all six Rural Development priorities – with the main priority being Priority 2: Enhancing farm viability and competitiveness of all types of agriculture in all regions and promoting innovative farm technologies and the sustainable management of forests. The four biggest RDP measures in budgetary terms (total public funding) are: € 567 million allocated for Measure 4: Investments in physical assets, € 273 million allocated for Measure 13: Payments in areas facing natural or other specific constraints, € 226 million allocated for Measure 7: Basic services and village renewal in rural areas, € 226 million allocated for Measure 6: Farm and business development (EC Factsheet on 2014-2020 RDP for Croatia, 2018).

2.2. Croatian Development Index and Measure M06

Administratively, the Republic of Croatia is divided into 21 units of regional self-government classified at NUTS 3 level, of which 20 counties and the City of Zagreb which is a special administrative unit. There are 556 units of local self-government, of which 127 are classified as cities and 429 are municipalities in accordance with the Law on Local and Regional Self-Government. In the statistical sense, the Republic of Croatia is divided into two NUTS 2 regions: Continental Croatia and Adriatic Croatia. In 2012, almost 80% of the Croatian land area was classified as predominantly rural, an area that is considerably higher than the EU-27 average, where the average is 51.3%. More precisely, according to Eurostat' urban / rural typology, 79.1% of Croatian land surface is classified as predominantly rural, 19.8% as mixed, while only 1.1% (CI-3) areas are classified as predominantly urban area categorized by NUTS-3 region level (Rural development Programme for Croatia 2014-2020, EC, 2014). Given the high significance of rural areas in the Republic of Croatia in every possible way and problems of rural areas already mentioned in the paper, it is an imperative to develop tools to further decrease the differences (especially in socio-economic terms, among others) between urban and rural areas in the Republic of Croatia. According to the current Law on Regional Development of the Republic of Croatia (ZRRRH) (Official Gazette no. 147/14, 2014), it is the policy objective of rural development to contribute to the socio-economic development of the Republic of Croatia, in accordance with principles of sustainable development, and to create conditions that will enable all parts of the country to be competitive and fulfill its own development potential. To achieve this goal, the regional development policy is made to ensure: the linkage of local and regional development needs with development priorities of the central level and achieving goals of the European Union cohesion policy; supporting less developed areas for maximization and optimization in using their own development potential by addressing the causes of their developmental difficulties; implementing appropriate measures for an even and sustainable development of local and regional self-government units in the border area; fostering territorial cooperation and effectively leveraging structural and investment resources of the European Union funds intended for regional and urban development (CLER, 2017).

As the umbrella document of regional policy implementation, ZRRRH prescribes evaluation and classification of units of local and regional self-government according to the degree of development and determines the method of determining which the assisted areas are (ZRRRH, 2014). Evaluation and classification of local and regional self-government units is performed on the basis of the calculation of the development index value, a composite weighted indicator of selected socio-economic indicators. Method of calculation, indicators for calculation of development index, share of individual indicator in the total value of development index and other related issues are regulated according to the Regulation of the

Government of the Republic of Croatia (Official Gazette no. 63/10, 2010 & Official Gazette 158/13, 2013). Development index according to ZRRRH is an instrument for assessing the socioeconomic level of development and evaluation of the degree of development of local and regional self-government units and for categorization of assisted areas. Therefore, it can be stated that the development index is one of key instruments of the regional policy of the Republic of Croatia. This is also confirmed by the approach The Ministry of Regional Development and EU Funds (MRRFEU) used on occasion of introducing a unified system for assessing the development of all territorial units based on the development index. MRRFEU estimates how such an approach contributes to simplicity and transparency of the whole system, allowing for directing better incentives and acquiring better foundations for including or excluding assisted area units for which the State additionally cares (MRRFEU, 2018). According to the Development Index Regulation, which is in effect since April 2010, the development index is calculated on the basis of following indicators (Marcelić, 2011): unemployment rate, per capita income, budget revenues of local and regional self-government units, migrations, aging rate and education rate. Regional self-government units are divided into four groups (MRRFEU, 2018): I. group of regional self-government units that are ranked according to index values in the second half of the sub-ranked units of regional self-government; II. group of regional self-government units which, according to the value of the index, are in the first half of the sub-ranked units of regional self-government; III. group of regional self-government units which, according to the index values, are in the second half of the above-ranked units of regional self-government; IV. group of regional self-government units which, according to the index values, are in the first half of the above-ranked ranking units of regional self-government. Local self-government units or LAU2 (Local Administrative Units) units in The Republic of Croatia are divided in 8 development groups. Local self-government units with Development index below average (under 100%) are distributed in four groups with equal number of units forming Groups I, II, III and IV. Units with Development Index above average are also distributed in four equal groups forming Groups V, VI, VII and the most developed Group VIII (regionalni-en.weebly.com, 2018). As such, Croatian Development Index is an important part of selection criteria (or ranking criteria) within Measure 06 of Croatian Rural Development Programme. Specifically, Measure 06 is orientated to Farm and business development in rural areas. Measure 06 is divided into four sub-measures, each directed to address a specific issue within farm and business development segment. Measure 06 is designed to help a very high number of small agricultural holdings with weak economic sustainability and the significant migration trends of younger people from rural areas as a result of poor living and working conditions for young families, low employment opportunities due to lack of economic viability and the employment opportunities in urban centers (Rural development Programme for Croatia 2014-2020, EC, 2014). Sub-measures are intended to encourage the development of small farms which are potentially economically sustainable. Diversification into non-

agricultural activities contributes greatly to the creation of new jobs as a response to the slowdown of economic activity which rural areas are facing today. Sub-measures are the following: Sub-measure 6.1. Business start up aid for young farmers, Sub-measure 6.2. Business start up aid for non-agricultural activities in rural areas, Sub-measure 6.3. Business start up aid for the development of small farms, Sub-measure 6.4. Support for investments in creation and development of non-agricultural activities (Croatian RDP, 2015). In this paper, Sub-measure 6.3. is examined more closely regarding the special distribution of funds awarded within this framework, as given the high number of small agricultural holdings in the Republic of Croatia, it can be considered as a powerful tool to “kick start” their business development. The survival and development of small agricultural holdings is based on the need for restructuring and increasing their added value through modernizing their basic assets. This type of operation shall provide support to small, potentially sustainable farms which are oriented towards market production in accordance with market requirements, but which lack the basic resources. This will help small farms in their transition towards market oriented production become commercially viable, which is a precondition for achieving competitiveness in the agriculture sector. In Croatia there are 93.080 farms which are between EUR 2.000 SO and 7.999 SO. These farms have a broad significance in the rural area from the point of the rural population, environmental protection and biodiversity conservation as such. Through this support, small farms will be provided with the possibility of achieving economic sustainability, as well as carrying out other activities set out in their business plans (transformation to organic production, diversification, modernizing assets etc.). In their business plans they need to clearly define the inputs, activities and goals to be achieved in the next three years. This type of operation contributes to Focus Area 2A and responds directly to Need 6 (Rural development Programme for Croatia 2014-2020, EC, 2014). The selection criteria for the eligible projects within Sub-measure 06, is published together with the call for proposals based on the following principles in order to achieve objectives set under this type of operation: size of farm (farms with higher SO are prioritized); impact of planned activities on the environment (positive impact on environment is prioritized); level of economic development of the area where the operation is located (investments in area with lower DI (development index) are prioritized). Only operations reaching a minimal threshold score are funded within this sub-measure. The value of public support per beneficiary is EUR 15.000. The support shall be paid in two installments over a period of maximum three years. Payment of the last installment will be conditional on the correct implementation of the business plan within the prescribed time period. According to this principle, at the time of conducting this research it was only possible to determine the funds awarded, not funds payment, as their three-year conditional period has not yet officially ended for most of applicants.

3. METHODOLOGY

3.1. Aims and Research Questions

The purpose of conducting this study is to determine spatial distribution of EU funds for rural development. The study aims to explore the status of small agricultural holdings/farms regarding their specific economic value and distribution of awarded EU funds within the last public proposal results available at time of writing the study. The aim of this paper is to provide empirical evidence on associations between the indicators of Croatian Development Index and spatial distribution of EU funds awarded within the Rural Development programme in The Republic of Croatia based on available data for the most recent public proposal for EAFRD funds. The research questions which guided the study are as follows:

- What is the spatial distribution pattern of awarded EU funds for small agricultural holdings?
- Is the number of awarded grants to small agricultural holdings that reside in areas with lower Development Index greater of those that reside in areas with higher Development Index?
- Is Development Index criteria for allocation of EU funds sufficient for prioritizing rural areas with lower Development Index?
- How strong are the correlations of DI indicators regarding the number of awarded grants of EU funds for small agricultural holdings in the Republic of Croatia?

3.2. Research Method

The research was conducted on a sample of 996 awarded grants/applications amounting to 113 358 961, 23 HRK of the last public proposal results within the Sub-measure 6.3.1. (APPRRR, 2018). Descriptive statistics were used in order to clearly and efficiently display the obtained results. In order to compare the number of awarded grants to DI value of the area in which the agricultural holding reside, Pearson Correlations were used to measure the strength of association between the variables. QGIS software was used to determine the spatial distribution of awarded grants/applications.

4. RESULTS AND DISCUSSION

4.1. Results on NUTS 2 classification level

On a NUTS 2 classification level awarded grants are distributed in favor of least developed groups – Group I and Group II, and the Pearson correlation coefficients confirm that there is a negative correlation ($r=-0,656521642$) in Continental Croatia where as the development group increases the number of awarded grants

decrease. In the Adriatic Croatia, a strong positive correlation between Development Index Group and number of has been determined ($r=0,765929034$), where as the Development Index Group increases the number of awarded grants increases as well. Results show that on a NUTS 2 classification level in Continental Croatia awarded grants are allocated in favor of areas with lower Development Index Group NUTS 2 Self Government Units. In this case, the results are encouraging and the grants are awarded to small agricultural holdings/farms in lesser developed rural areas.

Table 1. Pearson Correlation Coefficients for NUTS 2 classification level

	DI Group NUTS 2	Continental (NUTS 2)
DI Group NUTS 2	1	
Continental (NUTS 2)	-0,656521642	1
	DI Group NUTS 2	Adriatic(NUTS 2)
DI Group NUTS 2	1	
Adriatic (NUTS 2)	0,765929034	1

*statistically significant at the 0.05 significance level

Source: authors based on M0631 results (3rd Proposal) available at: aprrr.hr

The interesting results is that on a NUTS 2 classification level total funds (in HRK) are allocated in favor of Continental Croatia with 69% of the awarded grants allocated to farms residing there and only 31% are awarded to Adriatic Croatia. This is evident from Table 2, as most funds are allocated in Regional Self Government Units categorized as I and II Development Index Group of less developed units. Units categorized as I Development Index Group received 24.358.122, 00 HRK, and units categorized as II Development Index Group received 32.550.548, 79 HRK, which is much higher than III and IV, that received 7.169.794, 50 HRK and 13.771.351, 05 HRK respectively. At the same time, allocated funds are differently distributed in Adriatic Croatia. As evidenced in Table 2, Regional Self Government units that are ranked Development Index Group III and IV (more developed) received 17.867.040, 06 HRK and 12.975.799, 83 HRK which is substantially higher than units labeled as I and II Groups.

Table 2. Awarded Grants on NUTS 2 classification level (HRK)

Development Index Group of Regional Self-Govern. Units	4	3	2	1
Continental Croatia(NUTS 2)	13.771.351,05	7.169.794,50	32.550.548,79	24.358.122,00
Adriatic Croatia(NUTS 2)	12.975.799,83	17.867.040,06	1.820.752,50	2.845.552,50
TOTAL: 113.358.961,23 HRK	26.747.150,88	25.036.834,56	34.371.301,29	27.203.674,50
n	235	220	302	239
%	23,6	22,09	30,32	24

Source: authors based on M0631 results (3rd Proposal) available at: aprrr.hr

This can be connected to criticism of Development Index measurement that states that the DI gives priority to the level of development of units and not the level of development of human factor (human development) and that coastal regional self government units have higher incomes and financial assets (do to tourism activities that are not so highly present in the Continental Croatia as they are in Adriatic Croatia) but have lesser paid, lesser educated and older people, but are still categorized in higher Development Index Groups of regional self government units (Marcelić, 2011).

4.2. Results on NUTS 3 classification level

On a regional self government level or NUTS 3 level of classification the Republic of Croatia is divided in 20 counties and the city of Zagreb. Counties with the highest number of awarded grants or funds (n x 15.000€) are Splitsko-dalmatinska (12%) which is categorized as DI Group 3, Osječko –baranjska (11%) which is categorized as DI Group II and Bjelovarsko-bilogorska (8%) which is categorized as DI Group I. 4th, 5th and 6th place is occupied by 2 counties and the city of Zagreb that are in the highest DI development group IV (Picture 1).

Table 3. M0631 results on NUTS 3 classification level

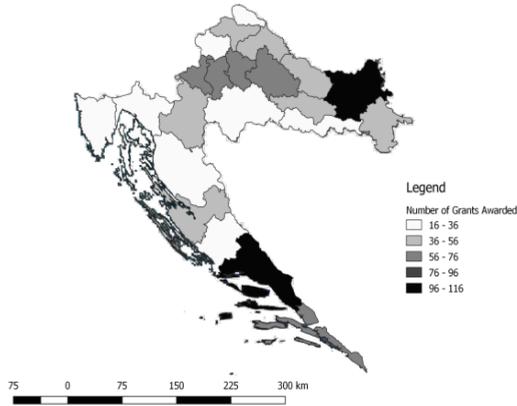
Regional Self Government Unit	n	n %	Awarded Funds	Funds %	DI Group	DI Group Total Funds	DI Group p%	Total n
Zagrebačka	57	6%	6.487.578,00 kn	6%	4	26.747.150,88 kn		
Grad Zagreb	64	6%	7.283.773,05 kn	6%	4		n	235
Primorsko-goranska	27	3%	3.073.002,78 kn	3%	4			
Istarska	21	2%	2.390.440,50 kn	2%	4			
Dubrovačko-neretvanska	66	7%	7.512.356,55 kn	7%	4		23,60 %	23,59 %
Varaždinska	45	5%	5.120.845,50 kn	5%	3	25.036.834,56 kn		
Međimuska	18	2%	2.048.949,00 kn	2%	3		n	220
Zadarska	41	4%	4.666.260,00 kn	4%	3			
Splitsko-dalmatinska	116	12 %	13.200.780,06 kn	12%	3		22,09 %	22,09 %
Krapinsko-zagorska	31	3%	3.528.535,50 kn	3%	2			
Karlovačka	49	5%	5.577.294,00 kn	5%	2	34.371.301,29 kn	n	302
Koprivničko-križevačka	45	5%	5.120.763,00 kn	5%	2			
Požeško-slavonska	48	5%	5.463.444,00 kn	5%	2			
Osječko-baranjska	113	11 %	12.860.512,29 kn	11%	2			

Šibensko-kninska	16	2%	1.820.752,50 kn	2%	2		30,32%	30,32%
Sisačko-moslavačka	33	3%	3.756.196,50 kn	3%	1	27.203.674,50 kn		
Bjelovarsko-bilogorska	75	8%	8.536.312,50 kn	8%	1		n	239
Virovitičko-podravska	43	4%	4.894.606,50 kn	4%	1			
Brodsko-posavska	24	2%	2.731.617,00 kn	2%	1			
Vukovarsko-srijemska	39	4%	4.439.389,50 kn	4%	1			
Ličko-senjska	25	3%	2.845.552,50 kn	3%	1		24,00%	24,00%
TOTAL	996	100%	113.358.961,23 kn	100%		113.358.961,23 kn	100%	100%

Source: authors based on M0631 results (3rd Proposal) available at: aprrrr.hr

Dubrovačko-neretvanska received 66 awarded grants within Sub Measure M0631 with total allocation of funds amounting to 7.512.356, 55 HRK and comprising 7% of total allocated funds. The City of Zagreb and the Zagreb County received total awarded funds of 7.283.773, 05 HRK and 6.487.578, 00 HRK, comprising approximately 6%. All three units are categorized as Development Index Group IV (most developed in regional self government units), with the number of awarded grants 64 and 57 respectively. Most developed group of regional self government units (DI Group IV) holds 23, 60% of total fund allocation within Sub Measure M0631, or 26.747.150, 88 HRK and 235 awarded small agricultural holdings. Development Index Group III holds 25.036.834, 56 HRK or 22, 09% of total awarded funds or 220 awarded small agricultural holdings. Regional self government units that are categorized as Development Index Group II hold 34.371.301, 29 HRK or 30, 32% of total awarded funds. Development Index Group I (least developed) hold 24, 00% or 27.203.674, 50 HRK of total awarded funds. It can be noticed that awarded funds in Development Index Groups I, III and IV are almost evenly distributed and only Development Index Group II stands out at 30, 32% of total awarded funds.

Picture 1. Spatial Distribution of M0631 Awarded Grants (NUTS 3)



Source: authors based on M0631 results (3rd Proposal) available at: aprrr.hr

Statistically significant correlation has been determined between the number of awarded grants and the Development Index Groups of counties that are divided in 4 groups (below average I and II, above average III and IV groups of development) (Table 4,)

Table 4. Pearson Correlation Coefficients for NUTS 3 classification level

	DI Group of Regional Self Govern.	AwardedGrants
DI Group of Regional Self Government Units	1	
AwardedGrants	-0.334776233	1

*statistically significant at the 0.05 significance level

Source: authors based on M0631 results (3rd Proposal) available at: aprrr.hr

The results show a small negative correlation ($r = -0,334776233$) between Development Index Group of Regional Self Government Units (Counties) and Awarded grants, which is explained as the development group of a unit increases the number of awarded grants decrease respectively.

4.3. Results on LAU2 classification level

On the Local Self Government Level, which is the level of Development Index Groups on a local level that is used in determining the Development Index criteria for M0631 call for proposals, the results show certain disparities. We can see that the most awarded funds are allocated in the most developed group of LAU2 (Local Administrative Unit) units, VIII and IV, followed by VI and III, then I and VII and at the end V and II (Table 5.)

Table 5. M0631 results on LAU2 classification level

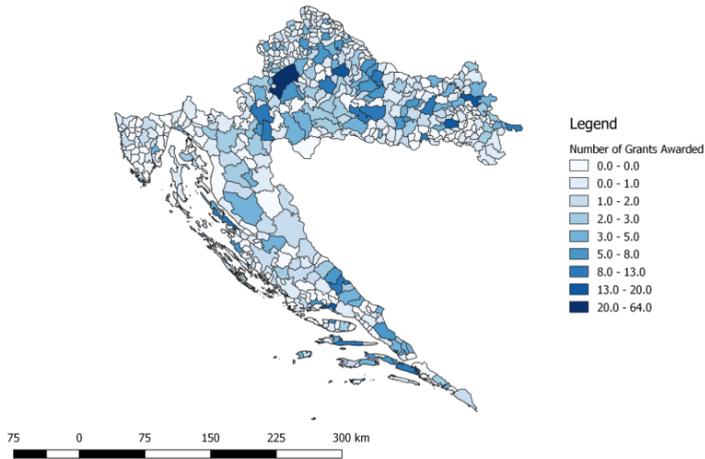
LAU 2 Development Groups	Funds	Funds%	(n)	(n) %
8	17.755.443,33 kn	16%	156	16%
7	12.861.261,69 kn	11%	113	11%
6	14.568.778,50 kn	13%	128	13%
5	12.747.324,39 kn	11%	112	11%
4	17.185.811,10 kn	15%	151	15%
3	14.567.178,72 kn	13%	128	13%
2	10.811.323,50 kn	10%	95	10%
1	12.861.840,00 kn	11%	113	11%
TOTAL	113.358.961,23 kn	100%	996	100%
AboveAverage	57.932.807,91 kn	51%	509	51%
BelowAverage	55.426.153,32 kn	49%	487	49%
TOTAL	113.358.961,23 kn	100%	996	100%

Source: authors based on M0631 results (3rd Proposal) available at: apprrr.hr

The 51% of funds are allocated in the above average (100%) Development Index Groups of LAU2 units and 49% in the below average groups. The results of the study on LAU 2 level show that slightly more funds are ending up in the above average developed local self government units. This indication should be observed carefully because we have to take into account certain outliers, like the city of Zagreb or LAU2 units that have much higher number of population meaning that units with higher numbers of population also mean higher rate or number of applicants, but nevertheless, analysis showed that on a LAU2 level most of the awarded grants still end up in highly developed units, taking into account warnings from certain local government officials that they are unjustifiably categorized in the higher development groups that can be generalized to small agricultural holdings applications as well; and certain before mentioned criticism of Development Index (Marcelić, 2011), the findings should be taken into account when devising or revising Development Index basis or Development Index criteria within call for proposals in the future.

When looking into spatial distribution of awarded funds based not on cumulative funds awarded for specific LAU2 group of Development but for the Development Level of single Local self government unit, we can observe a spatial pattern that is quite mosaic. It can be observed that the highest numbers of grants are allocated in single LAU2 units in the continental Croatia (NUTS 2).

Picture 2. Spatial Distribution of M0631 Awarded Grants (LAU 2)



Source: authors based on M0631 results (3rd Proposal) available at: aprrr.hr

Again, taking into account specific areas that can be considered outliers (above all the city of Zagreb – still people from Zagreb not necessarily perform their agricultural work in the city but elsewhere and only their HQ are registered in the City of Zagreb).

Pearson correlation coefficients analysis showed that when looking at single LAU2 unit development index there is a small positive and statistically significant correlation for every Development Index Indicator and the number of grants. The overall Development Index and correlation with the number of awarded grants shows a small but positive correlation of $r=0,176782224$; meaning that as the value of the Development Index increases the number of awarded grants increase as well. The coefficients are given in the next table:

Table 6. Pearson Correlation Coefficients for LAU 2 classification level

PearsonCorrelationCoefficients	LAU2
Indicators	Number of Awarded Grants (n)
Development Indeks	0,176782224
Incomepercapita	0,176544328
Income of local/regional budget per capita	0,105365351
Unemployment rate	-0,015884556
Populationchange	0,057380578
Aging indeks	-0,034346375
Rate of Education	0,339002927

*statistically significant at the 0.05 significance level

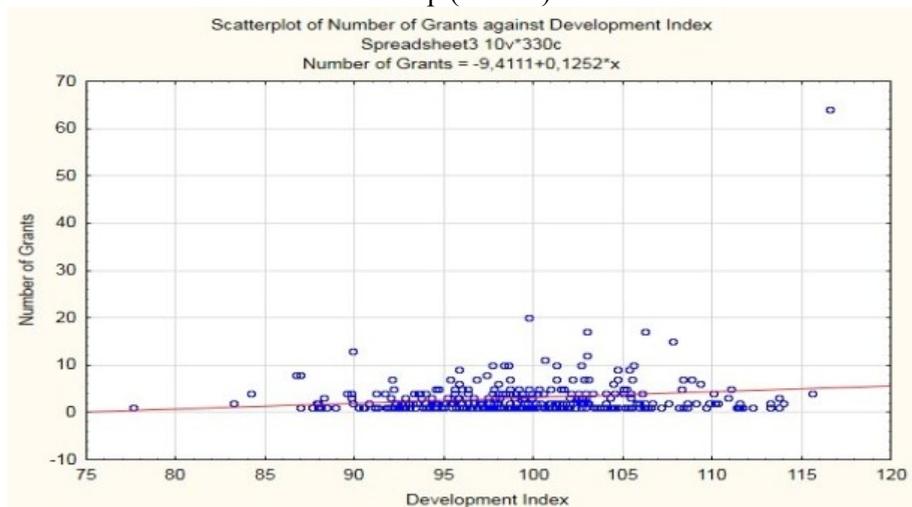
Source: authors based on M0631 results (3rd Proposal) available at: aprrr.hr

The results of the study regarding the specific Development Index Indicators that are used in calculating the overall Development Index of a unit are:

- There is a small positive correlation between income per capita and number of grants meaning that as the income per capita increases the number of grants rise as well ($r=0,176544328$),
- There is a small positive correlation between income of local budget per capita and number of grants meaning that as the income of local budget per capita increases the number of grants rise as well ($r=0,105365351$),
- There is a small negative correlation between unemployment rate and number of grants meaning that as the unemployment rate increases the number of grants fall ($r=-0,015884556$),
- There is a small positive correlation between population change and number of grants meaning that as the population increases the number of grants rise as well ($r=0,057380578$),
- There is a small negative correlation between aging index and number of grants meaning that as the aging index increases the number of grants fall ($r=-0,034346375$),
- There is a medium positive correlation between rate of education and number of grants meaning that as the rate of education increases the number of grants rise as well ($r=0,339002927$).

A scatterplot summarizes the results (Graph 1.). Overall, there was a small, positive correlation between number of awarded grants and the Development Index of a single LAU 2 unit.

Graph 1. Scatterplot of Number of Awarded Grants against Development Index Group (LAU 2)



Source: authors based on M0631 results (3rd Proposal) available at: appprrr.hr

Increases in number of awarded grants were correlated with increases in Development Index of single LAU 2 local self government units. As mentioned before in the paper, the City of Zagreb is an outlier that was taken into account when reading the results.

5. LIMITATIONS AND IMPLICATIONS FOR FURTHER RESEARCH

Further research might consider including a larger sample (possibly including results from all Sub Measures when they are available) and should focus not solely on a single Sub Measure but include other Measures within the Croatian RDP or other correlating Measures and Sub Measures within the RDP. Also, given that payment data is still not available because the process is not yet completed (applicants three year period for reaching defined objectives has not yet passed); when the data becomes available, further research into payments within the Sub Measure should provide more useful data and help investigate the impact of the M0631.

6. CONCLUSION

Development Index is an important part of RDP funds allocation criteria, but given the results of the study, Development Index based criteria should be further developed or revised in the future to allow least developed areas an easier access to RDP funds and entice a higher rate of applications and thus enable success of RDP implementation. Giving priorities to least developed areas based solely on Development Index based criteria will not be enough in the future but special interest has to be given to the internal factors influencing the rate of RDP funds applications at the level for small agricultural holdings. Internal factors influencing the rate of RDP funds applications of small agricultural holdings need to be determined in order to provide additional measures or programs outside RDP to increase the rate of applications (especially those from least developed groups). Before mentioned measures should be provided on a local and national level as well. At the local level, significant progress can be made in education and in specific LAG (Local Action Groups) projects strengthening local communities (including small agricultural holdings). On the national level (APPRRR), simplifying the procedures for smaller grants and prolonging the application periods should be considered as a first base measure for higher rate of applications.

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THE WESTERN BALKANS: ECONOMIC POTENTIALS AND LABOUR MARKET GAPS ON THE SUSTAINABLE PATH TO EUROPEAN UNION

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Abstract

One of the main aims of the paper is to estimate how sustainable is the transition of Western Balkans to the European union and to present scenario analysis for this region. The new momentum for real chance of success in accession process towards European Union depends on both economic results and political will of the governing bodies. In this respect, more flexible and differentiated approach towards the Western Balkans is required to enable the exploitation of economic potentials and reduction labour market gaps. Western Balkan Countries' ability to assume obligations of EU membership are summarized by using selected indicators which indicate the readiness of each country to integrate and to harmonize economic system. Taking into account the six transition qualities (Competitive, Well-governed, Green, Inclusive, Resilient, Integrated), the ranking of the Western Balkans countries was performed. By calculating the Pearson coefficient for economic potential (measured by GDP per capita) and the labor market indicator (Average monthly gross wages) in the period 2012-2017. for six Western Balkan countries, it is concluded that there is strong positive correlation between them. The basic research question which has been tested during the research is whether country rank based on transition qualities, respond to country rank based on labour market indicators (such as Average monthly gross wages).

Keywords: *Western Balkans, transition qualities, economic potential, labour market indicators*

JEL: E24, F6

1. INTRODUCTION

In 2018, the European Commission adopted a strategy for *"A credible enlargement perspective for and enhanced EU engagement with the Western Balkans"*, confirming the European future of the region as a geostrategic investment in a stable, strong and united Europe based on common values. The Strategy spells out the priorities and areas of cooperation, addressing the specific challenges the Western Balkans face, in particular the need for fundamental reforms and good neighbourly relations. A credible enlargement perspective requires sustained efforts and irreversible reforms. Progress along the European path is an objective and merit-based process which depends on the concrete results achieved by each individual country. The Strategy also underlines the need for the EU to be prepared to welcome new members once they have met the criteria. (European Commission, 2018)

The Western Balkan Six (WB-6) comprise Albania, Bosnia and Herzegovina, FYR Macedonia, Kosovo, Montenegro and Serbia, with a total population of about 18 million (merely 3.6% of EU's population) and a GDP of approx. €80 billion. An indicative deadline for admission to the EU of the two most advanced candidates – Serbia and Montenegro is 2025. This could incentivise all Western Balkan countries, including those candidates that have not yet started membership negotiations (Macedonia and Albania) and those waiting for candidate status (Bosnia and Herzegovina and Kosovo), to remove domestic political obstacles to EU accession, speed up reforms and reduce labour market gaps.

Recognizing the aims of the research, we will concentrate on testing the following hypothesis:

Hypothesis 1: *There is strong positive correlation between the economic potential (measured by GDP per capita) and the labor market indicator (Average monthly gross wages) in the period 2012-2017, for six Western Balkan countries.*

Hypothesis 2: *The most integrated Western Balkan country (measured by the transition qualities), has the highest average monthly gross wages.*

The paper is organized as follows. After introduction, the Section 1 of the paper is devoted to the Sustainable Transition of Western Balkans to the European Union. In the Section 2, we give an overview of the Economic potential of the Western Balkans measured by annual national accounts (including GDP). Labour market gaps and trends are presented in Section 3. The Section 4 gives Scenario analysis for the Western Balkans countries and future priorities. The last Section concludes the paper.

2. SUSTAINABLE TRANSITION OF WESTERN BALKANS TO THE EUROPEAN UNION

The transition of Western Balkans to the EU will take sustainable character if net positive effects in the long term surpass the negative effects. The speed of reducing gaps and catching up with the developed member countries depends on the degree of exploitation of economic potentials. Measures and drivers of economic catch-up with the developed countries are one of the preconditions for Western Balkans countries to successful integration process. From the perspective of economic catch-up with the developed economies, the divergence threatens to slow down or even stop the catch-up process. One of the challenges facing the Western Balkans is to reduce the large differences between the center and the periphery. The European Union countries play the role of economic and political center of gravity for Western Balkans. (Stojanović, Kostić, & Šaranović, 2018)

Western Balkan Countries' ability to assume obligations of EU membership are summarized in Table 1. Ten selected indicators (Free movements of goods, Freedom of movements for workers, Freedom to provide services, Free movement of capital, Company law, Intellectual property law, Competition policy, Economic and Monetary policy, Economic and Monetary policy, Social policy and employment, Enterprise and Industrial policy) indicate the readiness of each country to integrate and to harmonize their economic systems.

Based on the data given in Table 1, it can be concluded that the Western Balkan countries are on average *moderately prepared* for EU. Some level of preparation is done, but there is plenty to do in the next period.

Table 1. Countries' ability to assume obligations of EU membership

Indicator	Bosnia and Hercegovina	Kosovo*	Albania	Macedonia	Serbia	Montenegro	Average WB-6
Free movements of goods	1	2	3	3	3	3	2.5
Freedom of movements for workers	1	1	1	1	3	2	1.5
Freedom to provide services	1	1	3	3	3	3	2.3
Free movement of capital	3	2	3	3	3	3	2.8
Company law	1	1	3	4	4	4	2.8
Intellectual property law	3	2	2	3	4	4	3.0

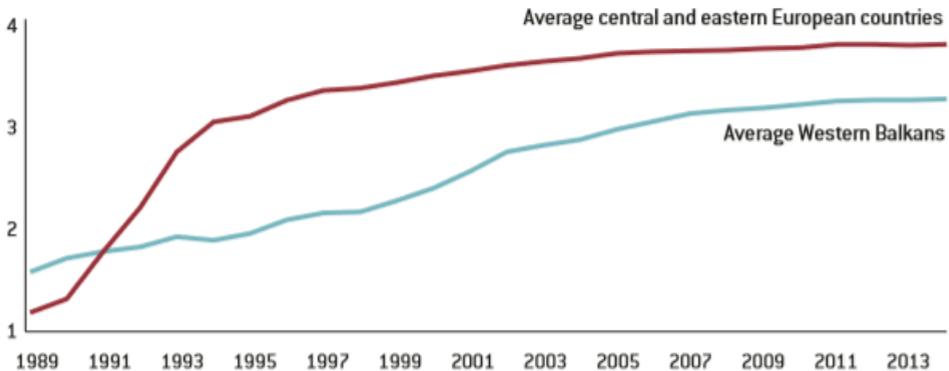
Competition policy	2	1	3	3	3	3	2.5
Economic and Monetary policy	1	1	3	3	3	3	2.3
Social policy and employment	1	1	2	3	3	2	2
Enterprise and Industrial policy	1	2	3	3	3	3	2.5

Note: The scores in the table are based on the EC's assessment of a country's preparedness to adopt the obligations of EU membership according to the following description: (1) early stage, (2) some level of preparation, (3) moderately prepared, (4) good level of preparation, and (5) well advanced.

Source: Systematization of the authors according to European Commission

In addition, the Western Balkan region lags behind other central and eastern European countries in terms of institutional reforms. As noted by the Dabrowski & Myachenkova by 2013, Western Balkan countries had made the same progress in reforms, measured by the EBRD transition scores, as the group of smaller central and eastern European countries (Bulgaria, Croatia, Estonia, Latvia, Lithuania, Slovakia and Slovenia) had by 1996 (Figure 1).

Figure 1: Average EBRD transition scores for Western Balkans and central and eastern European countries



Note: Data for Kosovo is missing

Source: Dabrowski, & Myachenkova, 2018, pp. 18.

EBRD transition score is calculated as the simple average of six EBRD indicators: price liberalisation, trade and foreign exchange system, small-scale privatisation, large scale privatisation, governance and enterprise restructuring, and competition policy, each

rated on a scale from 1 (no reform) to 4.33 (maximum reform). EBRD defines the six transition qualities:

1. *Competitive*: refers to open economic systems that function well are built on dynamic and competitive markets. It represents a core characteristic underpinning the move from a state-driven, top-down mechanism to one which is more flexible and responsive to market signals.
2. *Well-governed*: refers to improving the quality of both state and private sector institutions and ensuring that they work well together. Governance is about the quality of institutions and the processes that they support.
3. *Green dimension*: refers to environmental sustainability, implying that economic decisions should reflect the full value of resources to present and future generations.
4. *Inclusive*: Economic inclusion, the opening up of economic opportunities to previously under-served social groups, is integral to achieving transition towards sustainable market economies. An inclusive market economy ensures that anyone can access labour markets, entrepreneurship and, more generally, economic opportunity.
5. *Resilient*: market economy supports growth while avoiding excessive volatility and lasting economic reversals. It is about the ability of markets and market-supporting institutions to resist shocks, and about balance and sustainability in financial and economic structures.
6. *Integrated*: It enables trade at greater speed, lower cost and better quality and supports competition in product and services markets. As a transition quality, integration refers not only to the physical dimension but also improvements to domestic markets through national-level enhancements of ports, airports, cities and rural areas.

Table 2. The six transition qualities

Country	Competitive	Well-governed	Green	Inclusive	Resilient	Integrated
Montenegro	4.89	5.12	5.15	5.62	5.93	5.59
Serbia	4.94	4.39	5.77	5.16	5.55	6.39
Macedonia, FYR	5.39	5.20	4.91	4.72	5.31	6.04
Albania	4.41	4.31	4.85	5.11	4.86	5.76
Bosnia and Hercegovina	4.74	3.66	4.85	4.83	5.35	5.47
Kosovo*	3.37	3.73	3.80	4.70	5.09	4.89
Minimum	3,37	3,66	3,80	4,70	4,86	4,89
Maximum	5,39	5,20	5,77	5,62	5,93	6,39
Average	4,62	4,40	4,89	5,02	5,35	5,69
Standard Dev.	0,63	0,60	0,58	0,32	0,34	0,47

Source: Systematization of the authors according to European Bank for Reconstruction and Development

The data shown in the Table 2 suggest that Serbia is the most integrated country which also has the best results regarding the green dimension. FYR Macedonia is the most competitive and well-governed country, Montenegro is the most inclusive and resilient. Bosnia and Hercegovina, Albania and Kosovo* have achieved transition results below the region average.

Taking into account the data of the European Bank for Reconstruction and Development, the ranking of Western Balkans is done according to the six transition qualities (Competitive, Well-governed, Green, Inclusive, Resilient, Integrated) which have the same weight coefficients in the analysis (Figure 3).

Figure 2: Input-Output Efficiency

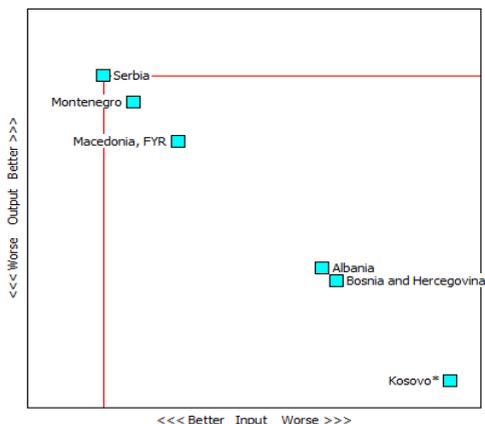
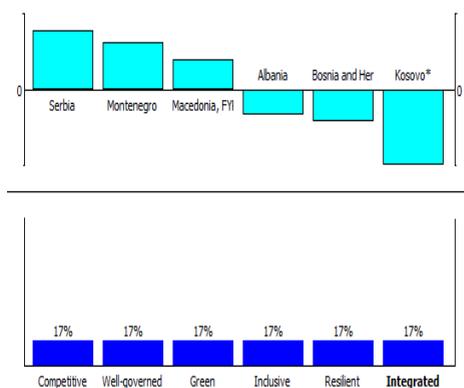


Figure 3: Walking Weights



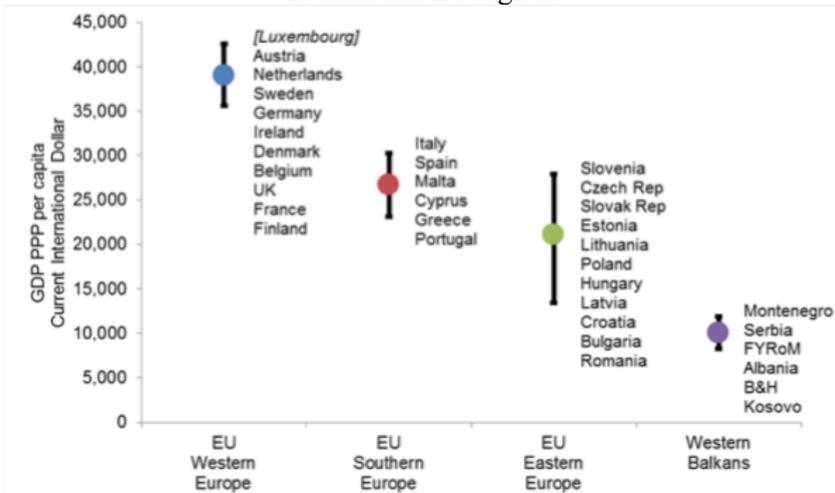
Source: Author’s presentations by using software Visual PROMETHEE Academic

The results presented in the Figure 2 show that Serbia is efficient frontier and then follow Montenegro, Macedonia FYR, Albania, Bosnia and Hercegovina and Kosovo*, respectively. Albania and Bosnia and Hercegovina have achieved the similar results.

3. ECONOMIC POTENTIAL OF THE WESTERN BALKANS MEASURED BY ANNUAL NATIONAL ACCOUNTS (INCLUDING GDP)

The Western Balkans (WB-6) face a major convergence challenge due to current average GDP per capita for the six countries is only half the average in the 11 EU member states of eastern Europe (EU-11), and just one-quarter of the most advanced western European countries. One of the main reasons behind this prosperity gap is the lack of appropriate factors and institutions needed for high levels of long-term productivity growth. The Figure 4 summarize GDP per capita (PPP adjusted) and order countries within sub-regions from highest to lowest.

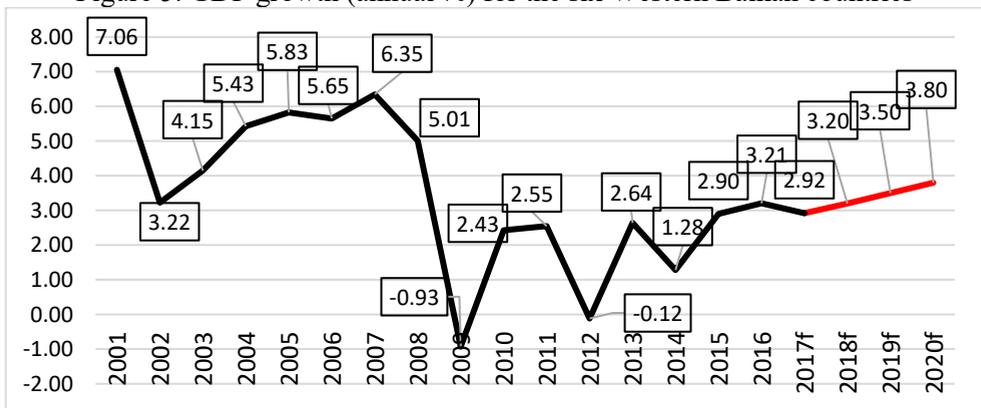
Figure 4. Comparative analysis of the GDP per capita (PPP adjusted) in Western Balkans and EU regions



Source: Sanfey, & Milatovic, 2018, pp.4.

Closer Economic relations with the EU, but with negative results can be explain with “reform fatigue”. Western Balkan are in the group of countries that are worst off in terms of income inequality and recovery of their pre-transition GDP. Serbia, Bosnia nad Hercegovina and Montenegro have not yet reached their real 1989 GDP level. If we look at the average GDP per capita in Purchasing Power Parities (PPP) in 2016, the six Western Balkan countries had not reached 30 per cent of the level in the EU15 member states, while Central and Eastern Europe countries were at around 60 per cent of the EU15 average.

Figure 5. GDP growth (annual %) for the six Western Balkan countries



Source: Authors presentation according to the World bank Group

Figure 5 shows annual percentage growth rate of GDP at market prices based on constant local currency (aggregates are based on constant 2010 U.S. dollars). While

the region had seen above EU average growth rates of 5.3% in the early 2000s, today these economies show volatile and slowing growth and high unemployment rates with high youth unemployment and significant brain drain. While economic performance did improve, the strong growth during 2001-08 was primarily based on the inflow of foreign capital. Projections for the period until 2020 are based on historical data in the previous period.

The clear evidence of the bad economic model in the Western Balkan countries is an extremely high unemployment rate. The difference in the pace and the manner of the implementation of the reforms at the labour markets among the Western Balkans is one of the the main causes of the difference in the speed of the income convergence. (Stanišić, 2016)

4. WESTERN BALKANS: LABOUR MARKET GAPS AND TRENDS

In the period from 2012 to 2017 the Western Balkan countries have made great results in improving labor market outcomes. On average, regional labor markets recorded improvements in activity rates, employment rates, unemployment rates, and youth unemployment rates. In some countries (Bosnia and Herzegovina, the FYR Macedonia, and Serbia) unemployment reached historical lows in 2017. Despite promising labor market developments in this region, key challenges include low activity rates, large share of long-term unemployment (over 80 percent in some countries) and inadequate growth rates in average gross wages. Table 3 presents the positive trend in the average monthly gross wages (in EUR) in the period 2010-2017. In relative terms, there was an increase of 15% in the average monthly gross wages in 2017 in comparison to 2012.

Table 3. Summarized labor market indicators for Western Balkans

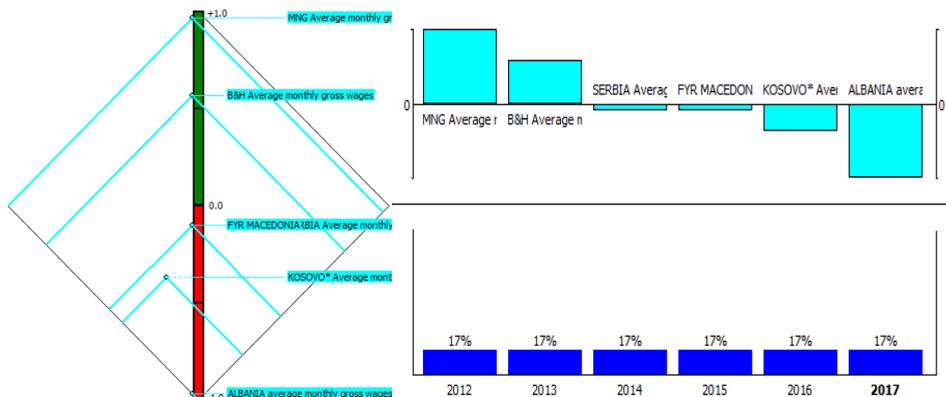
Total	2012	2013	2014	2015	2016	2017 Q2
Total population (1,000)	18,427	18,397	18,350	18,276	18,223	
Working-age population aged 15+ (1,000)	14,515	14,465	14,455	14,432	14,335	14,251
Employment rate (% population aged 15-64)	44.4	44.8	45.9	46.9	49.3	51.9
Activity rate (% population aged 15-64)	58.8	58.9	59.6	59.8	61.0	62.3
Unemployment rate (% labor force 15+)	23.9	23.4	22.4	21.2	18.7	16.2
Youth unemployment rate (% labor force 15-24)	48.6	48.3	50.2	47.7	42.1	37.6
Unemployment rate, high educated 15+ (ISCED 5-8)	17.7	18.0	17.1	17.1	16.0	14.3
Unemployment rate, low educated 15+ (ISCED 0-2)	22.6	22.6	21.9	19.8	17.1	14.3
Earnings and unit labor costs						
Average monthly gross wages, EUR	515,67	521,67	536,83	542,83	553,00	595,80

Note: Average monthly gross wages have been calculated according to the data of individual countries

Source: Systematization and calculation of the authors according to The World Bank Group & the Vienna Institute for International Economic Studies, 2018.

Wage levels differed both within the Western Balkans countries. Montenegro and Bosnia and Herzegovina reported the highest wage levels, with Albania reporting the lowest in the period from 2012 to 2017 (Figure 6)

Figure 6. Western Balkans ranking by Average monthly gross wages in the period 2012-2017.



Source: Author’s own presentations by using software Visual PROMETHEE Academic

Overall, the Western Balkan countries reported high levels of growth in real wages prior to the crisis of 2007/2008, followed by a sharp decline in all countries. Following the crisis, growth accelerated in the peer countries but not in the Western Balkan countries. According to data from 2016/2017 the share of low-wage earners (defined as employees who make less than two-thirds of the median wage) was 27.3 percent in Montenegro (which was higher than in any EU country), 25.1 percent in the FYR Macedonia (the third highest), and 22.9 percent in Serbia, compared with an EU average of 17.2 percent. The share of low-wage earners was highest among younger workers (above 40 percent in Montenegro and above 30 percent in the FYR Macedonia and Serbia). (The World Bank Group & the Vienna Institute for International Economic Studies, 2018)

Table 4: Correlations
Correlations

		wages2017	GDPpercapita2017
wages2017	Pearson Correlation	1	,778
	Sig. (2-tailed)		,069
	N	6	6
GDPpercapita2017	Pearson Correlation	,778	1
	Sig. (2-tailed)	,069	
	N	6	6

Pearson Coefficient values range from 0,688 (2015) to 0,778 (2017). The strongest positive quantitative connection between observed variables was achieved in 2017 (Table 4).

The statistical technique correlation was used in order to investigate the relationship between the variables: GDP per capita and Average monthly gross wages. By calculating the Pearson coefficient for GDP per capita and Average monthly gross wages in the period 2012-2017. for six Western Balkan countries, it is concluded that there is strong positive correlation between them in all observed years.

Table 5: Selected labor market indicators by country

Albania	2012	2013	2014	2015	2016	2017 Q2
Labor productivity	3.2	12.5	0.5	-2.4	-2.9	0.6
Monthly gross wages per employee, nominal	2.9	-3.2	0.9	2.8	-2.1	11.0
Monthly gross wages per employee, real	0.9	-5.0	-0.7	0.9	-3.4	8.8
Unit labor costs	-0.3	-13.9	0.4	5.4	0.9	10.3
Bosnia and Herzegovina	2012	2013	2014	2015	2016	2017 Q2
Labor productivity	-0.5	1.4	2.3	1.9	5.8	1.1
Monthly gross wages per employee, nominal	1.5	0.1	-0.1	0.0	0.9	1.8
Monthly gross wages per employee, real	-0.5	0.2	0.8	1.0	2.0	0.6
Unit labor costs	2.1	-1.3	-2.4	-1.9	-4.6	0.8
Kosovo*	2012	2013	2014	2015	2016	2017 Q2
Labor productivity		-7.9	6.1	13.2	-6.9	-4.4
Monthly gross wages per employee, nominal		3.0	8.6	5.8	1.8	
Monthly gross wages per employee, real		1.2	8.1	6.3	1.5	
Unit labor costs		11.8	2.3	-6.5	9.2	
FYR Macedonia	2012	2013	2014	2015	2016	2017 Q2
Labor productivity	-1.3	-1.4	1.9	1.5	0.4	-3.8
Monthly gross wages per employee, nominal	0.2	1.2	1.0	2.7	2.0	2.3
Monthly gross wages per employee, real	-3.0	-1.6	1.3	3.0	2.2	1.0
Unit labor costs	1.5	2.6	-0.9	1.2	1.6	6.4
Montenegro	2012	2013	2014	2015	2016	2017 Q2
Labor productivity	-5.2	3.1	-5.0	0.9	1.8	1.6
Monthly gross wages per employee, nominal	0.7	-0.1	-0.4	0.3	3.6	1.8
Monthly gross wages per employee, real	-3.2	-1.9	0.1	-1.1	3.5	-0.6
Unit labor costs	6.2	-3.1	4.8	-0.6	1.8	0.2
Serbia	2012	2013	2014	2015	2016	2017 Q2
Labor productivity	0.1	-0.9	-6.3	0.2	-2.7	-2.8
Monthly gross wages per employee, nominal	8.9	5.7	1.2	-0.5	3.8	4.7
Monthly gross wages per employee, real	1.0	-1.9	-1.7	-2.4	2.6	1.0
Unit labor costs	8.8	6.6	7.9	-0.6	6.7	7.7
Western Balkans - 6	2012	2013	2014	2015	2016	2017 Q2
Labor productivity		1.7	-2.0	1.0	-1.4	
Monthly gross wages per employee, EUR nominal		3.6	-0.3	-0.7	1.0	
Monthly gross wages per employee, EUR real		-0.5	-1.2	-1.4	0.6	
Unit labor costs, EUR adjusted		1.8	1.7	-1.6	2.3	

Note: Unit labor costs (ULC): average annual gross wages per employee relative to labor productivity (real GDP per employed person)

Source: Systematization of the authors according to The World Bank Group & the Vienna Institute for International Economic Studies, 2018.

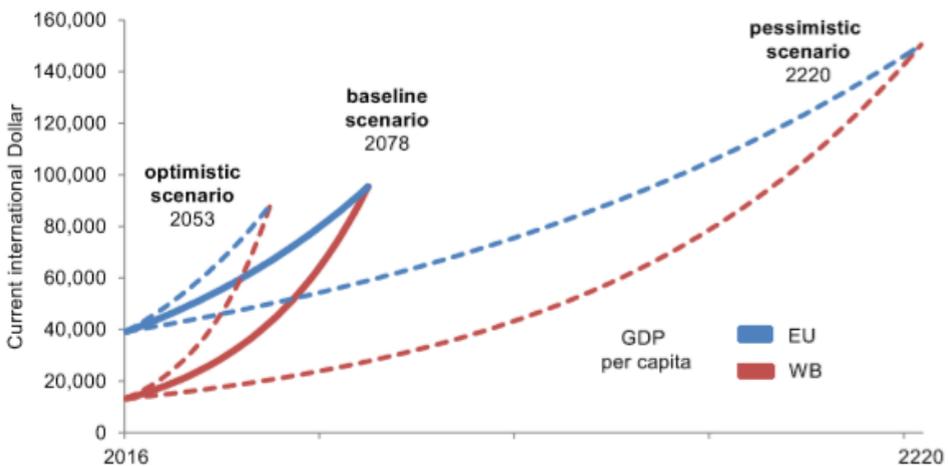
A detailed overview of the selected labour market indicators (Labor productivity, Monthly gross wages per employee, nominal and real, and Unit labor costs) was given in the Table 5 by country and by whole region in the previous six years.

5. SCENARIO ANALYSIS FOR THE WESTERN BALKANS COUNTRIES AND FUTURE PRIORITIES

The Western Balkan countries have converged among themselves and toward European Union, but the speed of the convergence is moderated with the hit of global crisis and the recovery still seems difficult to the rate of pre-crisis. As economies in transition that are attempting to converge with the European development stages, have to go through structural evolutions. Therefore, the convergence is a dynamic process which requires a proactive policies to establish strong and reliable institutions, to guarantee political stability, to promote the business climate in order to further guide economic development and welfare. (Meksi, & Xhaja, 2017)

According to IMF World Economic Outlook, catch-up process with EU living standards has taken place in the past 15 years and the average annual growth rate of the Western Balkans region was over 3 per cent, compared with about 1.4 per cent in the EU. However, this period can be divided into two distinct phases: the pre-crisis period (until 2008) and the post-crisis period (from 2009). There were double dip recessions in 2009 and 2012 and average WB-6 growth in this period was just 1.2 per cent, compared with 0.7 per cent in the EU. Taking into account the speed of convergence has thus slowed down markedly over the past seven years, full convergence with average EU living standards could take many decades.

Figure 7. Convergence scenarios for Western Balkans countries



Source: Sanfey, & Milatovic, 2018, pp.5 according to IMF World Economic Outlook

A baseline scenario, which uses the average growth rates for the period of 2001-16, implies that the WB-6 region, on average, could achieve the average GDP per capita in the EU in about 60 years time. An optimistic scenario, which uses pre-crisis growth rates, would yield catch up with EU living standards in just under 40 years, while a pessimistic scenario, which uses the postcrisis average growth rates, means that catching up takes place after 200 years (Figure 7).

The World Economic Forum defines some priorities for the future of the Western Balkans in 2018. While there is a more upbeat forecast for accelerating growth rates in the future, three key priorities need to be addressed:

1. Strengthening growth and investment through public-private partnerships,
2. Driving a future-oriented digital ecosystem (The Western Balkans have shown a strong growth of its start-up environment and several countries have launched digital initiatives to transform their economies and societies. However, business sophistication ranks still very low in the region, which points to a lack of integration and industry density and much remains to be done to ensure the region can withstand the pressures on their job markets and deliver successful efforts to develop reskilling and technological skills in all industries),
3. Supporting next-generation leadership.

6. CONCLUSION

The European Union countries play the role of economic and political center of gravity for Western Balkan region. The transition of Western Balkans to the European Union will take sustainable character if net positive effects in the long term surpass the negative effects. The speed of reducing labour market gaps and catching up with the developed member countries depends on the degree of exploitation of economic potentials.

Western Balkan Countries' ability to assume obligations of EU membership are estimated by using ten selected indicators (Free movements of goods, Freedom of movements for workers, Freedom to provide services, Free movement of capital, Company law, Intellectual property law, Competition policy, Economic and Monetary policy, Economic and Monetary policy, Social policy and employment, Enterprise and Industrial policy) which indicate the readiness of each country to integrate and to harmonize their economic systems. Based on the obtained results, it can be concluded that the Western Balkan countries are on average moderately prepared for European Union. Concrete, according to the six transition qualities, Serbia is the most integrated country with the best results regarding the green dimension. FYR Macedonia is the most competitive and well-governed country, Montenegro is the most inclusive and resilient. Bosnia and Herzegovina, Albania and Kosovo* have achieved transition results below the region average. According to the value of the transition qualities scores, the order of

the countries is the following: Serbia, Montenegro, FYR Macedonia, Albania, Bosnia and Hercegovina and Kosovo*, respectively.

In the period from 2012 to 2017 the Western Balkan countries have made great results in improving labor market outcomes. On average, regional labor markets recorded improvements in activity rates, employment rates, unemployment rates, and youth unemployment rates. In some countries unemployment reached historical lows in 2017. Despite promising labor market developments in this region, key challenges include low activity rates, large share of long-term unemployment and inadequate growth rates in average gross wages. Wage levels differed both within the Western Balkans countries. Montenegro and Bosnia and Herzegovina reported the highest wage levels, with Albania reporting the lowest in the period from 2012 to 2017. According to the value of the average monthly gross wages, the order of the countries is the following: Montenegro, Bosnia and Hercegovina, Serbia, FYR Macedonia, Kosovo*, and Albania, respectively.

During the research, the hypothesis 1 was confirmed due to there was strong positive correlation between the economic potential (measured by GDP per capita) and the labor market indicator (Average monthly gross wages) in the period 2012-2017. for six Western Balkan countries. Pearson Coefficient values range from 0,688 (2015) to 0,778 (2017), so the strongest positive quantitative connection between observed variables was achieved in 2017. On the other hand, hypothesis 2 was rejected due to Serbia, as the most integrated Western Balkan country measured by the transition qualities, had not the highest average monthly gross wages in the analysed period. In addition, the results of empirical research suggest that order of countries according to transition qualities, do not respond to order of countries according to average monthly gross wages, as one of key labour market indicators which is analysed in the paper.

This paper presents a good basis for further research due to taking into account the specificities of the Western Balkans countries on their sustainable path to the European Union. Based on possible new or expanded ways of thinking about measuring the labour market gaps, the paper summarizes relevant theoretical and practical evidence about correlation between the economic potential (measured by GDP per capita) and the labor market indicators. Combining observations and suggestions, this paper gives direct practical implications for evaluating trends in this area.

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REVISION OF THE PACKAGE TRAVEL DIRECTIVE AND ITS INFLUENCE ON THE CROATIAN TOURSIM LAW

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Abstract

The paper explores normative substance of the new Package Travel Directive (2015/2302/EU) and its influence on the Croatian Tourism Law. The new Directive was adopted on 25 November 2015, European Union Member States had to transpose it by 1 January 2018 and it is applicable from 1 July 2018. Internet as increasingly important medium for travel services resulted in surge of various forms of customized travel arrangements and rendered provisions of the old Directive obsolete to the needs modern tourist market. Although 23% of EU travellers still purchase traditional, pre-arranged packages, more and more either buy different parts of their trips separately or buy customized holidays, which are put together by one or more commercially linked traders to suit their needs and preferences. Vast majority of travellers buying packages and linked travel arrangements are consumers within the meaning of the EU Consumer Protection Law. Thus, new Package Travel Directive should result in the enhancement of the consumer protection. New legislation will extend protection of the of the 1990 EU Package Travel Directive to cover not only traditional package holidays, but also give clear protection to 120 million consumers who book other forms of combined travel. Scope of the new Package Travel Directive is substantially wider than the scope of the old Directive. The new Package Travel Directive applies to packages offered for sale or sold by traders to travellers and to linked travel arrangements facilitated by traders for travellers. The new Directive broadens the concept of package and now will apply to different sorts of travel combinations: pre-arranged packages; customised packages and linked travel arrangements. This paper elaborates on normative and substantive influence of the new Directive in Croatian Tourism Law. Following comparative legal overview current Croatian legislation

of package travel including applicable sections of the Civil Obligations Act will be inspected.

Keywords: *package travel Directive, Croatian tourism law, civil obligations, EU Law*

JEL: K2

1. INTRODUCTION

The new Package Travel Directive (2015/2302/EU)¹ was adopted on 25 November 2015 with aim of updating EU *acquis* with the developments in the travel market. The new Directive once when transposition period expires will replace old Directive 90/314/EC of 13 June 1990.

Internet as increasingly important medium for travel services caused surge of various new forms of customized travel arrangements. Majority of new forms fall outside the scope of traditional pre-arranged packages covered by the old Directive. Therefore need for regulating increasing range of grey zones in the matters of travel arrangement influenced EU legislator to intervene and revise existing legislation. Increasing the consumer protection of tourists was one of the key motivators or *ratio legis*. Obviously, vast majority of travellers buying packages and travel arrangements are consumers within the meaning of the EU Consumer Protection Law.

The EU internal market, imagined by the Treaty on Function of the EU (TFEU) as the area without internal frontiers in which the free movement of goods and services and the freedom of establishment are ensured, in the field of travel arrangements becomes more and more integrated due to the new technological developments. The EU decided with the new Package Travel Directive to construct formal and normative framework to facilitate this somewhat spontaneous and informal process. The new Directive broadens the concept of package and now will apply to different sorts of travel combinations: pre-arranged packages; customised packages and linked travel arrangements.

The new Package Travel Directive increases level of harmonization in comparison with the minimum harmonization of the old Directive. Once when transposition period for the new Directive expires on January 1st 2018 Member states of the EU

¹ Full name of the new Package Travel Directive is: Directive (EU) 2015/2302 of the European Parliament and of the Council of 25 November 2015 on package travel and linked travel arrangements, amending Regulation (EC) No 2006/2004 and Directive 2011/83/EU of the European Parliament and of the Council and repealing Council Directive 90/314/EEC

should have more harmonized rules on this subject matter. We have seen in the past that old Directive left number of ambiguities requiring even Court of Justice of the European Union (CJEU) to issue interpretations of its provisions in several judgments. In its judgment in the case *Club Tour* Court of Justice interpret that term ‘pre-arranged combination’ in provisions of the old Directive necessarily covers cases where the combination of tourist services is the result of the wishes expressed by the consumer up to the moment when the parties reach an agreement and conclude the contract². In German and Czech national laws such situations were not considered to be pre-arranged combination. Case law of the CJEU on the provisions of the old Directive should also be applicable to the provisions of the new Package Travel Directive where appropriate.

Table 1. Timeline of the new Package Travel Directive

Enactment of the Directive	Entry into force	Deadline for transposition	Deadline for application of transposed provisions
25 November 2015	16 December 2015	1 January 2018	1 July 2018

Source: authors according to the new Package Travel Directive (2015/2302/EU)

Member states of the EU have produced variety of different solutions in transposition of the provisions of the old Directive into their national laws. Due to the different level of harmonization the new Package Travel Directive shall reduce this variety to a certain extent. The EU latest Member country - Croatia transposed provisions of the old Directive into section 24 of its Civil Obligations Act (ZOO). This paper *inter alia* analyses normative possibilities for transposition of the new Directive in Croatian Civil Obligations Act.

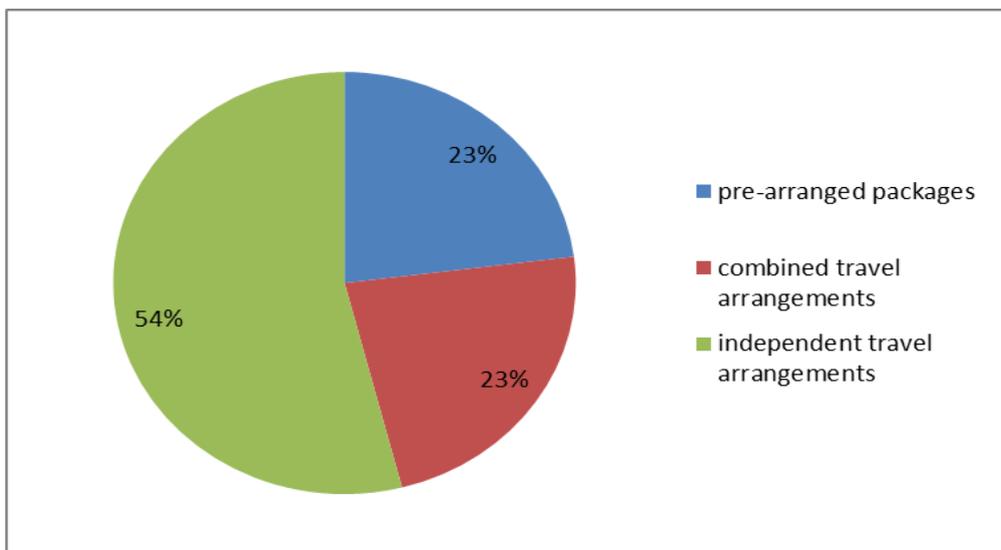
2. ECONOMIC IMPORTANCE OF PACKAGE TRAVEL MARKET IN THE EUROPEAN UNION FROM THE STANDPOINT OF THE NEW PACKAGE TRAVEL DIRECTIVE

The EU’s travel market encompasses 1.8-million business which employ 5.2% of the total workforce (European Commission, 2013). Majority of them are in the form of small and medium enterprises (SME). In some countries like Croatia there is substantial share of private accommodation in overall capacity. Majority of private accommodation in Croatia is operated by SME’s (Vlahov, Vuletić, 2016). The travel market has been transformed by the liberalization of the airline sector, leading to cheaper and more accessible flight tickets (European Commission, 2013). Travel, tourism and related sectors account for around 10% of the EU’s gross domestic product (GDP). The EU is the world’s number one tourist

² Issue of scope of the term ‘pre-arranged combination’ in the text of the new Package Travel Directive was determined in accordance with European Court of Justice ruling in the *Club Tour* case (new provisions now cover and customized packages).

destination. Aforementioned summarized data clearly and conclusively demonstrates that economic importance of the EU's travel package market is substantial. This conclusion has even stronger meaning for EU Member countries in which tourist sector contributes in the overall economy more than EU average (e.g. Greece, Croatia, Austria and Spain) Therefore, legislative grey area in the package travel should be reduced to minimum. Although 23% of EU travellers still purchase traditional, pre-arranged packages, more and more either buy different parts of their trips separately (54% of Europeans who took a holiday in 2011) or buy customized holidays, which are put together by one or more commercially linked traders to suit their needs and preferences.

Chart 1. Share of various forms of travel arrangements in the EU (in 2011)



Source: European Commission (2013: 5)

The European Commission estimates that under new Package Travel Directive almost 120 million travellers buying combined travel arrangements will be protected, which was not the case under the old (existing) EU rules. Furthermore, Commission estimates that new rules will reduce damages to consumers by about €430 million a year (European Commission, 2016). The European Federation of Travel Agents and Tour Operators Associations (ECTAA) welcomed the initiative of the European Commission to modernize the existing legislation in its Position paper (ECTAA, 2013). It is important to notice that new rules will have an effect on global tourist market since significant share of travels covered under the scope of the new Package Travel Directive is directed to non-EU destinations.

3. SCOPE AND LEVEL OF HARMONIZATION OF THE NEW PACKAGE TRAVEL DIRECTIVE

3.1. Scope of the new Package Travel Directive

Scope of the new Package Travel Directive is substantially wider than the scope of the old Directive. The new Package Travel Directive applies to packages offered for sale or sold by traders to travellers and to linked travel arrangements facilitated by traders for travellers. Consequently, new Directive covers pre-arranged packages, customised packages and linked travel arrangements. The old Package Travel Directive covered only pre-arranged travel arrangements³.

In the new Package Travel Directive ‘package’ now means a combination of at least two different types of travel services for the purpose of the same trip or holiday, if:

- those services are combined by one trader, including at the request of or in accordance with the selection of the traveller, before a single contract on all services is concluded; or
- irrespective of whether separate contracts are concluded with individual travel service providers, those services are: purchased from a single point of sale and those services have been selected before the traveller agrees to pay; offered, sold or charged at an inclusive or total price; advertised or sold under the term ‘package’ or under a similar term; combined after the conclusion of a contract by which a trader entitles the traveller to choose among a selection of different types of travel services; or purchased from separate traders through linked online booking processes where the traveller's name, payment details and e-mail address are transmitted from the trader with whom the first contract is concluded to another trader or traders and a contract with the latter trader or traders is concluded at the latest 24 hours after the confirmation of the booking of the first travel service.

Travel service under new Directive covers following: carriage of passengers; accommodation which is not intrinsically part of carriage of passengers and is not for residential purposes; rental of cars and other motor vehicles; any other tourist service not intrinsically part of a travel service. However, ‘any other tourist services’ are not covered under the definition of the package if they do not account

³ ‘Package’ for the purpose of the old Package Travel Directive covered only pre-arranged combination of not fewer than two of the following (when sold or offered for sale at an inclusive price and when the service covers a period of more than twenty-four hours or includes overnight accommodation): transport, accommodation and other tourist services not ancillary to transport or accommodation and accounting for a significant proportion of the package.

for a significant proportion of the value of the combination and are not advertised as and do not otherwise represent an essential feature of the combination or are selected and purchased only after the performance of a travel service has started.

Under individual travel service new Directive implies following services: services purchased from a single point of sale and those services that have been selected before the traveller agrees to pay, offered, sold or charged at an inclusive or total price; services advertised or sold under the term ‘package’ or under a similar term; services combined after the conclusion of a contract by which a trader entitles the traveller to choose among a selection of different types of travel services or purchased from separate traders through linked online booking processes where the traveller's name, payment details and e-mail address are transmitted from the trader with whom the first contract is concluded to another trader or traders and a contract with the latter trader or traders is concluded at the latest 24 hours after the confirmation of the booking of the first travel service.

The new Package Travel Directive still does not apply to:

- packages and linked travel arrangements covering a period of less than 24 hours unless overnight accommodation is included;
- packages offered, and linked travel arrangements facilitated, occasionally and on a not-for-profit basis and only to a limited group of travellers;
- packages and linked travel arrangements purchased on the basis of a general agreement for the arrangement of business travel between a trader and another natural or legal person who is acting for purposes relating to his trade, business, craft or profession.

3.2. Level of the harmonization of the new Package Travel Directive

The new Package Travel Directive is Directive of predominantly maximum harmonization in contrast to the old Directive, which required only minimum harmonization. Maximum harmonization basically means that Member states have fewer regulatory choices in transposition of the provisions of the Directive into their national law. Member states cannot maintain or introduce in their national law provisions diverging from those laid down in Directive, including more or less stringent provisions, which would ensure a different level of traveller protection.

Directives of minimum harmonization leave to Member states wider area for regulatory choices so that they are free to introduce stringer provisions than the minimum standard required by the directive. The old Package Travel Directive required only minimum harmonization. The method of minimum harmonization was clearly sub-optimal for this subject matter. Various ambiguities emerged from the harmonization of national laws with provisions of the old Directive. One of the

best examples is unclear formal requirements⁴ for the package travel contract (Schulte-Nölke and Meyer-Schwickerath, 2008). Even the term ‘consumer’ was defined differently than standard concept of EU Consumer Protection Law. The European Court of Justice resolved variety of ambiguities emerging from the provisions of the old Directive. Most relevant case law, in addition to previously mentioned judgment in case *Club Tour*, are rulings in the *Rechberger* and *ABS Finland* cases and judgment in joined cases *Pammer and Hotel Alpenhof*.

Naturally the new Directive is imperative in nature and addressed to all Member States. Any contractual arrangement or any statement by the contractual parties, which directly or indirectly waives or restricts the rights conferred on travellers pursuant to this Directive or aims to circumvent the application of this Directive shall not be binding on the traveller.

4. PACKAGE TRAVEL CONTRACT

The package travel contract is defined in the new Directive as contract on the package as a whole or, if the package is provided under separate contracts, all contracts covering travel services included in the package. Definition of the term ‘package’ under the new Directive has been explained in third chapter of this paper.

Contractual parties of the package travel contract are called traveller and trader. Traveller is any person who is seeking to conclude a contract, or is entitled to travel on the basis of a contract concluded. Trader is any natural person or any legal person, irrespective of whether privately or publicly owned, who is acting, including through any other person acting in his name or on his behalf, for purposes relating to his trade, business, craft or profession in relation to package travel contract. Trader can be acting in the capacity of organizer, retailer, and trader facilitating a linked travel arrangement or as a travel service provider. Generally subject is to be considered a trader irrespective of his position in the distribution chain.

Prior to the conclusion of the package travel contract traveller has to be provided with following information:

- the main characteristics of the travel services;
- the trading name and geographical address of the organizer and, where applicable, of the retailer, as well as their telephone number and, where applicable, e-mail address,

⁴ The old Package Travel Directive uses following ambiguous requirement for the form of the package travel contract: ‘in writing or such other form as is comprehensible and accessible to the consumer’ (Art. 4).

- the total price of the package inclusive of taxes and, where applicable, of all additional fees, charges and other costs or, where those costs cannot reasonably be calculated in advance of the conclusion of the contract, an indication of the type of additional costs which the traveller may still have to bear,
- the arrangements for payment, including any amount or percentage of the price which is to be paid as a down payment and the timetable for payment of the balance, or financial guarantees to be paid or provided by the traveller,
- the minimum number of persons required for the package to take place and the time limit before the start of the package for the possible termination of the contract if that number is not reached,
- general information on passport and visa requirements, including approximate periods for obtaining visas and information on health formalities, of the country of destination;
- information that the traveller may terminate the contract at any time before the start of the package in return for payment of an appropriate termination fee, or, where applicable, the standardized termination fees requested by the organizer,
- information on optional or compulsory insurance to cover the cost of termination of the contract by the traveller or the cost of assistance, including repatriation, in the event of accident, illness or death.

The main characteristics of the travel services include: travel destination(s), itinerary and periods of stay, with dates and, where accommodation is included, the number of nights included; the means, characteristics and categories of transport, the points, dates and time of departure and return, the duration and places of intermediate stops and transport connections. Where the exact time is not yet determined the organizer and, where applicable, the retailer shall inform the traveller of the approximate time of departure and return. The main characteristics of the travel services also include: location, main features and, where applicable, tourist category of the accommodation under the rules of the country of destination; the meal plan; visits, excursion(s) or other services included in the total price agreed for the package; where it is not apparent from the context, whether any of the travel services will be provided to the traveller as part of a group and, if so, where possible, the approximate size of the group; where the traveller's benefit from other tourist services depends on effective oral communication, the language in which those services will be carried out; and whether the trip or holiday is generally suitable for persons with reduced mobility and, upon the traveller's request, precise information on the suitability of the trip or holiday taking into account the traveller's needs.

The new Directive contains in Annexes A and B standardized information forms for package travel contracts that should be visible to travellers. This standardized

information forms informs travellers that they will benefit from all EU rights applying to packages and encompasses, where possible, hyperlinks to key rights under the Directive.

Example 1. Selection from of the standard information form for package travel contracts

Standard information form for package travel contracts where the use of hyperlinks is possible

The combination of travel services offered to you is a package within the meaning of Directive (EU) 2015/2302. Therefore, you will benefit from all EU rights applying to packages. Company XY/companies XY will be fully responsible for the proper performance of the package as a whole.

Additionally, as required by law, company XY/companies XY has/have protection in place to refund your payments and, where transport is included in the package, to ensure your repatriation in the event that it becomes/they become insolvent.

More information on key rights under Directive (EU) 2015/2302 (to be provided in the form of a hyperlink).

Source: Annex I, Part A of the new Package Travel Directive (2015/2302/EU)

The package travel contracts should be stipulated in plain and intelligible language and, in so far as they are in writing, legible. At the conclusion of the package travel contract or without undue delay thereafter, the trader shall provide the traveller with a copy or confirmation of the contract on a durable medium. The traveller shall be entitled to request a paper copy.

The package travel contract under the new Directive has to contain (*essentialia negotii*):

- any special requirements of the traveller which the organizer has accepted,
- information that the organizer is responsible for the proper performance of all travel services included in the contract and that he is obliged to provide assistance if the traveller is in difficulty,
- the name of the entity in charge of the insolvency protection and its contact details, including its geographical address, and, where applicable, the name of the competent authority designated by the Member State concerned for that purpose and its contact details,
- the name, address, telephone number, e-mail address and, where applicable, the fax number of the organizer's local representative, of a contact point or of another service which enables the traveller to contact the organizer quickly and communicate with him efficiently, to request assistance when the traveller is in difficulty or to complain about any lack of conformity perceived during the performance of the package,
- information that the traveller is required to communicate any lack of conformity which he perceives during the performance of the package,

- where minors, unaccompanied by a parent or another authorized person, travel on the basis of a package travel contract which includes accommodation, information enabling direct contact with the minor or the person responsible for the minor at the minor's place of stay,
- information on available in-house complaint handling procedures and on alternative dispute resolution (ADR) mechanisms,
- information on the travellers right to transfer the contract to another traveller

The burden of proof as regards compliance with the information requirements will always be on the trader.

Traveller can before the start of the package, after giving a reasonable notice on a durable medium, transfer the package travel contract to a person who satisfies all the conditions applicable to that contract. Notice given at the latest seven days before the start of the package shall in any event be deemed to be reasonable. However, in the case of transfer of the contract to another traveller both of them are jointly and severally liable to the trader for the cost of the transfer and due balance. Trader can charge additional costs for the transfer if they can be considered reasonable.

After the conclusion of the package travel contract, prices may be increased only if the contract expressly reserves that possibility and states that the traveller is entitled to price reduction (in that event the package travel contract shall state how price revisions are to be calculated). Price increases shall be possible exclusively as a direct consequence of changes in: the price of the carriage of passengers resulting from the cost of fuel or other power sources; level of taxes or fees on the travel services included in the contract imposed by third parties not directly involved in the performance of the package (including tourist taxes, landing taxes or embarkation or disembarkation fees at ports and airports) or the exchange rates relevant to the package. In any case if trader increases the price more than 8% traveller can terminate the contract without paying a termination fee.

Trader may not unilaterally change package travel contract terms (other than the price under aforementioned conditions) unless: the organizer has reserved that right in the contract; the change is insignificant and the organizer informs the traveller of the change in a clear, comprehensible and prominent manner on a durable medium. The traveller may within a reasonable period specified by the trader accept the proposed change or terminate the contract without paying a termination fee.

The traveller may terminate the package travel contract at any time before the start of the package in which case he may be required to pay an appropriate and justifiable termination fee. In the event of unavoidable and extraordinary circumstances occurring at the place of destination or its immediate vicinity and significantly affecting the performance of the package, or which significantly affect the carriage of passengers to

the destination the traveller shall have the right to terminate the package travel contract before the start of the package without paying any termination fee. In aforementioned event traveller shall be entitled to a full refund of any payments made for the package but excluding any additional compensation.

If, after the start of the package, significant elements of the package cannot be provided as agreed, suitable alternative arrangements will have to be offered to the traveller at no extra cost. Travellers may terminate the contract without paying any termination fee, where services are not performed in accordance with the contract and this substantially affects the performance of the package and the organizer fails to remedy the problem. Travellers are also entitled to a price reduction and/or compensation for damages where the travel services are not performed or are improperly performed.

The organizer may terminate the package travel contract and provide the traveller with a full refund of any payments made for the package. Furthermore the trader shall be considered liable for additional cost caused by termination. Exception to this liability for additional compensation are the following situations: when the number of persons enrolled for the package is smaller than the minimum number stated in the contract and the organizer notifies the traveller of the termination of the contract within the period fixed in the contract, but not later than: 20 days before the start of n the case of trips lasting more than six days; seven days before the start of the package in the case of trips lasting between two and six days; 48 hours before the start of the package in the case of trips lasting less than two days. The organizer will never be liable for additional cost caused by termination in situations when prevented from performing the contract because of unavoidable and extraordinary circumstances and notifies the traveller of the termination without undue delay before the start of the package.

The organizer is responsible for the performance of the travel services included in the package travel contract, irrespective of whether those services are to be performed by the organizer or by other travel service providers. It is very important to note there is always at least one trader who is liable for the proper performance of all the travel services included in the contract.

The trader is liable for any errors due to technical defects in the booking system which are attributable to him and, where the trader has agreed to arrange the booking of a package or of travel services that are part of linked travel arrangements, for the errors made during the booking process. A trader shall not be liable for booking errors which are attributable to the traveller or which are caused by unavoidable and extraordinary circumstances.

The organizer's insolvency protection has to be established in the form of security for the refund to the traveller. Travellers shall benefit of this insolvency protection

regardless of their place of residence, the place of departure or where the package is sold and irrespective of the Member State where the entity in charge of the insolvency protection is located.

5. LINKED TRAVEL ARRANGEMENTS

Linked travel arrangement under new Directive are at least two different types of travel services purchased for the purpose of the same trip or holiday, not constituting a package, resulting in the conclusion of separate contracts with the individual travel service providers. They constitute a linked travel arrangement if a trader facilitates:

- on the occasion of a single visit or contact with his point of sale, the separate selection and separate payment of each travel service by travellers; or
- in a targeted manner, the procurement of at least one additional travel service from another trader where a contract with such other trader is concluded at the latest 24 hours after the confirmation of the booking of the first travel service.

The trader facilitating linked travel arrangements must provide security for the refund of all payments they receive from travellers insofar as a travel service which is part of a linked travel arrangement is not performed as a consequence of their insolvency. If such traders are the party responsible for the carriage of passengers, the security shall also cover the traveller's repatriation.

Provisions of the new Directive relating to the termination of the contract, right of withdrawal before the start of the performance and alteration of the price in package travel contract apply to the linked travel arrangements as well. Other provisions relating to package travel contracts in general are not applicable to linked travel arrangements. Therefore, new Directive stipulates obligation of a trader to inform traveller on this exclusion on standardized information forms contained in the Annexes.

Example 2 Selection from the standardized information form for travellers

If, after selecting and paying for one travel service, you book additional travel services for your trip or holiday via our company/XY, you will NOT benefit from rights applying to packages under Directive (EU) 2015/2302

Therefore, our company/XY will not be responsible for the proper performance of the individual travel services. In case of problems please contact the relevant service provider.

However, if you book any additional travel services during the same visit to or contact with our company/XY, the travel services will become part of a linked travel arrangement. In that case XY has, as required by EU law, protection in place to refund your payments to XY for services not performed because of XY's insolvency. Please note that this does not provide a refund in the event of the insolvency of the relevant service provider.

Source: Part A of the Annex II of the new Package Travel Directive (2015/2302/EU)

6. IMPLEMENTATION INTO TOURISM LAW OF MEMBER STATES: COMPARATIVE OVERVIEW AND STUDY OF NORMATIVE POSSIBILITIES IN CROATIA

6.1. Comparative legal overview in EU Member States

Until the adoption of the old Directive package travel contract in majority of EU countries was unregulated or in the terminology of continental civil law un-nominated contract (Gorenc et al, 2014: 1356-1365). Notable exception was Germany with an act regulating travel contracts in 1979 (*Reisevertragsgesetz*). Spain regulated travel contracts in 1963 within national legislation regulating to travel agencies (*Reglamento que regula el ejercicio de las actividades propias de las agencias de viajes*). Croatia regulated travel contracts prior to full membership in the EU.

It should be noted that the International Institute for the Unification of Private Law (standard abbreviation is UNIDROIT), distinguished international organization, prepared the International Convention on Travel Contracts in 1970. This Convention regulates travel contracts as ‘organized travel contracts’ and ‘intermediate travel contracts’ in the more general manner than new Package Travel Directive. In principle the UNIDROIT Convention sets lower standard of regulating than the new Directive but they are not mutually exclusive. UNIDROIT Convention is wider in scope than old Directive because it regulates intermediate travel contracts. However of 28 EU Member states only Belgium and Italy ratified the International Convention on Travel Contracts (UNIDROIT, 2015).

After the adoption of the old Directive EU Member States decided to transpose its provisions into their national laws by two general methods:

- (1) by enacting special statute regulating travel contracts in particular,
- (2) by enacting revisions into general civil law or national consumer protection law.

EU Member States that enacted particular statutes on travel contracts are Ireland, Portugal, Finland and Sweden (Gorenc et al, 2014: 1356-1365). Other method is incorporating provisions of the Directive into general civil law or consumer protection legislature. Latter method was adopted by Germany, Austria, Portugal, Belgium, Netherlands and Austria. Spain represents special case due its regulation of travel contracts within national rules relating to travel agencies.

In the transposition of the provisions of the new Package Travel Directive generally it would be reasonable to assume that each particular EU Member State will maintain current method. Germany will incorporate provisions of new Directive into its Civil Code (BGB). Sweden will adopt revisions to particular Act

regulating travel contracts but probably also will have to adopt revisions of its general consumer protection law. However, since the provision of the old Directive are very specific and are targeting maximum harmonization in detailed manner transposition into national laws will be more demanding in comparison with old Directive. This could result that some of the Member States even decide to change method of adoption.

6.2. Normative possibilities for transposition in the Croatian Tourism Law

Croatia transposed provisions of the old Directive into section 24 of its Civil Obligations Act (ZOO) substantially prior to the full membership in the EU. Package travel contract (*ugovor o organiziranju putovanja*) is regulated in Art. 881-903. of Croatian Civil Obligations Act. Thus, Croatia is in the group of Members States that adopted method of transposition by enacting revisions of the general civil law. Croatian Act on the Provision of Tourism Services along with Civil Obligations Act represents national source of law for package travel contracts. Act on the Provision of Tourism Services defines term of package travel in Croatian law but primary source for this matter is Civil Obligations Act. Part of the Croatian Civil Obligations Act that deals with tourist contracts is inspired by UNDROIT International Convention on Travel Contracts (Pešutić, 2006; Petrović and Tepeš, 2005) despite the fact that Croatia is not party to the Convention. UNDROIT Convention was used as model law within the broader framework of soft law (Vuletić, 2011). After provisions that regulate package travel contract, national Civil Obligations Act contains provisions regulating intermediate travel contract (*posrednički ugovor o putovanju*) modeled after the UNDROIT Convention. Intermediate travel contract is regulated in the section 25 of the Croatian Civil Act. Provisions regulating package travel contract are *legi generali* in relation to provisions regulating intermediate travel contract.

Due to the maximum harmonization required by the new Package Travel Directive Croatia will have to adopt necessary legislative revisions until transposition deadline inspires. Most logical, reasonable and practical solution that is in line with existing national legal tradition would be revisions and amendments to Croatian Civil Obligations Act and Act on the Provision of Tourism Services.

Generally revision of the Civil Obligations Act could follow two principal normative solutions. First, to unify sections 24 and 25 into one section that would deal with package travel contracts and linked travel arrangements in accordance with provisions of the new Directive. This solution would require removal of intermediate travel contract as nominated contract from Croatian law. Second solution is to revise only section 24 of the Civil Obligations Act and to maintain intermediate travel contract modelled after UNDROIT Convention. In that case provisions regulating intermediate travel contract should be revised in accordance with requirements of the new Directive. Consequently, Croatian Act on the

Provision of Tourism Services should also be revised in accordance with provisions of the new Package Travel Directive.

Standardized information forms for travellers contained in Annexes to the new Directive should also be annexed to future versions of Croatian Civil Obligations Act or alternatively to the revisions of to the Act on the Provision of Tourism Services.

Croatian Parliament enacted revisions to Civil Obligations Act in March 2018 which purpose was *inter alia* transposition of the new Package Travel Directive. Legislator opted for the first normative solution and removed specific provisions intermediate travel contracts modelled after UNDRUIT Convention. Detailed and full harmonization modelled practically the level of translation was achieved with New of Croatian Act on the Provision of Tourism Services from 1 st of January 2018.

7. CONCLUSION

The primary purpose of this paper was to explore normative substance of the new Package Travel Directive and its perspective influence on the Croatian Tourism Law. New legislation will extend protection of the of the old 1990 EU Package Travel Directive to cover not only traditional package holidays, but also give clear protection to 120 million consumers who book other forms of combined travel. The new Directive broadens the concept of package and now will apply to different sorts of travel combinations: pre-arranged packages; customised packages and linked travel arrangements.

Internet as increasingly important medium for travel services produced surge of various forms of customized travel arrangements and rendered provisions of the old Directive obsolete to the needs modern tourist market. EU is the world's number one tourist destination. This information alone demonstrates substantially economic importance of the EU's travel package market. Thus it stand to reason that European Commission decided to construct new formal and normative framework in order to facilitate this somewhat spontaneous and informal process. We have seen in the past that provisions old Directive left number of ambiguities requiring even Court of Justice of the European Union (CJEU) to issue interpretations of its provisions in several of its judgments (most formative being ruling in the *Club Tour* case). The new Package Travel Directive requires maximum harmonization in contrast to the old Directive, which required only minimum harmonization.

Vast majority of travellers buying packages and linked travel arrangements are consumers within the meaning of the EU Consumer Protection Law. Thus, new

Package Travel Directive should result in the enhancement of the consumer protection.

Process of transposition of the provisions of the new Package Travel Directive should be completed by January 1st 2018. It would be reasonable to assume that during this process each particular EU Member States will maintain current method of transposition for package travel contracts (e.g. Germany will incorporate provisions of new Directive into its Civil Code). However the provisions of the old Directive are very specific since they are targeting maximum harmonization in detailed manner. Thus, transposition into national laws will be more demanding in comparison with old Directive.

The EU latest Member country - Croatia transposed provisions of the old Directive into section 24 of its Civil Obligations Act (ZOO) and into Act on the Provision of Tourism Services. Thus, Croatia is in the group of Members States that adopted method of transposition by enacting revisions of the general civil law. Most logical, reasonable and practical solution that is in line with existing national legal tradition for new transposition process would be revision of the Croatian Civil Obligations Act.

Croatian enacted revisions to national Civil Obligations Act in March 2018 which purpose was transposition of the new Package Travel Directive. Legislator opted for the normative solution that required removal of specific provisions intermediate travel contracts modelled after UNDROIT Convention. In the beginning of same year full and detailed harmonisation was achieved by enactment of the New Act on the Provision of Tourism Services.

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SENSITIVITY OF DIVIDENDS TO EARNINGS CHANGES

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Abstract

This paper deals with probabilities of dividend changes for a given change in earnings. This so-called sensitivity of dividends to earnings changes was analyzed on a sample of Advanced economies and Emerging and developing economies, according to International Monetary Fund classification. The main goal of the research is to empirically verify the assumption that companies are generally reluctant to cut or reduce dividends regardless of the stage of economic development of the country. In addition, the probabilities of dividend changes for a given change in earnings in characteristic groups of countries - Baltic countries and former Yugoslavia countries - have been analyzed. Research results show that earnings are significant dividend factor in all sample countries, that companies are generally reluctant to cut or decrease dividends and that dividends are less sensitive to earnings changes in Advanced economies, compared to Emerging and developing economies. Research has also shown that dividends are less responsive to earnings changes in former Yugoslavia countries compared to Baltic countries. These findings are in line with Lintner (1956) who has shown that reduction in earnings is not necessarily followed by reduction in dividends. Such behavior of dividends can be explained even by prospect theory created by Kahneman and Tversky (1979). They have shown that investors are more sensitive to negative events than to positive events and that investors do not make decisions in relation to the overall wealth but in relation to a particular reference point, which is usually the status quo. If this is the case, the previous dividends represent a specific reference point in relation to which investors make decisions. Having in mind asymmetric reaction of the investing public to dividend increases and dividend decreases (or dividend cuts), companies are reluctant to cut or decrease dividends because they are trying to avoid negative market reaction.

Keywords: *dividends, earnings, sensitivity, probability analysis.*

JEL: G11, G31

1. INTRODUCTION

Dividend decision is one of the most important decisions in corporate finance. It aims to establish the dividend payout ratio that will maximize the long-term value of the company. This ratio reflects not just the essence, but also the complexity of the dividend policy. Do dividend paying companies worth more than companies that do not pay dividends? The bird in hand theory established in works of Myron Gordon and John Lintner is based on the hypothesis that cash dividends are more certain than future capital gains. In this way, dividend paying companies would have lower cost of capital and consequently higher value of the company. By contrast, advocates of the tax differentiation theory, Litzenberger and Ramaswamy, argue that there is a negative relationship between the dividends and the value of the company. The authors point out that the capital markets are not perfect places and higher taxation of dividends in relation to capital gains will increase the required rate of return before tax thus reducing the value of the company. Between these two extremes, the neutral position is taken by dividend irrelevance theory by Miller and Modigliani (1961) who have shown that the value of a company in a perfect capital market is function of company investment policy, not the dividends. They argue that, for a given investment budget, the dividend payout would require an additional stock issue, so the effect of the stock price increase caused by the payment of dividends would be canceled through the effect of stock dilution or reduced stock price. Investors or stockholders who would want to make current income can sell the portion of their stocks to create the so-called homemade dividends.

Regardless of which of the aforementioned theories are closest to the real world, it is quite certain that many companies still pay dividends on a regular basis and that dividend policy is perceived as an active variable of corporate governance. Lintner (1956) found that managers in the US are not inclined to reduce dividends. Moreover, they decide to increase dividends only when they believe that future earnings will justify higher level of dividends. In other words, companies tend to smooth dividends toward long-term, targeted payout ratio. These findings were verified by Fama and Babiak (1968), Aivazian, Booth and Cleary (2006), Brav et al. (2005) and by many others. However, most of these studies have been conducted in the United States and other developed countries with an active capital markets neglecting emerging and developing economies, especially transition countries of Central and South-Eastern Europe which are characterized by younger and less liquid capital markets. In contrast, Glen et al. (1995) have documented that companies in transition countries focus on the stability of the payout ratio instead of smoothing the absolute amount of dividends per share, implying a greater sensitivity of dividends to earnings changes. Bearing this in mind, the aim of this

paper is to assess the likelihood of dividend changes for different changes in earnings on a sample of developed and emerging and developing countries to examine whether the reluctance to cut or reduce dividends is global phenomenon.

The paper is organized as follows: The first part presents a systematic literature review of the link between profitability and dividends. In the second part, research sample and methodology have been defined. The third section summarizes the research results regarding the link between current earnings and dividend per share in all sample countries. In the fourth section, we compared the sensitivity of dividends to earnings changes in developed and emerging and developing countries, according to IMF classification. In the fifth section, we compared the sensitivity of dividends between former Yugoslavia countries and Baltic countries. In the last part of the paper, general conclusions were made as well as the main limitations of the research.

2. AN OVERVIEW OF EMPIRICAL RESEARCH

Retained earnings together with current earnings are the basic source for dividend payments so it is reasonable to expect that growth in earnings will affect the amount of paid dividends. This is confirmed by numerous empirical researches. Lintner (1956) conducted a survey in 28 major US companies showing that current earnings and last year dividends have a significant impact on current year dividends. Fama and Blasiak (1968) came up to the same conclusion on a sample of 392 US industrial companies in the period from 1946 to 1964. They have shown that current earnings are better measure of profitability than a cash flow or net income plus depreciation. More recent research conducted by Fama and French (2001) has also shown that more profitable companies are more likely to pay dividends, where profitability is measured as the ratio of earnings before taxes and total assets. DeAngelo, DeAngelo and Stulz (2006) have also documented that the likelihood of dividend payout increases with raising portion of retained earnings in total stockholder equity. According to these authors, higher portion of retained earnings in total stockholder equity indicates the maturity phase of a company's life cycle in which companies are better candidates for dividend payouts due to higher profitability and less investment opportunities. The link between profitability and dividends is also related with signaling theory of dividends, which emphasize that dividends contain some information about future earnings (Bhattacharya, 1979; John i Williams, 1985; Miller i Rock, 1985).

The important role of earnings for dividend payouts is confirmed by number of surveys. By polling directors in 318 companies from the New York Stock Exchange, Baker, Farrelly and Edelman (1985) as the main determinants of dividend payouts identified the anticipated level of future earnings and the historical pattern of dividend payments. Similar results were also published by Baker and Powell (2000) who, among other things, emphasize the importance of

the level of current and expected earnings for dividend decision. In addition, the authors point out that dividend determinants are industry specific. Baker, Veit and Powell (2001) conducted a survey among NASDAQ's market leaders, citing an anticipated level of future earnings and a pattern of previous dividend payments as important factors of dividend policy. More recent survey was conducted by Brav et al. (2005) on a sample of 384 financial directors in 256 US companies. The authors point to the perceived stability of future earnings as a significant determinant of dividend policy, emphasizing that the link between profitability and dividends has weakened over time, as most directors tend to favor the stock buybacks as a more flexible way of distributing earnings.

Similar conclusions regarding the impact of profitability on dividend payouts were also reached in the studies of dividend policy across European countries (Hedensted and Raaballe, 2006; Denis and Osobov, 2007; Kowalewski, Stetsyuk and Talavera, 2007; Statescu 2006, Bancel, Bhattacharyya and Mittoo, 2005; etc.) Bebczuk (2004) first explored the dividend determinants in Argentina on a sample of 55 companies during the 1996 to 2002 period. By analyzing the characteristics of dividend paying companies, he also found that larger and more profitable companies, without good investment opportunities, have higher dividend to cash flow ratios. Aivazian, Booth and Cleary (2003) have explored the dividend policy on a sample of companies from eight developing countries (Jordan, Pakistan, Turkey, India, Zimbabwe, Thailand, South Korea and Malaysia). Their results have shown that corporate profitability in these countries measured by return on equity (ROE) is one of the main determinants of dividend payouts measured by the ratio of dividends to total assets.

2. RESEARCH SAMPLE AND RESEARCH METHODOLOGY

The research sample consists of 33 countries from Europe, Asia, Australia and North America. The sample included all the countries for which research data on research variables were available, namely: Croatia, Slovenia, Macedonia, Bosnia and Herzegovina, Latvia, Lithuania, Estonia, Poland, Czech Republic, Hungary, Bulgaria, Romania, Turkey, Portugal Spain, France, Switzerland, Italy, Netherlands, Belgium, Denmark, Germany, Austria, Sweden, Norway, Finland, Ireland, United Kingdom, United States, Australia, New Zealand, Japan and China. In each sample country, a subsample of public companies that paid dividends at least five times over a period of 10 years (2003: -2012) was created. The number of companies by country is given in Table 2. The sensitivity of dividends to earnings changes was tested by various methods. First, a simple correlation analysis was conducted to investigate the correlation between these two variables and its strength and direction. After correlation analysis, a panel regression analysis was performed to investigate the causal link between profitability and the dividend payout on the secondary panel data. Based on these regression coefficients, difference between developed and emerging and developing countries was tested

using *t* test. In addition, the probabilities of dividend changes for a given changes in earnings in both groups of countries were examined using the contingency table. Dependent variable in case of the panel regression analysis was represented by dividend per share, while the independent variable was represented by current earnings per share. After testing for differences in the regression coefficients obtained by panel regression analysis, contingency table was used for a descriptive comparison of the sensitivity of dividends to earnings changes between the former Yugoslavia countries and the Baltic countries. Dividends per share and earnings per share data were collected from Thompson Reuter's database and from audited and consolidated financial statements in the case of Croatia and Bosnia and Herzegovina.

3. SENSITIVITY ANALYSIS OF DIVIDENDS TO EARNINGS CHANGES

As mentioned above, the first method used to investigate association between earnings per share and dividends per share in each of the countries from the research sample was a simple correlation analysis. The results obtained by correlation analysis are presented in Table 1.

Table 1. Correlation coefficients

Country	Observations	Correlation coefficient	p-value
United States	5805	0,14	0,00
Australia	2338	0,66	0,00
Austria	300	0,75	0,00
Belgium	240	0,31	0,00
Denmark	489	0,85	0,00
Finland	639	0,68	0,00
France	2400	0,65	0,00
Ireland	160	0,74	0,00
Italy	579	0,68	0,00
Japan	13723	0,44	0,00
China	4154	0,8	0,00
Netherlands	469	0,3	0,00
Norway	340	0,71	0,00
New Zealand	529	0,15	0,00
Germany	920	0,66	0,00
Spain	420	0,86	0,00
Sweden	980	0,6	0,00
Switzerland	710	0,87	0,00
Great Britain	3890	0,15	0,00
Croatia	195	0,47	0,00
Slovenia	100	0,54	0,00
Bosnia and Herzegovina	20	0,97	0,00
Macedonia	40	0,69	0,00
Poland	380	0,82	0,00

Lithuania	50	0,34	0,02
Latvia	40	0,71	0,00
Estonia	30	0,81	0,00
Hungary	70	0,72	0,00
Turkey	570	0,39	0,00
Bulgaria	80	0,52	0,00
Romania	89	0,97	0,00
Czech Republic	30	0,64	0,00
Portugal	169	0,54	0,00

Note: Data for earnings per share and dividend per share from Thompson Reuters and audited financial reports

Looking at the previous table, there is a clear positive correlation between dividends and earnings in all countries of the sample, and it is statistically significant at the significance level of 5 percent. At the same time, the smallest correlation coefficients were recorded across most developed capital markets, such as United States and Great Britain (0.14 and 0.15). Developed countries in Europe recorded much higher correlation coefficients ranging from 0.30 to 0.80. Among the developed countries of Europe, only Spain and Estonia have coefficients greater than 0.80. When it comes to the European transition countries as a segment of the emerging and developing countries, the biggest correlation between dividends and earnings is recorded by Bosnia and Herzegovina and Romania at 0.97. These results are in line with the hypothesis that dividend policy, in terms of dividend smoothing, is more important on the more developed capital markets. After the correlation analysis, a panel regression analysis (pooled OLS) was performed in all sample countries. The panel analysis results are given in Table 2.

Table 2. Panel regression (pooled OLS) results

Country	Companies	Obs.	Pooled OLS	p-value	Classification
United States	583	580 5	0,02	0,00	Advanced economies
Australia	234	233 8	0,28	0,00	Advanced economies
Austria	30	300	0,26	0,00	Advanced economies
Belgium	24	240	0,05	0,00	Advanced economies
Denmark	49	489	0,14	0,00	Advanced economies
Finland	64	639	0,32	0,00	Advanced economies
France	240	240 0	0,35	0,00	Advanced economies
Ireland	16	160	0,22	0,00	Advanced economies
Italy	58	579	0,27	0,00	Advanced economies
Japan	1253	125 9	0,08	0,00	Advanced economies
China	418	415	0,30	0,00	Emerging and develop.

		4			econ.
Netherlands	47	469	0,03	0,00	Advanced economies
Norway	34	340	0,29	0,00	Advanced economies
New Zealand	53	529	0,01	0,00	Advanced economies
Germany	92	920	0,28	0,00	Advanced economies
Spain	92	420	0,20	0,00	Advanced economies
Sweden	98	980	0,26	0,00	Advanced economies
Switzerland	71	710	0,30	0,00	Advanced economies
Great Britain	389	389 0	0,01	0,00	Advanced economies
Croatia	20	195	0,06	0,00	Emerging and develop. econ.
Slovenia	10	100	0,16	0,00	Advanced economies
Bosnia & Herzegovina	2	20	0,68	0,00	Emerging and develop.econ.
Macedonia	4	40	0,16	0,00	Emerging and develop.econ.
Poland	38	380	0,71	0,00	Emerging and develop. econ.
Lithuania	5	50	0,21	0,02	Emerging and develop.econ.
Latvia	4	40	0,24	0,00	Emerging and develop.econ.
Estonia	3	30	0,89	0,00	Advanced economies
Hungary	7	70	0,34	0,00	Emerging and develop.econ.
Turkey	57	570	0,41	0,00	Emerging and develop.econ.
Bulgaria	8	80	0,27	0,00	Emerging and develop.econ.
Romania	9	89	0,71	0,00	Emerging and develop.econ.
Czech Republic	3	30	0,61	0,00	Advanced economies
Portugal	17	169	0,12	0,00	Advanced economies

Note: Data for earnings per share and dividend per share from Thompson Reuters and audited financial reports

Pooled OLS panel regression results confirm the findings obtained by correlation analysis. One can see that earnings per share are significant dividend predictor in all sample countries at a significance level of 5 percent. The United States, Great Britain, New Zealand, Japan and some of the most developed European countries recorded the lowest coefficients of dividend changes given changes in earnings, which shows the greater propensity of firms in these countries to smooth dividends. Among emerging and developing countries, only Croatia has slopecoefficient below 0.1.

4. SENSITIVITY OF DIVIDENDS TO EARNINGS CHANGES IN ADVANCED ECONOMIES AND EMERGING AND DEVELOPING ECONOMIES

Comparison of the level of sensitivity of dividends to earnings changes between Advanced economies and Emerging and Developing economies was made on the basis of the International Monetary Fund classification. For this purpose *t*-test was used to test the difference between mean coefficients obtained by panel regression analysis. The results of the *t*-test are given in Table 3.

Table 3. Testing the differences between the mean coefficients of pooled OLS (*t*-test output)

Advanced economies (Mean)	0,23	Emerging and developing economies (Mean)	0,37
	Mean diff.	Ha: diff < 0	Ha: diff != 0
Advanced vs. Emerging	0,14	Pr(T < t) = 0,9554	Pr(T > t) = 0,0893
			Pr(T > t) = 0,0446

Source: authors

According to Table 3 mean coefficient for current earnings in Advanced economies is 0.23 and 0.37 for Emerging and developing economies. *t*-test results show that mean coefficient obtained by panel regression analysis for advanced economies is significantly lower compared to mean coefficient for emerging and developing economies, at significance level of 10 percent. Therefore, it can be concluded that dividends are less sensitive to earnings changes in developed countries.

Based on the results of the panel regression analysis it is quite clear that in most countries current earnings have a significant positive impact on dividends. Likewise, there is a significant difference in the coefficients of the change in dividends in relation to the changes in earnings between these two groups of countries. However, the thesis about the global propensity to smooth dividends is more precisely analyzed by contingency tables. In this respect, earnings trends can be observed through four options: no change, increase, decrease, and loss (negative earnings). Each of these categories is followed by certain behavior of dividends (no change, increase¹, decrease or dividend cut). Therefore, the question arises as to how the probability of a certain direction of dividends is affected by different behavior of earnings per share. It is to be expected that in most cases, growth in earnings will be accompanied by increase in dividends as shown by correlation analysis and panel regression analysis. However, if dividend smoothing practice is widespread phenomena, the results will show the immunity of dividends to

¹ Dividend initiations (first time payers) are included in the increase category.

earnings decline or negative earnings. The results of the probability analysis of dividend behavior given changes in earnings are given in Table 4.

Table 4. Conditional probabilities of dividend changes for a given changes in earnings

CLASSIFICATION BY IMF			DIVIDEND CHANGES			
			No change	Increase	Decrease	Cut
EARNINGS CHANGES	No change	Advanced economies	23,49%	59,04%	16,27%	1,20%
		Emerging economies	32,14%	39,29%	28,57%	0,00%
	Increase	Advanced economies	23,27%	70,00%	5,20%	0,68%
		Emerging economies	19,13%	63,94%	12,11%	4,81%
	Decrease	Advanced economies	38,45%	39,57%	20,46%	1,51%
		Emerging economies	21,03%	29,33%	38,59%	11,05%
	Loss	Advanced economies	37,68%	17,88%	27,56%	16,88%
		Emerging economies	32,16%	18,13%	6,43%	43,27%

Note: Data for earnings per share and dividend per share from Thompson Reuters and audited financial reports

Table 4 shows that in case of earnings growth, majority of companies in both groups of countries increase dividends per share (over 70% of cases). However, in case of earnings decrease, 38.6% of companies in emerging and developing countries reduce dividends, while in developed countries only 20.46% of companies decrease dividends. Dividends are more responsive to earnings changes in emerging and developing countries even in cases of negative earnings. More precisely, 43.27% of companies in emerging and developing countries cut dividends in case of negative earnings, while in developed countries, only 16.88 percent of the companies decide to cut dividends. Looking at the joint probability of not reducing dividends in case of earnings decline, or in case of negative earnings, one can notice that over 50% of companies in both groups of countries do not reduce or cut dividends despite fall in earnings (developed countries - 78.02% in development - 50.36%). This leads to a conclusion that dividends are generally immune to earnings decline (or loss), but also that dividends are more resistant to earnings decline(or loss)in developed countries compared to dividends in emerging and developing countries. These results seem to support the prospect theory argument about investor's asymmetric reaction to gains and losses(Kahneman and Tversky, 1979). Having in mind asymmetric reaction of the investing public to

dividend changes, companies are reluctant to decrease dividends in case of earnings decline because they tend to avoid negative market reaction.

5. SENSITIVITY OF DIVIDENDS TO EARNINGS CHANGES IN FORMER YUGOSLAVIA COUNTRIES AND BALTIC COUNTRIES

From the previous analysis one can conclude that companies are generally reluctant to cut or reduce dividends. It is also clear that dividends in emerging countries are more sensitive to earnings changes compared to dividends in developed countries. However, within these two groups of countries, among other things, there are differences in capital market development, the level of investor protection and the role of the banks in external financing that can be reflected in the dividend policy. Dzidic (2016) has shown that countries with stronger investor protection mechanisms, more developed capital markets and weaker role of the banks have higher portions of dividend smoothing companies, where smoothing follows a strict definition - not reducing dividends per share for five consecutive years. Consequently, the lower sensitivity of dividends to earnings changes is expected in countries with better investor protection and higher level of capital market development. These conclusions will be tested on two distinct groups of countries - the countries of the former Yugoslavia and the Baltic countries. Former Yugoslavia countries, like the Baltic countries, have gone through a similar period of transition into a market economy, whereby some countries have made a faster and better progress than their neighbors in the same group of countries. For example, Slovenia and Estonia according to the IMF classification belong to a group of developed countries while other countries are being classified as emerging and developing countries. Similarly, some of them, like Croatia, Slovenia, Lithuania and Estonia, have achieved a respectable capital market development while some, such as Bosnia and Herzegovina, have completely neglected this segment of the financial market. In case of former Yugoslavia countries, only the countries for which data on dividends and earnings were available entered into analysis: Croatia, Slovenia, Bosnia and Herzegovina and Macedonia. In case of Baltic countries Latvia, Lithuania and Estonia were examined. Table 5 shows the probability of dividend changes for each category of earnings change in both groups of countries.

Table 5 Conditional probabilities of dividend changes for a given changes in earnings

CLASSIFICATION BY AUTHOR			DIVIDEND CHANGES			
			No change	Increase	Decrease	Cut
EARNINGS CHANGES	No change	Former Yugoslavia	16,67%	33,33%	50,00%	0,00%
		Baltic countries	33,33%	33,33%	33,33%	0,00%
	Increase	Former Yugoslavia	17,26%	63,69%	17,26%	1,79%

		Baltic countries	15,00%	71,67%	13,33%	0,00%
		Former Yugoslavia	19,82%	36,94%	36,94%	6,31%
	Decrease	Baltic countries	26,47%	23,53%	44,12%	5,88%
		Former Yugoslavia	10,00%	0,00%	40,00%	50,00%
	Loss	Baltic countries	0,00%	20,00%	20,00%	60,00%

Note: Data for earnings per share and dividend per share from Thompson Reuters and audited financial reports

From the previous table, it is clear that public companies in both groups of countries are inclined to increase dividends in case of a earnings growth while they are not prone to reduce dividends in case of earnings decline (even 50 percent of the companies increases or keeps dividend per share at the same level despite fall in earnings). In addition, it is evident that dividends of Baltic companies are slightly more sensitive to changes in earnings compared to public companies in former Yugoslavia countries. Table 6 shows the indicators of capital market development and investor protection for the both groups of countries.

Table 6. Indicators of capital market development and investor protection

Country	IMF Classification	Market cap. (%GDP)	Stocks traded (% GDP)	Minority investor protection	Anti-self – dealing index
Croatia	Emerging econ.	36,96	1,24	3,6	0,25
Slovenia	Advanced econ.	13,35	0,95	3,4	n /a
Bosnia and Herzegovina	Emerging econ.	n /a	n /a	3,1	n /a
Macedonia	Emerging econ.	5,66	0,41	3,5	n /a
Lithuania	Emerging econ.	9,19	0,47	3,9	0,38
Latvia	Emerging econ.	3,73	0,14	4,1	0,35
Estonia	Advanced econ.	8,47	0,9	4,3	n /a-

Note: Data for market capitalization and stocks traded from Federal Reserve Bank of St. Louis; for minority investor protection from Global Competitiveness Report 2012; for anti-self-dealing index from Djankov et al. (2008).

Comparing a group of countries in the former Yugoslavia region (Croatia, Slovenia, Macedonia and Bosnia and Herzegovina) with a group of Baltic countries (Latvia, Lithuania and Estonia), one can see that the Baltic countries have a somewhat higher level of investor protection but a somewhat less developed capital markets, despite stronger integration through a common trading platform (Nasdaq OMX group, INET trading platform). In the countries of the region, Macedonia and Bosnia and Herzegovina are significantly lagging behind Croatia and Slovenia whose capital markets are larger and more active, measured by the market capitalization as percentage of GDP and the value of stocks traded as a percentage of GDP. For example, Bosnia and Herzegovina has a highly undeveloped and illiquid capital market measured by the value of stocks traded as a percentage of market capitalization of the listed companies (Dzidic, 2016). Within the group of Baltic countries, Lithuania and Estonia have more developed capital markets than Latvia measured by market capitalization as a percent of GDP or by the ratio of stocks traded to GDP.

These results should be taken with certain degree of caution due to small sample sizes in all Baltic countries and also in Bosnia and Herzegovina and Macedonia. However, despite the fact that none of the Baltic countries has more than 5 companies meeting the criterion of the design of the research sample (dividend payment for at least 5 years in the period 2003-2012) it should be noted that the number of listed companies is generally lower in Baltic countries than in countries of the region, so there is a smaller sample of dividend paying companies that satisfy sample construction criterion. For example, according to data from the Nasdaq Baltic market in 2012, Estonia had 16 listed companies, Latvia 32, and Lithuania 33 listed companies. At the same time, data taken from the local stock exchanges in the countries of the former Yugoslavia show that there were 51 listed companies in Slovenia at the end of 2012, 200 in Croatia, 179 in Bosnia and Herzegovina and 32 listed companies in Macedonia. As a whole, more companies have met the sample construction criterion in the countries of former Yugoslavia over the Baltic countries. The smallest sample of companies was created in Bosnia and Herzegovina, not because of the small number of listed companies, but primarily because of the lack of data on research variables among majority of listed companies.

6. CONCLUSION

The aim of this paper is to examine sensitivity of dividends to earnings changes across different groups of countries. The results of the research show that earnings are significant dividend predictors in all sample countries and that dividends are more sensitive to earnings in developed countries such as the United States, Great Britain, Japan etc. Furthermore, probability analysis suggests that companies are generally reluctant to cut or reduce dividends, regardless of the stage of economic development of the country. This is in line with Lintner (1956) findings that a

reduction in earnings does not necessarily lead to a reduction in dividends, which is best illustrated by the positive constant of his partial adjustment model. Such behavior of dividends follows the conclusions of Brav et al. (2005), who show that managers are aware of the asymmetric reaction of the investing public to dividend changes, whereby the market does not value the increase in dividends to the extent that they "penalize" the reduction of dividends. According to prospect theory of Kahneman and Tversky (1979) investors are more sensitive to negative events than to positive events meaning that a loss will hurt them more than the gain of the same size will please them. In addition, the authors have shown that investors do not make decisions in relation to the overall wealth but in relation to a particular reference point, which is usually the status quo. If this is the case, the previous dividends represent a specific reference point in relation to which sudden drop in dividends is followed by stronger price decrease than unexpected growth in dividends is followed by stock price increase.

When it comes to comparison between the Former Yugoslavia countries and the Baltic countries, one can conclude that dividends are less responsive to earnings changes in former Yugoslavia countries compared to Baltic countries. This may reflect the fact that Croatia and Slovenia are ahead of their Baltic peers in terms of capital market size measured by market capitalization as a percent of GDP and in terms of capital market liquidity measured by the value of stocks traded as a percent of GDP. Among the Baltic countries, Lithuania and Estonia are ahead of Latvia which is the smallest and less liquid capital market in this group of countries.

Like any other empirical research this study has certain limitations. They are primarily related to the quality of data in former Yugoslavia countries. Data inconsistency from different data sources has led to sample size reduction due to exclusion of some dividend paying companies. In addition, the lack of data on dividends and earnings per share from companies in other countries of the region, such as Serbia and Montenegro, to some extent distorts the general conclusion on the dividend policy in this group of countries. A broader sample size over a wider period of time would certainly contribute to the reliability of the conclusions. Hence, addressing these issues presents new research challenge through which one could reach more credible conclusions about the role of dividend policy in different economic environments.

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IS THERE STILL A FUTURE TO THE REGIONAL TRADE AGREEMENTS?

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Review

Abstract

Regional Trade Agreements (RTAs), are Treaties between two or more states to liberalize mutual trade or other economic relations. Among such RTAs the European Union is the largest one and most complex, including 28 member states with developed high levels of trade, monetary and economic cooperation in 2018. Generally RTAs follow the idea that more free trade and more liberal environment for other economic cooperation activities among the integrated states create an environment enabling additional and accelerated economic growth of member states, together with some other positive structural and economic gains. After 1992 the number of newly registered RTAs with GATT and later with WTO started to increase very fast in comparison to the entire period after the WW II. In May 2018 all WTO registered active RTAs reached the number of 287. The number of active RTA evidently exceeds the number of all world's states. The number of 287 active RTAs suggests that at least some states participate in more than one form of RTA. Such fact further strongly suggests that at least before 2017 there was globally developed an intensive interest among states to join or create one or another form of the RTA. The growth of registered and active RTAs in the last 25 or so years confirms realization of the theoretically predicted positive economic impacts of the RTAs on the member states economic achievements. However Mr. Trump, as the actual President of the USA, started to question expected positive economic gains of the existing RTAs. The policy of unilateral increases of USA's import tariffs introduced by new USA administration presents open violation of the WTO trading rules. The USA's discriminatory trade policy has been further extended by the decided that USA has to exit from its existing RTAs. USA's decision of dismantling of the existing RTAs creates questions about their real economic efficiency and generally about the future of such international trade agreements. The process and

actions after the dismantling and renegotiating of the USA's RTA with Mexico and Canada, known as North American Free Trade Agreement (NAFTA, established Jan.1, 1994) produce some insight into the weaknesses and into the potential changes of the future RTAs.

In the paper we analyse expected economic gains and eventual disadvantages of the RTAs for the member states. The expected end of NAFTA and creation of a new trade agreement between USA, Mexico and Canada are analysed with the purpose to develop insights into the probable future existence and reforms of the RTAs in the global economy.

Keywords: *Liberal trade, beggar-thy-neighbour policy, regional trade agreements (RTAs), RTAs and gains, uneven distribution of trade gains or benefits, trade restrictions, North American Free Trade Agreement, new trade agreement USA, Mexico, Canada, non-traditional forms of dumping, RTAs'and reform issues.*

JEL: F5, F6

1. INTRODUCTION

From the times of Adam Smith and David Ricardo international trade, especially with limited or no state regulation - free or liberal trade-, was supposed and in practical terms it really was, beneficial to all trading nations. Liberal attitude in trade issues was accepted as leading orientation (doctrine) for the economic policy of many nations widely and lastingly. In the past the problem was that liberal trade policies were not always equally appreciated, understood and practice among different trading nations. Especially during and after the Great Economic Depression of the 1930s (GED) of the 20th century sizable number of nations decided to improve their national economic achievements by policies implementing different new trade restrictive measures together with increasing of the existing classical trade restrictions. The policy of continuously increasing and introducing new trade barriers was simultaneously combined with a policy of excessive national currency exchange rate value depreciations. Combination of discriminatory trade and currencies' exchange rate policies was expected to create necessary economic conditions for a substantial national exports volume growth, together with the decrease in the volumes of national imports. Both economic developments were expected to secure a higher national economic growth that was needed to improve the critically low levels of the national aggregate labour employment.

In general the expected positive impacts of the restrictive and discriminatory trade policy together with the anticipated exchange rate devaluation policy should help the economy to get successfully out of the existing economic crises. The practical short-comes of such economic policies were on one side reduced national economic efficiency and on the other side negative economic and political reactions of the partner countries. The partner countries were production and

employment negatively affected by the decreasing exports to all the states that had been using discriminatory trade and exchange rate policies. Decrease in national exports started to deepened their national economic crises. The states with falling exports that were caused by the trade protection measures used by partner countries started to experience the accelerated national GDP level decreases together with simultaneous growth of the labour unemployment rates.

The general reaction to such negative and hostile discriminatory trade and exchange rate polices was that nation after nation started to stimulate their national exports and to limit simultaneously national imports. To achieve needed export growth, and expected import decrease the measures of the trade discrimination were increasingly used together with the exchange rate discriminatory practices. Such combination of economic measures was expected to create economic conditions necessary for the reduction of the continuously growing national unemployment rate.

Nowadays the USA trade policy of the unilateral dismantling of the existing Regional Trade Agreements (RTAs) and of unilateral increases of import tariff rates, for selected products and states, is in a great deal similar to the trade and exchange rates discriminatory policies that were used in the period before the WW II.

2. HISTORIC REASONS AND EVIDENCES OF TRADE AND EXCHANGE RATES DISCRIMINATORY POLICIES

The historic intensive and broad use of trade and exchange rate discriminatory policies resulted from economic and political problems associated with the impacts of the Great Economic Depression (GED) of the thirties of 20th century. The broad use of trade discriminatory policies caused sizable decrease of the volume of international trade before the World War II (WW II). Discriminatory trade policy was characterised by intensive trade barriers increases and was further associated with the increased level of exchange rate risks. The risks were increased following the practices of the anticipated intensive national currency devaluation policies. Data and analyses of the effects made by trade barriers increases and by the anticipated devaluation policies used during and after GED show generally negative results for employment and economic growth levels.

“Using panel data estimates of export and import equations for 17 countries in the interwar period, this paper estimate the effects of increasing tariff and nontariff trade barriers on worldwide trade over the period 1929 to 1932. The estimates suggest that real world trade contracted approximately 14% because of declining income, 8% as a result of discretionary increases in tariff rates, 5% owing to deflation-induced tariff increases, and a further 6% because of the imposition of nontariff barriers. Allowing for feedback effects from trade barriers on income and

prices, discretionary impositions of trade barriers contributed about the same to the trade collapse as the diminishing nominal income.”¹ The tariff increases in the period of GED are documented in Table 1. Only the trade restrictions used in period 1929-1932, according to Madsen’s calculation, had reduced trade of the analysed 17 states for 19%. Obviously, but not included into the above analyse, there were additional trade reduction effects based on increased trade and payment risks following the policies of anticipated currencies devaluations. Substantially reduced exports together with reduced imports started to affect negatively the level of national incomes, the level of aggregate production and the intensity of the economic growth in all and each of the states that were using discriminatory policies. Negative economic growth effects following the trade discrimination impacts caused further decreases in the levels of the nation aggregate employment. The vicious cycle of economic depression and of growing unemployment was effectively closed by the practice of using trade and exchange rate discriminatory policies in the efforts of national governments to overcome the highly negative impacts of GED.

Negative national economic results created by the impacts of the trade discrimination that developed into a trade war started to develop new economic and political tensions and conflicts among growing number of states. Before the WW II such ineffective and even dangerous trade and exchange rates discriminatory policy was known as a **beggar-thy-neighbour** policy.

The term was originally devised to characterize policies of trying to cure domestic depression and unemployment by shifting effective demand away from imports onto domestically produced goods, either through tariffs and quotas on imports, or by competitive devaluations. Such policy can be associated with the concepts of mercantilism and neomercantilism and in theory and practice they open the way for trade wars between countries. Before the WW II trade wars based on the use of the beggar-thy-neighbour policies were unfortunately altogether ineffective attempt to reduce negative impacts of the GED. Negative impacts of the resulting trade wars were, according to a number of professional analyses from the past² and together with some political statement³ of the time, among the major causes creating the

¹ Madsen, Jakob B.; Trade Barriers and the Collapse of World Trade During the Great Depression, Southern Economic Journal 2001, 67(4), 848-868; <http://www.people.vcu.edu/~lrazzolini/GR2001.pdf>

² French economist Frédéric Bastiat (1801-1850) is often quoted as saying that when goods do not cross frontiers, armies will. Whether he said it or not, it's right. See: <https://fee.org/articles/trade-wars-lead-to-shooting-wars-and-depressions/>

³ In 1938 the USA Secretary of State Cordell Hull reasoned, “Our nation, and every nation, can enjoy sustained prosperity only in a world which is at peace; a peaceful world is possible only when there exists for it a solid economic foundation, an indispensable part of which is active and mutually beneficial trade among the nations.” For Hull, trade was essential for peace. When he won a Nobel Peace Prize in 1945, the awarding committee

outbreak of the WW II. As domestic industries weakened by the negative impacts of the beggar-thy-neighbour policies, increasing national political pressures to protect them from foreign competition started to develop. In short trade wars were part of GED and caused very slow economic recovery in Europe, Japan and in both Americas. According to historic facts related to GED and its impacts is evident that trade wars could actually cause even a real shooting war. "In the violent Depression," Winston Churchill⁴ wrote, "Britain and 40 other countries felt increasingly compelled, as the years passed, to apply restrictions or tariffs against Japanese goods produced under labour conditions unrelated to European or American standards." The reasons for the economic tensions between states, explained by W. Churchill, were historically based on "labour conditions unrelated to European or American standards". The reasons related to different "labour standards" that caused trade wars in the past, could unfortunately be equally observed and missus din the global economy of today. In contemporary global economic environment, after his election, Mr. Trump started to "protect" American economic interests by introducing additional import tariffs and by disrupting RTAs that USA had agreed in the past. According to Mr. Trump's reasoning goods produced and imported from China and from other countries including (potentially) the EU countries, are made under labour and other conditions that are unrelated to American standards, so they are harmful for USA economy and USA labour employment levels.

Today's economic situation created by the USA restrictive economic/trade policy introduced by Mr. Trump has a number of similarities with the economic situation in the World before the WW II. Unfortunately economic and trade wars that developed after GED between different states, including Europe and Japan, as

summed up Hull's thinking this way: "High tariffs are barriers obstructing the development of trade and friendship between nations, thereby becoming barriers also to lasting international peace." See:

<http://origins.osu.edu/article/trade-wars-collapse-americas-free-trade-consensus>

⁴Winston Churchill: "The Gathering Storm," Published May 5th 2005 (first published June 1st 1948),

ISBN 0141441720 (ISBN13: 9780141441726), Series; The Second World War

It is interesting for the nowadays international trade relation policies and for their needed reforms that already before the WW II W. Churchill realized that the international trade competition based on extremely low levels of salaries in fact requires introduction of the specific national trade restrictions. Similar argument was used by President Trump when he renegotiated the "old" NAFTA concepts with Mexico. The issue of production costs in international trade is getting increasing attention following the fact that social, taxation and environmental costs are not globally under the same framework rules or standards. So for example in spite of relative comparative advantage of China or Bangladesh based on their relative labor abundance, the salaries should still cover standardized labor costs like reasonable working conditions protecting cost, reasonable sustainable level of wage etc.. The problem is that the global economy has not yet accepted such standardization of labor costs.

explained by Mr. Churchill, were among the major causes for the outbreak of the WW II. We should hope that today's similar international economic and political situation will not cause similar negative global effects and developments in the future. However we should be aware that similar problems exist in competitive environment of international trade today as they were present in the past. As in the past, today's global competitive trade problems, if not adequately treated, might cause intensifies trade was among states. Today's trade wars, due to many similarities with the pre WW II period, could unfortunately create eventually as well somehow similar unwonted outcomes.

To understand better what are the reasons for the present international returning to the dangerous historic international economic situation, and to judge how the present unilateral discriminatory use of trade restrictions could develop in the future, we intend to:

- use theory and data to explain trade, trade relations, and trade impacts after the WW II,
- overview the multilateral trade rules (WTO) to understand why in the past they succeeded to enable intensive global trade and economic growth, and further to evaluate if WTO's rules can still be implemented today and in the future,
- Assess the development and impacts of RTAs from the past based on the fact that they developed intensively especially after 1990s and that they contributed significantly to trade growth and to economic globalization.

Describing and assessing the above three trade related issues will help to elaborate conclusions whether the history of mankind in relation between trade War and actual War is possible to be eventually repeated again in our modern times.

3. ECONOMIC IMPACTS OF INTERNATIONAL TRADE

Based on traditional trade theory we could accept that trade is beneficial to economic growth of all nations, provided that the theoretically assumed conditions are reasonably well realized in practical circumstances.⁵ To discuss the future of

⁵In international trade theory basically the conditions for perfect competition apply (see: https://saylordotorg.github.io/text_international-trade-theory-and-policy/s08-02-heckscher-ohlin-model-assumpti.html). Theoretical trade models are further based on one or more production factors, two or more trading states and two or more traded products. Some newer theories even are not based on perfect competition conditions, other accept product differentiation, technological progress etc. The point is that in practically in and trade theory we could find some assumptions that are actually not fulfilled in reality of global trade developments. Difference between theoretical assumptions and reality doesn't mean that trade theories are entirely wrong and that trade could not be positive and beneficial for trading economies. The differences between reality and theory assumptions only suggest that the theoretically expected sizes of trade impacts are in reality bigger or smaller

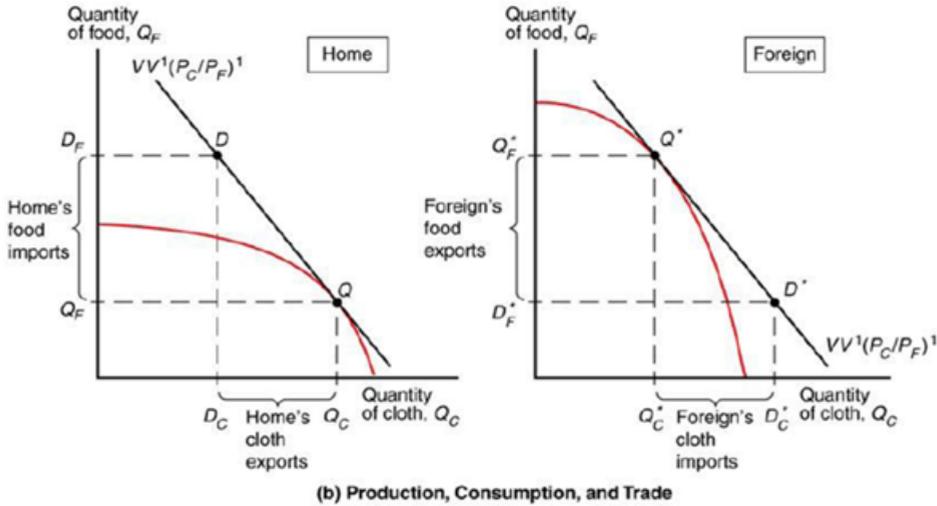
RTAs it is vital to prove that trade is in reality positive to create additional and increased economic growth of the nation. Positive growth effect of trade on trading economy derives from the positive difference between the economy's equilibrium production and consumption points. The positive difference between the two points is based on improved economic results following the production specialization that is made possible in fact only through trade development (Fig.1).

Only trade creates conditions necessary to position the national consumption equilibrium points of the trading countries (Fig.1: points D and O') above their production possibility curve. Trade besides enabling the higher levels of national aggregate consumption enables further production increases based on enlarged national investment consumption which is part of by the trade enlarged aggregate national consumption. If assumption of free trade is only partially fulfilled then consumption points are located lower, closer to national production possibility curves, and the expected positive trade effects are partially more or less reduced.

In such perspective any form of trade liberalization among states, and especially eventual signing and implementing of a RTA could cause, based on eliminating existing trade barriers, an increase in the levels of the national equilibrium aggregate consumption points. Higher levels of aggregate consumption points lead to more investment consumption and consequently to higher economic growth.

compared to theoretical explanations. As a result the actual trade based economic results are (more) unevenly distributed among the trading states. In theoretical explanation of trade impacts used in our paper we assume that theoretical assumptions and trade reality are reasonably closely connected. That means that fundamental theoretically explained trade impacts are generally correct although they could in reality vary by size and location in relation to the different trading participants/states. (For some further explanations see: <https://www.nber.org/papers/w8169.pdf>) Based on limited size of the paper we leave aside description of further reasons for the actually uneven distribution of trade positive impacts. Such further reasons for the uneven distributing of positive trade benefits are related to the impacts created in international trade by the existence of large international business subjects – multinational/global corporations (MNCs). MNCs additionally distort theoretically expected level and structure of national trade benefits expressed by additional and accelerated national economic growth and employment. The market distortions created by MNCs are and will be eventually controlled and neutralized by implementation of the effective national competition protecting legislation.

Figure 1. Trade impacts on production and consumption points of the trading economies



In our model (Fig. 1) we see another important effect of trade. The increase of the aggregate consumption equilibrium point above the production possibility curve is actually different for each of the trading countries. It is different by its position level relative to national production possibility curve and by its structure of products that form the aggregate of the national consumption. Such differences in impacts created by trade might not be equally appreciated by all trading countries. Unavoidable differences in trade benefits or gains created among trading nations, which are expressed by different level and structure of the national aggregate consumption point, might unfortunately be a trigger of trading tensions among partner countries. In ideal theoretical conditions such consumption points' differences among trading partners are entirely unavoidable and by that they are somehow "natural". The differences in national trade benefits expressed by level and structure of their consumption points are in ideal trade model caused by the differences between the shapes and positions of the national production possibilities curves. Basic differences in the level and structure of consumption points based on trade between nations with the different production possibility curve are unavoidable and so they are some have "natural" and to some extent acceptable for each of the trading nations. In real life differences between the trading partners national consumption points are often enlarged by the fact that in practice only partially a number of specific theoretical conditions that are presumed in the theoretical models are fulfilled and realized.. Among such additional unwonted factors that further create differences in the level and structure of the nations' realized trade benefit or gain could be the following facts; difference in the economic size of the trading economies, difference in the levels of economic and technological development of the trading economies, difference in the national governance efficiency, and some other objective differences.

In a case of a longer RTA's implementation period, or in a case of practicing rather liberal multilateral trade environment, for a longer period all above mentioned differences affecting distribution of the trade gains start to accelerate and multiply negative effects of the unbalanced trade gains distribution. The satisfaction of partners in the RTA or in the multilateral trading liberalization agreement starts to deteriorate by the passing of time. Decreasing satisfaction with the impacts of the open trade system follows the gradual increase in the unbalanced distribution of the trade gains among RTA's member states or among states members of the multilateral trade agreement.

In the case of the European Union (EU) such unbalanced distribution of RTA's trading gains among partner countries has been recognized from the start. The specific provisions were accepted in the Treaty of Rome (1957), so as to reduce the negative impacts of uneven distribution of the positive trade effects among partner countries⁶. Today the EU cohesion policy performs as at least a partial corrective instrument for the negative impacts developed within the integration on the bases of economic and other differences among partner countries. These differences are expressed in increasingly different levels of realized national aggregate consumption equilibrium points. The EU nations with larger economy, better technological level and better governance enjoy accumulated improvements in the level and structure of their aggregate consumption points based on free trade growth that is RTA's secured. Other members of the EU as well enjoy faster economic progress and increased trade gains as a result of general RTA's and trade growth effects. However the smaller, less efficient or otherwise deprived members of the EU start through time to lag behind the progress of the better suited integration members. The recent increasing national political criticism of the EU in a number of the member states might be a signal that the present cohesion policy of the EU is not in reality any more effective enough in compensating the too large RTA based free trade created differences among the actual levels of the national aggregate consumption points.

The trade gains based on the levels and structures of the national aggregate consumption points are distributed significantly more unevenly when general market competition conditions are distorted from the theoretically ideal situation. The market competition is distorted based on different sizes of partners, based on use of trade and of other regulation measures, based on lack of information, etc. Some of such market and trade cooperation distortions could be corrected by specific provisions included in different existing multilateral agreements like

⁶ The Treaty of Rome was based on understanding the problems of uneven conditions for realizing similar trade gains among economically different Treaty's partners. So the Treaty ensures (more) balanced trade and fair competition and further envisions reduction of the economic and social differences between the EEC's various regions. The policy that aims to neutralize unbalanced distribution of trade and other integration gains is today known as the EU cohesion policy. See: http://publications.europa.eu/resource/cellar/20ba20c8-6d6e-4901-b167-33bed13d6209.0005.02/DOC_4.

agreements forming the World Trade Organization (WTO). Similarly on more limited scale with regard to a number of participating countries but simultaneously more intensively related to the issues of trade liberalization among the participating states the trade distortions could be effectively reduced by concluding regional trade agreements (RTAs).

4. TRADE IMPACTS AND MULTILATERAL TRADE RULES AFTER WW II

After the WWII efforts were made to reach multilateral trading agreements that could generally correct and limit use of numerous instruments for trade distortion that were used in the period of using “beggar-thy-neighbour policies“. Efforts for new multilateral trade agreements have been especially focused on eliminating the conditions that could potentially recreate pre WW II economic environment that had made „a beggar-thy-neighbour policy” generally accepted and practiced policy by most of the trading states. The efforts after WW II to reduce danger of a new world’s trade discrimination practices and the efforts to increase the openness of the multilateral trade environment were rather successful. Formally success of the international trade liberalization and non-discrimination efforts are reflected in successful contracting of the General Agreement on Tariffs and Trade (GATT 1947) and in 1995 by establishment of the World Trade Organization (WTO).

Table 1. Average Tariff Levels for the USA and Major European Countries before and after GATT signing

<i>Country</i>	<i>1913</i>	<i>1925</i>	<i>1931</i>	<i>1952</i>	<i>2007</i>
Belgium	6	7	17	n.a.	5.2
France	14	9	38	19	5.2
Germany	12	15	40	16	5.2
Italy	17	16	48	24	5.2
UK	n.a.	4	17	17	5.2
United States	32	26	35	9	3.5

Source: https://www.brookings.edu/wp-content/uploads/2016/07/selfenforcingtrade_chapter.pdf

The achievements in trade liberalization are seen through general decreases in the levels of the import tariffs rates (Table 1) during time. Especially after nineties of the twenty century general efforts to make trade growth faster, and more beneficial to the participating states, were increasingly associated with specific trade liberalization agreements known as Regional Trade Agreements (RTAs).

Once negotiated and accepted any type of multilateral trade agreement or of regional trade agreement is in fact a very powerful instrument supporting trade

growth among partner countries. Multilateral trade agreement is generally more difficult to agree because of often big differences in interests among a large number of negotiating states. Smaller number of states and more economically and culturally similar states negotiating trade liberalization can reach agreement faster and easier. The interest for such trade agreements – for RTAs – was increased after nighties of 20th century when new fast technological progress (Internet, ITC technologies, etc.) started to demand free access to new and larger (foreign) markets so as to increase capital turnover rates. Increase in capital turnover rates made businesses able to accelerate investments into new technologies necessary to keep competitive advantage on national and foreign markets. Although the generic name - RTA – of such trade agreements with a smaller number of partners suggests that partner states are from the same region, the reality is that a modern RTA extends often well across the borders of just a narrow geographic region. If we look for example to the North America Free Trade Agreement we see that it extends over more than one continent. Similarly today's EU, by its membership covers large areas of the continent named Europe. The EU geographically in fact covers such a big part of the continent that (not well informed) people and unfortunately often some politicians instead of saying EU just say Europe. The mistake is on one side misleading and on the other potentially politically dangerous.

After the WW II the GATT was contracted among 23 states⁷ and signed in October 1947. During the years states signatures to GATT succeeded to negotiate control and reduction of tariff rates and of other trade barriers like quantitative restrictions, subsidies etc. (Table 2). GATT successfully promoted progress in trade liberalization and attracted increasing number of contracting states as partners. Partially the number of contracting parties to GATT grew as result of the decolonization process that created a number of new independent states in decades after the WW II. In 1995 GATT was included into a newly created World Trade Organization (WTO). WTO resulted from successful conclusion of the GATT's Uruguay round. WTO rules were in comparison to GATT extended to cover beside trade in goods as well trade in services, trade related issues of intellectual property rights and other topic related to trade including anti-dumping rules and rules on settling the disputes among the member states (Table 2).

Signing of GATT and later successful negotiations in its framework on lowering and controlling different other groups of trade barriers beside tariffs was an unprecedented and successful multilateral negotiation outcome. The underlying principle of reciprocity that served to influence early multilateral trade negotiations turns out to have been an important international force allowing governments to

⁷ The 23 countries engaging in the Geneva negotiations that led to the signing of the GATT in 1947 were Australia, Belgium, Brazil, Burma (Myanmar), Canada, Ceylon (Sri Lanka), Chile, China, Cuba, Czechoslovakia (Czech Republic and Slovakia), France, India, Lebanon, Luxembourg, Netherlands, New Zealand, Norway, Pakistan, South Africa, Southern Rhodesia (Zimbabwe), Syria, United Kingdom, and United States.

coordinate trade issues and simultaneously lower trade barriers. Furthermore, this reciprocal balance of trade obligation across countries is what has allowed them to keep the trade barriers low toward one another; for the most part of over the 70 years after the first trade and tariff contracts were signed. However the long lasting internationally developed and accepted understanding of the positive impacts developed on the grounds of a reciprocal balance of trade obligations have unfortunately been interrupted after the USA presidential election in November 2016.

Among important achievements of the GATT Uruguay round of negotiations was agreement on “dispute settlement procedure”. The procedure is today part of the WTO rules. More detailed analyse of the dispute settlement procedure is of interest especially in the light of the recent USA unilateral increases of selected import tariffs. It is as well interesting for formation of the understanding how WTO members use the dispute settlement process to self-enforce the agreement and maintain reciprocal balance in applying trade barriers. In our paper these issues however interesting they are will not be analysed further due to its size limitations.

Table 2. GATT and WTO Rounds of Multilateral Trade Liberalization negotiations

Year	Name (location)	Subjects covered	number of countries
1947	Geneva	Tariffs	23
1949	Anneux	Tariffs	13
1951	Torquay	Tariffs	33
1956	Geneva	Tariffs	26
1960-61	Dillon Round (Geneva)	Tariffs	26
1964-67	Kennedy Round (Geneva)	Tariffs and anti-dumping measures	62
1973-79	Tokyo Round (Geneva)	Tariffs, non-tariff measures, “Framework” agreements	102
1986-94	Uruguay Round (Geneva)	Tariffs, non-tariff measures, rules, services, intellectual property, dispute settlement, textiles, agriculture, creation of WTO, and etc.	123
2001-present	WTO Doha Round	The major reform of the international trading system through the introduction of lower trade barriers and revised trade rules. The work programme covers about 20 areas of trade. Last document a “Nairobi Package”, December 2016. The main reason the Doha talks collapsed was that the USA and EU weren't willing to give up their agricultural subsidies.	142

Source: https://www.brookings.edu/wp-content/uploads/2016/07/selfenforcingtrade_chapter.pdf and https://www.wto.org/english/tratop_e/da_e/da_e.htm

It is however relevant to note in the face of contemporary relatively challenging political and economic circumstances that in the past the WTO dispute settlement procedure was successful in a number of cases including the case of the USA unilateral increase of import tariffs for still products in 2002.

The steel Safeguard Measure imposed by the United States on 5 March 2002 is an exemplary case of the distortionary impacts of protectionism, resulting from the attempts of the Bush Administration to appease domestic lobbying. The additional tariffs took effect March 20, 2002 and were lifted by Bush on December 4, 2003. Research shows that the tariffs adversely affected US GDP and employment. The temporary tariffs of 8–30% were originally scheduled to remain in effect until 2005. Canada and Mexico were exempt from the tariffs because of penalties the United States would face under the North American Free Trade Agreement. The Bush administration justified the tariffs as an anti-dumping response, namely that the US steel industry had to be protected against sudden surges of imports of steel. Mr. Trump's administration currently uses similar arguments for its introduction of additional import tariff. The new tariff increases are some have based on assumptions that China and some other countries apply labour price "dumping" practice so as to increase exports to the USA.

The additional USA-Bush steel tariffs ignited international controversy as well. Immediately after they were filed, the European Union (EU) announced that it would impose retaliatory tariffs on the United States, thus risking the start of a major trade war. To decide whether or not the steel tariffs were fair, a case was filed at the WTO Dispute Settlement Body. Japan, Korea, China, Taiwan, Switzerland, Brazil and others joined with similar cases. On November 11, 2003, the WTO came out against the USA additional steel tariffs, saying that they had not been imposed during a period of import surge -- steel imports had actually dropped a bit during 2001 and 2002 -- and that the tariffs therefore were a violation of the USA WTO tariff-rate commitments. The WTO ruling authorized more than \$2 billion in sanctions, the largest penalty ever imposed by the WTO against a member state, if the USA did not quickly remove the illegal additional tariffs. After receiving the verdict, Bush declared that he would preserve the tariffs. After receiving the verdict, Bush's administration declared that the USA would preserve the tariffs. In retaliation, the EU threatened to counter with tariffs of its own on products ranging from Florida oranges to cars produced in Michigan, with each tariff calculated to likewise hurt the President in a key marginal state. The USA reasoned and backed down and withdrew the additional tariffs on December 4, 2003. When he lifted the tariffs, Bush said, "I took action to give the industry a chance to adjust to the surge in foreign imports and to give relief to the workers and communities that depend on steel for their jobs and livelihoods. These safeguard measures have now achieved their purpose, and as a result of changed economic circumstances it is time to lift them".⁸

What lessons could be taken from the past USA additional still tariffs in relation to the present situation when the USA use policies introducing additional tariffs for a number of products imported from different countries and often massively from

⁸See: https://en.wikipedia.org/wiki/2002_United_States_steel_tariff

China. Obviously recent USA trade protectionisms much broader in sense of products and states that are export hurt by the present additional USA tariffs. A number of countries — including Mexico, Canada, Turkey, Vietnam, the EU and others — disputed U.S. tariffs on foreign steel, aluminium and other products at meetings of the WTO from summer to outmen of 2018. Rarely has the WTO faced so many disputes about a handful of actions taken by a single state. However President Trump's pursuit of the USA protectionist trade policies practice has stoked nationalism and trade protectionism around the globe. One of the proven effects created by the increasing trade protectionism is and will be negative impacts on the global and national economic growth, The following Figure shows data on the close relation between trade and economic growth in the period 1995 to 2015. According to theory which defines trade as the engine of economic growth Fig.2, shows that less trade is necessarily related to less economic growth.

Figure 2. Relation between trade and economic growth



Source: <https://itdoesnotaddup.com/2016/04/05/more-trade-faster-economic-growth/>

International trade experts say the protectionist measures taken recently by the USA and some responses to such practices have reviled how fragile and how less effective the WTO trading system has become in last ten or so years. The disputes against the USA filed to the WTO in second half of 2018 will be a critical test of whether the WTO still has the ability to stay efficiently against the open and massive violation of the accepted international trading rules.

5. POSSIBLE OUTCOMES OF THE USA CONTEMPORARY TRADE PROTECTIONISM AND THE RTAS

The Trump's trade protectionist tariffs are a series of additional unilateral tariffs imposed during the presidency of Mr. Donald Trump as part of his economic policy. In January 2018, Trump imposed tariffs on solar panels and washing machines of 30 to 50%. Later in the year he imposed tariffs on steel (25%) and aluminium (10%) from most countries. On June 1, 2018, this was extended on the EU, Canada, and Mexico. The only countries which remain exempted from the steel and aluminium tariffs have been Australia and Argentina. Separately, on July 6, 2018 the Trump administration set a tariff of 25% on 818 categories of goods imported from China worth \$50 billion. China is asking the WTO to review the tariffs on roughly half of its exports to the USA. The USA is fighting back with complaints about Chinese counter-tariffs and generally too low export prices that are as was mentioned already often caused by too low level of salaries. Such low prices of labour create potentially a dumping case. The antidumping procedures are accepted within the WTO rules. The anti-dumping procedures based on low level of salaries or on the grounds of so called "social dumping" were used in a very limited number of cases. That leads to conclusion that the present anti-dumping rules legally limit the potential success of the anti-dumping procedures against exports based on using social, environmental, or other specific non-traditional dumping practices⁹.

The outcomes of the WTO dispute settlement procedures related to present USA protectionist practice, are much less possible to predict as they had been in 2003. The reasons are numerous among them is rough and highly selfish behaviour of the USA such as have never been seen or practiced in the entire period after the WW II. Such USA political and economic behaviour make rather slim chances that USA would respect eventual future WTO decision to remove all at the moment too high import tariffs. There are further different suspicions present about the actual WTO ability to accept relevant decisions to penalize the USA in case of not removing the too high import tariffs. The suspicions could have a number of arguments but let it be enough to note that WTO, which means its member states, was not able at all to get realised the Doha round negotiations agenda in more than a decade and half long period.

Eventually USA policy of unilateral too high import tariffs could end following bilateral negotiation with major trading partners like China, EU and some others.

⁹ For antidumping and countervailing USA duties

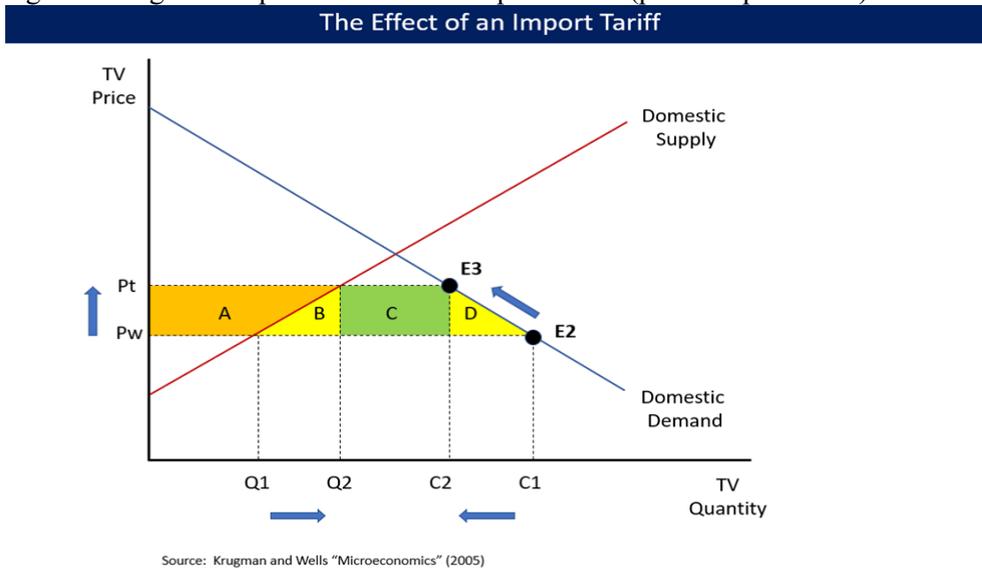
see: https://help.cbp.gov/app/answers/detail/a_id/219/~/-/antidumping%2Fcountervailing-duties-%28list-of-commodities-subject-to-ad%2Fcvd%29.

The list of anti-dumping investigations of the USA shows rather low number of Chinese product under the current USA investigation. See: https://www.usitc.gov/trade_remedy/731_ad_701_cvd/investigations.htm

Interest to get some consensus with major trading partner about the import tariff levels and about some other trade regulating instruments will grow in the USA when the negative impacts of increased import tariffs will start to show. From historic results of the Bush additional steel import tariffs is evident, in spite of the short period of their use, that the additional import tariffs were in fact negative for the USA economy¹⁰.

A negative impact of increased import tariff on the economy could be explained by so called net dead weight losses created by imposed higher tariffs. The Fig 2 shows impacts of an import tariff increase. The tariff increase negatively reflects on domestic consumers. Their losses are bigger than are the domestic producers' gains based on increased domestic production. So entire economy performs a net loss based on higher negative impacts on consumption as are the positive impacts of the import tariff on the increased domestic supply. On the bases of the partial equilibrium model the Fig.3 explains the reasons for creation of the net negative result for the economy that uses import tariff,

Figure 3. Negative impact of increased import tariffs (partial equilibrium)



Higher prices and lower consumption quantities reduce consumer surplus (the area above price but under the demand curve) by areas A+B+C+D, while increased producer surplus based on higher import tariff (the area below price but above the supply curve) is presented only by the area A. Import tariffs create new government revenue by the area C (the imported quantity times the tariff value.) Evidently the areas B and D are national dead-weight losses, resulting from surplus

¹⁰See: https://en.wikipedia.org/wiki/Trump_tariffs

lost by consumers and overall. The entire economy following the use of additional import tariffs will (general equilibrium case) drop to a lower level of the national equilibrium consumption point. Use of the higher import tariffs causes further drop of the national equilibrium consumption point level. As observed in the USA such effects were registered already in a short period of the Bush's use of the additional steel import tariffs. In case of broader and more intensive use of increase import tariffs by Mr. Trump one could reasonably expect similar but larger negative impacts for the USA economy. The period needed to show the negative economic impacts of the additional tariffs use is not clearly evident in the USA case. That is so because of relatively small share (around 12% in 2016) of exports of goods and services in the total USA GDP¹¹.

Besides using unilaterally increases of the import tariffs as part of the USA trade policy Mr. Trump's administration has accepted a number of decisions that entirely negate the US's obligations and membership in a number of the agreed and valid RTAs. The most interesting development in the area of the contemporary USA protectionist trade policy is the one-sided attempt to terminate free trade agreement with Mexico and Canada - NAFTA. End of August 2018 the US President has announced that he intends to dump the nearly 25-year-old NAFTA agreement, making it the latest deal to be targeted as part of his "America First" trade strategy. Later President Trump notified the Congress of his plans to sign an agreement with Mexico in 90 days to replace NAFTA. And despite earlier suggestions that he may cut Canada out of the agreement altogether Mr. Trump was later suggesting that Canada could be brought into a new RTA agreement of the three countries too. Under the USA pressure the negotiation on a new trade agreement – new RTA - with Mexico and Canada was concluded fast. Trump, Canadian Prime Minister Justin Trudeau and outgoing Mexican president Enrique Peña Nieto signed a new trade agreement already on Nov.30, 2018. The new RTA agreement is named the United States-Mexico-Canada Agreement (USMCA)¹². Formally the USA and both other NAFTA members had the right to withdraw from NAFTA. Under Article 2205 of the NAFTA, a country can withdraw from the agreement by providing a six-month notice to fellow signatories. This means Trump could had, in theory, send a letter of notice to Canada and Mexico indicating his intent to withdraw from Agreement. But, according to professional comments, the president would have first needed congressional approval to actually terminate US involvement in NAFTA. Not in the negotiations with the USA trading partners for a new agreement and not in the internal USA required procedure to terminate NAFTA the normally expected and formally valid procedures were respected. While the USA, Mexico, and Canada have concluded a new, reshaped RTA agreement, the old NAFTA agreement however currently remains in effect. The USMCA can come

¹¹ See: <https://www.statista.com/statistics/258779/us-exports-as-a-percentage-of-gdp/>

¹² See: <https://www.theguardian.com/us-news/2018/dec/02/trump-terminate-nafta-formal-notice-congress>, and <https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement>

into effect following the completion of TPA procedures¹³, including a Congressional vote on an implementing bill.

Our goal in this paper is to understand better the future use and importance of the RTAs in the global trade relations following the fact that in last couple of years international trading system is dominated and in the process of reshaping by the “new” USA’s trade protectionist policy. Before getting closer to our analytical goal and before making further explanation of the major changes contained in the process of changing NAFTA into USMCA, we would shortly show the importance of the existing RTAs in global trade relations after the WW II, when free trade agreements mostly started to be negotiated to regulate trade cooperation among member states.

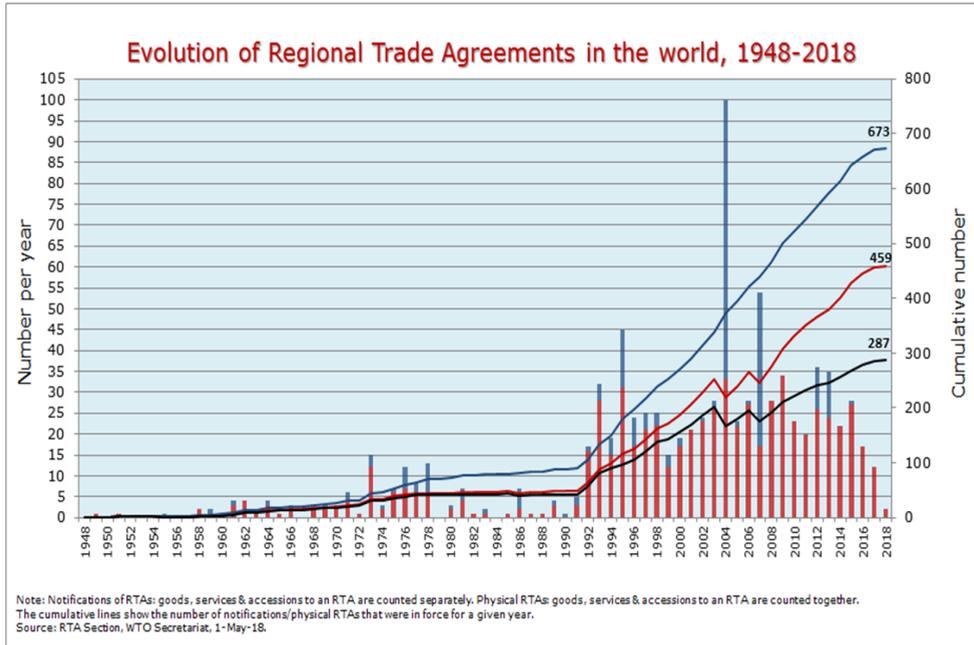
After the WW II among the very early agreed RTAs was an agreement that is today known as the European Union (EU). The EU started with six countries as its members and was partial type of economic integration. The first EU free trade and economic integration Treaty established the European Coal and Steel Community (1951). Later in 1957 the same member states concluded agreement on establishing The European Economic Community (EEC) and the European Community for atomic Energy (Euro atom)¹⁴.

¹³For more than 30 years, the USA Congress has enacted Trade Promotion Authority (TPA) laws to guide both Democratic and Republican Administrations in pursuing trade agreements that support U.S. jobs, eliminating barriers in foreign markets and establishing rules to stop unfair trade. See:

<https://ustr.gov/trade-agreements/other-initiatives/Trade-Promotion-Authority>

¹⁴ For better historic and conceptual overview of the free trade cooperation development and of the broader economic integration performed among increasing number of the European states see: https://europa.eu/european-union/about-eu/history_en. It is good to note that trade and economic cooperation of the today’s EU member states have from the beginning covered economic cooperation aspects broader as just sole free trade cooperation issues.

Figure 4. Number of concluded and active (black line) registered by WTO (1948-2014)



After the WW II the interest to sign treaties on establishing new RTA among two or more states was always an interesting international trade cooperation option. However the real explosion in the number of agreed RTAs happened after nighties of 20th century (Fig. 4). RTAs have always been used as a vehicle to create faster trade and economic cooperation possibilities among specific groups of the GATT contracting parties.

The relevant question is what happened that the number of RTAs registered by GATT and after 1995 by WTO had started to increase intensively during the last decade of the 20th century and later. There are number of different reason for explosive growth in the number of registered and active RTAs signed among different groups of the GATT contracting parties and later among member states of the WTO. Among major reason for RTAs number growth are economic impacts imposed globally by the beginning of an accelerated general global technological process. Technological progress started to develop with unprecedented speed in the last few decades of the 20th century. The fast technological progress was mostly related to exponential increase in the increasing number of inventions in sectors of computing, informatics, communication, transport and in other sectors like biotechnology, Nano technology etc.

The technological progress in computer chips is well known—but surprisingly, it isn't a special case. A range of other technologies demonstrate similar exponential growth, whether bits of data stored or DNA base pairs recorded. The outcome is

the same: capabilities have increased by thousands, millions, and billions for less cost in just decades¹⁵. To make it short, new technologies offer competitive advantages to nations and companies if implemented fast and if used to make chipper and better products and to create further new technological inventions. To do so new investments in relative short investment cycles are critical and necessary. The trade as we noted already makes new and increased investment possible. Need to implement and use advantages of new technologies pushed states towards the need to improve market openness and foreign markets accessibility so as to create favourable conditions for more and faster growing trade. By opening economies and by creating more trade successful states wanted to enable opportunities for the new growing business to increase and accelerate investments especially into new technologies. New and growing investments are made possible by increased trade growth that accelerates national income growth. Opening of markets and improving access to foreign markets is a demanding and time consuming effort standing before the new national trade and economic policy implementation. Multilateral trade negotiations take a lot of time and are often difficult to finalize as a tool to open markets and to improve markets access. Slowness and complexity of multilateral trade negotiation could be convincingly illustrated by unsuccessful Doha WTO agenda negotiations that have been going on unsuccessfully for a little less than two decades already. The needs for increased investments and the needs for accessing larger open markets to enable required faster and larger capital investments turnover have convinced a growing number of states to use a faster option for realization of open access to new and larger markets. Such faster option for getting more open and more accessible new foreign markets has realized through negotiations with a limited number of partners. After negotiations partner states accept a specific free trade arrangement. Such agreement is based on one or another form of the Regional Trade Agreement (RTA) concepts that is acceptable and allowed by the GATT or today by the WTO rules.

The need for more trade and so the need for concluding new RTAs was intensive and even intensifying in the last few decades. The need for new RTAs was growing parallel with the acceleration of the technological progress in the entire global economy. The benefits and gains of increased trade are already explained, as are explained already the specific trade system conditions that could distort the balanced and fair distribution of trade gains and benefits. Trade system distorted conditions in practice enlarge the problem of unequal distribution of trade gains among partner states and within each of the states. Through passing of the time the problem with unbalanced distribution of trade gains is accumulated into distorted distribution of trade gains among the partner states. Accumulation of the unbalanced trade gains distribution in real life could escalate into different tensions

¹⁵Technology Feels Like It's Accelerating — Because It Actually Is; <https://singularityhub.com/2016/03/22/technology-feels-like-its-accelerating-because-it-actually-is/#sm.0001txnz78mqdegry5b1r29ems42a>

and even into new protectionist behaviour among partner countries. The solution for such negative development is to agree on renegotiation of the RTA or of some other trade agreement provisions. Further in such negotiations partner countries could further agree on implementing RTA specific corrective measures that will neutralize too large distortions in trade gains distribution¹⁶. The problems of too large distortions in trade gains distribution among partner countries probably are reflected in the present protectionist trade policy of Mr. Trump and in his tuff approach in renegotiating the NAFTA. Studying the American trade policy under the Presidency of Mr. Trump, in the environment of increasingly unbalanced distribution of the trade gains, makes two observe possible. First observation reflects the fact that USA trade policy today is based on rough one sided and selfish power based negotiation methods. Such methods of negotiation are combined with unconventional blunt ignorance of international obligations that USA has accepted in relation to different international agreements and institutions. An example of such blunt USA obligations ignoring practice is present protectionist trade policy that violates the WTO trading rules. The second observation developed from the present USA trade policy practice is that in substance the recant USA one sided negative reactions towards the existing trade cooperation issues somehow help to unearth some relevant and existing trade gains distribution problems. Such problems have been accumulating during the last few decades in the USA economy and general in the majority of states within the global economy.

Before focusing more on trade gains distribution problems in relation to NAFTA renegotiation let make some reflections on the issue of the good or bad future of the RTAs in general. RTAs obviously have the future as part of international trading system provided that eventual distorted distribution of trade gains and accumulation of such distortions in time could be fairly renegotiated and if necessary as well compensated by agreed trade measures among the RTA member states. As the actualities prove of the correctness about the RTAs' explained future existence the NAFTA renegotiation into new RTA of USMCA could be convincingly used following the following facts. The first option of the new USA trade policy was to exit unilaterally from NAFTA. Later the idea was to leave Canada out of a new agreement. The final result is however just the new name of agreement and redesigned and in relevant areas corrected content of the renegotiated free trade agreement – RTA. All three states ream as partners in the new RTA.

¹⁶The case of such corrective policy is already mentioned as the EU Cohesion policy.

6. THE NAFTA NEGOTIONS AND THE FUTURE OF THE INTERNATIONAL TRADING SYSTEM

To better understand reasons that often create dissatisfaction with the impacts created by the present international trading system a swift analyse of the NAFTA renegotiation case might be of certain help. In renegotiating the NAFTA some specific issues that are relevant for causing distorted distribution of trade gains among trading states were opened, discussed and agreed upon. Renegotiation of NAFTA was obviously based on one-sided interest of the USA to follow the realization of the political idea contained in the words: “America first”. However a number of discussed and renegotiated issues in creating USMCA from NAFTA were and still are highly relevant for understanding the causes of the existing problems creating increasing distortions in the process of trade gains distribution among states trading in the framework of the contemporary international and RTA based trading systems. In the future multilateral and RTAs trade system renegotiation efforts will have to focus on correcting the “weak” parts of the present international trading system. The identification of the weak parts that are contained in the present international trading system might be much easier if the expected future reforms of international trading system will be organized around the topics that were accepted as problems that create distortions in the trade gains distribution between the NAFTA member states. The idea that USA’s one-sided trade interests and the related definition of trade distortion used in the NAFTA renegotiations process might be accepted as relevant in the future reform of the international trading system could look strange and wrong at least at the first glance. The surprise about using the renegotiation issues of NAFTA to discuss international trading system reform will be smaller if we recall the fact that international trade, whether based on multilateral agreements or on RTAs, creates the distribution of trade gains inequalities that are larger in practice as in the theory. The issues renegotiated within NAFTA in a number of cases respond to “unnecessary” trade related distortion that cause increased deformation in the trade gains distribution balances.

The problems that were discussed during the renegotiation of NAFTA were in the scope of existing reasons producing the unnecessarily large inequalities in the global trade gains distribution. The official USA description of their expected negotiation achievements shows there, and by some generalization, as well the actual global trade gains and benefits distribution problems. “When finalized and implemented, the agreement will create **more balanced, reciprocal trade** that supports high-paying jobs for Americans **and grows** the North American economy. Agreement highlights include:

- **Creating a more level playing field for American workers**, including **improved rules of origin** for automobiles, trucks, other products, and **disciplines on currency manipulation**.

- Benefiting American farmers, ranchers, and **agribusinesses by modernizing** and strengthening food and agriculture trade in North America.
- Supporting a 21st Century economy through **new protections for U.S. intellectual property**, and ensuring **opportunities for trade in U.S. services**.
- **New chapters covering Digital Trade**, Anticorruption, and Good Regulatory Practices, as well as a chapter devoted to ensuring that Small and Medium Sized Enterprises benefit from the Agreement.”¹⁷

From the above explanation of the objectives that were followed by the USA in their renegotiation of the NAFTA a set of relevant conclusions for the future trading and RTA system reform could be constructed.

The USA felt that their trade with partners was not properly balanced, so they stress “agreement will create more balanced, reciprocal trade”. As noted already in the case of the EU some political options feel similar. Trade gains and other benefits of the EU membership in perception of some member states and in the perception of some nationalist orientated political options are not properly balanced among all member states. Rather similar observations could be seen in official or political statement all around the world. To reform world’s trading system so that more balanced trade gains distribution could be secured the elements that in practice cause more than just theoretically expected differences in sizes and structures of the gains based on trade development must be renegotiated, assessed and reshaped. Which are such elements in the international trading system that in practice too much distort functioning of the international trading system? To answer the question the NAFTA renegotiation issues could help.

The first issue renegotiated within NAFTA is related to a USA statement that new trade agreement should create a more level playing field for American workers. The “levelled playing field” goal in global trade environment refers to a problem of extremely low salaries payment levels that are actual often in (less)developed states. The use of too low level of salaries in production and in service industry obviously distorts the trade competition and by that provides unnecessary distortions in the distribution of trade gains among states and people. The problem of (too) low salaries used to create more export could be evaluated as a form of “social duping”. Unfortunately according to the WTO anti-dumping rules proofing the fact that certain salaries are too low and so the exports product prices are too low is legally very difficult. Consequently the introduction of anti-dumping measures in case of exports that are based on the too low level of salaries is practically not possible. The reform of the anti-dumping rules in salaries case could reduce one part of reasons for the distortions in trade gains distribution. The reform of anti-

¹⁷ See: <https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement>

dumping rules become even more actual and necessary by the realization of the fact that some sort of dumping practice to push exports is in many cases based further on not respecting – not paying – the standard levels of labour safety and protection costs, of environment protection costs and even of taxation costs. In the last case the unfair competition is created when exports are being pushed by using specific state's taxation policy measures. To reach agreed international standards for the mentioned costs is no doubt a demanding task. However it is to decide what is more problematic to overcome: the costs and efforts of performing successful standardization negotiations or to accept the danger of further trade wars escalation in the future. Although negotiations on mentioned costs standardization to secure more fair competition in international trade are complex and difficult the fact is that international community already has on its disposal for negotiations number of existing relevant institutions together with their basic rules that can together be implemented to make the process of negotiations easier and faster. Among such institutions are; WTO, International Labour Organization, some other United Nation specialized agencies, and a number of other international and regional economic organizations and agreements. Obviously the problems of reaching necessary agreements on trade and broader economic system reform are not related to the eventual lack of international institutions. Actual problem to start and finalize discussion on the trade system reform is in fact related to lack of understanding that new agreed trade rules are necessary for the future benefit of all states.

The NAFTA renegotiation achievement can help to understand better way negotiations about the above mentioned costs and about some other not here specified issues of trade gains distortions are in fact necessary. The new eventually negotiated standardization agreements will bring additional trade benefits to all participating states. The NAFTA performance in past years was a huge economic and foreign policy success. Trade between U.S. and Mexico has greatly increased since 1994. In last years about 40% of the imports value from Mexico consisted of content originally made in the U.S. Although the NAFTA performance was successful its renegotiation supports the idea that international trading system reform is needed at list in some specific segments that distort the proper functioning of the international competitive environment.

Accepting the idea of a needed trading system reform should not cover up the fact that actual employment and growth problems of some states are not caused only by the trading system's imperfections. Based on results of different analyses technology progress, not trade and RTAs, was behind the losses of the manufacturing jobs in advanced economies, including USA. Between 2000 and 2010 in USA, employment in manufacturing fell by 5.6 million. But productivity growth accounted for 85% of job losses, only 15% resulted from trade¹⁸. Since trade is (often) not the only or major key cause for job losses, trade protectionism is not

¹⁸ See: <https://itdoesnotaddup.com/2016/06/28/why-free-trade-is-so-important/>

the adequate solution. Although technology and other developments affect employment and growth the proper treatment of the problems of too low salaries and of the other to low costs have still to be treated and standardized on the international scale. Without costs standardization in international trading system the danger of trade wars continuation will remain high and continuously present. Similarly agreed corrections in some other fields of unfair trade competition are necessary to keep international trade as the engine of growth and global economic progress in the future. Among such other necessary corrections are regulations improving the rules of origin, especially for certain groups of products. Further there is a need for: improved rules on preventing the currency manipulation for trade effects, improved protection of intellectual property rights, ensuring stable and more transparent opportunities in services trade and new rules regulating the area of digital trade.

7. CONCLUSION

The World Trading System that was created after the WWII has increasing problems to provide stability and trade development that secures global and national economic growth and prosperity. Competition distortions accumulated in the post WWII trading environment are among the reasons for the increasing dissatisfaction with the realized international trade impacts among and within different nations. Job losses, unequal distribution of incomes and of trade gains are just some of the problems accompanying present global trading relations. The problems related to present global trading system created a need for reforms. The problems of competition distortions, problems of large discrepancies in trade gains distribution and some other problems stimulate development of increasingly negative national and individual economic, social and political reactions to the impacts that are based on increasing trade openness created by multilateral and regional trade agreements. Among contemporarily most dangerous reactions to the problems created by the poor functioning of today's international trade system are probably the USA's unilateral use of new and increased trade barriers, and their cancellations of existing RTAs obligations. USA trade practice of the last two years seriously re-establishes the danger of actual repeating of the pre WWII policy practice known as „a beggar-thy-neighbour policy“. Such trade policy potentially leads to trade wars and to other conflicts and tensions in the global environment.

USA aggressive trade protectionist practice might be unfortunately soon followed by other big and economically strong nations. Such situation calls for fast and relevant reform of present international trade system. The dialog on reform can be started within existing global organizations and agreements.

Some topics relevant to the international trade system reform are known and they are as already noted surprisingly adequately addressed in the new RTA between USA, Mexico and Canada. The USA renegotiation of NAFTA offers some inside into the probable new future provisions of RTAs around the world. RTAs are and

will be needed as an effective tool for faster and deeper trade liberalization among a limited number of members. RTAs in the future will have to pay more attention to secure the more balanced trade gains distribution among partner countries, so as to make RTA a more stable and lasting trade cooperation instrument.

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THE OUTBREAK OF A NEW CONFUSED CENTURY, MONETARY AND FINANCIAL CHAOS, RECONSIDERED

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Review

Abstract

The forced overthrow of the historic meter of commercial development, the monetary Gold Standard, as adopted originally in the USA on the first of August 1914's, triggered, and led during the next decade, the great inflations in France, Germany, Russia and almost all other European Countries. The ensuing convulsions of the social order, the rise of the speculator opportunities, the obliteration of the savings of the laboring and middle classes, based on fixed incomes, produced directly and afterwards, the rise of Bolshevism, Fascism, and Nazism. They were follow-ups of the floating European currencies, perennial budgetary and balance of payments deficits, Central banks' emergency money printing, currency wars and the neo-mercantilism practices.

After Nixon 15 August 1971 second American repudiation of the new Gold Exchange Standard, we entered a slow replay of the first experience, trough inflation, large monetary quantitative expansions and, through bursting bubbles, recessions and stagnations and, finally, new consequent barriers and tariffs perspectives. The most relevant comment, I always share in my speeches is this, coming from a statement on the 100th anniversary of the birth of Jacques Rueff. The comment address has been formulated by Lewis E. Lehrman, at the parliament of France (Assemblée Nationale), on November 7, 1996: “Money will decide the fate of mankind, because individual liberty is only possible - or even thinkable - when confined within the boundaries of a collective discipline, calculated to curb the disorders that uncontrolled action is bound to provoke”. (Rueff, 1971).

Keywords: *Banks; Other Depository Institutions; Finance; Internal and external deficits; International payments.*

JEL: G21

1. THE MONETARY DILEMMA: ORIGIN

Money is very commonly defined as a medium of exchange, a commodity, it is said, is chosen for this purpose, and people who come to market avoid the inconvenience and complication of bartering one product against another. By selling one product against another, for an agreed quantity of the chosen commodity, they use it to buy whatever they might require in future. The chosen commodity has become historically the gold, lately inserted in the, *Stop of the Exchequer* provision (Horsefield, 1982). The “*stop the exchequer*” occurred on Tuesday 2 January 1672, just after the *Glorious Revolution*, also called the Revolution of 1688 (Quinn, 1996), the political overthrow of King James II of England (James VII of Scotland) by a union of English Parliamentarians with the Dutch *stadtholder* William III, Prince of Orange, who was James's nephew and son-in-law.

The gold standard became a generally accepted measure of value as well as a universally borderless accepted medium of exchange. The repeal of the *Corn Laws* as a decisive shift toward the free trade in Britain and the opening of a great first trade globalization, that was suddenly and definitely halted by the huge cross orders coming from the World's main markets, asking for price unlimited sales of equities and shares to convert in gold bullions or depositary's titles. The simultaneous orders coming from all continents forced the closure of the NY Stock exchange on the first of August 1914, with the opening of the battle hostilities in the First World War contrary to the provisions of the Morgan committee formulated on Friday afternoon at the Vanderbilt Hotel session.

During the gold standard there were no currency controls or exchange markets turmoil and, as the transatlantic cable was connected in 1866, the banking and financial crises in New York were quickly transmitted to London or Paris and globally settled. John Monks, the head of the British Trades Union Congress, (he AFL-CIO of Britain), remarked in the agenda for the TUC's Congress in Manchester England, in 1868, listed items needed to be discussed as: “*The need to deal with competition from the Asian colonies and the need to match the educational and training standards of the United States and Germany.*”ⁱ

ⁱThe first TUC meeting was held in 1868 when the [Manchester and Salford Trades Council](#) convened the founding meeting in the [Manchester Mechanics' Institute](#) (on what is now [Princess Street](#) and was then David Street; the building is at no. 103). The fact that the TUC was formed by Northern Trades Councils was not coincidental. One of the issues, which prompted this initiative, was the perception that the London Trades Council (formed in 1860 and including, because of its location, many of the most prominent union leaders of the day) was taking a dominant role in speaking for the Trade Union Movement as a whole. The second TUC meeting took place in 1869 at the Oddfellows Hall, Temple Street, Birmingham where delegates discussed the eight-hour working day, election of working people to Parliament and the issue of free education.

In those days, people also migrated more than we remember and, other than in wartime, countries did not require passports for travel before 1914. All those immigrants towards America's shores came without visas. When you consider all of globalization before World War I, the world shrank from a size "large" to a size "medium and finally to a set of minimum slices".

The precious metals have been generally chosen by humanity as the most suitable commodity for this purpose aimed to the measure of values and to the protected deferral of the purchasing negotiations. Economists have at times been inclined to teach that this usage is so firmly established that it approximates to a moral principle, if the use of a metallic currency were somehow essential to honest dealing. Credit, it is said, is a means of economizing gold and silver. A right and expectative to receive gold serves as well as the gold itself, if all that is required is a reliable medium. So long as gold is required only as a medium of exchange, the right to receive gold fulfils these requirements. It is only when someone acquires the right such as an industrial manufacturer, jewelry dealer, gold leaves or fountain pens trader, who wants to use it as a material for industry, that the physical right would be exercised, and the metal handed over.

The last effort to settle the dispute about currencies is linked to the WW I° and WW II° consequences, at Bretton Woods the last argument has become a dispute about gold, after the unsuccessful, unsettled previous Genoa Conference of 1922 based on Hawtrey assumptions (Hawtrey, 1919). Then most of the economists convened on a return to the gold standard, dismissed because of the disrupting huge worldwide general demand. On the first day of August 1914, the sale of equities and the contextual purchase order of gold, with the dollars sale revenues, requested all unforeseen, unexpected developments indicating a potential collapse of the New York stocks' exchange and a general wish of gold hoarding for most of the World liquid available assets.

The New Deal in the thirties, after the collapse of both, the plans to return to the gold standard and the confiscation in 1933 of all gold by President Roosevelt, on his assuming the US Presidency, is a linked consequence of the latent barbaric conflict between political messages and real spending possibilities, in their implementation through unconvertible monetary deficits only.

"But a bank can create credit out of nothing. When one bank grants an advance to a trader, two debts are created, one from the trader to the bank, which is payable at a future date, bears interest and is included in the assets of the bank, the other from the bank to the trader, which the trader can assign away by cheque and so use as a means of payment". (Hawtrey, 1939).

The large capability of banks to easily create credit and therefore actually inexistent values, after the fractional reserves facility, has strengthened the link

between banks and political lobbies. Worldwide, since the bank credit has become the principal medium of payment, money, even standard money on legal tender, is no more than a subsidiary medium. We have seen that bank credit can exist without money. That does not mean that this is a desirable state of things, but it enables us to understand the proposition that the idea of money is dependent on that of a debt, while that of a debt is not dependent on that of money. After that, the fractional reserves lending capability and the Central Bank clearing and lending facilities arise, with all the monetary and financial imbalances of the last decades.

2. THE FIRST GLOBALIZATION

The financial and banking activities unthinkable integration through commercial banks, especially after the *Modernization Act (Gramm-Leach-Bliley Act of 1999)* should have always required a clear separation between banks and financial intermediaries, whether they were investing third parties' moneys in irregular deposits or house funds.

It will be observed that the working of international monetary systems would be always greatly facilitated if the participating countries had sufficient confidence in one another's currency units, to buy and hold each other's currencies as foreign exchange reserves.

The danger of a scarcity of gold or alternative reserves, which was the ground for the recommendation at Genoa in favor of different foreign exchange reserves, is no longer a cause of anxiety. Nevertheless, some use of such reserves had introduced a very desirable element of elasticity through the international gold-exchange standard system proposed by Henry Dexter White at Bretton Woods (Steil, 2013).

In the 1933 Resolution, the new Administration did not insist on an agreed interpretation of the medium bearing mutual business activity. In case of a difference of opinion, each central bank might choose on its own judgment. That is a thoroughly practical course, because the facts would resolve by themselves all doubts. Anyway, it remains doubtful whether or not there would be a tendency to disequilibrium, calling for corrective action, in any case it probably did not matter very much by then what kind of action would have been taken. When a decided tendency either to depression or to excessive activity, would appear or be revealed, it was hoped that there would no longer linger differences of opinion.

Thus, the plan put forward in 1933 preserved the maximum of freedom and independence for the authorities of that time, a recognition of their individual international task. Is so entirely to the interests of all concerned that should be worth avoiding that any more strict binding agreement would be unnecessary.

From a trade point of view, the Bretton Woods resolution to enter a general tariffs and trade agreement, worked out a global World Economy growth, likely in the second globalization, as long as the Smith's comparatives advantages worked on a general scale (Smith, 1991).

Ricardo was right; David Ricardo (1772-1823) was the classic English economist who developed the free-trade theory of comparative advantages. Such theory stipulates that, when each nation specialize in the production of goods in which it has a comparative cost structure advantage and then trades with other nations for the goods in which they specialize, there will be an overall gain in trade, and the overall income levels should rise in each trading country. Until the 1971 15th August panicking declaration of inconvertibility, the pseudo or quasi gold-standard operating as the dollar currency became a legal international tenderable unit of payment, generally accepted and linked to gold on the IMF declared parities (Friedman, 1961). The World experienced a huge increase in its global output, most of the WW 2 damages were restored, at least outside the communist Soviet area.

After some monetary first uncertain evolution, the Smithsonian Institute agreement, the European first monetary union designs, till the EMS definite plan that led to the EURO, the outcome, during the eighties, was a disruptive financial and monetary instability and markets uncertainties' collapsing in the sequence of market bubbles eruptions and general recessions with a general depressed Western economic scenario called *austerity* (Blyth, 2013).

John Locke was one of England's most famous philosophers. A part of a movement that culminated in the Glorious Revolution of 1688, which disempowered the king and empowered the electorate. Well, people like Lock grounded the notion of what constitutes legitimate rule in individual property rights, without which there can be no economic liberalism, the base of the Deng Xiaoping transformation of China.

Locke had to make several moves: naturalize income and wealth inequality, legitimate the private ownership of land, explain the emergence of labor markets. At base, Locke's liberalism is an economic liberalism, that puts the individual against the state. The present austerity's intellectual history starts here.

Locke, property resides in us a first force in our persons, but it is only important because it is alienable with our labor. That is when I work on something, such as land, our laboring makes it our own. As Locke argued, whatsoever we remove out of state nature and mixed it with our labor, we make it our property.

Luckily, time and habits have given us a device called money that allows us to get over the problem of spoilage. We can store money and swap it for consumables, it

allows Locke to explain as inevitable, and therefore good, the creation of markets in land, labor, and capital, that happened to be the very political project that people of his class were looking in at that moment. His next step was to protect these new institutions of market from the emergent capitalism's nemesis: the state.

Locke famous right to rebel against and the deep suspicion of the government, only makes sense in relation to the violation of the rights of private property, he has just awarded himself. In Locke's world, the power of the legislature is limited to the public good of the society, which is as freedom from the intervention of government into private especially concerning property, unless citizens consent to it.

Remember that these arguments were formulated in the seventeenth-century England, when public debt was the debt of kings, kings who invoked rights given by God to appropriate the property of others unconditionally. Thus the liberal dilemma that generates austerity is born. The state: *wecan't live with it, can't live without it, don't want to pay for it*. Laying their intellectual bricks on Locke's narrow foundations are the giants of the Scottish enlightenment, Adam Smith and David Hume.

Turning first to Hume, his contributions to political economy are still of value and explain most of modern social evolutions. The idea that a monetary stimulus can in the short run stimulate economic activity, but in the end must either show up as inflation or dissipate, without effecting real variables, forms the centerpiece of his essay "On Money." It is also the standard line in contemporary macroeconomic theory where it is known as the long-run neutrality of money thesis. He is also credited with working out the in Richard Cantillon (Cantillon, 1755) balance-of-trade ideas, through his price-specie-flow mechanism, the mechanism that underlay the nineteenth-century gold standard. We, however, might be interested in Hume for his writings on public credit what we call government debt.

Hume, like Locke, sees money as an instrument, as nothing but representation of labor and commodities, a method of rating or estimating them. Rather, money follows trade, which places Locke's merchant classes, and not the state, at the center of everything. They are, according to Hume, one of the most useful races. For Hume, merchants are the catalyst for trade and the creators of wealth, intermediaries who serve as agents between parts of the State.

If we turn to the actual institutions by which the money of a civilized country is governed, we shall find that the foundation is always a law prescribing by what means a debt may be paid, in technical language, it prescribes what is "*legal tender*."

Law never says what may or must be a medium of exchange. Any one is free to use anything as a medium of exchange. The idea of money derives from the idea of a debt. At first, that conclusion may appear to be the pedantry or sophistry. For if the idea of is derived from the idea of a debt, is it not equally true that the idea of a debt is derived from idea of money? Can a debt have any other meaning than an obligation to pay the official money?

So long, as all goes smoothly, it is convenient and legitimate to think of a debt as meaning nothing but an obligation to deliver a specified quantity of gold silver or legal tenderable paper money.

Effectively, the excepting and superficially plausible assumptions seem to break down. Provided the holders of the paper notes were satisfied to carry on circulating them, the assets backing those notes could themselves be illiquid and not suitable for conversion, quickly or reliably, into money. From the practice emerged the system of banking we see emerging and prevailing today. Illiquid assets financed by liquid deposits or banknotes. The interesting feature of free banking was that it revealed the inherent tension between the use of bank liabilities as money, which requires that notes or deposits exchange at face value and the risky nature of current bank assets. If banknotes in the seventeenth century were exchanged at face value, there was a risk that the underlying assets might one day be undated to support that valuation. This alternative view of the history of money has the merit in explaining why bank deposits should comprise the offer a positive rate of return, either explicitly as interest, or, in the case of current accounts, implicitly in the task of subsidized money transmission services.

A basic problem with public debt is that it has no limit, at least until the interest rates on the debt become crushing. Furthermore, debt is easy to play since its costs are hidden and intergenerational, which makes states love debt. Therefore, contemporary, the even more famous Adam Smith was also troubled by the problem of public debt as Hume troubled by the problem of public debt, seeing the slide into insolvency and unreliability as unavoidable. He identifies both the problem and the solution. To solve the problem of debt we should embrace the principle of austerity, otherwise known as the parsimony of the Scots, nowadays the outcome of the *trojka*.

3. THE BRETTON WOODS COLLAPSE

The last political effort to overcome the fiat money threats and worries was overcome in the July 1942 in Bretton Woods. The supremacy of the US undersecretary Henry Dexter White succeed in force an identification of the US dollar to gold bullions as a reserve currency under the gold base equivalence at 35 oz. in a restricted external convertibility to Central banks of Countries adhering to the International Monetary Fund. A *quasi* gold standard monetary system was

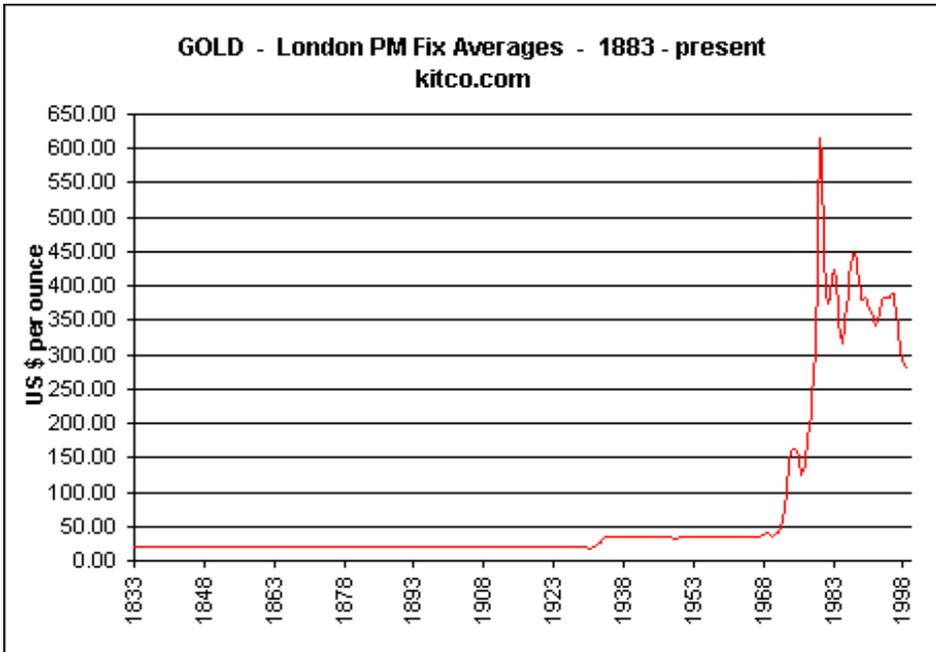
imposed, with the after war reconstructions programs and IMF and WB facilities as attractive rewards.

Actually, the pseudo gold standard was immediately criticized by both Anglo-Saxons and French Authorities and academics. Robert Triffin (Triffin, 1960) and Jacques Rueff were the most critics of the scheme, on the ground of the inconsistency of the huge gold base required to support the likely volume of international imbalances otherwise support by USA fiat money.

Indeed, after the initial phase of the reconstruction, the ideological and military operations of the fifties and sixties, the gap between the physical gold monetary basis locked in Fort Knox and annexed US depository entities and the dollars widened, and the convertibility was not any more compatible with the huge US dollars balances stationing in the foreign Central banks. It seems strange to assess today's ratio, which shows that the percentage of US dollar is still prevailing in the foreign reserves of Central banks even without the convertibility concession.

These were floating in most of the Central banks and swelling the Eurodollar World market located in the UK. The crisis erupted on 15 August 1971 in the quiet, but not relaxed meeting of Camp David, when President Nixon adopted the temporarily dismantling of the gold standard refusing the conversion request even from Central banks (Mundell, 1999).

Figure 1. Gold Debasement 1971



What was then foreseeable did not happen, the price of gold, newly free traded in the markets and released from the monetary basis function started to swell, the dollar lost progressively most of its purchasing power, a decade of inflation wiped away the Phillips curve and its meaning, the new landscape was named *stagflation*. The WIN (win inflation now) slogan appeared as a pin on American jackets and the economists shifted to the supply side assumption in the economics arenas (Domitrovic, 2018). Arthur Leffer draw his napkin slope, showing the decreasing public revenues, linked to the rising taxation rates and a new monetary era was born.

After the seventies inflationary years and the collapse of the Phillips curve, the eighties saw the major historical changes with the collapse of the Soviet ideology, the Deng reform of the Chinese economy shifted from the, mostly State governance oriented policies, to the market oriented new pattern. A new wave of liquidity spread over the planet but was counterbalanced, in its potential inflationary effects by the reversal of the Asian World plants, left for some decades inactive, now pressing over most of the valuable markets in a competitive unusual competitive costs' structure and unrestricting fiscal hurdles.

The World market since then and in a progressive larger quantity furthermore, was expressing the converging global identical raw materials prices and most of the other production factors. Correspondingly, similar unique costs, with the exception of some specific costs structures, high and growing under some strong compelling forces in the West, are free to float uncontrolled and generally lower in the whole Asian World.

4. THE MONETARY UNRESOLVED QUESTION

The main problem facing the modern new Bretton Woods fallout lies on the not extensible legal enforcement of the *fiat money principle* over the globe, in the inadequacy of a monetary sustainable real basis. The legal enforceable actions are applicable in the single Country issuing his own currency and in the legal local framework, (Simmel, 1898) expressing his philosophical consideration about the objectivity concept of the money value, excludes the international feasibility of a fiat money implementation. He expresses the first potential conflict about two conflicting modern monetary and financial guiding principles: is money a token, a symbol without any value by itself, or we must consider it a value, in order to carry out sound services of measurement, exchange and become substantially a sound saving medium?

Oil was the first surrogate to the gold easily dismissal of 15 August 1971, as long as the oil barrel was available without limits and at convenient prices performing some monetary inappropriate functions even after several Gulf war's fallout of this new evidence. The military North American World police functions were

supporting the reliability of such function as long as the political division of the World was contraposing the Soviet block to the Western Countries. The introduction of the Euro was a first effort to overcome the unreliable foreign exchange fluctuations within the European Countries, after the demise of the International Monetary Fund balancing power.

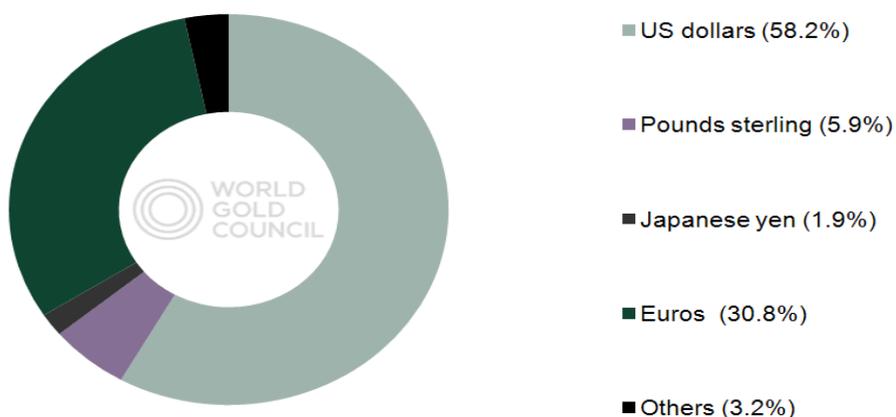
In the seventies, and in the eighties, with the appearance of the now powerful far Eastern Countries on the single World market, the demise of the Marxist economies, all exchange rates started to float without a whatsoever safe anchor basis.

The new administration approach, led by F.D. Roosevelt after confiscating in the year 1933 all the physical and title gold, under a penal and monetary relevant fine, was the World safe gold depository owner. At Bretton Woods, the US accepted to a formal constraint to return gold bullions for Central banks adhering to the IMF agreement, on weighted gold reserves based on actual owned gold and floating currencies the gold-exchange system lasted until the demise in Camp David 1971.

As long as the system was running and on short time transitory unbalances, it worked with a soft continuous adjustment with dollar balances and gold deposits shifts providing temporary adjustments.

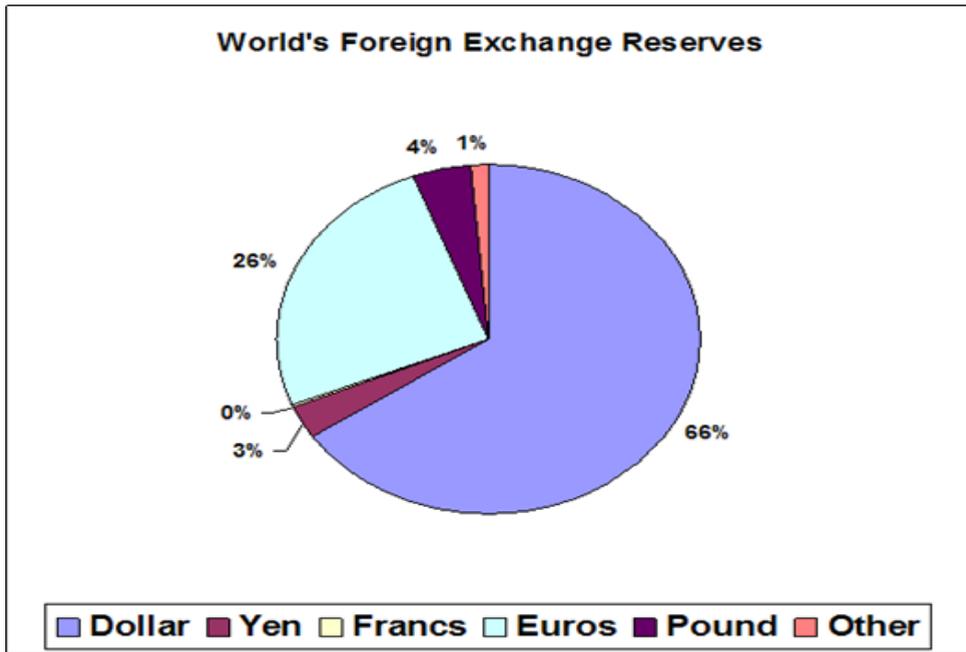
Figure 2. Compositions of Official Foreign Exchange Reserves Q4 2009

**Currency Composition of Official Foreign Exchange Reserves,
Allocated Reserves (% of Total, Q4 2009)**



Source: <http://www.gold.org/government_affairs/reserve_asset_management/>

Figure 3. Composition of Official Foreign Exchange Reserves Q2 2017



Source: <<http://data.imf.org/?sk=E6A5F467-C14B-4AA8-9F6D-5A09EC4E62A4>>

The oil price provided successively a progressive balance on a three adjusting factors: oil price, gold reserves and dollars loans, in a gold-oil-exchange international adjusting mechanism.

The present US trade imbalance is disrupting the system since the 1971 Camp David decision, which should have been “*temporarily enacted*” both the Gold convertibility and the related Bretton Woods agreements, but the international settlement procedures, enacted in the year 1944, are still going on despite a huge US trade deficit, which is progressively growing. The internal deficit, as well, has been disrupting the previous parities, with an over twenty US \$ trillion internal debt never seen before as a public deficit. Nevertheless, most likely, the US overpassed the point of no return, as the troubled assets recovery plans and the bailouts have worsened the general American financial scenario (Mallaby, 2016).

Finally, the financial improper commercial banking activities, released through the Modernization, (Gramm–Leach–Bliley Act, 1999) have transformed the classical commercial credit suppliers in social accounting amortizations operating procedures allowing the financial function of the investment banks as inhibited by the Glass and Steagall Act, 1933.

The final feeling has isolated the US economy in a newly row of old-fashioned tariffs and custom duties, defensive instruments disrupting the efficient trade global system.

5. CONCLUSION

The principal beneficiary of this wonderful new international order has been China and some close market economy in the Far East. China has been the principal winner. Back in 1980, China accounted for perhaps 2 percent of the world economy. In addition, the United States and Canada together were about a quarter of the world economy. Today, China accounts for 18 percent of the world economy and the United States and Canada together slightly less than 17 percent. According to the present trends, that differential will grow. By 2021, China will account for a fifth of the world economy. How can there be a reliable international order if the prime beneficiary is a one-party state, run by a communist elite? The challenge has been made to the Western post Colombian economies by the emerging new regions of Eurasia, as described and foreseen by Mc Kinder (Mc Kinder, 1904). We have seen, since then an increasing Islamic extremist disorder, started with the overthrow of Reza Pahlavi, claiming tens of thousands of lives every year since 1979, the ayatollah Khomeini became the supreme religious leader of the Islamic Republic of Iran. Tens of millions of people displaced from their homes in a growing depression in the rest of the stagnating World have become migrants in search of a better life.

Then, the free-trading system, the so-called General Agreement and Trade, or GATT, had seventy Countries. Twenty-eight countries in 1970. It now, as WTO (World Trade Organization) has 170 members. The European Union (EU), which had six countries in the year 1970, now has twenty-eight – twenty-seven when will be finalized the fall-out of the Great Britain. Still an enormous expansion from that time, the United Nations calculates that in the last fifty years, we have taken more people out of poverty than in the preceding five centuries.

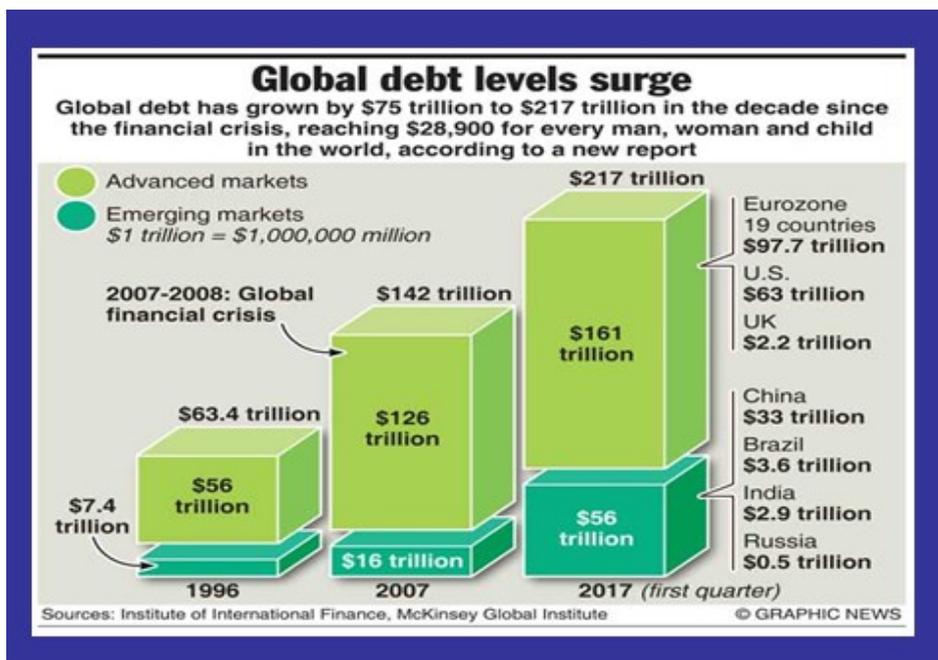
Figure 4. GDP (US\$ Billions) 2000 – 2017

World - Data	2000	2005	2007	2008	2014	2017
GDP (current US\$) (billions)	32,001	45,232	54,891	60,587	87,180	80,684
GDP growth (annual %)	4.1	3.5	3.8	2.0	2.9	3.2
Inflation, GDP deflator (annual %)	4.7	4.9	5.4	8.1	2.0	3.4

<http://databank.worldbank.org/data/reports.aspx?source=2&series=NY.GDP.MKTP.KD.ZG&country=>

The three stages of the modern banking activity go from the Italian Middle Ages bankers, as outlined in their historical records, to the continental German banks developing the investment banking functions. In their two main sections of prevailing potential institutional activity, they find their modern qualification and definition as monetary functions (Ferguson, 2009). This is the first instance of the conflicting interpretations we encounter about the check: one side contending that the issue of a credit instrument (bank notes or current accounts balance transferrable by checks) merely puts into circulation deposits received beforehand, the other side contending that *money* comes by such issues. Contillon's idea that banknotes are credit instruments, which make a more rapid circulation of money possible, but are not themselves money in the real sense of the word, is completely discarded. Ricardo makes no distinction between the issue of convertible notes and the creation of paper money. He sees precautions concerning those who issue money, and admits that they should be compelled to provide the government with certain guarantees against potential over issues.

Figure 5. Present external imbalances and austerity factors



He is not considering the suggestion that fixed interest bearing securities can serve as sufficient guarantee. Never for a moment does it occur to him that careful selection by the banker in granting credits and responsibility for the convertibility of his notes provide adequate protection for the public. For him there is no difference between money and other circulating media of payment; the only thing that matters is limitation of the quantity.

As to *checks*, Ricardo thinks of them not as instruments of circulation, but as a *means of economizing the use of money*. He was the first to make a distinction between checks and banknotes (called to-day bank money and notes) as currency instruments; the eighteenth century had made no such distinction, and it was a long time before the error was eradicated. He came to this conclusion because he did not regard checks as currency instruments; they could not therefore affect prices. This origin of all the debates and discussions led to the passing of the Peel Act in 1844. Under the Act, no bank other than the Bank of England could issue new banknotes, and issuing banks would have to withdraw their existing notes in the event of their being the subject of a takeover. At same time, the Bank of England was restricted to issue new banknotes unless they were 100% backed by gold or up to £14 million in government debt. The Act served to restrict the supply of new notes reaching circulation, and gave the Bank of England an effective monopoly on the printing of new notes. The Act exempted demand deposits from the legal

requirement of a 100 percent reserve, which was demand with respect to the issuance of paper money.

The present century is qualified by a general prevailing of monetary policies of Central banks' policies without normal inflationary following ups (El-Erian, 2016) (DiMartino, 2017) now dismissed (Koo, 2009). At same time, the Asian countries are mostly producing and selling most of their high technology modern production with a single general prevailing advantage, the absence of a strict price control and rigidity in the cost structure and competitive resulting markets prices. In a single 24 hours global market, every industrial factor is strictly monitored and the prices are adjusted to the comparative advantages prices by every single consumer in the World around, correspondingly a global informatics cluster of digital technology networks supply online real time comparative details.

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COMMENCEMENT OF NEGOTIATIONS AND A SIGNIFICANTLY INCREASED PRESENCE OF THE EU AS THE BASIS OF STABLE GROWTH AND DEVELOPMENT OF BOSNIA AND HERZEGOVINA

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Review

Abstract

It is important for Bosnia and Herzegovina, but also for the European Union, that the negotiation process begins as soon as possible. Real changes in the legal, administrative and political sense commence only with fulfilment of benchmarks for opening and closing of chapters. The negotiation process is also important for learning and progressing in the understanding of European policies which help to strengthen state institutions, democracy and openness to grow and result with stronger economic growth due to an increased level of trust and safety. It is important for the European Union that the country at the very heart of Europe, which belongs to Europe not only geographically, but also historically and in terms of tradition and culture becomes a part of it as soon as possible and also in terms of the standards it applies. In this paper we give an overview of recommendations that the European Commission has provided to Bosnia and Herzegovina since 2002, and it is precisely from the recommendations which are being repeated each year that the most important challenges which Bosnia and Herzegovina needs to solve are still visible. Rule of law, respecting human rights and rights of minorities, as well as the constitutionality of the three nations, in addition to a fast and efficient judicial system and the public sector as a whole are the key elements for fulfilling political, legal and administrative criteria.

In terms of GDP per capita in PPS, B&H has been converging during the last ten years, however with a very slow tempo. Thereby in 2005 GDP per capita in PPS amounted to 24 % in relation to EU28, whereas during the last four years it amounted to 29%. At the moment B&H is significantly lagging behind even the least developed Member States and convergence towards the EU average is necessary because on the current level B&H could not equally participate in the EU Single Market, and accession would create more obstacles than advantages. The EU is expected to take a more active approach in solving the challenges of economic convergence of B&H, therefore in this paper is provided an overview of the priorities of the new EU Enlargement Strategy in which support to socioeconomic development is pointed out as one of the initiatives.

Keyword: *European Union, Bosnia and Herzegovina, convergence,*

JEL: O52, P48

1. INTRODUCTION

As of 2005 the European Commission draws up reports on the progress of Bosnia and Herzegovina and monitors the country's readiness for the commencement of negotiations. In November 2005 negotiations on the Agreement on Stabilization and Association, which was concluded in December 2007 and entered into force on 1 July 2015, were also initiated.

In 2005 Bosnia and Herzegovina was stated in the Enlargement Package¹ as a potential candidate country along with Albania, Montenegro, Serbia and Kosovo. The Enlargement Package represents a set of documents which the European Commission issues on an annual basis, which evaluates the implementation of key political and economic reforms in the countries of Southeast Europe and Turkey, as well as pointing out what needs to be done in order to respond to the remaining challenges. The Progress Report represents one of the documents from the Enlargement Package through which the European Commission provides information on the progress which a particular candidate country or potential candidate country has made with regard to fulfilling requirements and objectives set by the European Union, as well as a summary of measures which need to be taken based on established plans of action.

In the Progress Report fulfilment of measures and benchmarks in the area of democracy and rule of law, public administration, judicial system, anti-corruption policy, as well as observation and protection of human rights and rights of national

¹ Communication from the Commission - 2005 enlargement strategy paper, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52005DC0561>

minorities are monitored as the basic preconditions which a country must meet in order for the process of commencement of negotiations to be initiated. A country's progress is evaluated on the basis of decisions brought, laws adopted and measures carried out. This approach ensures equal treatment in all reports and allows for an objective evaluation.

The first Progress Report for Bosnia and Herzegovina was published in 2005², preceded by annual reports on the Stabilization and Association Process (from 2002 to 2004). From twelve Progress Reports drawn up it may be concluded that it would have been much more efficient both for the European Union and B&H if accession negotiations had commenced immediately and if different important issues which are key for the functioning of the legal system and democracy in Bosnia and Herzegovina were solved during the negotiations through benchmarks for opening and closing of chapters. This way, instead of progress, different important issues often come up which return the entire process several steps backwards.

On 6 February 2018 the European Commission brought the EU Enlargement Strategy for the Western Balkans³ (hereinafter: Strategy), on which a discussion was held on the same day at a plenary session of the European Parliament in Strasbourg. A clear message was given that the European Union wants Western Balkans countries to become Member States, and that the moment of accession depends solely on themselves, the speed of implementing reforms and harmonization with EU standards and benchmarks.

Hereafter is provided an overview of the main conclusions from the Enlargement Strategy, a comparison of progress made in countries of Southeast Europe, as well as an overview of the recommendations provided to and progress made by Bosnia and Herzegovina since the commencement of drawing up of the Progress Report.

2. CONCLUSIONS AND MESSAGES FROM THE EU ENLARGEMENT STRATEGY FOR THE WESTERN BALKANS (WB6)

On 6 February 2018 the European Commission presented the new Enlargement Strategy for the Western Balkans, which had been mentioned in the State of the Union Address by European Commission President Jean-Claude Juncker relating to the reaffirmation of the European future of Western Balkan countries. As of the meeting of the Council of Europe in Thessaloniki in 2002, the EU has been

² Full report available at: https://ec.europa.eu/neighbourhood-enlargement/sites/near/files/pdf/key_documents/2006/nov/bih_sec_1384_en.pdf

³ Strategy for „Credible Enlargement Perspective for and Enhanced EU Engagement With the Western Balkans”

https://ec.europa.eu/commission/sites/beta-political/files/communication-credible-enlargement-perspective-western-balkans_en.pdf

involved in the future of that area as a component part of the EU. The Strategy relates to 6 countries under the title of WB-6 (Montenegro, Serbia, Bosnia and Herzegovina, Macedonia, Albania and Kosovo). During 2018 the Commission commenced carrying out several initiatives aimed at improvement of the democratic, institutional and political framework of the Union by 2025 based on agreements currently in force.

During the presentation of the Strategy, Federica Mogherini, High Representative of the European Union for Foreign Affairs and Security Policy, pointed out that the Western Balkans represents a part of Europe wherein we all share the same history, geographical and cultural heritage, the same opportunities and challenges, as today so in the future. This Strategy provides a joint, unambiguous and concrete perspective for European Integration for each of the six partners. Setting 2025 as the key year for accession of the mentioned countries to the EU, primarily Montenegro and Serbia, does not represent the final deadline but a perspective for accession, which will depend solely on results achieved and the speed of negotiations.

WB6 countries must continue fulfilling key conditions for membership. In order to fulfil all conditions for membership and strengthen their democracies, they still require comprehensive and convincing reforms, as well as solving the issues in key areas such as the rule of law, protection of basic human rights and rights of minorities, public administration reform, solving bilateral disputes and strengthening good neighbourly relations. In addition to those issues, emphasis was also put on strengthening the economies because at the moment no economy of WB6 countries can be considered functional.

Through this enlargement policy the EU wants to continue in the direction of strengthening stability among the countries covered by the Strategy. This especially relates to solving all bilateral disputes which are still slowing down the way towards EU membership and must be solved bilaterally or through arbitration. Definitive and obligatory solutions of those disputes must be reached and carried out prior to the accession of the countries to the EU. Commissioner for European Neighbourhood and Enlargement Negotiations Johannes Hahn stated that this Strategy has no shortcuts and that criteria for accession are clearly defined and must be fulfilled. Progress will depend exclusively on work, will and results of each particular country⁴.

⁴ Press release available at: http://europa.eu/rapid/press-release_IP-18-3342_en.htm

The following steps of countries of Southeast Europe on the way to EU membership: Strategy Initiatives

With the Strategy the EU should increase its political involvement in Southeast Europe, focusing on areas of joint interest such as the judicial system and internal affairs, including security and fight against organized crime, the economy and the Single Market, energy, transport and digital policy, social policy, education and innovation, as well as foreign affairs and defense. By strengthening its policy the EU is beginning to carry out a series of leading initiatives which represent a significant increase of EU's involvement in South European countries, which is of joint interest.

The Strategy defines six initiatives and 57 concrete, innovative measures. Hereafter is provided a short overview of the initiatives which are the basis of new enlargement-related documents:

- 1. Strengthened support to the rule of law** – Reforms in this area need to be intensified through analysis of legislation and practice. In the negotiating frameworks for Montenegro and Serbia special emphasis has been placed on reforms in the area of rule of law. Activities relating to concrete judicial system reforms, fight against organized crime and corruption are the way to strengthening the rule of law.
- 2. Reinforcing engagement on security and on migrations** – Increased strategic and operational cooperation regarding security and migrations is of key importance for efficient and effective addressing the existing security and terrorist threats. Although significant progress has already been made in this area, countries of Southeast Europe should be more involved in discussions on security policy taking place in the EU on an ad hoc basis. Increased involvement in the fight against terrorism and radicalization, cooperation in the fight against different types of organized crime, support to capacity building in the area of cyber-security and fight against cyber-crime by EU agencies such as Interpol is necessary in the following period. Precisely with that objective the Commission will set up and coordinate an Interagency Workgroup on EU level.
- 3. Supporting to socio-economic development** – Increased financing has been foreseen in the areas of transport, energy, social sector, environment and private sector development, including digital economy. The objective is to link socio-economic development in the region with investment priorities of the Union in order to significantly increase the provision of guarantees under the investment framework for Southeast Europe, with the aim of attracting private investments in the region, in full complement with the existing initiative. With the aim of development of the regional economic area, the Commission will additionally facilitate trade between the EU and countries of Southeast Europe. In order to strengthen entrepreneurship and innovation, the Commission will introduce a scheme of support to technology transfer and startups in the entire

region and provide support to efforts directed at smart specialization, as well as circular economy. Through the new strengthened social dimension for countries of Southeast Europe, the Commission will work on support to employment and carrying out social policies in the region, by encouraging corresponding involvement of all levels of government, social partners and the civil society. In order to provide support to social inclusion, increased financial support to the social sector is planned, especially for investment in education and healthcare. Financing under Erasmus+ programme will be doubled and a mobility pilot scheme for students and teachers in the area of vocational education and training will be set up in close cooperation with all stakeholders, including the European Education Foundation.

4. **Increasing connectivity** –Increasing transport and energy connections will allow for increasing competitiveness, economic growth and safety of supply, and at the same time will be an important precondition for economic integration with countries of Southeast Europe. The Commission will work on ensuring more efficient use of the Connecting Europe Facility in Southeast Europe countries.
5. **Launching a Digital Agenda for the Western Balkan**–Through implementation of the Digital Agenda the price of roaming will be reduced. Support will be provided to the introduction of broadband internet in countries of Southeast Europe. The Commission will provide support to capacity building in the area of industry security and digitalization in order to ensure that all sectors benefit from digital innovations.
6. **Supporting reconciliation and good neighbourly relations** - Good neighbourly relations should develop through regional cooperation initiatives promoting education, culture, young people and sports. The extent and reach of the Regional Youth Cooperation Office will be extended. With increased financing under Erasmus+ programme, the Commission will continue to promote cultural linkage with the region. That will include work on the protection of cultural heritage of countries of Southeast Europe and promotion of their cultural and creative industries.

The objective of the initiatives is to encourage joint work on projects and reforms, exchange of knowledge and experiences, as well as strengthening activities of the European Union in WB6 countries. It is important not only to act from the level of EU institutions, but as much as possible to include the Member States themselves, which can significantly accelerate reforms in these candidate and potential candidate countries for EU membership with their knowledge and practical examples.

3. THE EUROPEAN WAY OF COUNTRIES OF SOUTHEAST EUROPE (WB6)

The process of gradual integration of countries of Southeast Europe commenced in 1999 with the Stabilisation and Association Process, which represents the strategic framework for accession to the Union, based on bilateral agreement relations, financial assistance, regional cooperation, political dialogue, as well as trade relations. The Stabilisation and Association Process represents the backbone for strengthening the capacity of countries for adoption of European standards and the EU acquis, whose manners of implementation and process elements were formulated in Zagreb in 2000⁵ and in Thessaloniki in 2003⁶. By signing the Stabilisation and Association Agreement (SAA), the signatory country covered by the Process of Stabilisation and Association is given the status of an Associate Member and the status of a potential candidate for EU membership. An important element of the agreements is its focus on regional cooperation which obliges the signatory country to sign bilateral agreements with other countries undergoing the Stabilisation and Association Process and candidate countries, whose objective is encouraging countries in the region to cooperate in a series of areas, including criminal prosecution of war crimes, solving border disputes, the refugee issue and fight against organized crime. The Agreement itself enters into force upon ratification by all signatory parties.

In order to acquire the status of a candidate country for EU membership, countries must prove that they respect the basic values set out in Article 2 of the *Treaty on the Functioning of the European Union*⁷, specifically: respecting human dignity, freedom, democracy, equality and rule of law, fundamental freedoms including minority rights, as well as a pluralistic society, non-discrimination, tolerance, justice, solidarity and gender equality.

Table 1. Overview of the status of the process of accession to the EU as per countries (status on 28 February 2019)

Country	Application for membership	Entering into force of SAA	Candidate status awarded	Number of open chapters	Number of closed chapters
Serbia	19th December 2009	1st September 2013	1th March 2012	16	2
Montenegro	15th December 2009	1st May 2010	17th December 2010	32	3

⁵ <http://www.esiweb.org/pdf/bridges/bosnia/ZagrebSummit24Nov2000.pdf>

⁶ http://europa.eu/rapid/press-release_PRES-03-163_en.htm

⁷ Treaty on the Functioning of the European Union, Article 2. Document available at: <http://eur-lex.europa.eu/legal-content/HR/TXT/?uri=CELEX%3A12016ME%2FTXT>

Macedonia	26th February 2004	1st April 2004	16th December 2005	/	/
Albania	24th April 2009	1st April 2009	27th June 2014	/	/
Bosnia and Herzegovina	15th February 2016	1st June 2015	Potential candidate	/	/
Kosovo	/	1st April 2016	Potential candidate	/	/

Source: Elaborated by the author

Montenegro submitted its application for EU membership on 15th December 2008. The SAA entered into force on 1st May 2010, whereas the Council awarded Montenegro the status of a candidate country on 17th December 2010. On 12th October 2010 the Commission proposed the opening of accession negotiations, which was accepted by the Council on 29th June 2012. By now 32 out of 35 negotiation chapters have been opened, whereas three have been temporarily closed (science and research, education and culture and foreign relations). The 12th meeting of the Accession Conference with Montenegro at ministerial level took place on 10 December 2018. The conference opened negotiations on Chapter 27 - Environment and climate change.⁸

Serbia submitted its application for accession to the EU on 19th December 2009, and on 12th October 2011 the Commission proposed that Serbia be awarded the status of a candidate country, which the Council awarded after the agreement between Beograd and Priština on regional representation of Kosovo, whereby Serbia became a candidate country. The SAA entered into force on 1st September 2013, whereas accession negotiations were opened on 21st January 2014. By now 16 out of 35 negotiation chapters have been opened, and two have been temporarily closed (science and research, education and culture). The 9th meeting of the Accession Conference with Serbia at ministerial level took place on 10 December 2018. The conference opened negotiations on Chapter 17 - Economic and monetary policy and Chapter 18 – Statistics⁹.

Macedonia submitted its application for accession to the EU on 26th February 2004, thereby prior to all countries of Southeast Europe. The SAA entered into force on 1st April 2004, and on 16th December 2005 the Council awarded to Macedonia the status of a candidate country. By 2015 The European Commission proposed opening of accession negotiations six times, however, considering that the Council requires approval of all Member States, commencement of negotiations was blocked because of an unsolved bilateral dispute with Greece regarding the

⁸ <https://www.consilium.europa.eu/en/policies/enlargement/montenegro/> , accessed on 9th March

⁹ <https://www.consilium.europa.eu/en/policies/enlargement/serbia/>, accessed on 9th March

name of Macedonia. On 1 July 2015 the Pržin Agreement was concluded, which has been partly implemented, based on which progress in carrying out urgent reform measures has been made. On 25th January Greek parliament ratified the Prespa Agreement¹⁰ to end a nearly three decade-long dispute over neighboring Macedonia's name, in a landmark vote that will see the small country renamed North Macedonia and clear its path to NATO membership. On 6th February North Macedonia has signed up to become NATO's latest member. The signature of the NATO accession pact does not mark the end of the journey just yet. The enlargement of the alliance now has to be ratified by the national parliaments of the 29 NATO member states. The timeline for this process will largely be driven by the time required for national ratification procedures in the national parliaments. In case of Montenegro, which joined NATO as its 29th member last year in July, the signature of the accession protocol and its admission took about one year.

Albania submitted its application for EU membership on 24th April 2009. The SAA entered into force on 1st April 2009. Albania had to achieve the required degree of conformity with criteria for membership according to the Commission's opinion, and the proposal for awarding the status of a candidate country was conditioned by a judicial system reform, fight against corruption, as well as organized crime, and on 27 June 2014 the European Council awarded Albania the status of a candidate country upon the Commission's proposal. The Stabilisation and Association Council (SA Council) between Albania and the European Union held its 10th meeting on 14 November 2018 in Brussels. The SA Council positively noted the European Commission's 2018 Albania Report, which recommended that accession negotiations be opened with Albania, in light of the progress achieved, maintaining and deepening the current reform momentum. The EU reiterated that constructive cross-party political dialogue and cooperation in the Assembly of Albania is essential for further progress on reforms and for the overall sustainability of the engagement in the EU integration process. They also reiterated the critical need for Albania to maintain and deepen the current reform momentum, to further consolidate progress made on judicial reform in particular through the vetting process, and to deliver further tangible results in the fight against corruption at all levels and in the fight against organised crime, in particular on the cultivation and trafficking of drugs, building on the positive results in the fight against cannabis cultivation that have continued throughout the current crop season. The SA Council also commended Albania's continuous participation in regional initiatives and structures in South Eastern Europe and its good neighbourly relations and constructive regional stance.¹¹

¹⁰ Full text of Prespa agreement is available on web page:

<https://greece.greekreporter.com/files/symfwnia-aggliko-keimeno.pdf>

¹¹ <https://www.consilium.europa.eu/en/policies/enlargement/albania/> , accessed on 9th March

Bosnia and Herzegovina submitted its application for accession to the EU on 15th February 2016, whereas the SAA entered into force on 1st June 2015, thereby eight months earlier. By adopting the reform plan, which put emphasis on solving the problem of the difficult socioeconomic condition in the country, implementation of the rule of law and public administration reform in July 2015, the way to the EU was established. Answers to a survey questionnaire delivered in February 2016 were submitted on 28th February 2018. The European Commission posed additional 106 questions which the B&H authorities still didn't submit. The contents of the survey questionnaire should serve as the basis for bringing a decision on awarding the status of a candidate country for accession to the EU. After B&H delivers its answers to the Questionnaire, the European Commission will bring an opinion (avis) on its preparedness for acceptance and fulfilment of conditions for membership, which can be positive or negative. Based on European Commission's opinion, the European Council approves the status of a candidate country to the applicant country.¹² On 13th of February 2019 European parliament voted on 2018 Commission report¹³ on Bosnia and Herzegovina. They reiterated that the authorities in B&H needs to proceed with constitutional, political and electoral reforms, to advance the EU integration process. Finally highlight that BiH's EU membership application represents a strategic choice and a commitment, to advancing towards the EU

Kosovo has not yet submitted its application for accession to the EU. The SAA entered into force on 1st April 2016, which makes it the first contractual relation between the EU and Kosovo. Implementation of the mentioned agreement, which is necessary for strengthening of the rule of law and implementation of economic reforms, is awaited. Reforms relating to the rule of law have been carried out, and in May 2015 the Commission brought a proposal to transfer Kosovo to the list of countries with visa-free regime in the Schengen area. With regard to normalization of relations with Serbia, negotiations between Belgrade and Priština are underway, and integration of Kosovo, as well as Serbia in the EU depends precisely on those negotiations. Four high-level official meetings were held with the presence of Commissioner Federica Mogherini in July, August and September 2017, and in March 2018. Presidents Taçi i Vučić agreed to work on a new phase of dialogues with the aim of comprehensive normalization of relations between Kosovo and Serbia. This is currently underway and all activities need to be accelerated. Meetings on the technical level have continued in the second half of this year. The 6th EU-Kosovo Stabilisation and Association Parliamentary Committee (SAPC) held its meeting in Strasbourg on 14 February 2019, where they reiterated that hat progress in the process of normalisation of relations between Kosovo and Serbia

¹² Maletić, I, Kandžija, V., Accession Process and IPA Funds in Bosnia and Herzegovina – An Opportunities for Reconstructing Public Spending and Convergence Towards EU, Journal of Economy and Business, Faculty of Economics Mostar, 2016, pp. 238-267.

¹³ This interim report covers the period from October 2016 to February 2018.

was necessary and that Kosovo had fulfilled all of its obligations and that decisions by respective EU institutions should be taken without delay. Five EU Member States (Spain, Cyprus, Greece, Romania and Slovakia) still do not recognize Kosovo as an independent country, which makes Kosovo's position for acquiring the status of a candidate country for EU membership and commencement of negotiations more difficult.

4. OVERVIEW OF RECOMMENDATIONS TO AND PROGRESS OF BOSNIA AND HERZEGOVINA FROM THE PROGRESS REPORT

The Progress Report¹⁴ represents the Commission's official document in which the state of play in each candidate country and potential candidate country is evaluated in detail on an annual basis, and instructions on reform priorities are provided. It represents a sort of guide for each candidate country or potential candidate country, showing the direction which needs to be followed in order to fulfill conditions and criteria required for membership in the EU as best as possible. Reports for 2017, which the European Commission presented on 17th April 2018 and based on which the European Parliament drew up its reports and brought resolutions regarding each particular country of Southeast Europe are currently actual, and the focus is on issues relating to the the judicial system, rule of law, protection of human rights and rights of national minorities, fight against corruption and organized crime, public administration reform, fight against terrorism, regional cooperation, macroeconomic development, as well as infrastructure development.

4.1. Democracy and rule of law

Reforms including the need for improvement of the functioning of democratic institutions, strengthening ministries and agencies on state level were postponed in B&H due to significant differences within state institutions, the central state and entities. Better and more systematic coordination of legislative programmes needs to be ensured between all levels of government. Distrust in the transfer of any kind of competence from entities or cantons to the central state is a significant obstacle to a comprehensive and sustainable reform of institutions and the constitutional order.

In Progress Reports it is continuously pointed out that the constitutional order does not allow for fast decision-making and is slowing down implementation of reforms. The problem is inadequate coordination with regard to legislative plans between the state parliament and entity parliaments, as well as non-existence of a consensus on the transfer of competences from the entities to the state. Complicated decision-making procedures, problems with lack of capacities, lack of political will and

¹⁴Progress reports by each of WB6 countries can be found at: https://ec.europa.eu/neighbourhood-enlargement/countries/package_en

different national interests in the Parliaments at state and entity levels are continuously slowing down and stopping adoption of laws and advancement of B&H, which is repeated in all Commission reports.

It has been established that lack of coordination, national tensions, inability of achieving consensus among political parties and a lack of resources are postponing the required constitutional reforms, and conducting policy is still fragmented.

Reforms are being postponed due to different standpoints and interests between entities, inadequate resources and a lack of political dialogue. There is no joint vision of political leaders on the general direction of the movement of the state. It is necessary to solve the issue of expensive and complex governance structure and overlapping between the Federation, cantons and municipalities.

No progress has been made in harmonization with the rulings of the European Court of Human Rights in the court case of Sejdići-Finci.

With the last report from 2017 it was finally established that the Council of Ministers had adopted the coordination mechanism for the process of European integration, as well as the action plan for implementation of the Reform Agenda on central state level, which brought to adoption of reforms such as debt management, prevention of money laundering, customs policy and fight against organized crime. The need for adoption of a Strategic programme for harmonization of legal regulations with the EU *acquis* was pointed out. In addition, it is necessary to draw up a strategic framework for establishment of cooperation between governments and civil society organizations.

The Election Law, which leaves room for violation of the constitutive principle of the Croats, which was evident in the recent final elections in which Bosniaks elected a Croatian representative as a member of the Presidency of Bosnia and Herzegovina, is a significant problem.

4.2. Public administration

In the very first report from 2005, public administration reform was identified as one of the most important reforms. Constant political involvement disables advancement and employment of officials based on knowledge and quality. Depolitization of institutions and increasing the efficiency of public administration is necessary. In an attempt to solve these issues, analyses in seven key public administration sectors were carried out already in 2005: police, judicial sector, education, healthcare, agriculture, environment and return of refugees. In March 2005 a systematic analysis of the entire public administration was carried out, including a review of horizontal functions such as human resources, public finance, drawing up of laws, administrative procedures, information technology and institutional communication. These analyses resulted in detailed recommendations

to authorities on how to improve public administration and make it faster, more flexible, more efficient, transparent and independent. In addition, in 2007 a Public Administration Reform Coordinator was appointed for a four-year term, and all governments adopted a joint platform for implementation of the Public Administration Reform Strategy (PAR) which defines responsibilities on the political level of coordination and implementation.

However, implementation of systematic reforms has failed. Year after year it is repeated in reports that governance structures of B&H are still massive, fragmented and prone to duplication and unclear division of competences, as between institutions on the same level, so also vertically between different levels of government. No progress has been made in the direction of development of an expert and depoliticized civil service, and no improvements have been made in employment procedures in order to ensure application of objective employment criteria based on knowledge and quality.

The Public Administration Reform Coordinator's Office (PARCO) carries out coordination tasks, but on the technical level of coordination of different assistance instruments. PARCO's monitoring capacity is continuously weak due to a lack of adequate effect indicators for measuring progress in the realization of objectives set in the Public Administration Reform Strategy.

For the whole time this reform in B&H is lacking necessary political support. The European Commission points out that civil service capacities are weak with regard to harmonization with the EU acquis and implementation of commitments arising from the Interim Agreement and Stabilisation and Association Agreement. It is necessary to strengthen administrative structures in the country in order to efficiently respond to requirements for the process of accession to the EU. In a report from 2015 it is stated that the continued lack of comprehensive political support for reforms in the entire country and fragmentation of public services are endangering efforts to implement institutional and legislative reforms.

Lack of mid-term policy planning for the entire country represents a serious obstacle for development, but also for public supervision of the operation of governments. Government reports available to the public do not provide information allowing for comparison of what has been achieved with specific policy objectives. B&H does not have a comprehensive public administration reform strategy because the last one expired in 2014. There has been no progress in the preparation of a new strategy, mostly because of the lack of wider political support and strategic guidelines.

In the last report from 2016¹⁵ the Commission warned that B&H regressed with regard to amendment of the legal framework for civil service in the Federation and that politization and instability of the public sector increased. Once again, for the nth time, the Commission requests activation of political support for implementation of a comprehensive public administration reform. An agreement upon approach to policy making and coordination is urgently required. Certain elements of policy creation and drawing up regulations in an inclusive way and based on evidence have been introduced, but the quality of policy and legislative proposals needs to be additionally improved. Public consultations are defined by law, but are still not being implemented completely.

Without a quality arranged, fast and efficient public administration, clearly defined objectives based on joint work and cooperation not only between different levels of government but also all segments of society, the realization of B&Hs accession to the EU will not be possible.

4.3. Judicial system

In the reports the problem of inefficient operation of courts is pointed out, especially due to the existence of four parallel and separate jurisdictions (State, Serb Republic, Federation and Brčko District). Lack of financial resources required for the operation of the overall judicial system is pointed out. The need for reform of the judicial system is repeated year after year. Reform strategies are being brought, but implementation of measures is continually lacking. As of 2008 the Commission has been requesting establishment of a Supreme Court which would be able to harmonize the application of laws between four internal court jurisdictions because fragmentation of the judicial system and differences in legal frameworks, as well as the lack of a single budget are completely impairing the quality and efficiency of the operation of the judicial system.

Lack of political will and corresponding planning, insufficient distribution of human and financial resources, as well as poor coordination between competent institutions are making implementation of the Judicial Reform Strategy difficult. Progress has been made by enhancing the information system, and a digital approach to court cases is used in most courts. Better informatization has also led to acceleration, and the number of unsolved cases is reducing, but is still very high.

¹⁵ Full progress report for B&H from 2016 available at: https://ec.europa.eu/neighbourhood-enlargement/sites/near/files/pdf/key_documents/2016/20161109_report_bosnia_and_herzegovina.pdf

In the report from 2012¹⁶ it was stated that a new Handbook on Temporal Benchmarks for the operation of judges, expert associates and other employees at B&H courts, which has been significantly improved in relation to the preceding one has been adopted, whereby further steps have been taken for reducing the number of unsolved cases. The Handbook entered into force on 4th June 2012, and the last amendment was made in December 2015. In the following year the Commission stated that a proposal has been made for a Law on the Courts, planning the establishment of a State-level Appellate Court separated from the court of first instance, in line with recommendations of the European Commission and the Venice Commission of the Council of Europe. A positive step was taken with the introduction of a single human resources management system, whereby the efficiency of the judicial system in the procedure of appointment, planning and management of human resources has been strengthened. The judicial system infrastructure in the country has been improved. Thereby the Commission stated that in 2012 and 2013, unlike in the preceding years, partial progress in the improvement of the operation of the judicial system has been made.

In the report from 2015, the Commission still points out that because of the lack of a Supreme Court on state level harmonization of court practices between different levels of the judicial system is not ensured. It is pointed out that B&H must strengthen the mechanisms of responsibility and integrity, as well as modernize the education of judges and ensure complete access to court decisions. In March 2017 the Council of Ministers adopted an action plan for state-wide judicial sector reform strategy for the period 2014-2018, with new, adapted implementation deadlines. In the report from 2018 it is stated that the blueprint of the Law on Bosnia and Herzegovina

Courts should be finalized under the leadership of the Ministry of Justice of Bosnia and Herzegovina, in line with penal jurisdiction standards as defined by the Treaty of the Functioning of the European Union. The adoption of this law is needed to reinforce legal certainty and functioning of the judiciary, notably in the fight against serious crime.

Independence of courts and autonomy of prosecutors need to be further strengthened. Politically motivated threats addressed to courts and prosecutors must be detected in time and acted upon appropriately. The constitutional and legal framework with regard to protection of independence, impartiality and autonomy of judges and prosecutors is still weak.

¹⁶Full progress report for B&H from 2012 available at: https://ec.europa.eu/neighbourhood-enlargement/sites/near/files/pdf/key_documents/2012/package/ba_rapport_2012_en.pdf

4.4. Anti-corruption policy

In the first Progress Report from back in 2005, the need for harmonization of penal codes including chapters dealing with corruption, sanctions against corruption and measures for promotion of responsibility was established, and bringing of a strategy for fight against corruption and implementation of concrete measures requested. The first Strategy for fight against organized crime and corruption was adopted for the period 2006-2009, however, there have been no positive movements. Bringing of the Law on Conflict of Interest, Law on Public Procurement and Law on Value Added Tax was positive, however, anti-corruption legislation is not completely harmonized in the entire country.

The Commission is continually warning about the lack of concrete measures and a high level of corruption which is present on all levels of government as well as in the public and private sectors. Progress has been very slow the whole time, and adoption of a new Strategy for Fight Against Corruption for the period 2009-2014 and the accompanying Action Plan should have initiated significant changes and concrete implementation. Regardless of the new strategy, measures for fight against corruption are still not being adequately carried out. Corruption has a significant negative impact on all areas of life, economic development and the rule of law. Investors have no trust, and entrepreneurs are giving up expanding their businesses or undertaking new ventures. The Commission is continuously calling for implementation of the Strategy and the Action Plan.

During 2014 key laws relating to financing political parties, conflict of interests and approach to information were changed in the way that standards lower than preceding ones are applied, and therefore instead of a step ahead there has been regression. The Commission is warning about the lack of political will for a shift from words to actions, initiating efficient investigations and bringing convictions in highly-ranked cases. Corruption still prevails in many areas in B&H and represents a serious problem and an obstacle to progress, growth and development.

4.5. Respecting and protecting human rights and rights of national minorities

In this area, as in the area of fight against corruption, there has been no significant progress as of 2005. Implementation of laws and respecting and protecting human rights and rights of national minorities are insufficient, inter alia, because minority languages are not used in the administration, courts and education system.

The problem of no progress having been made in the reform of the Constitution of B&H is pointed out, and minorities are still excluded from the Federation House of Peoples and the Presidency. It is proposed that all three nations be included in bringing better and more efficient laws regarding the protection of human rights. The Constitution contains most of the principles from human rights conventions and guarantees that they will be above domestic legislation. In a number of cases

decisions of the Commission for Human Rights of the Constitutional Court of B&H were not properly implemented. This resulted in submission of complaints to the European Court of Human Rights. Implementation of Commission for Human Rights decisions is slow, especially because of entity governments' avoidance of compensating victims. Decisions of the Commission for Human Rights of the Constitutional Court of B&H have not been properly implemented in a large number of cases. Application of decisions relating to amendments to laws and other provisions is extremely slow because it requires coordination between different institutions.

Establishment of a National Minority Council on state level which has become operational represented a positive step ahead. The Commission is continuously recommending that implementation of the existing law on national minorities should be further improved on the state and entity level, and that increased involvement of minorities in the Federation House of Peoples and the Presidency is necessary. With regard to political participation of national minorities, amendments to the Election Law from 2008 allowed national minorities to have their own list of representatives. Certain progress in the area of minority rights, cultural rights and protection of minorities has been made, but they are still underrepresented in political life.

In the area of gender equality progress in the harmonization of entity and cantonal laws with the Law on Gender Equality is slow. In spite of increased financing, administrative capacities for ensuring gender equality on the state and entity/cantonal levels are still weak. This is preventing adequate monitoring and implementation of the Law on Gender Equality and the Gender Action Plan.

National minorities are still excluded from the state House of Peoples and the Presidency because they do not belong to the three constituent nations. No progress has been made in the implementation of the European Charter for Regional or Minority Languages. The legal and institutional framework for respecting human rights has been established, and the basic elements of international regulations on human rights have been incorporated in the legal system.

The National Strategy for Civil Society Development is in preparation, and the procedure for consultations with the civil society during the drawing up of legal regulations has been established, but is not being fully implemented. The legal framework for protection of minorities was mostly established by 2013, but practice and non-implementation are a problem. Numerous activities aimed at promotion of human rights, such as trainings for judges, prosecutors, prison guards and police officers have been undertaken.

Constitutional and legal guarantees regarding the freedom of opinion, conscience and religious confession are mostly respected. Cases of discrimination on a

religious basis are still being reported. Incidents concerning religious symbols, religious officials, believers and the property of religious institutions have been recorded.

In the last report for 2016 it is stated that during the reporting period certain progress was made in solving recommendations from preceding periods, especially in view of minority issues. Efforts in adoption of relevant amendments to anti-discrimination laws are visible. It is stated that it is necessary to significantly improve the strategic, legal and institutional framework, as well as policies for respecting human rights. The provision regarding the death penalty has not yet been abolished in the Constitution of the Serb Republic. As of September 2015, the European Court of Human Rights identified at least one violation of the Convention for the Protection of Human Rights and Fundamental Freedoms (ECHR) in three cases concerning the right to freedom, safety and non-discrimination. The decision-making body received a total of 383 new cases, after which the total number of unsolved cases reached 1027. The remaining unsolved cases mostly concern return of tenancy rights, missing persons and discrimination based on ethnic origin.

In the latest B&H Progress Report from 2018 it is stated that the Constitution of B&H, represented by Annex 4 of the Dayton/Paris peace agreement, has established a complex institutional structure which is still inefficient and subject to different interpretations. The Constitution of Bosnia and Herzegovina is preventing citizens who do not declare themselves as Bosnians, Croats or Serbs to run for the Presidency and the House of Peoples of the Parliamentary Assembly. No progress has been made in the implementation of rulings of the Court of B&H in the cases of Sejdić-Finci and Zornić. On 22nd December 2009 the European Court of Human Rights brought a verdict in the case of Sejdić-Finci based on a lawsuit by Derva Sejdić and Jakob Finci, who were prevented from being elected for the Presidency and the House of Peoples of B&H as members of national minorities (Roma and Jewish) because of the fact that they did not belong under the constitutional category of a „Constituent Nation“. In the lawsuit they claimed that this prevention constituted racial discrimination and a violation of Article 14 of the European Convention on the Protection of Human Rights and Fundamental Freedoms. In the verdict the Court stated that violation of the mentioned rights represents direct discrimination. On 30th November 2016 the Ministry of Justice delivered a proposal for an Action plan for implementation of rulings of the European Court of Human Rights to the Council of Ministers of B&H. The Council of Ministers of B&H has not yet implemented the decision. For a long time the EU set the implementation of that ruling as one of the first conditions which B&H must fulfil in order to be able to submit a plausible application for membership, however, after a series of failed attempts to solve this issue, it has been postponed for a later phase of B&H's accession to the EU. Equality of all three constituent nations, manifesting among other things in equal participation in all institutions and

decision-making processes, is of the key importance for development of B&H based on European values.

5. CONCLUSION

Bosnia and Herzegovina's progress towards EU membership is slow. The country is facing numerous problems, the most actual of which is the dispute concerning the Election Law and the *Sejdić-Finci* ruling which established that the Constitution of B&H is contrary to the provisions of the Convention on Protection of Human Rights and Fundamental Freedoms relating to election of members of national minorities to the House of Peoples and the Presidency. A reform of the election system is required, and the „Mostar“ case raised tensions due to the inability of electing local representatives.

The public administration reform is in an early phase, and adoption of a new strategic framework for the public administration and public finance management policy is necessary. The judicial system is also slow and subject to political influence and urgent bringing of an action plan for implementation of the justice system reform is called for, particularly because of questionable independence. Polarization and a negative socioeconomic position are affecting the creation and spreading of radicalism, especially among young people.

It is visible from all Progress Reports which the Commission has drawn up for B&H as of 2005 that political will and togetherness between the state and entity levels required to implement necessary changes are lacking. Thereby B&H is stagnating and standing still, which in the present time of fast changes and adaptations taking place in all countries represents a setback for B&H.

The objective is that B&H acquires the status of a candidate country by the end of 2018, however, it is facing a demanding, but not necessarily long way, and thorough reforms are required in order for B&H to completely transform into an efficient and functional country based on the rule of law which guarantees equality and democratic representation of all constituent peoples and citizens. The first step was made by delivering to the Commission a survey questionnaire containing 3242 questions on 28th February of this year, following which the Commission requested answers to additional 600 questions to be delivered within a deadline of 3 months, which relate to a great extent to political criteria. The content of the survey questionnaire serves as a basis for bringing the decision on awarding the status of a candidate country for accession to the EU.

The principles of federalism, decentralization and democratic representation, as well as implementation of efficient social and economic reforms must be the priorities on B&H's way to EU membership. The Enlargement Strategy is a clear message to political leaders in B&H that the speediness of accession depends upon

them. It is extremely important for B&H to use this opportunity and solve the issues regarding the Constitution and the Election Law and focus on economic strengthening of the country in order for it to be able to keep its young talents, attract others and raise the standards of developedness and economic and social excellence in order to be able to successfully compete on the EU Single Market as a Member State.

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EUROPEAN UNION INTEGRATION PROCESS AND ITS CHALLENGES FOR KOSOVO

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Review

Abstract

European integration is process that has rules which must be followed from all aspirant countries, as well as with a great dedication to the process. Kosovo and its integration into the European Union, has in front very difficult road to be passed. Main objectives of Kosovo is being member of European Union. To achieve that, threshold mentioned in articles 49 and 6 of European Union Treaty should be passed. Being part of European Union, Kosovo must respect all principles mentioned in article 6.

Function of rule of law system is very important for economic development of Kosovo and its integration in European Union. Even there exists commitment from Governmental institutions of Kosovo for empowering rule of law, problems and challenges that Kosovo faces in this field are complex and much more in number, and much more must be invested in all types of resources in order to achieve requested corrections. Legal system of Kosovo still can be described as one of the most complex systems and that represents obstructions for security and legal clearance. As multidimensional process, complex and dynamic, integration process is based in the fact that even European Union together with its institutional structures are in ongoing reforms. Reforms process is requested for the reason of continuously integrations processes of new countries in European Union structures. European Union today faces big challenges, in one side there is challenge of democratic, politic and economic control of candidate countries and in other side internal reforms for its own structures. Today, very important issue of Kosovo is European Integration process. Based in main objectives and achievements that Kosovo has made in this direction, large institutional commitment exists for this process. Especially there are many economic challenges for Kosovo including implementation of CEFTA Agreement, as pre-entrance instrument in European Union.

Keywords: *CEFTA, Kosovo, European Union, European Commission, Stabilization and Association Agreement etc.*

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1. INTRODUCTION

With its 28 member states, European Union is powerful force (for good intent) in the world. European Union is the biggest common market in the world, which makes $\frac{1}{4}$ of the total economic global production and $\frac{1}{5}$ of the world's trade. With more than 508 million residents, is the 3rd biggest market in the world as per residents, after China and India. 24 official languages and more than 60 indigene, regional and minority languages from the residents in the whole European Union. By being together as states in the continent, unseen historically to spread common values and common work benefits, especially in political and economic issues.

European Union works under the integration principle, known as vertical as well as horizontal. Vertical integration or Union creation, happens when member states agree to separate or to transfer their national competences in European Union level, by agreeing that policies can be implemented better in that level. For example, 19 of 28 member states, are using common European currency Euro, and 25 states (including 3 states that aren't EU member), have removed borders among them according to the Schengen Agreement. Horizontal integration or Union expansion, has to do with Union expansion to include other European countries as European Union members. This offer is opened, especially for Western Balkan countries. Until European Union deepens and expands, it continues to change and to get developed, by getting adapted for its member state's needs.

Moreover, European Integration is long process. Those countries that has aim to be part of European Union, must fulfill required standards, by sharing same democratic values, market based economic principles same as existing member states. Respective country must have functional market economy to challenge with competitors in the European Union level and the ability to implement tasks (not only benefit's) of being European Union member. Approval and approximation of national legislation and processes with levels and standards of European Union has nothing to do with translation and approval of a law, but more with a long time transformation process, during which candidate countries can learn how existing member states have acted, because by their self, they implement necessary reforms in order to make possible membership into the European Union.

As it is seen from the last European Union expansion processes, many countries of Central and Eastern Europe, like Malta, Cyprus, Bulgaria, and Romania and in recent time Croatia became member of European Union. Integration process is progressive and transformative. More than 66 years after the creation of the European Union, Western Balkan countries, by joining European Union, has become their main political objective. European Union is main partner of Kosovo. Today, European Union is the biggest foreign investor in Kosovo, and its main

trade partner, except offering half of international aid in Kosovo. As newest democracy in Europe, Kosovo today is advancing in its European Integration process, and continues to play key role in institutional and legal development.

2. EUROPEAN INTEGRATION PROCESS

One of the main objectives for Kosovo is being member of European Union. For such membership, threshold should be passed as it is set in article 49 and 6 of the European Union treaty, respectively Kosovo can be European Union country which respects defined principles in article 6¹. According to the article 6 of the European Union Treaty, there are basic principles on which European Union is created and that must be respected from each new member, which includes among all the principle of rule of law. Rule of law principle, restated in so-called “Copenhagen Criteria” of the year 1993, must be fulfilled from each state candidate, as condition for their membership in European Union. In fact, this principle, is one of the most fundamental principles of the European Public Right, and includes a number of concepts and other different conclusions. However, content of this principle can be taken out from a comprehensive analyze of the European Union member state constitutions and jurisprudence of the European Court of Justice.

Figure 1. European Integration Process



Source: Etias (European Automated Information System of Viagem)

¹ Karl Doehring: Allgemeine Staatslehre, Heidelberg: 2000, pp. 170.

Function of the rule of law system, is among the most important issues for economic development in Kosovo and its integration process in European Union. Even it exists as verbal commitment from Kosovo authorities for the enforcement of rule of law, problems and challenges which Kosovo faces in this field are very complex and they are more in quantity, and must include investments in many resources in order to achieve necessary corrections. Juridical system of Kosovo still can be described as one of the most complex systems which represents obstructions for security and juridical clearance. Processes for creation of primary and secondary legislation, requires more focus on the concept “politics before the law” and must be opened and by having more toward transparency and democratic participation, before any legislation is being approved. Kosovo needs security and juridical clearance, especially in sensitive fields known as property right, since only one juridical security, clearance and stability will create necessary framework for investments and entrepreneurship, which it is meant that Kosovo will generate necessary economic development and social stability. Well-structured juridical system can serve for its goals, only if it is administrated from regular and functional juridical system, which despite many efforts, still remain one the weakest pillars of Kosovo’s public institutions. Investments in human resources through better juridical education in both levels, academic and professional, presents the most important elements. Courts, especially Basic Courts, has the need for more care in form of better financing, as well as investments in infrastructure and human resources, because in opposite, capacities cannot be faced in successful way with bigger number of cases collected from the past years. Independent functionality of the Juridical Council of Kosovo is primary important issue for having positive results in juridical sector, but main challenge isn’t to secure just formal independence of juridical institutions, but substantial independence of judiciary from executive interventions, especially in budget field and administration staff. Despite difficult problems and challenges that are in great number, state of Kosovo and created presence of European Union in the field of rule of law, has the opportunity to undertake necessary reforms and to avoid possible mistakes that were made during Interim Administration of United Nations.

Rule of law known as “Rechtsstaat” or “Etat de Droit”, equivalent from German and French Constitutional Right, has general meaning which concludes that there must exist Law Government, not People government. First of all, this can be described as everything must be made as per law, especially every public authority, which takes any action, must be able to justify its actions that are authorized as per law (general principle)².

Second ascertainment of the rule of law principle is that public authorities must be in line with the rule and principle framework, which limits freedom power of taking actions, with the aim to prevent the misuse of such power. State candidates

² Wade, W, Forsyth, C, (2004), *Administrative Law*, Oxford

must have stable institutions, which can guarantee democracy, rule of law, human rights and respect and minority protection³.

Approximation and advancement of the relations between European Union and Western Balkan countries, including Kosovo, as process today is very important, based in final goal of those countries for being part of European Union. European expansion agenda will secure support for institutional reforms, financial support, economic reforms, market liberalization, also support for democracy and legislation consolidation in accordance with European standards. Some aspects or main mechanisms of cooperation and connection with Kosovo are: conducting mechanism of Stabilization and Association 2002, as instrument which involves Kosovo in European way, Thessaloniki Summit 2003 – reconfirmed European Union commitment toward Western Balkans, by promising European perspective, European partnership is important instrument of European Union in duties implementation and requests that were given from European Union toward Kosovo.

Yearly progress report is one mechanism, through which work and progress of Kosovo institutions can be seen. It is considered that reforms in accordance with European Union standards are one of the most effective measures for speeding and successful passing of transitional process and in the same time advancing the process of European Integration. Those objectives consist with action plan of European partnership, and also with Copenhagen Criteria for European Union integration⁴.

Western Balkans countries (Kosovo, Albania, Macedonia, Montenegro, Serbia and Bosnia and Hercegovina), are continuing to face different challenges, which are shown as obstacle and that do have impact in Brussel's hesitation about secure accesses that countries of this region can in faster way be part of European Union. Unsolved ethnic and among state cases of those countries, as result of post war, have impact in his process, and other challenges known as lack of legal sustainability, corruption, unemployment, organized crime, are causes that force European Union to have hesitant approach toward those countries.

In context with challenges that Kosovo had and continues to have, there are meanings that political achievements made in Kosovo are connected with a wide range of action fields in Kosovo's and International Institutions, both in local and central level. There are some integration challenging fields: building a healthy institutional basement, preparing legal framework and building respective structures, adoption of government efficient capacities in local level, creation of

³ European Community Commission: Communication of the Commission for European Parliament and Council, (2008), *Western Balkans: Correction of European Perspective*.

⁴ Copenhagen Criterias for European Union integration are: 1. Politics Criterial, 2. Economic Criteria, 3. European Standards Criteria – Eu Acquis.

healthy economic structures and successful management of the privatization process within the existing legal definitions.

Many people are considering this process as unreturnable. Within the wider plan, there is no doubt with the other candidate states, including Republic of Kosovo, that this integration process can be considered stable and unreturnable, despite being difficult to be foreseen in time. Preconditions for membership remains the same: strong state with effective state administration, strengthening of rule of law, improvement of economic growth conditions and expansion of regional cooperation⁵.

However, Kosovo in relationship with EU, have to deal with strong and perspective organization. European Union has achieved high scale of enlargement. After XXI century, European Union enlargement process is made toward Eastern and Southeastern part of Europe, and with final aim to include Western Balkan countries. Process of European Integration, has the aim to get expanded further more in the East of the continent. Integration or main objective of European Union, in continuous way, is the creation of serious economic cooperation order among countries. In later processes, goals are forced in political cooperation objectives, in security and culture field.

Figure 2. Kosovo and European Integration process



Source: KFOS (Kosovo Foundation for Open Society)

⁵ Preci, Z, (2013), *Integrimi European*, Tiranë,

From an initial organization in the frame of regional cooperation, European Union today is organization with wider dimensions of expansion in continental level and even more. As it is seen today, globalization processes and regional cooperation have helped each other. Globalization as process in great extent has intensified the need for regional cooperation of states all over the world and this cooperation is seen as opportunity to build good relations in business and economic field, and has in focus solving regional development problems, economic cooperation, searching of natural resources, free movement of people and goods, capital, labor force, etc.

Kosovo as new state, which pretends to enter European Union, faces same problems as their neighbors, and in other side, in great extent is facing political problems, especially in relation with Serbia, for known opened issues. But, agreements that are achieved in Brussels and which they regulate normalization of relations between both countries, are primary signal in the direction to create political stability in the region. However, agreements between both countries must be implemented in practice. Agreement implementation still remains concrete challenge, and dialogue continuation remains as perspective of building good neighborhood relations and de jure recognition between both states.

3. KOSOVO'S ECONOMY

In global policy, today is undisputable tendency of globalization process that slowly, but surely, is overshadowing dynamic development frames in world, with the aim of marginalization of organizational and management traditional forms in inhabitants life, as those processes got out as serious obstacles in integration process. In this context, is seen that trend of new competencies which flows from discourse values of state sovereignty, that for globalists is identified as "stocks" of special type, there isn't any characteristic exclusion when it is in question process of adding their global interests.

Biggest dilemma that exists today among globalization sociologists, is when those bigger changes are in question, is role and future perspective of state institutions. For developed countries, respective dilemma somehow is materialized through new integrated forms, and for developing countries, there is still stumble and hesitation as per role institutions as a part of competency transfer process in new regional integration forms. For Kosovars, in comparison with others neighbor nations, nature of internal issues, when building process of state institution capacities is in question, all over there are specifics that cannot be seen in any other development process of building state institutions in the world.

In Kosovo, since the case of building state institutions is still actual, mainly, in thick stripes, there are two quality rare specifics that can be identified and that nowhere else can't be find and that is the specific of elementary democratic infrastructure building and goals realization, for building such elementary

infrastructure with above mentioned institutional mechanism, which for other's has started to have changes and deep modifications in the form and its content for the reason of new globalization processes.

If we address to the permanent goal of Kosovars and that is building identification mechanism which can be used for new national identity, is gained impression that this process is identified not as need of commodity, for as existence of its citizens during the whole past century in new conditions and circumstances' of a process affirmed as globalism, then with no doubt it is required to understand new surrounding development trends. This way of access must be involved also for the historic delay that Kosovars have suffered not with their fault.

Figure 3. Economic growth level of East and Southeastern European countries

	2015	2016	2020
	3.0	3.0	3.4
Albania	2.7	3.4	4.2
Bosnia and Herzegovina	2.0	3.0	4.0
Bulgaria	1.7	1.9	2.5
Croatia	0.8	1.0	1.8
Hungary	3.0	2.5	2.1
Kosovo	3.2	3.8	4.1
FYR Macedonia	3.2	3.2	3.8
Montenegro	3.2	4.9	3.3
Poland	3.5	3.5	3.6
Romania	3.4	3.9	3.3
Serbia	0.5	1.5	4.0
Turkey	3.0	2.9	3.5

Source: IMF (International Monetary Fund)

At the end, it is better for the integrational process that this problem can be solved which includes also Kosovo. Sovereignty, even today has been attractive for the dominant majority of developed countries and for those in developing process, and discussion about those countries that are in transitional process and in process of state-creation as it is Kosovo's case, where interest of its citizens are connected with the desire and their long-term passion for having own state, where it can find its own explaining source and very identical with other neighbor nations.

4. KOSOVO'S CURRENT ECONOMIC SITUATION

In fact, Kosovo's economy, actually is in extremely conditions, first of all as consequence of catastrophic damages made by war and the dragging of privatization process, it cannot be revitalized and even less to secure necessary

phase of prosperity, without any “infusion” of foreign direct, indirect or portfolio investments. It is known fact that due to the demolition of economy during occupation period, Kosovo’s industry is reduced by falling in its pre-industrial phase, with heavy consequences such as unemployment growth especially among young people, and also for the existence of extremely poverty population.

Until February 2008, Kosovo didn’t gained yet it’s sovereignty and was under Interim Protectorate of UN, it’s development cannot lay in inflationary investments, but in foreign direct investments and investment loans from international financial institutions or financial capital of foreign banks. As conclusion, in law for foreign investments, as addition of foreign direct investments, investment loans must be included for international financial institutions and financial capital.

When whole this situation is seen in context with low level of economic development, with 40% of unemployment, GDP of about 2800\$, with unfavorable trade balance with other countries, where only 20 percent of import is covered by export and extreme poverty in which Kosovo population is reduced, clearly is seen that there are multidimensional problems that could prevent the solution for economic crises in Kosovo. Gross Domestic Product in Kosovo is about 2800\$ per capita, there isn’t any opportunity to increase it from other incomes, respectively to share a part of it in accumulation fund, to secure a well expanded economic development of country in transitional phase. When crises solving opportunities are discussed, the prosperity process will start in Kosovo in many aspects, by taking into consideration endogenous and exogenous factors, which determine the start of prosperity and the given solution for economic crisis.

Emerging from the crisis and so waited start of prosperity, the current situation cannot be supported beyond in declarative desires and with no base hypothesis, but in first row, in contexts with factual opportunities, in which current level of economic development of Kosovo can offer. Deep conviction that exists among citizens in Kosovo along with standards priority implementation, institutional independence must be forced, first of all as necessity that will help to achieve pretended economic development and start of prosperity during actual transitional phase. International economic cooperation of a country, is result of economic development level and economic structure development of respective country, region respectively. Therefore, Kosovo’s international economic cooperation depends on two main factors, who designates general frames, dynamic and main directions of this cooperation. Trade strategy of Kosovo must address also the connection with neighbor economies. Fee and non-fee obstacles from some neighbor jurisdictions have impact in negative way in Kosovo’s export, transit problems are added to the above mentioned issues, by increasing cost of imports and by reducing export competition.

5. AIM OF BEING PART OF EUROPEAN UNION

EU membership is seen as essential process for Kosovo's in further domestic and international development. EU membership is believed to bring economic, political and security benefits, which are essential for Kosovo's challenges. Kosovo has clear domestic challenges to deal before accession process might start, but EU has its own interests; the fight against corruption is with high importance along with the rule of law enforcement. It is in the EU's own interest to make Kosovo a success story and to secure a stable democratic state due to its geographical location. Due to Kosovo's problem with corruption and organized crime, a worst-case scenario for the EU would be a free trade zone for organized crime, traffickers and terrorists, and a return of conflict.

The EU's main focus has been in the past and it is actually to encourage Kosovo and Serbia to get focused in their European future; it has not sought to change the domestic situation inside Kosovo. Since 2012, there has been an intensification of the relationships between the EU and Kosovo, and there have been important developments of a practical nature, which increase Kosovo's duties fulfillment toward the Union. The Commission and The High Representative of the Union for Foreign Affairs and Security Policy, in recent time reported that Kosovo had met all short- term priorities set out in the feasibility study. The SAA is generally recognized as the first formal step for Balkan states toward EU membership. The SAA is an important milestone in Kosovo's European integration process. While this is a step forward for Kosovo, there are still great domestic and external challenges for accession into the EU. Besides the obvious ones of the Copenhagen criteria, and the relationship to Serbia, there are states within the Union, which do not recognize Kosovo's independence. These are obstacles that Kosovo will need to deal with them in the near future before it can start accession process into the Union.

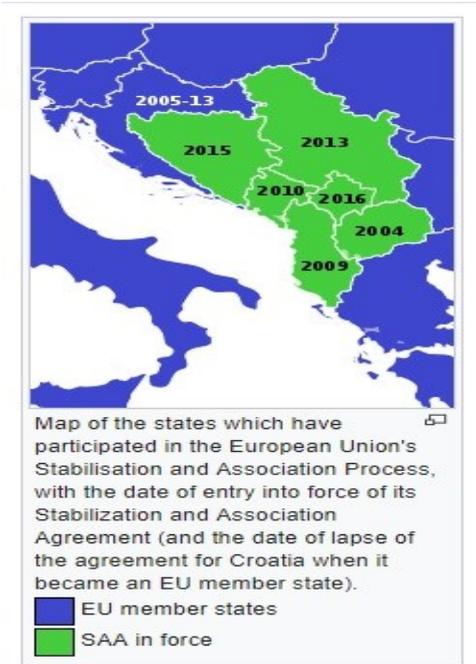
6. STABILIZATION AND ASSOCIATION AGREEMENT

In 2012, the European Commission declared Kosovo "largely ready" to start the SAA negotiations in the form of an EU- agreement, after taking some measures in the field, regarding the implementation of rule of law, public administration, protection of minorities and trade. Kosovo was proclaimed ready to open the negotiations and after signing of the first agreement, the European Commission concluded that Kosovo has addressed the aforementioned priorities. This can confirm that the external criteria's are more important than the internal ones. At least the short-term priorities were not sufficient on their own, signaling that the external criteria are more important than the reform and implementation of the internal criteria⁶. The "Commission considered that Kosovo has made serious

⁶ Sorheim, I, (2014), *Kosovo's present challenges*, Trondheim,

engagements and constructively in taking steps toward a visible and sustainable improvement of relations with neighbors”. As it is clearly shown, Kosovo has large domestic challenges which needs political commitment and a willingness to proceed with the implementation of policies. Obstacles that Kosovo is facing needs to be both overcome for an EU future and to secure a liberal democracy. It is essential for Kosovo’s domestic challenges and for EU membership that recommendations are implemented and enforced. As it is indicated, the implementation has not been the problem, but the challenge lies in actual change and enforcement of the laws in place. EU legislation and international standards should be implemented. Northern Kosovo is one of the most delicate problems, which still needs work and progress. Kosovo is obliged to protect minorities, and to promote a multi- ethnic society.

Figure 4. Conclusion of Stabilization and Association Agreement with Western Balkan countries



Source: European Commission

Kosovo will need to establish a free trade area where the four main Union policies are guaranteed, including free movement of goods, services and capital. Kosovo will further need to align its national legislation with EU rules, and cooperate more with the EU in certain areas; such as education, social affairs, culture and environment. While these are clearly set out as areas of cooperation, there is uncertainty regarding the EU’s role in the implementation of the first agreement in Kosovo.

7. COPENHAGEN CRITERIA

Political criteria conclude that Kosovo needs to achieve stability of institutions guaranteeing democracy, the rule of law, human rights, and the respect for the protection of minorities. The economic criteria related to the existence of a functioning market economy, and the capacity to cope with competitive pressure and market forces within the Union. Potential members need to implement EU legislation. There is also an additional criteria's for the Western Balkans, coming from the 1999 Stability Pact for South Eastern Europe and the Stabilization and Association Process, with a condition of regional cooperation and good neighborhood relations.

Normalization of relations between Kosovo and its neighbors is an EU requirement. The EU stated that this isn't new criteria for membership, good neighborhood relations have always been a demand for potential members. While the SAA negotiations began after the signing of the First Agreement, there are needs that can push forward further development of the relationship between Kosovo and its neighbors before accession process can begin. Kosovo still needs to fulfil key requirements, and deal with the challenges presented before. In spite of the accession process that has started, Kosovo has large challenges in front to overcome before it can achieve membership in the Union.

There has been a critical shift of preconditions that need to be fulfilled for EU integration. Especially the concern discussed above, the external criteria will become more important than the internal criteria. While they are both criteria's for EU membership, it seems more likely that the EU will focus mostly on the external criteria in the case of Kosovo. It even seems like the EU is going to demand more than good neighborliness and good regional relations.

Ministers Council and the European Council must act unanimously when taking enlargement decisions. One state could stop the accession process, if it believes that it might not be in its interest. The enlargement decisions are largely based on the Commission's reports and with recommendations. However, with the non-recognizers, Kosovo faces an extra challenge to its accession process. Potential members will only be permitted for membership when it is judged that their accession will have beneficial consequences for the whole EU.

8. EVALUATION OF FULFILLED CRITERIA

The European Commission issues a Yearly Progress Report. The purpose behind this is to develop and strengthen communication about the challenges that Kosovo is facing, and to recommend measures that the government should take in the view of accession to the EU. The government of Kosovo is committed for EU membership, and has adopted laws to make accession into the EU a possibility.

The problem for Kosovo isn't the adoption of laws, but their implementation and enforcement.

For EU membership, Kosovo will need to fulfil the Copenhagen political criteria, i.e., stability of institutions which guarantees democracy, the rule of law, human rights, respect and protection of minorities. It also monitors regional cooperation and good neighborhood relations. Already in 2009, democracy, respect for the rule of law, corruption, and the protection of minorities were set as priorities for Kosovo's progress toward the EU. Those are still the main challenges Kosovo faces today in terms of the political criteria, and its aspirations toward establishing a liberal democracy. As these are direct criteria's and requirements for EU accession, Kosovo will need to demonstrate actual willingness and improvement in these areas before it can make further steps toward the Union. Kosovo seems to have experienced a democratic setback in its efforts to build strong and independent institutions of democratic governance. There are several issues of serious concern, which could harm Kosovo's aspiration toward EU membership.

In terms of administrative independence, Kosovo has made little progress since the EU reports began, especially in terms of financial and administrative independence. Corruption is hindering Kosovo's progress in both democratization and economic development. The lack of transparency and accountability is a high concern issue, according to the 2017 Progress Report. Corruption and political interference are hindering professionalism, and Kosovo will need to demonstrate change in these areas. Overall, Kosovo must demonstrate actual change, and implementation of legislations in all areas. Kosovo has the lowest level of democratic processes and in national democratic governance of all regional countries. Freedom House ranks Kosovo as a semi- consolidated Authoritarian regime.

Both the Progress Report and Freedom House's findings, illustrate the challenges that Kosovo is facing in regards with the rule of law, and especially in terms of corruption. The situation is of serious concern, according to the Progress Report. For Kosovo admission to the EU, effective prevention of corruption in all levels of society needs to be have high priority level. When Kosovo signed the SAA, the EU held that it had met the short- time criteria. When it comes to accession into the Union, Kosovo will need to demonstrate concrete action in enforcing the Copenhagen criteria. The only concrete action that Kosovo has taken is the implementation of a legal framework in accordance with EU's standards and it has not demonstrated any actual enforcement or actions to improve the domestic situation. Kosovo will not be able to join the EU before necessary changes are carried out, especially in fighting corruption.

While this can possibly change with the First Agreement according to the 2017 Report. According to the Progress Report from 2017, the First agreement "represents a fundamental change in relations between the two sides". In the 2010,

in Yearly Progress Report, key priority was that Kosovo needs to offer delivery public services in the whole of Kosovo.

To join the EU, Kosovo will need to have full commitment for human rights. Kosovo will need to continue to cooperate according to the ad hoc agreements, and report regularly to the UN treaty bodies and the Council of Europe on human rights. During the period that the EU Reports have been issued, there has been limited progress with regards to the promotion and enforcement of human rights. The main challenges fall in the protection of civil and political rights. The Yearly Progress Report of 2017, holds that Kosovo's key challenge in relations to human rights is to "improve implementation of the existing legal framework and enforcement of decisions remedying human rights infringements.

Kosovo's challenges in the protection of human rights fall in the freedom of expression, protection of minorities, freedom of assembly, freedom of thought, conscience and religion, women's rights and gender equality, anti- discrimination.

While much of Kosovo's legislation on human rights is in line with international standards, Kosovo's challenge is the implementation and improvement of the actual situation. Kosovo remains reliant upon support from the international community in the area of protection of minorities. The difficulties that Kosovo is facing in regards to the protection of human rights, is great challenge for the development of a liberal democracy, but also is a direct hindrance for EU accession. To secure success, recommendations from international bodies should be implemented.

The other side of the Copenhagen Criteria is related to the economic situation. Membership in the Union requires existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union. Corruption and lack of clear political willingness, are seen as obstacles in the area of economic development. The high level of corruption and unemployment in this area are directly hindering membership. While foreign direct investments (FDI) are held to be the solution by the Kosovo's government, this will not happen with the high level of corruption. In 2016, FDI even declined to the lowest level since 2005, according the Yearly Progress Report from 2017. The weak level of rule of law and underdeveloped policy framework have continued to hamper the economy.

For EU membership, Kosovo will need to demonstrate full compliance with EU standards. To estimate a time frame for this process is impossible, due to the many challenges and incalculable variables in play. Kosovo clearly does not satisfy the Copenhagen criteria. Previous Progress Report describes Kosovo as far away from European standards. When Kosovo has signed the SAA, despite not having deal with all necessary challenges, it has sent signal that it has understood that it will not receive membership until actual changes have taken place. In order to fulfil the

Copenhagen criteria, Kosovo needs to make more efforts, and there is rapid need for radical change in the whole society, to roll back corruption, democracy strengthening and the rule of law.

Kosovo has a complicated relationship with the EU, as the country is committed for accession, but in the same time, lack of the political will have to act upon recommendations. As the indicators from the Freedom House shows that Kosovo has large challenges in its aspiration for EU accession. Due to earlier mistakes that were committed by the EU in previously member's admission, Kosovo needs to demonstrate full compliance with EU standards. Bulgaria and Romania waited 12 years for membership after their application, but this still is perceived as too rapid. Rapid accession to the EU, have experienced difficulty in intervening in a country's internal politics once it has become a member. This means that Kosovo needs to demonstrate political acceptance and willingness along with enforcement of the recommendation to show progress in its aspiration to gain EU membership.

9. DIFFICULTIES FOR KOSOVO IN INTEGRATION PROCESS

With the difficulties that Kosovo is already facing in its accession process, there are other factors which could delay it even more. Due to Kosovo's domestic challenges and its small size, with few available resources, the benefits for the EU are minimal. Kosovo's membership to the EU is unlikely without domestic improvement, due to the costs in terms of political tension, weak democracy and corruption. There are few benefits for the EU to accept Kosovo as a member to the Union. For membership Kosovo would need to maximize the perceived benefits, and minimize the cost, i.e., fight corruption.

In terms of getting accepted as a member of the Union, the clearest external obstacle is the resistance of states within the EU, which have not recognized Kosovo's independence: Spain, Greece, Slovakia, Romania and Cyprus. The five non-recognizers within the EU have prevented further advancement of Kosovo on the international scene. The position of the non-recognizers within the EU has weakened Kosovo's claim, and led to the lack of recognition from the EU as a legal entity. But the biggest obstacle is their ability to hinder Kosovo from joining the EU, if it by a miracle did fulfil the Copenhagen criteria. In order to be accepted into the EU, Kosovo needs full recognition and a consensus within the Union. This could then evolve into a situation where these five could block Kosovo's membership.

The prospect for success is also limited. The normalization of relations is essential for EU membership, as the Union clearly does not want to import internal security problems. Cyprus accessed the Union at the same time when the authority of the government wasn't extended to the Turkish territory, and the EU has made it clear in which such the same situation, will not be permitted for Kosovo.

Without the signing of the First agreement, Kosovo doubtfully would have received the SAA. It is further held that such a new criterion should not have been added, and Kosovo's way into the EU should be negotiated separately from that of Serbia. To prevent further problems in for Kosovo's road toward EU membership in the external criteria, the term of normalization should be defined, with a official time frame for this announced.

a. Relationship's with European Union

Despite the lack of diplomatic recognition, Kosovo has started the SAA negotiations, it remains unclear if this agreement will be ratified by all of the Union members once it is finished. Non- recognition of Kosovo's independence could prolong the accession process even more. The EU has for now set aside Kosovo's domestic challenges, and chosen to focus on the external one, and the normalization of relations with Serbia. But it is certain that the Copenhagen criteria will serve as the basis for Kosovo's accession into the Union. Kosovo is the only state in the region, where the path toward EU membership is not based on a contractual agreement.

EU has not fulfilled its promise to Kosovo, as it was led to believe that it would receive visa liberation for the technical dialogue with Serbia. Originally the requirements for the SAA and visa liberation overlapped with each other. This is an indicator of the challenge it's facing in its aspiration to obtain membership and the difficulties, which lie ahead. While the domestic challenges were put aside for the SAA, it has not been put aside for the visa liberation. This situation also shows the incomplete EU policy on Kosovo. Taking into consideration the challenges of corruption and lack of economic development, and the absence of a clear EU position and lack of recognition, this could be an optimistic view.

10. CONCLUSION

In order to become a fully recognized member of the international community, and to enter the EU, the prerequisite for Kosovo is to develop a liberal democracy. This is clearly set as a criterion for potential EU candidates, and it is in Kosovo's own best interest to function as a liberal democracy if it is going to be accepted into the international community. Kosovo has today no prospects of being admitted into the UN. Today there are 115 states that recognize Kosovo's independence. As this thesis has shown, Kosovo's disputed statehood is known above all as a political problem, and not a legal one. Kosovo is in the unusual position of having been neither effectively accepted, nor rejected, by the international community at large.

Kosovo's domestic challenges are a direct obstacle for EU membership. The implementation of EU legislation has started. Some recommendations have been followed up upon, but the EU demands actual enforcement and a willingness to

change. The main challenges lie in the same areas as in the establishment of a liberal democracy, the rule of law, economic development, and stable political institutions. An additional challenge to Kosovo's aspiration to gain EU membership is the lack of legal recognition from some of the members of the Union itself. However, it is clear that accession into the Union will not depend solely upon the EU, but for membership in the EU, Kosovo will need to intensify its campaign against corruption and show progress on all the required criteria. It will take much time and effort for Kosovo to improve its record on the domestic aspects of EU requirement, and not least, willingness for the politicians. So far, the requirements are not satisfied. To have any chance of achieving accession into the EU, above all, domestic change is needed. Kosovo is facing challenges and becoming a state based on the principles of democracy, the rule of law and human rights.

Kosovo is not a country based on democratic values, nor is it a system of parliamentary democracy despite the reassurance in the constitution. Corruption and the homogeneous political system are undermining the democratic system and the core foundation of a liberal democratic state. The political system needs to have a liberal character, which is defined by the rule of law, toleration, a commitment to equality, and the protection of basic liberties of speech, assembly, religion, and property.

Today, Kosovo is described as a corrupt polysepalous oligarchy. Democracy entails other crucial elements, such as multi-party elections – this has been realized only superficially in Kosovo where there is no real choice in politics. The lack of separation of powers is hindering the development of a stable democratic state. Corruption is undermining all functions of the state, and is a threat to the stability and sustainability of Kosovar institutions. Economic development will not take place until corruption is dealt with; this entails enforcement of the legal framework in place. To have a functioning democratic state, a certain degree of economic prosperity is necessary. Unemployment, poverty, and the trade deficit need to be prioritized if Kosovo is to move forward. According to the World Bank, corruption and bribery remain a key factor deterring companies from investing in Kosovo. Corruption is an obstacle to attracting investment, hence is a obstacle for economic development. The fight against corruption and organized crime is one of the key criteria for Kosovo's further European integration.

Kosovo's key challenges are to implement and enforce the existing legal framework, especially to enforce decisions remedying human rights infringements. In order to ensure the development of a liberal democracy the focus should be on integration rather than segregation of the Kosovar Albanian and Kosovar Serb population. All of these are essential factors in the development of a democratic life.

Kosovo faces large challenges in the development of a liberal democratic state. It is of outmost importance that it accomplishes change and improvements economically and institutionally. Programmatic pluralization in politics needs to be pursued, along with the establishment of the rule of law. It should secure a liberal character by guaranteeing individual rights, equality and the protection of human rights, all of which are essential for a liberal democracy, Kosovo needs to develop a political system, which is defined not simply by free and fair elections, but also the rule of law, toleration, a commitment to equality, and the protection of basic liberties of speech, assembly, religion, and property. To tackle the domestic challenges is essential not only to liberal democracy, but also for the political and social stability which Kosovo needs to move forwards – both into the international community, and in its aspiration on joining the EU.

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**EUROPEAN INTEGRATION AND GOVERNANCE –
CHALLENGES AND PERSPECTIVES**

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Review

Abstract

European integration is largely seen as a process that has delivered stability and peace, as well as the economic prosperity of the Member States of the European Union (EU). It has helped to raise standards of living and build an internal market. But, there are more and more arguments that the EU decision-making system is not effective and the governance model is obsolete. Some are pointing out increasingly rising divergence on crucial EU policy matters. Others are arguing that the EU has been confronted with the challenge of heterogeneity, stressing the issue of immigration as the one of the most contentious policy matters currently facing the EU. Besides those controversial issues inside EU and different positions among member states there is Brexit.

The paper analyses in particular the issue of EU economic governance and one of its main pillars – the European Semester. The Country Specific Recommendations, as the integral part of the economic governance model are presented in a view of the new framework envisaged to tighten budgetary coordination and keep the deficit and debt levels in accordance to the EU rules.

Keywords: *European integration, EU economic governance, European Semester, Country Specific Recommendations*

JEL: O52

1. INTRODUCTION

We – Europeans are living in the challenging world. There are so many issues that have confronted the process of the European integration. The new EU economic governance architecture that has been introduced after the financial and economic crisis is questioned in the light of the new developments. While the EU policy-making is getting broader agenda of cooperation, with almost no policy domain untouched, the results of the economic governance are not encouraging. On political front there is a huge distraction caused by the one country (United Kingdom) leaving the membership of the European Union. Therefore, today is more than ever appropriate to challenge the issues of the European integration and governance.

In accordance to the developments of the EU research this work firstly starts with the analysis of the European integration. As the second phase of the research on the European Union that occurred in early 1990s was completely oriented to the analysis of the EU governance process, the second part of this paper is devoted to the EU policy-making process. The main intention of the work is to analyse the European economic governance system and its main coordination instrument so-called the ‘European Semester’(ES) with the associated Country Specific Recommendations (CSRs). Therefore, the third part of the paper is about the European Semester and the CSRs.

The concept of the European integration is presented to be followed by the analysis of the main actors of the EU integration and the institutional framework. Also, the historical development of the integration process is given in a form of the short overview. The issue of the European economic governance, especially the coordination and supervision of the fiscal policy is in the main focus of the work, as it is crucial for the further integration process. Third part is devoted to the implementation and effectiveness of the Country Specific Recommendations. Lastly, some conclusions are drawn upon.

2. EUROPEAN INTEGRATION

It is definitely true saying of Diez and Wiener (2018) that “There is surely no shortage of books on the European integration (EI)”. After analysing the literature on the European integration one should agree that it is a booming field and it is difficult to make a selection of the appropriate literature as they are growing continuously. The vast majority of literature is dealing with the economic integration of countries and regions. This is still remained an intensely debated topics, both from a theoretical and empirical point of view. Theoretical discussions are essentially articulated around the concept of convergence/divergence in per capita income, as well as the possible trade-off between efficiency at country level and inequality at regional level.

There is also considerable part of the EI literature that has in the main focus process of institutional-building and political integration at the European level. Most of the studies recognized existence of the two inter-related processes at the European level. First one is in regard to the policy competences that are delegated to the supranational level to achieve particular policy outcomes. The second one is related to the creation of the new bodies and institutions at the European Union level. Goetz and Mayer-Sahling (2009) comment that is a completely “new set” of political institutions with executive, legislative and judicial powers that have been established. The governance issue was recently introduced in the EI literature and more on the way how the power is exercised in the EU, having focus on the policy-making process.

At the beginning of the research on the European Union the primarily focus was on the explanations of the European integration process - the process where national sovereignty is transferred from domestic level to the European level (Diez and Wiener, 2018). Later on in the beginning of 1990s the governance issue started to dominate at the academic level. The studies that resulted from the research were more oriented to the policy analysis in order to explain the process of policy formulation and its implementation. That development coincided with and was stimulated by an increase in European level policy-making competencies of the Single European Act¹ and the single market. As the European governance has developed over time it was evident that the concept included more and more areas of EU policy-making activities (Kohler-Koch and Rittberger, 2006).

The last decades were also characterized by the development of different integration theories that have emerged after the first attempt to explain the EU integration done by functionalists and Monnet. Rosamond (2016) argues that “all important theories² of the European integration generate multiple perspectives on the practice of the integration. Earlier integration theories were focused usually only to the one research objective - how to explain a state’s decision in favour of supranational institutional building. Today the most of the European integration research topics deal with the work of the EU’s formal institutions or with some particular policies”. But, as Diez and Wiener (2018) conclude “the concise overview of the integration theory still remains rare”. The reason is caused by the changing environment and the changing substance of the process, so any attempt to conceptualize the integration theory as a ‘mosaic’ that is constituted by a range of

¹The Single European Act (SEA) was the first major revision of the 1957 Treaty of Rome. The Act set the European Community an objective of establishing single market by 31 December 1992.

²Those are: neo-functionalism (Hass, 1958, Lindberg, 1963), inter-governmentalism (Hoffmann, 1966, Taylor, 1982), federalism (Spinelli, 1972), liberal-intergovernmentalism (Moravcsik, 1998), multi-level governance (Marks, Hooghe and Blank, 1996), historical institutionalism (Sandholtz and Stone Sweet, 1997), and sociological constructivism (Risse in Diez and Wiener, 2003).

distinct theoretical standpoints rather than a ‘grand theory’ would be the most suitable approach (Wiener, 2018).

In order to capture different aspects of the European integration process the elaboration of several elements need to be done. Firstly, the short historical overview of the development of the process of European integration is presented. Then, the institutional framework and main actors are reviewed as they are necessary for understanding the EU governance model.

2.1. History and the main characteristics of the process of European integration

The formal start of the process of the European integration was marked by the year 1951 when the six countries agreed upon the creation of the European Coal and Steel Community (ECSC). The so-called Treaty of Paris was signed on 18 April 1951 and came into force on 25 July 1952. It was for the first time that six European States agreed to work towards integration. The Treaty laid the foundations of the Community by setting up an executive known as the ‘High Authority’, a Parliamentary Assembly, a Council of Ministers, a Court of Justice and a Consultative Committee. The founders of the ECSC were clear about their intentions for the Treaty to be the first step towards a ‘European Federation’. The common coal and steel market was gradually extended to other economic spheres.

The next event was also signing of another treaty – Treaty of Rome that was signed in 1957. With that Treaty the European Economic Community (EEC) was established and the European Atomic Energy Community. Unlike the ECSC Treaty, the Treaties of Rome were concluded for an unlimited period of time. Later on, in May 1992, the Maastrich Treaty was signed. It was important as it marked the beginning of a ‘new stage in the process of creating an ever-closer union among the people of Europe’ by giving the previous communities a political dimension. The Treaty covers issues of Economic and Monetary Union and regulates coordination of economic policies of Member States (MSs). The multilateral surveillance of this cooperation and financial and budgetary discipline were also introduced.

Besides the Treaties the European integration is also characterized by the enlargements of the countries. After the original six countries in 1973 three more countries (Denmark, Ireland and the United Kingdom) joined the EC. In 1981 Greece became the new member of the EC, marking the start of a decade of increased expansion and integration. Portugal and Spain become EU members in 1986. The biggest enlargement was in 2004 when ten new countries joined the EU- Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. In 2007 Bulgaria and Romania become the 26th and 27th members of the EU and on June 1, 2013 Croatia joined the EU. The main important events of the European integration are elaborated in the following table (Table 1).

Table 1. Timeline of the European integration (EI)

Year	Event
1951	The Treaty of Paris is signed by Belgium, France, West Germany, Italy, Luxembourg and the Netherlands (the 'Original Six'), creating the European Coal and Steel Community (ECSC).
1957	The Treaty of Rome is signed as the first step towards establishing the common market, customs union and free movement of capital and labour. The European Economic Community (EEC) is established.
1958	The first European Commission takes office.
1965	The Merger Treaty is signed in Brussels. It merges the executives of the ECSC, EEC to become collectively known as the European Communities (EC).
1973	Denmark, Ireland and the United Kingdom formally join the EC.
1981	Greece becomes the 10 th member of the EC.
1986	Portugal and Spain become members of the EC.
1987	The Single European Act (SEA) comes into force.
1992	The Maastricht Treaty is signed.
1999	On 1 January, the Euro is launched as the official currency in 11 out of the 15 EU MSs.
2004	On 1 May 10 new countries joined the EU (Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia).
2007	Bulgaria and Romania become the 26 th and 27 th members of the EU on 1 January.
2011	European Semester was introduced
2013	Croatia becomes the 28 th Member State of the EU.

Source: based on www.civitas.org.uk/content/history

It is evident that the dominant feature of the European integration is about signing of the different treaties. Namely, the European Union is based on a series of treaties, pacts and agreements which have increased over time. The second characteristic of the European integration process is connected to the issue of the membership. The growing number of the Member States and enlargements shaped the European integration process that has tended to occur in waves, particularly accelerated since the early 1980s.

For Schimmelfenning (2018) the history of the European integration is a story of growth. From its initial specialisation in coal and steel industry it developed in several areas. The European Union's roots, as well as start of the European integration were situated within the post-world war II context. At that time, the integration was indicated by the move towards founding the ECSC, and "motivated by the need to prevent future security threats based on the means of economic collaboration" (Wiener, 2018). These two industries had a key role and initiated

regional collaboration that was based on a strategic decision to build and preserve a peace. The enhanced economic collaboration in other sectors appeared later on as it was agreed with the Single European Act.

The Schumann declaration led in 1951 to the European Coal and Steel Community among six countries (France, West Germany, Italy, the Netherlands, Belgium, and Luxembourg). The ECSC was then used as the institutional template for two proposed communities (the European Defence Community and the European Political Community) which included the formation of a common army, a common budget, and common institutions with significant legislative and executive powers. For Moravcsik (1999) it would have basically amounted to a European federation. Next important date occurred in 1955 when few politicians, including Jean Monnet, created an ‘Action Committee for the United States of Europe’. Alesina and Perotti (2004) state that the “attempt to integrate European defence and foreign policy was not finished successfully”.

The Treaty of Rome (1957) expresses in its preamble the necessity for Member States “to strengthen the unity of their economics and to ensure their harmonious development by reducing existing differences. This clearly communicates the willingness to contain (regional) disparities from the very start of the European integration process.

In 1987 the Single European Act (SEA) comes into force and modifies the Treaty of Rome with the aim to complete the formation of a common market. The national vetoes are abolished by introducing Qualified Majority Voting (QMV) in the Council of Ministers for areas relating to the single market (based on ‘four freedoms’). The SEA was the first commitment by Member States to create ‘European Union’.

In 1992 the Maastricht Treaty was signed. It turns the European Community into the ‘European Union’ (EU)³. The Treaty also introduced the principle of ‘subsidiarity’⁴ stated that “in areas which do not fall within its exclusive competence, the Community shall take actions, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed actions cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale of effects of the proposed action, be better achieved by the Community⁵”. The principle of ‘subsidiarity’ is also a key pillar of European governance architecture and made full use of the advantages of diversity within the EU. All those events in

³The Treaty includes developments for monetary union and a chapter on social policy. It also introduced the concept of EU Citizenship, which give Europeans the right to live and vote in elections in any EU country. The Treaty is also relevant as it reorganised and redefined the European institutions.

⁴Article 3b of the Treaty.

⁵<http://www.eirtreatoes.com/maastricht>

the history of the European integration can be called as ‘critical junctures’. They marked the way how the process was shaped and dictated further development not only at the EU level but also at the national-state front.

For Spolaore (2015) the process of the European integration is all about successes and failures. “The history of European institutional integration started with an early success (the formation of a coal and steel community, proposed with the Schuman declaration in 1950 and established with the Treaty of Paris in 1951), and a dramatic failure (the collapse of the defence and political community in 1952). Those two different experiences motivated the subsequent strategy of the European integration” (Spolaore, 2015). The failures have a special attention for Spolaore as they are “keys to understanding the beginning of the integration process, its setbacks, and the following path of European integration”.

Alesina et. al. (1997) see that the trade-off between costs and benefits is central to the political feasibility and stability of European integration. Potential benefits from full political unification include economies of scale in the provision of federal public goods (such as defence and security). Accordingly, Spolaore (2015) argues that the main issues lie in a general problem of the political economy: the trade-off between costs and benefits when heterogeneous groups are politically integrated under a common authority. Namely, “the formation of a European federation across heterogeneous populations, which share diverse social and economic structures, languages, cultures and identities, would come with several benefits, but also with high costs”.

Namely, they state that the “political unification comes with significant costs when various groups speak different languages, share different cultural norms and identities, and have different preferences for public policies and institutions “(Alesina et. al., 1997). The highest form of economic integration is a single market in which all producers and consumers are governed by the same rules and treated equally. If countries within a single market agree to coordinate their economic policies than is a case of the economic union, while in the event that countries within a single market agree to common policies in almost every sector one can speak about political union.

Caporaso (1998) concludes that in order to anticipate the future of the European integration it is necessary to understand the past events that shaped the process. He added “that the subject matter of the European integration is inherently dynamic and involves changes over time in the structure of supranational governance. To develop coherent explanations of constantly moving phenomena presents a daunting challenge.”(Caporaso, 1998)

Spolaore (2015) elaborated issues of heterogeneity and points out that “the creation of layers of distinct and overlapping jurisdictions, each organized around a subset of public functions and policies with different economies of scale and heterogeneity costs, faces limitations and challenges both in terms of economic

efficiency and political stability.” Different populations with different histories, cultures and identities are likely to disagree over the type of government in charge of such a federation, so heterogeneity could be reason to explain failures to integrate in the past and that the “realistic supporters of European integration understand that convergence of political preferences through reduction of linguistic and cultural barriers, will be a slow and gradual process, which should take place naturally and consensually” (Spolaore, 2015). As a result, heterogeneity of preferences is mostly beneficial when people interact about rival goods but costly when sharing non-rival goods. The European integration has been much more successful when fostering economic exchanges and a common market, while it has stalled when attempting to pool ‘federal’ public goods, such as defence and security (Spolaore, 2015). Therefore, the idea of the European federation with its own budget and redistribution policies that could provide insurance against asymmetric shocks was accepted. A later on a growing literature has explored the links between measures of heterogeneity and political outcomes, such as the provision of public goods, the extent of redistribution, the quality of government, and the likelihood of civil and international conflict.

Some authors distinguish different dimensions of the European integration. Schimmelfenning (2018) is speaking about so-called sectoral integration that refers to a process through which policy areas or sectors are regulated at the EU level. There is also another dimension of the integration often called as a vertical integration. It is mainly about the distribution of competencies between the EU institutions. One can speak about a horizontal integration that refers to the territorial extension of sectoral and vertical integration. That integration is commonly accepted as the ‘EU enlargement’.

Lastly, as another relevant feature of the European integration the matter of complexity is put forward. The complexity is caused not only by a big cast of actors (including governments, technocrats, interest groups, and voters), who in turn pursue a range of economic and political goals. The complexity of the institutional framework is also evident especially at the EU level where a new institutional constellation has been established. The several new institutions and bodies have been either established or substantially strengthened. Also some new roles have been given to parliamentary bodies. The reforms of European governance led also to an adaptation of the institutions, especially European Commission.

2.2. Main actors and the institutional framework of the European integration

The European Commission is in the centre of the process of the European integration and as Bauer and Becker (2014) state “It is powerful player in the European governance system. The Commission is an independent body and has an exclusive right of initiative”. Namely, the Commission has a supranational

executive's role in financing stability support, economic policy surveillance, coordination of national policy and supervision of the financial sector. In accordance to the Treaty the Commission role is to promote the general interest of the Union and take appropriate initiatives (Article 17 TEU). The Commission is also responsible for ensuring the application of primary and secondary EU law, executing the budget and managing programs, as well as exercising coordinative, executive and management functions. Its authority varies depending on the decision-making procedures governing the respective policy field.

But, its primary role is changing. When the European stability architecture emerged, its competences grew more complex. Commission expertise is employed at various stages in the process of granting financial assistance, mostly along with the European Central Bank (ECB) and IMF (so-called *troika*).

Bauer and Becker (2014) argue that “while the EU agenda-setting power is decreasing most decisions in economic governance depend on the Commission to make them work”. The governance architecture of financial stability support involves the Commission in various capacities. It proposed decisions on granting assistance, negotiates conditionality agreements and monitors compliance. The Commission in liaison with the ECB (and where appropriate with the IMF) also monitors the implementation of the adjustment programmes. It also examines changes to the adjustment programme and if observes significant deviations it makes proposals on the further steps. For Bauer and Becker (2014) “the Commission fulfils crucial tasks in all phases of the particular policy cycle”.

In regard to the national institutional framework involved in European integration and governance De Streel (2013) observes that was initially ‘relatively simple’. Namely, the EU requirements in that regard were mainly related to the provision of statistics and were minimal. There were also no clear sanctions if the Member States manipulated with statistic data. Such situation existed until 2009 when a new regulation on national fiscal statistics was adopted. A year later was revised, besides other things, to increase the investigation power of Eurostat. In 2011 with the introduction of the European Semester and ‘Six-pack’ the minimum quality for the budgetary framework defined as ‘the set of arrangements, procedures, rules and institutions that underlie the conduct of budgetary policies of general government’ was introduced. Thus, all Member States must have in place public accounting systems, subject to internal control and independent audits, adopt realistic macroeconomic and budgetary forecasts and establish a credible, effective medium-term budgetary framework⁶.

The European integration has achieved results which would not have been possible by individual Member States (MSs) acting on their own. Membership of the European Union confronts government with a set of particularly testing

⁶Article 5 Regulation 473/2013

organizational and managerial challenges. On one hand it requires abilities to form coherent national positions in the EU decision-making. On the other, the EU accession calls for institutional-building, supplant of new institutions that embody a new type of organizational culture and new way of policies.

The role of directly elected European Parliament (EP) is rapidly changing as it is taking a new tasks becoming a co-legislator. Through the co-called co-decision procedure a number of regulations and directives need to be adopted by both the Council and the EP before they become binding ‘legislation’.

The process of policy coordination within the European integration was link to the deliberative and consensual quality of EU decision-making. “Deliberation and consensus-seeking have long been taken as the behavioural hallmarks of supranationalism, but in the post-Maastrich period they have imposed themselves as dominant norms regulating the relations between national actors” (Bickerton, Hodson and Puetter (2015)). European Council is a deliberative and consensus-building body per excellence.

There are also some newly created institutions that are established and have autonomy (by way of executive or legislative power), as well as a control over their own resources. They fulfil certain functions and have a mechanism for the Member state representation as a part of their governance structure. Those new institutions include the European Central Bank, the European External Action Services (EEAS), the European Stability Mechanism (ESM) and numerous regulatory and executive agencies.

The process of the European integration has evolved through times, following by the evolution of the European governance especially over the last decade. De Streel (2013) describes it as a ‘remarkable process’. The establishment of European economic governance is mainly based on the Treaty on the Functioning of the European Union (TFEU) and regulations adopted by the Council while the implementation relies mainly on recommendations proposed by the Commission and adopted by the Council. “Those recommendations do not have direct binding effect as their violation cannot lead to an infringement case at the Court of Justice. However, they have indirect binding effect as their violation may lead to an investigation and the imposition of sanctions by the Council” (De Streel, 2013).

Co-ordination between actors is built into the Treaty for economic, fiscal and employment policies with a system of guidelines and multilateral surveillance. The Council assumes a key role in relation to coordinating processes. Hodson and Maher (2000) state “the Commission’s role of analysis, neutrality and synopsis is different from the one under the classic Monnet method, but also weakened with its agenda-setting function”. The Commission can trigger a number of procedures, but in the form as a recommendation and not proposal. There are opinions that the

Commission is gradually losing political clout, while several authors (like Bauer and Becker, etc.) are on contrary arguing that the role of the Commission has been considerably strengthened after the latest financial and economic crisis.

In the time of crisis, the role of the Commission was not very visible, but after the crisis “in the reformed economic governance architecture its role has changed and has been more strengthened”. Due to the new given responsibilities the Commission has been in charge for the implementation of numerous reforms. Bauer and Becker (2014) state the Commission “has been entrusted with ever wider and deeper implementation tasks that are of the high political importance”. Also, several new developments happened after the financial and economic crisis and influenced that the overall European integration setting was changed. The EP has been empowered and “progressive political leadership by the European Council and proliferation of new regulatory institutions has been influenced at new power settings” (Bauer and Becker, 2014). The power relations between institutions also changed due to the differences within the certain policy area.

3. EUROPEAN GOVERNANCE

The dominant feature of EU governance is a ‘community method’ for which Scharpf (2003) used the term ‘joint-decision mode’. Such a method is characterised by a strong role of the European Commission in the formulation and execution of Community legislation. All legislation is adopted by the Council of Ministers, but before a Council of Ministers several committees discuss and work out to find compromise solutions. For some authors (like Hodson and Mahler, 2001) as a reaction to the imminent risk of deadlock in Community decision-making the ‘new modes of governance’ were introduced so called the ‘open method of co-ordination’ (OMC). Such a method of governance was established by the Maastricht Treaty⁷ as an instrument destined for the co-ordination of national primarily economic policies through the use of recommendations and guidelines. It departs from the Community method (of legislating through regulations and directives) relying on ‘soft law’ which is not legally binding and has no legal sanctioning mechanisms against non-compliance. OMC is about ‘benchmarking’, ‘peer review’ and ‘best-practice’. The underlying assumption is that participating actors can learn from assessment and comparison (Eberlein and Kerwer, 2004).

Lebessis and Paterson (1998) are of an opinion that the open method is being focused on horizontal learning processes and peer pressure where individual action runs counter to broadly accepted principles. They also see OMC as a “dynamic process and decentred as *modus operandi* without any particular rule or single policy objective as an objective”. Swyngedow (2004) argue that “since the rules

⁷ The OMC was officially introduced in May 2000 at the Lisbon European Council.

and practice of participation do not guarantee equality between actors the multitude of actors is still far from promoting EU democracy’.

Another element of EU governance is its multi-level nature. The concept of ‘multi-level-governance’ (MLG)⁸ represents a system of continuous negotiation among governments. It assumes that decision-making authority is not monopolised by the governments of the MSs, but that is diffused to different levels of decision-making. European policymaking is also characterised by specific features that distinguish it from policy-making at national level. These features are linked to the institutional structure of the EU and its role vis-à-vis the Member States.

The EU itself has no competences to implement policies directly. The implications are that the EU is dependent on national governments for policy implementation. Therefore, Tommel and Verdun (2009) conclude that the European policy-making often ‘entails strategies and procedures that direct the behaviour of decentralised actors on due implementation’.

Kohler-Koch and Rittberger (2006) added that “despite the omnipresence of ‘governance’ in the study of the EU governance is still ambiguous and under-specified as a concept, let alone as a theory. But as the term ‘governance perspective’ suggests, governance research on the EU comprises works with a shared interest in the transformation of governance beyond the state through normative and empirical-analytical lenses”. Furthermore, they argue that in spite of rapidly and increasingly diversified literature on (new) modes of governance in the EU policymaking, theoretical reflection and empirical research have not resulted in a clear conceptualisation of the governance approach, let alone in a stringent methodology for its application to the analysis of new forms of policymaking.

For Tommel and Verdun (2009) ‘a wide variety of competing concepts, interpretations, and perceptions of the term *governance* and its meaning coexists in the literature’. Wallace and Young (1997) argues that a special form of policy co-ordination involving national and Community officials allow the Member State governments to retain considerable control but still transform the ways in which states traditionally go about doing their business.

3.1. Institutional framework of the EU governance

Current institutional framework of the EU governance is contemplated around the open method of-coordination (OMC). In practice it means that the EU economic governance consists of three Council committees⁹ that are involved in the everyday

⁸ It was developed by Marks in 1993.

⁹ The Economic and Finance Committee (EFC) is an advisory committee of ECOFIN and has consultative and review functions, being responsible for the co-ordination of fiscal policy through the operation of the Stability and Growth Pact. Another Committee is Economic Policy Committee (EPC) with a role to monitor structural policy.

work and preparation of the Council of Economic and Finance Ministers (ECOFIN). It is often saying that such co-ordination is associated with convergence towards predetermined targets, as the Member States agree on keeping the agreed economic indicators up to the certain limits, namely to maintain their budget deficits within 3 per cent of GDP and their medium-term budgetary position close to balance or in surplus. Therefore, the European economic governance is enforced through multi-lateral surveillance and the excessive deficit procedure. The former requires each Member State to formulate a Stability Programme or Convergence Programmes in the case that the state is outside the euro-area. In the event of deviation from the predetermined targets, the Council can issue a recommendation for corrective action. In the event of an infringement the Excessive Deficit Procedure (EDP) can be triggered, culminating in formal sanctions, including fines.

The main instrument for a co-ordination of economic policies are so-called the Broad Economic Policy Guidelines (BEPGs) that are drawn up annually by the Commission and Council and adopt by the European Council. The consistency of national economic policies with the economic objectives of the Union was assessed. The economic policies of Member States are coordinated through the BEPGs (in accordance to Article 121.2 of TFEU) as an annual exercise.

In 2011, the European Semester was introduced to make the coordination of national economic polices more effective. As Benassy-Quere (2015) comments “the objective of the European Semester was to transform BEPGs into a binding process”.

European economic governance could be described as a system of multilateral negotiating or networking in order to coordinate national policies. It is often state that it takes form of supranational, European economic government. The economic governance framework was established with the Treaty of Maastricht (in 1992) and enforced with the Stability and Growth Pact (SGP) in 1997. According to De Streel (2013) the economic governance is based on three main areas, namely:

1. the coordination of the Member States' economic policies (Article 121 TFEU),
2. the prohibition of financial solidarity among Member States (Art 125 TFEU) except in very extraordinary circumstances beyond the control of the States (Art 122 TFEU) and the prohibition of monetary financing by the European Central Bank and the National Central Banks (Art 123) and
3. limits to fiscal deficits to 3% of GDP and public debt to 60% of GDP (with sanctions decided by the Council in order to force sustainable fiscal policies).

The economic governance at European level takes two forms. The first one is so-called a 'soft' and it is known as the Open Method of Coordination. It also rests on moral persuasion and peer-pressure. The second one is a 'hard' governance and it is

based on a mechanism of material sanctions and it is best exemplified by the Stability and Growth Pact.

The current governance model is result of several changes introduced to make it more efficient and transparent. Therefore, the economic governance framework was reformed several times. The first reform was in 2005 and initiated with the situation in which the Stability and Growth Pact was not strictly implemented. Schuknecht et al. (2011) are arguing that on the request of some MSs (most vocally France and Germany) the full application of the provisions of the corrective arm of the Pact was not followed. Its strict implementation was blocked. The Commission recommendation to move a step further in the direction of sanctions under the excessive deficit procedure (EDP) was rejected. The reasons/arguments put forward were mainly concentrated around the fact that the specific situation of each Member States were not taken into account, especially phase of the economic cycle in each country.

The main aim of the reform was to strengthen the surveillance and coordination, as well as to clarify some procedures related to the Excessive Deficit Procedure (EDP). Reform was also targeting to enable a better national ownership and allow for more details in the recommended economic policy.

The second reform of the economic governance was initiated after the European economic and financial (debt) crisis. Namely, during the crisis it was evident that the current EU governance model was not properly designed to tackle such circumstances. Therefore, in 2011 the effectiveness of the Stability and Growth Pact was once again put into question. It was further reinforced with the so-called 'Six-pack'¹⁰, which has been created to enhance the surveillance in the Excessive Deficit Procedure and sanction procedures. Several other features were also introduced in the system of economic governance, of which the minimum requirements for budgetary planning and the Macroeconomic Imbalance Procedure (MIP)¹¹, are the most important.

In the reform that was initiated in 2013 the so-called 'Two-Pack' was introduced with common budgetary timeline and rules for Member States. The new element was also a system of enhanced economic and budgetary surveillance for those Member States that have experienced financial stability difficulties or those that

¹⁰ Six-pack consists of five regulations that are aimed to strength the implementation of efficient budgetary surveillance and enforce measures to correct excessive macroeconomic imbalances, as well as to introduce requirements for budgetary frameworks in the Member States.

¹¹ The MIP is also a form of a surveillance mechanism which is aimed to identify the potential risk in the early stage and prevent macroeconomic imbalances and correct those that are already in place.

receive financial assistance from the European Financial Stability Facility¹² (EFSF) and the European Stability Mechanism (ESM) as a permanent crisis resolution mechanism for euro-area Member States. There for the enhanced SGP became a part of the European Semester that presents the EU's annual cycle of economic policy guidance and surveillance.

Although the European economic governance model went through all that changes it is evident that the framework is still not properly enforced. Namely, the governance model is still incomplete since it did not prevent the build-up of fiscal imbalances in some Member States, as well as it failed to identify (and remedy) the triggers of the crisis in countries (like Ireland and Spain).

There is also problem with the enforcement mechanism in the European economic governance model. The enforcement mechanism used by economic governance present two main differences compared with the standard enforcement based on sanctions decided by courts. The first difference is that enforcement of economic governance rules is mainly based on voluntary actions by Member States and peer pressure, and, only as a last resort, on sanctions. The second difference is that the sanctions are not decided by independent courts, but are proposed by the Commission and decided by the Council. Unfortunately, the last decade shows that such an enforcement system was not very effective (De Streel, 2013).

Also, one of the issues of the EU economic governance model is a problem with the national ownership. In spite that all reforms have been tackled that issue in order to influence and improve the national ownership still a lot need to be done. The ownership was tried to improve by requiring a minimum quality for national fiscal institutions, thenwith the establishment of a national correction mechanism (in parallel to the excessive deficit procedure) and by the coordination of policies during the first semester of the year before the adoption of national decisions during the second semester.

De Streel (2013) concluded that recent reforms also increase the possibilities of sanctions which may be imposed earlier in the Excessive Deficit Procedure, and also during the annual multilateral surveillance.

The Commission conducted a review of the SGP in 2014 and highlighted both the strengths and the possible areas for improvement of the framework of the economic governance. The year after (in 2015) the Commission issued guidance on how it intends to apply the SGP rules to strengthen the link between structural reforms, investment and fiscal responsibility in support of jobs and growth.

¹² EFSF was introduced in June 2010 for the euro area MSs and provided financial assistance to Ireland, Portugal and Greece.

The current structure of the economic governance framework is based on four pillars (De Streel, 2013) of which each of them has its own objectives and methods, with strong differentiation between the countries which are in the euro-area and those which are outside. The first pillar of economic governance is a fiscal surveillance that aims to control, and if necessary correct, the fiscal imbalances of the Member States. It consists official rules – i.e. rules related to government deficit - the 3% deficit rule and rule related to government debt (the 60% debt rule and the 1/20 per year correction in case it is breached). The second pillar of economic governance is a surveillance and enforcement mechanism that aims to prevent and correct macroeconomic imbalances within the EU that have spill-over effects. It consists of a scoreboard of early warning macroeconomic indicators for the timely identification of internal and external imbalances and the surveillance procedure¹³. Third pillar of the economic governance relates to the coordination of national economic and social policies in order to prevent fiscal and macroeconomic imbalances and to stimulate growth and jobs in Europe. The fourth pillar is on financial solidarity.

4. EUROPEAN SEMESTER AND THE COUNTRY SPECIFIC RECOMMENDATIONS

The European Semester (ES) is one of the main pillars of the European economic governance model. It is called European Semester as during that time period each year Member States' budgetary, macro-economic and structural policies are coordinate in order to allow states to take Commission consideration into account during their national budgetary processes and in other aspects of their economic policymaking.

Within the framework of the ES several key stages are established. Starting point of the European Semester (ES) is a publication of the Annual Growth Survey (AGS) and the Alert Mechanism Report (AMR) usually in November/December of the preceding year¹⁴. AGS sets out EU priorities for the coming year to boost growth. Usually in June the Commission drafts Country Specific Recommendations (CSRs) proposing economic policy measures for each Member State, depending on the country's economic and social performance in the previous year. The recommendations are based on the results of a country report and reflect the priorities set out in the AGS. The CSRs are then adopted in July by the European Council.¹⁵

¹³There is so called preventive and a corrective phase while the preventive phase includes the Commission's Alert Mechanism Report (AMR). The corrective phase refers to the Excessive Imbalance Procedure (EIP), the corrective action plans, the assessment of the Member State's corrective action and potential financial sanctions.

¹⁴2017 Semester Cycle (AGS and AMR) started 27 November 2017.

¹⁵ Implementation of the 2017 Semester Cycle was at ECOFIN Council (EE) on 24 January 2018. On 28 June 2018 the EC presented its CSRs 2018.

The CSRs are tools designed to enhance the economic growth and job creation in Europe, while maintaining sound public finances. They are proposed by the Commission within the framework of the European Semester, based on its assessments of Member States' medium-term budgetary plans and economic reform programmes in the light of broad policy priorities outline in the AGS.

The Commission, as the integral part of the European Semester cycle produces in-depth assessment of each Member State's implementation progress against the previous year's CSRs. CSR implementation is assessed on the basis of actions taken rather than observed outcomes. Deroose and Griesse (2014) conclude that "the quantification of qualitative information is notoriously difficult and subject to judgement issues". It is also observed that CSRs are not all equally important, as within each country, but also across countries.

4.1. The Country Specific Recommendations – implementations and issues

The Country Specific Recommendations (CSRs) provide guidance to the EU Member States on macro-economic, budgetary and structural policies in accordance with the Treaty on the Functioning of the European Union ¹⁶(TFEU). They are issued within the framework of the European Semester with the aim to boost economic growth and in the same time maintaining sound public finances and preventing excessive macroeconomic imbalances. Therefore, the CSRs include both fiscal requirements based on the preventive arm of the Stability and Growth Pact and other requirements based on the prevention of the macro imbalances. In addition, they include advices for the national reforms in order to achieve more 'inclusive and sustainable growth'.

The European Commission identifies priority areas for action each year in its AGS that mutually reinforce one another. The European Semester focuses on those areas (fiscal responsibility, structural reforms, investments and recently employment policy and social protection). The CSRs focussed on those four priorities. First one is in regard to the investments that will support growth in EU. In order to achieve such objectives, barriers to financing and launching investment projects were envisaged. Then the second area is on structural reforms in product, service and labour markets that raise productivity, competitiveness and investment, as well as in the financial sector to ease access to finance for investment. The third area is about sound fiscal policies that strike a balance between short-term stabilisation and long-term sustainability. In MSs with weak fiscal position (both deficits and debt) further efforts are required to fix their balance sheets, and in MSs with fiscal space expansionary stance towards productive investment should be taken. The fourth area is in regard to the improvement of employment and social protection.

¹⁶ Article 121 and 148.

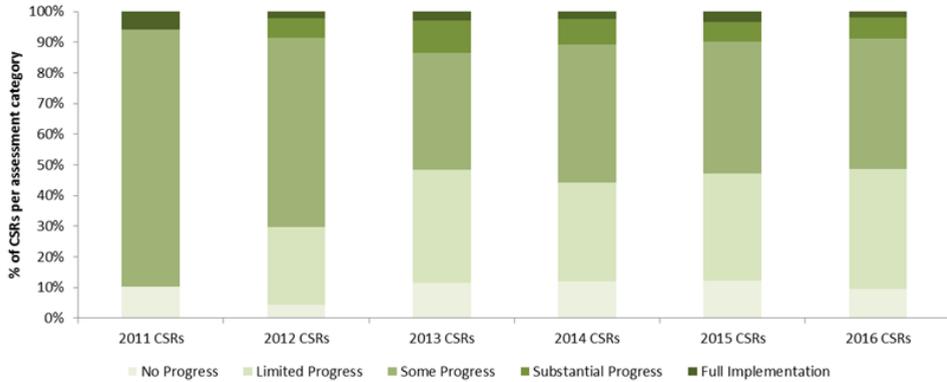
The Country Specific Recommendations was a first time issued in 2011 to the twenty-two countries, except Member States with macroeconomic adjustment programme linked to EU financial assistance (Greece, Ireland, Portugal, Latvia and Romania) which do not receive CSRs.

The number of CSRs given to the MSs during the first period until 2015 every subsequent year increased, namely from 118 in 2011 to 138 in 2012, then to 141 in 2013 and 157 in 2014. But, since the 2015 CSRs have been prepared in line with the co-called streamlined approach that is characterised by fewer and refocused CSRs. Hradisky and Ciucci (2018) add that “under the streamlined Semester, the recommendations also put greater emphasis on the objective to achieve, while largely leaving definition of the measures needed to attain it to the discretion of national authorities”. The total number of recommendations issued to MSs was more than halved in 2018 and amount only 73 CSRs. The reason of such reduction Hradisky and Ciucci (2018) are explaining with the new focus and prioritisation of the Semester and the fact that some policy areas that were covered separately in one Semester cycle have been merged during the next cycle”. The number of MSs for that the CSRs have been issued also has gradually increased as the Member States that receive the financial assistance successfully exited from the related programmes (Ireland, Portugal and Cyprus).

The experience with ES and the implementation of CSRs after several years of the implementation clearly shows that results are not encouraging. In the Graf 1 the implementation of CSRs is presented since 2011. The best results and the highest percentage of full progress were recorded in 2011 which was the first year after the CSRs were introduced. But, it should be noted that the different methodology were used for that year (with only three assessment categories¹⁷). These results cannot be converted into the current five-point scale, so the interpretation of the achievements should take that into account. It is also evident from the Graf that in year 2016 the percentage of the full implementation of CSRs was less than in the previous year. Also, for the last four years almost the same percentage of the CSRs is labelled with “no progress” with just slightly improvements in 2016.

¹⁷Namely, ‘no implementation’, ‘partial implementation’, ‘full implementation’.

Figure 1. Implementation of country-specific recommendations: yearly assessment in each consecutive year



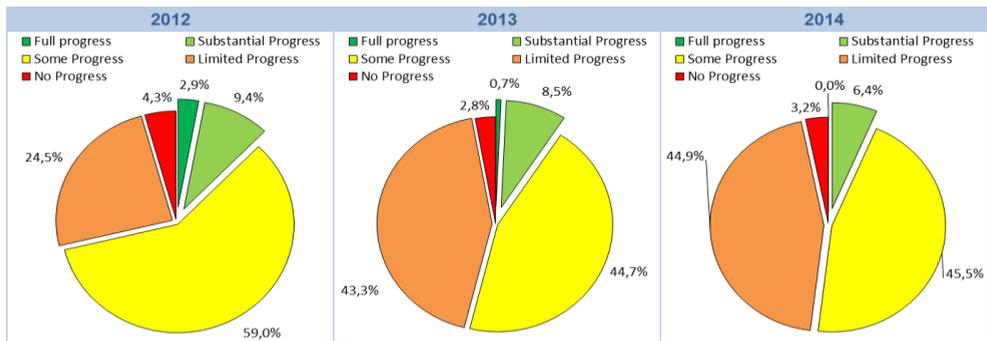
* 2011-2012 CSRs: Different assessment categories

** The overall assessment of the country-specific recommendations related to fiscal policy includes compliance with the Stability and Growth Pact.

Source: Communication from the Commission on 2017 European Semester: Country-specific recommendations (EC, 2017)

Looking also at the first years of the CSRs implementation it is noted (see Graf 2) that CSRs that were categorized as ‘fully implemented’ decreased significantly. In contrast to that trend the CSRs implemented with ‘limited’ progress increased dramatically from 24.5% in 2012 to 43.3% in 2013. The same trend continues in 2014 where the percentage of CSRs implemented with ‘limited’ progress reached almost 45%. Gern, Janssen, Kooths (2015) also observed that the CSRs have been insufficiently addressed by Member States. Only around ten percent of recommendations have been fully or substantially met, meaning that Member States have adopted and implemented measures that are appropriate or go a long way in addressing the country-specific recommendations. At the same time, the share of recommendations which have been insufficiently addressed, where adoption or implementation is at risk or no measures have been announced or adopted at all (limited or no progress in implementation) has risen from 29 percent in 2012 to 46 percent in 2013 and 48 percent in 2014.

Figure 2. CSRs – first years of implementation

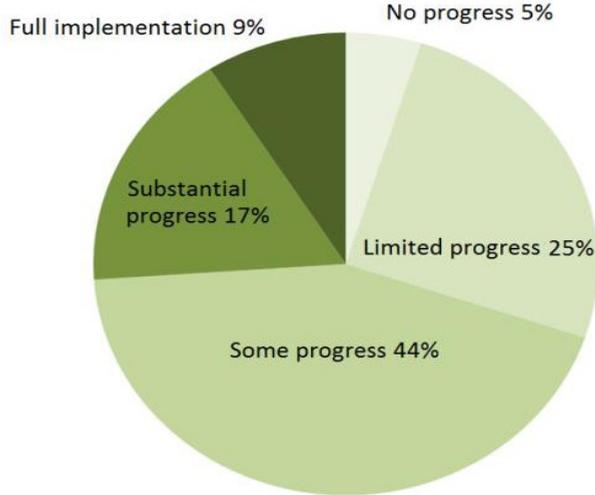


Source: Gern et al. (2015) Economic policy coordination in the euro area under the European Semester, Kiel Institute for the World Economy

Only around one third of the country-specific recommendations issued until 2017 have been implemented with ‘limited progress’, while 44% of them were implemented with ‘some progress’ (see Graf 3). The reasons for such relatively poor results are often contributed to the several factors of which one is timing. Namely, the implementation of reforms takes time, so it was suggested that it is important to assess the process over the medium term and not only the short term perspective. Ragot (2017) is of opinion that the question of the timing is relevant as some reforms may have effects in the long run, while others may have a direct effect already in the short run.

Since the start of the European Semester in 2011, the pace of progress – as assessed one year after the adopting of the recommendations – has been slightly decreasing. The EC is arguing that this could be because politically easier reforms were done first and because of the greater sense of urgency during the crisis (EC, 2017).

Figure 3. Overall implementation of 2011-2017 CSRs



Source: European Commission, 2018 European Semester: Country-specific recommendations

Deroose and Griesse (2014) argue that “an interesting angle from which to look at CSRs implementation by country is the national electoral cycle. Namely, the average implementation was superior when CSR adoption was not followed by an election within 12 months. The Member States also act in the way to ‘pick the low-hanging fruit’ first and more challenging set of CSRs in subsequent rounds of the European Semester “. Ragot argues (2017) that “it raises political issues, as it may involve some financial costs or the use of limited political capital. He also noted that “one cannot expect an ownership of different types of reform to be the same. In addition, the tools to incentivize reform implementation cannot be the same for the all types of reforms, as their legal basis differs” (Ragot, 2017).

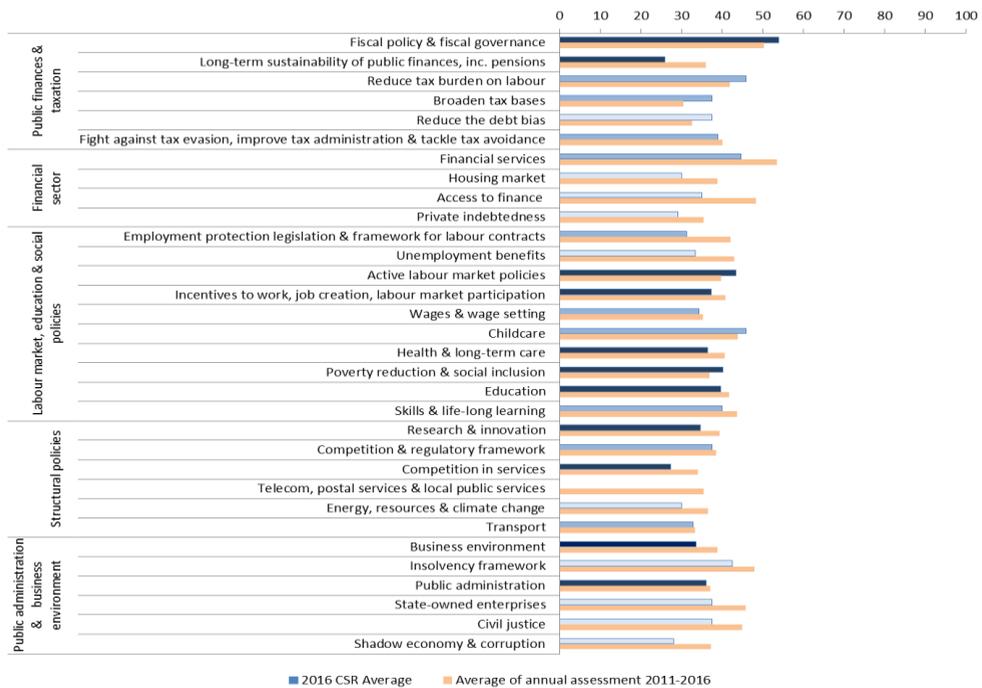
Regarding the question of the policy areas identified within the CSRs it is evident from the Graf 4 that they are covering a very broad set of policy areas - from public finances and taxation, to structural policies and public administration, including a wide range of sub-activities. The implementations of policy reforms activities during the period 2011-2016 on average is relatively modest as the degree of progress ranges between ‘limited’ and ‘some’ for most policy areas identified, meaning that there is still work to be done before the reforms are fully implemented and deliver results.

The best result in the implementation is for financial sector reform and public finance. Deroose and Griesse (2014) argue that “the financial sector reform recommendations (most of which concern the banking sector) stronger implementation may be related to the urgency of policy actions in view of financial stability concerns and concomitant market pressure in several Member States. For

public finances, the stronger implementation record may reflect not only market pressure, but also the fact that fiscal recommendations are in large part derived from the Member States ‘obligations stipulated by the EU’s Stability and Growth Pact, such as the reduction of the general government deficit to below 3% of GDP or reduction of public debt”. These rules come with significant enforcement powers, notably financial sanctions, so they may spur compliance (Deroose and Griesse, 2014).

The lowest implementation records of CSRs are usually within the area of tax reform as characterized like a politically highly sensitive and with the direct distributional implications (Deroose and Griesse, 2014). Similar is also in area of education and public administration reform where the implementation of CSRs are relatively low. It is understandable as all policy areas do not have the same economic or political relevance, so it would be desirable to make a hierarchy of them.

Figure 4. Policies areas covered in the country-specific recommendations



Source: European Commission, 2017 European Semester: Country-specific recommendations

Darvas and Leandro (2015) in their analysis of the implementation at the CSRs from 2011-2015 they calculate a *European Semester reform implementation index* (which ranges between zero where is no progress and one where is full implementation of CSRs). Their study shows that the track record of

implementation of CSRs is modest and deteriorating and that the average value of the reform implementation index for the 21 EU countries for which recommendations were made every year since 2011 was 40 percent. Finally, they conclude that “Despite the collective decision to create the new system of policy coordination, the findings show that the European Semester has been rather ineffective. This failure highlights the fundamental problem of policy coordination in the EU: national policymakers are accountable to their national parliaments and focus on national interest, which in many cases differ widely in different Member States” (Darvas and Leandro, 2015). The implementations of CSRs for the period from 2013-2017 are almost the same and they show on average relatively poor results as it ranges between ‘limited progress’ and ‘some progress’, meaning that on average Member States fell short on adopting measures to address the recommendations. It should be noted that the deterioration in the implementation of CSRs coincides with the streamlining of the CSRs which reduced their number and length.

Besides the Commission’s assessments of the implementation of CSRs there are not so many others. Recently, Efsthathiou and Wolff (2018) produced interesting analysis but using the dataset of scores from the Commission. They transformed scores into numerical variables in order to find the average implementation scores. Despite the simplicity of the synthetic indicator (with equal weights assigned to each CSRs the score per country) their analysis coincides with the Commission’s qualitative country assessments¹⁸.

One should argue that the relatively disappointing results of the implementation of the CSRs are achieved because there are so many different procedures and rules in place introduced by different regulations and that is difficult to follow all that. There is also a view that the current system “strengthens procedures, but not institutions and that the role of the Commission has been weakened, while the Eurogroup lost authority” (Pisani-Ferry, 2018).

In regard to the role of institutions within the ES the debate is going on the relevance of the inclusion of other especially non-EU institutions, especially the International Monetary Fund (IMF). Pisani-Ferry (2018) is of opinion that “the IMF and ECB only complicate situation for the countries that are under the financial assistance programmes”. On the other hand, he is in favour of the introduction of a new bodies in the institutional structure of the European

¹⁸The countries with highest implementation scores were Finland, the United Kingdom, Slovenia, Malta and Spain. The implementation was the lowest in Luxembourg, Slovakia, Hungary, Germany and Bulgaria. The implementation in countries including Luxembourg and the Netherlands has fluctuated significantly, but they conclude that “It is beyond the scope to examine the political economic factor driving the country actions. The factors include issues such as the capacity of a country to put in place reforms, electoral cycles and the business cycle”.

Semester, as well as for the broadening the remit of existing (like a fiscal councils). He is also proposing to create the National Competitiveness Councils in order to monitor current accounts, development in exchange rates etc.

It is evident that proposals to improve current EU governance framework are headed in several directions. Most of the proposals are concentrated to the applications of current rules, pointing out that the sustainability of the public finances is more relevant economically than the fiscal rule - 3% deficit and 60% debt ceilings (De Streel (2013)). There is also many criticisms about the calculation of the (structural) deficit, as it is rather complex and methodology is not so transparent. Comments are that such situation is not in favour of the implementation of the reforms prescribed by the CSRs as it is difficult to explain it to the general public, “hence the case for painful socioeconomic reforms to meet those rules is more difficult to make” (De Streel (2013)).

Regarding the improvements within the implementation of the CSRs the issue of the national ownership dominates. There are views in favour of enhanced dialogues between institutions in order to raise awareness of the effects of the budgetary decision between Member States, as well as strengthening the oversight of parliamentary bodies over their executives. Furthermore, the sanctions mechanism exists, but it was not applied to the Member States that are not performing well.

Several authors are arguing that the better transparency is needed for the functioning of the whole system and especially for the explanation of the methodology in the case of EDP. De Streel (2013) observes regarding the fines that “their credibility and effectiveness depend on their timing and on the situation of the Member States concerned. The fines are effective if they are imposed or threatened to be imposed early in the surveillance procedure and when the Member State concerned does not face a liquidity of solvency crisis”.

It is also true that the MSs may respond to recommendations on structural policies with so many measures and that would be difficult to say whether these measures will achieve intended results. Zuleeg (2015) is pointing out that the “implementation gap will remain, craven by a fundamental political economy problem; namely because of the fact that the implementation of reforms is decided at the EU level and need to be justified politically at the national level”:

Regarding the Country Specific Recommendations there is a common agreement that they are usually precise, but that contain a number of targets. Alcidi and Gros (2014) argue that “they consist of other policy recommendations which can be quite vague and contain exhortations, without giving any precise target to be achieved. The implementation of the structural part of the CSRs is also often too vague to allow one to judge about the implementation. They are also arguing that “the politically and financially strong countries tend to ignore CSRs, while the

politically and financially weaker countries usually respond to recommendations on structural policies with many measures, but it is often difficult to say whether these measures will achieve the intended results” (Alcidi and Gros, 2014). Therefore, Schneider, Zuleeg and Emmanouilidis (2014) propose that “the Commission together with the European Parliament focus the process on a smaller number of key priorities for each country, with a strong attention on the future growth”. They are in favour of the strict implementation of CSRs and the introduction of sanctions if the key recommendations are not implemented.

Efstathiou and Wolff (2018) make a remark that “the ES exercise is a very difficult to digest and communication of key analyses and recommendations could be significantly improved to make them more accessible”. Regarding the transparency of the European Semester some authors, like Gern, Jannsen and Koots (2015) state that “the transparency of the ES could be strengthened by being more explicit on the theoretical foundations on which recommendations are based”. They also stress that “it is particularly important to elaborate a coherent theoretical framework for those events that threaten the functioning of the EU economic governance as a whole and that a common understanding is crucial for creating ownership for policy initiatives that are supposed to address common interest shared by all MSs”. Namely, as the economic policy is left under the authority of the MSs the implementation rate of CSRs will remain relatively low whenever conflict with the aims of national authorities. Furthermore, the decision-making process is complicated even more because of “the mistrust among Member States and between them and the Commission, so it represents an essential barrier that needs to be overcome” (Zuleeg, 2015).

5.CONCLUSION

It is obvious that in spite of the reforms introduced to improve the European Semester still some shortcomings exist. The CSRs implementation record is marked by a downward trend since the introduction. The experiences so far show that the current governance framework relies on a complex set of institutions and procedures in order to provide recommendations to the MSs in accordance to the EU rules. Such governance model also involves so many actors, legal basis and different competences.

The main issues on the CSRs and on the European economic governance had been brought up. The paper just highlighted main shortcoming of the European governance system and present some of the problems that are facing the EU’s economic coordination.

The policy coordination is a very broad concept and the European economic governance/ES is a well-intentioned attempt to foster (macroeconomic) policy coordination between MSs. Because of the implications and complexity some of

the recommendations classified as politically costly are less likely to be followed by policy implementation. Besides, it is difficult to determine which of the reforms being implemented by governments would have been taken forward in any case.

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**THE IMPACT OF STOCK-FLOW ADJUSTMENTS ON CHANGES
IN CROATIAN GENERAL GOVERNMENT DEBT LEVEL**

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Review

Abstract

Surveillance of government deficit and debt data is a very important issue from the point of view of national policy makers, as well as international financial and statistical organizations. Deficit and debt developments in EU member states has been regularly (twice a year) monitored by Eurostat, which collects and publishes so called excessive deficit procedure (EDP) statistics on government deficit and debt. The European Commission uses the EDP statistics to assess whether EU Member States' government deficits and debt levels comply with the relevant EU legislation (according to the Maastricht Treaty criteria, government deficit should be less or equal to 3% and government debt less or equal to 60%) of GDP. Deficit and debt data are published mostly in relative terms, i.e. compared with the nominal GDP and compiled according to the ESA2010 methodology. In simplified theory, annual government deficit/surplus should be equal to change in the level of government debt at the end of the actual year and at the end of the previous year. In reality, this is not true due to the impact of the stock-flow adjustments (SFA), which explains the difference between the change in government debt and the government deficit/surplus for a given year. Main aim of this paper is to identify the main factors contributing the changes in government debt other than deficit/surplus (SFA) in Croatia during the period 2010-2017. Those factors are divided into three main categories: net acquisition of financial assets (further broken down by financial instruments), adjustments (for coverage, valuation and exchange rate changes) and statistical discrepancies (reflects differences arising from the use of various data sources). Second, not less important aim of paper is to identify size and impact of the particular SFA factors on changes in debt level during the observed period in Croatia, and based on results obtained, short recommendations for Croatian policymakers will be outlined.

Keywords: *national government, fiscal policies, deficit, debt, stock-flow adjustment*

JEL: E62, H10, H30, H62, H63

1. INTRODUCTION

Government deficit and change in government debt are closely interrelated in theory, but in reality the change in the government debt level in particular period can be higher or lower than the corresponding deficit. At this point, somebody may ask a question: where is the (taxpayers) money? Stolen or not recorded properly in statistics? The right answer is that deficit and debt are properly recorded in statistics, but due to non-harmonized compilation methodologies, we have an explanatory statistics category introduced in order to assure the mutual consistency between two statistical datasets. The difference between the change in government debt and the deficit is known as the “stock-flow adjustment” (SFA). A positive SFA means that the government debt increases more than the annual deficit (or decreases less than implied by the surplus). On the contrary, a negative SFA means that the government debt increases less than the annual deficit (or decreases more than implied by the surplus). A detailed “SFA decomposition analysis” tries to identify the origins of observed difference between deficit and change in debt, i.e. to identify the main factors contributing to changes in government debt other than government deficit/surplus. According to the Eurostat methodological framework, the SFA can be distinguished into the following main categories: net acquisition of financial assets, debt adjustment effects and statistical discrepancies. During the SFA decomposition it is possible to find out the size of the main contributing factor and legitimate explanation of discrepancy sources, but observed SFAs are closely monitored by Eurostat during quality checks of data for the excessive deficit procedure (EDP) provided by the member states, in order to ensure adherence to statistical rules and consistency across the reported data. Member states with exceptionally large SFAs in absolute terms deserve particular attention, even though these values normally have appropriate explanations. Close consideration should also be given to large but offsetting values. Also, SFAs decomposition analysis can highlight data quality problems: governments might, for example, have an incentive to underreport their deficits by reporting transactions under the SFA, especially in case if deficit figure during the compilation process becomes close to the deficit reference value of 3% of GDP, known as deficit criteria prescribed by the Maastricht Treaty.

Due to the fact that stock-flow adjustment (SFA) analysis is relatively new analytical tool, related recent literature is limited. A general conceptual framework for the measurement of government debt, which also explained stock-flow adjustments detailed analysis (or “deficit-debt adjustment” – DDA in the ECB

glossary of terms) is described in Lojsch, Rodriguez-Vives and Slavik (2011). Also, some additional useful technical explanations are disposable in Eurostat (2016, 2018). Finally, Weber (2012) used the results of the implemented SFA analysis to explain relations between the stock-flow adjustments and fiscal transparency, while Rybáček (2015) investigated the relations between government deficit and debt and the importance of the SFA aggregate in case of government debt developments in Czech Republic during the 1996-2014 period. The data set used for the preparation of this paper is the Eurostat Database (online), series extracted from tables gov_10dd_edpt1 and gov_10dd_edpt3 for the Republic of Croatia, period 2010-2017.

The paper is structured as follows: section 2 provides basic definitions and general concept of stock-flow adjustment analysis, section 3 is dedicated to the evolution of general government deficit, change in government debt and stock-flow adjustments in Croatia during the 2010-2017 period, while section 4 provides detailed decomposition of the main SFA categories in Croatia 2010-2017. Finally, section 5 provides a summary of conclusions.

2. BASIC DEFINITIONS AND GENERAL CONCEPT OF STOCK-FLOW ADJUSTMENT ANALYSIS

General government deficit and change in debt are interrelated in theory, but the change in the debt level in any given period can be larger or smaller than the corresponding deficit in reality. Observed difference between the change in debt and the deficit is known as the “stock-flow adjustment” (SFA). In order to perform identification of the sources of this difference, use of “SFA analysis” is a necessary analytical framework.

Stock-flow adjustments (SFA) are simply defined with the following formula:

$$SFA_t = (D_t - D_{t-1}) - d_t \quad (1)$$

Where D_t is general government debt at the end of the period t ; D_{t-1} is general government debt at the end of the period $t-1$ and d_t is general government deficit recorded in year t .

On the other hand, the stock-flow adjustment can be broken down into the following main categories: net acquisition of financial assets, debt adjustment effects and statistical discrepancies (Eurostat 2016, 2018). We can denote this with the following formula:

$$SFA_t = NAFA_t + DA_t + SD_t \quad (2)$$

Where $NAFA_t$ is net acquisition of financial assets in year t ; DA_t is debt adjustment in year t and SD_t stands for statistical discrepancies in year t .

Each main SFA category can be further elaborated in details, as follows:

1.) **The net acquisition of financial assets ($NAFA_t$) adjustments** appear because financial transactions in assets are not contributing to the deficit, but they lead to increases or decreases in the stock of debt. Those transactions have been observed in practice as the main factor contributing the SFA. They reflect difference between the acquisition and disposal of financial assets held by the general government sector in the form of the following ESA 2010 financial instruments: currency and deposits (F.2), Debt securities (F.3), Loans granted by government to non-governmental units (F.4), Equity and investment fund shares/units (F.5), Financial derivatives (F.71), Other accounts receivable (F.8) and Other financial assets (Monetary gold and SDRs (F.1) and Insurance technical reserves (F.6)). Transactions in financial assets are reported regularly on a consolidated basis, excluding transactions with other government units (consolidated within general government). In such case, the lending from one unit of government to another is canceled out and is shown neither as acquisition of assets nor as increase in debt. Similarly, the acquisition of government bonds by government units is not shown as acquisition of assets, but as reduction in consolidated debt level. The amounts of transactions between sub-sectors of general government (central government, state government, local government and social security funds) can be also observed and canceled out in the second step of consolidation process. It means that such information on SFAs broken down by government subsector exists. For the purpose of illustrating typical transactions in financial instruments, sales of government shares (F.4) have no direct impact on government debt, because they lead to increase in holdings of other types of financial assets, for instance currency and deposits (F.2). Later on, there can be a subsequent impact on the debt if government uses the privatization proceeds (currency and deposits, F.2) to repay its debt, by decreasing the level of loan (F.4) liabilities. On the other hand, changes in market value (holding gains/losses due to price changes, both realized and unrealized) of financial assets owned by general government are not included in net acquisition of financial assets, but in the revaluation accounts. It means that they have not any impact neither on government deficit nor on the change in government debt.

2.) **Debt adjustment (DA_t)** consists of three main sub-categories. The first category is related to *coverage adjustments* and includes transactions in those liabilities that exist in coverage of the deficit transactions, but they are excluded from the government debt definition (Financial derivatives (F.71), Other accounts payable (F.8) and Other liabilities (F.1, F.5, F.6 and F.72)). The second one comprises *valuation adjustments*, e.g. three types of valuation effects (Issuances above/below nominal value, Difference between interest (D.41) accrued and paid

and Redemptions of debt above/below nominal value). Those effects exist due to the fact that government debt (or Maastricht debt, defined in Council Regulation 479/2009) is measured at face value, while deficit transactions are measured at market value. The third sub-category includes the *exchange rate adjustments* (Appreciation/depreciation of foreign-currency debt, reflecting the impact of changes in exchange rates on those government debt components denominated in foreign currencies, taking into account hedging activities) and *other changes in volume*: Changes in sector classification (K.61), arise from the classification of units inside or outside general government and Other volume changes in financial liabilities (K.3, K.4, K.5)), mainly arise in other rare cases of extinguishment of debt that are not reflected in the deficit/surplus.

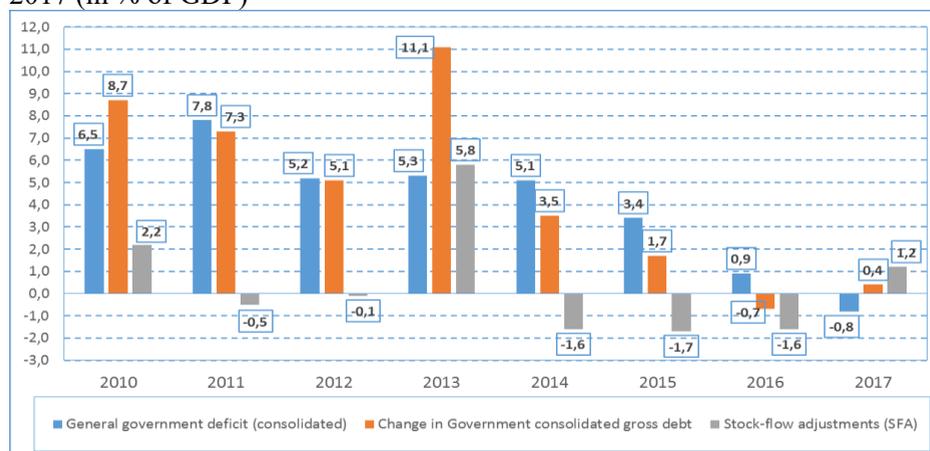
3.) **Statistical discrepancy (SDt)**, which reflects differences arising from the diversity of data sources and might also indicate problems with the quality of data. The government sector accounts in national accounts (ESA 2010) are often compiled from a diversity of sources, which may not be fully integrated or completely homogenous, leading to differences between the revenue and expenditure data (non-financial accounts) and the financing data (financial accounts). Discrepancies between the non-financial and the financial accounts (B.9-B.9f) often relate to the time of recording of treasury or budget transactions compared to the moment these flow through the banking system. Therefore, a notable source of discrepancies originates from the accrual recording applicable to ESA 2010 data and the difficulty to match cash and accrual data. One source of discrepancies is time of recording, referring to the difference between the recording of expenditure and the related payments and that of revenue and the related cash flow to government. For instance, taxes are recorded as government revenue at the time of assessment, even though their receipt payment may take place somewhat later. The delayed payment of taxes does not reduce the government borrowing requirement, although the taxes themselves decrease the deficit. A large accumulation of delayed taxes may lead to concerns as to whether tax revenue is overstated owing to amounts that are unlikely to be collected. Another time of recording difference, issue is related to the advance or delay in reimbursement by the EU of the funds the government spends on its behalf. In general, time of recording differences tend to broadly cancel out over time: for example, expenses reported as expenditure but not yet paid in one year will be paid, but no longer reported as expenditure in the subsequent year. Second part of statistical discrepancies represents the Other statistical discrepancies (any unexplained remaining factors).

Finally, last key element of stock-flow adjustment analytical framework is a general government deficit (d_t from equation (1)), often called as a Net lending (+) / net borrowing (-) (B.9). This is a basic factor contributing to the change in government consolidated gross debt ($D_t - D_{t-1}$) from equation (1).

3. EVOLUTION OF GENERAL GOVERNMENT DEFICIT, CHANGE IN GOVERNMENT DEBT AND STOCK-FLOW ADJUSTMENTS IN CROATIA 2010-2017

During the observed period 2010-2017, general government deficit and change in debt figures for Croatia were very high during the euroarea (post)crisis period 2010-2013, resulting with positive SFA's in 2010 (2.2% of GDP) and 2013 (5.8% of GDP), while small negative SFA's were recorded in 2011 (-0.5% of GDP) and 2012 (-0.1% of GDP, Chart 1). Croatian general government deficit in 2012 was amounted at 5.2% of GDP, huge amounts were also recorded in previous years and European Commission and Council (EU) has been decided to start the Excessive Deficit Procedure (EDP) in Croatia. The EDP is a rule-based process established by the Treaty on the Functioning of the European Union (TFEU, Article 126), with the main purpose to ensure that Member States adopt appropriate policy responses to correct excessive deficit (>3% of GDP) and debt (>60% of GDP). Introduced partly in response to the economic crisis, it forms the imperative part of the economic governance architecture in the EU. The EDP begins with a Member State either having breached or being at risk of breaching the deficit threshold (3% of GDP) or having violated the debt rule, which is not diminishing at a satisfactory pace. Official inclusion of Croatia into the EDP began in January 2014 and Council Recommendation set up initial deadline for correction for the end of 2016, with the possibility of official abrogation from EDP in mid-2017. Croatia successfully abrogated the EDP in June 2017.

Figure 1. General government deficit, change in debt and SFA - Croatia 2010 - 2017 (in % of GDP)



Source: Eurostat

During the EDP, Croatia has reduced government deficit from 5.1% of GDP in 2013 to 0.9% of GDP in 2016, while in 2017 Croatia recorded government surplus for the first time in history (0.8% of GDP). In mid-2013, Croatia became a full

member of the EU and Croatian statistical authorities started with the first official EDP statistical reporting on deficit and debt to the Eurostat. Croatian statistical authorities have immediately adopted the existing ESA95 statistical rules, but in September 2014 they make a quick methodological switch to the new ESA2010 rules. A huge change in debt growth at the end of 2013 compared to the end 2012 (11.1 percentage points) was a consequence of reclassification of several important public enterprises (HRT, HŽ, etc.) to the central government sub-sector, one-off increase due to debt assumption of certain Croatian shipyards by Croatian government, as well as by increase in debt (F.4, loans) related with huge accumulation of cash (F.2) by government in December 2013 (SFA, Net acquisition of assets). Aforementioned growth in debt was almost two times higher than corresponding deficit (5.3%). The result was huge positive SFA's of 5.8% of GDP in 2013. In the rest of observed period (2014-2017), economic recovery took place in Europe and Croatia, resulting in reduction of government deficit and debt in Croatia, as well as in reduction of corresponding SFA's. We can observe that developments in deficit, debt and SFA's during the 2010-2017 period were very volatile from one year to another. If we calculate 8 year total and average changes in deficit, debt and SFA's, we can easily observe that cumulative 8 year change in SFA's counts for 3.7% of GDP, while average annual SFA's counts for only 0.46% of GDP (Table 1). We may simply conclude that strong "cancelation effect" is observed, i.e that total cumulative and average size of SFA's is pretty low in the long run, probably due to the different time of recording in deficit and debt statistics.

Table 1: Total cumulative and average changes in deficit, debt and SFA's 2010-2017 (in % of GDP)

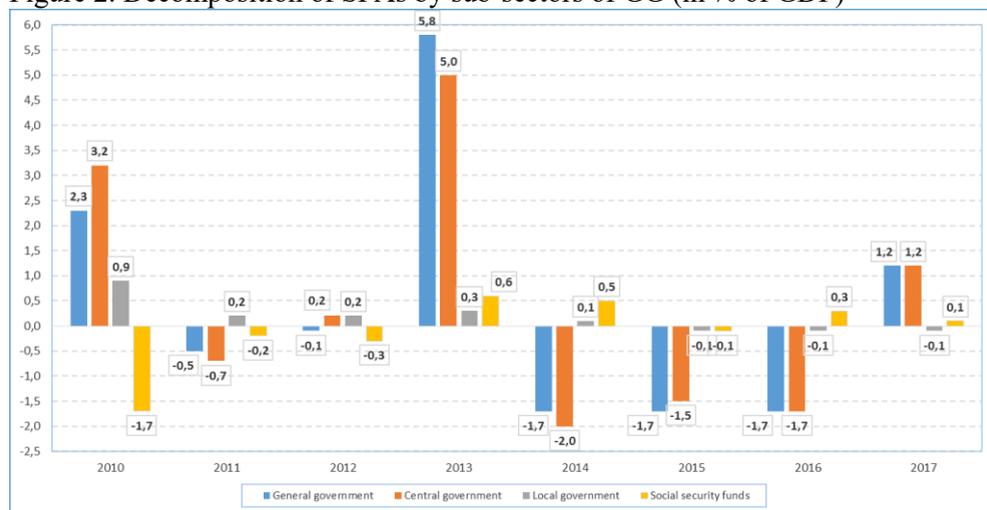
	2010-2017	8y average
General government deficit (consolidated)	33.4	4.18
Change in Government consolidated gross debt	37.1	4.64
Stock-flow adjustments (SFA)	3.7	0.46

Source: author's calculation based on Eurostat data

General government sector (S.13) in Croatian deficit and debt statistics (according to the ESA 2010 standard) consists of the three main subsectors: Central government (S.1311), Local government (S.1313) and Social security funds (S.1314). A strong interrelation between General government and Central government SFA's is obvious during the entire period under observation: it seems to be self-explanatory understandable because huge majority of total general government debt belongs to the Central government sub-sector. SFA's of Social securities funds were negative and high in 2010 (-1.7% of GDP), positive and moderate in 2013 and 2014 (0.6% and 0.5% of GDP, respectively), and negligible in the rest of observing period). Local government SFA's were 0.9% of GDP in

initial period, during the rest of period were volatile in range from -0.1% to 0.3% of GDP (figure 2).

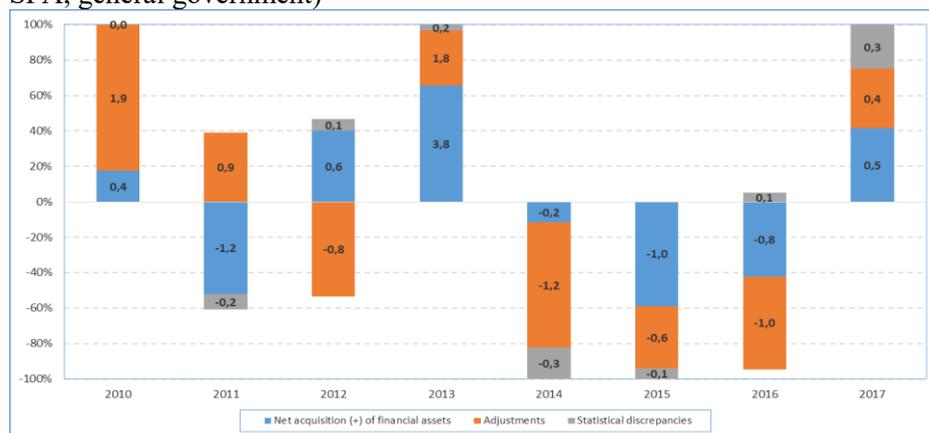
Figure 2. Decomposition of SFAs by sub-sectors of GG (in % of GDP)



Source: Eurostat

The impact of the three main SFA categories on change in government debt during the observed period is shown by Chart 3. Contribution of Net acquisition financial assets (NAFA) was the largest and positive in 2013 (3.8% of GDP or 65.5% of total annual SFA's). In the rest of observed period, impact of the NAFA varied from -1.2 to 0.6% of GDP. Adjustments are the second largest source contributing to the SFA's, ranging from -1.2% to 1.9 of GDP, while impact of Statistical discrepancies was negligible during the 2010-2017 period.

Figure 3. Decomposition of the 3 main SFAs categories (in % of GDP and of Total SFA, general government)



Source: Eurostat

Trends in SFA's development were very volatile during the observed eight years' period and we have to determine impact of "cancelation effect". Total cumulative size of Net acquisition of financial assets was 2.1% of GDP during the period of observation, while period average size was 0.3% of GDP, contributing with 58.3% to total SFA's. Total adjustments count for 1.4% of GDP in 2010-2017 period (or 0.2% of GDP in terms of period average), contributing with 38.9% to total SFA's. Finally, cumulative Statistical discrepancies were amounted to 0.1% of GDP (i.e. zero in average), with small contribution to total SFA's of 2.8% (Table 2).

Table 2. Total cumulative and average size of the 3 main SFA categories, cumulative 2010-2017 (in % of GDP and % of Total SFAs)

	2010-2017	8y average	contribution
Net acquisition (+) of financial assets	2.1	0.3	58.3%
Adjustments	1.4	0.2	38.9%
Statistical discrepancies	0.1	0.0	2.8%
Total SFAs	3.6	0.5	100.0%

Source: author's calculation based on Eurostat data

4. DETAILED DECOMPOSITION OF THE MAIN SFA CATEGORIES IN CROATIA 2010-2017

As we have mentioned before, the Net acquisition of financial assets (NAFA) reflects difference between the acquisition and disposal of financial assets held by the general government sector in the form of the various ESA 2010 financial instruments. Financial transactions in assets are not contributing to the deficit, but they lead to increases or decreases in the stock of debt. During the observed period 2010-2017, currency and deposits were the most significant financial instrument contributing to the development of Net acquisition of financial assets, in range from -1.6% to +3.2% of GDP, or from -80% to 82% of total NAFA. In December 2013, one part of increase in debt (F.4, loans) was connected with huge accumulation of cash (F.2 / SFA / Net acquisition of assets) by central government in December 2013. Accumulation of cash on Croatian government treasury accounts in 2013 was used as a "buffer" for government deficit financing operations scheduled for 2014. It means that main source of discrepancies related to net acquisition of financial assets in 2013 and 2014 was due to different time of recording of book-keeping counterpart transactions in deficit and debt statistics (Chart 4). The second most NAFA contributing financial instrument was the Other accounts receivable. In 2010 Other accounts receivable was negative (-0.4% of GDP or around 36% of total NAFA), while positive amounts were recorded in the rest of observed period, varying from 0.1% (in 2013) to 0.7% of GDP (in 2017). Significant and positive contribution to the NAFA was observed for Loans, within a range from 0.2% (in 2011 and 2012) to 0.6% of GDP (in 2016). Starting from 2015, Croatian government has intensified the use of financial derivatives, which

contributed to creation of negative NAFA and further increase over the time, up to the maximal value of -0.6% of GDP (or around 32% of total NAFA) in 2017.

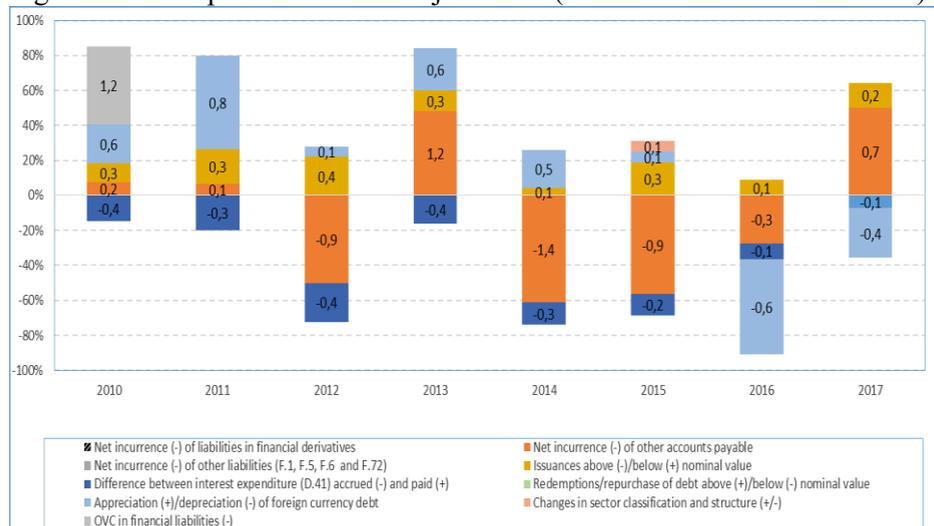
Figure 4. Decomposition of Net acquisition (+) of financial assets (in % of GDP and of Total NAFA)



Source: Eurostat

The second most influential SFA's category is known as a Debt adjustment (DA), which consists of three main sub-categories: coverage adjustments, valuation adjustments and exchange rate adjustments. Largest impact on Debt adjustments in Croatia during the 2010-2017 period arise from Net incurrence of other accounts payable, varying from -1.4% of GDP (in 2014) to 1.2% of GDP (in 2013, Chart 5).

Figure 5. Decomposition of Debt adjustments (in % of GDP and of Total DA)



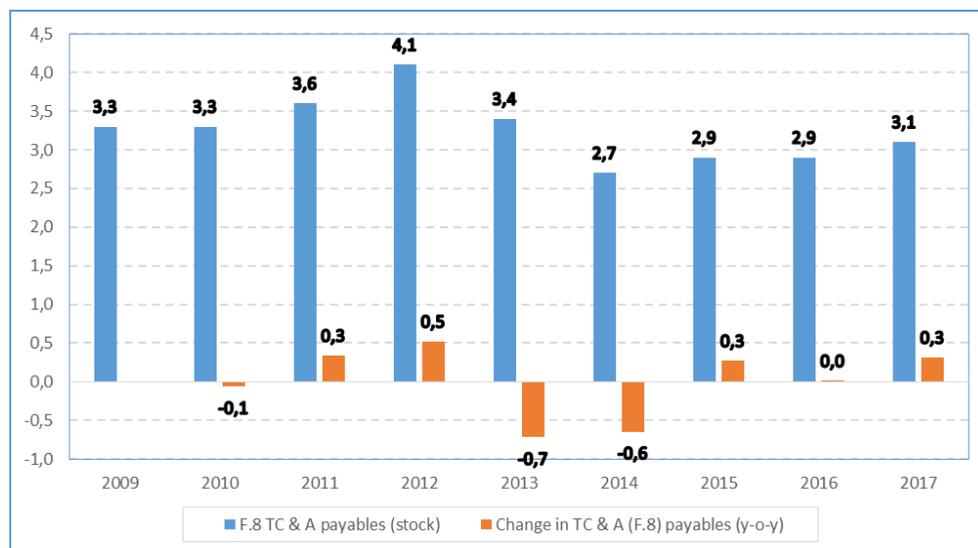
Source: Eurostat

Net incurrence of other accounts payable is generated by changes in trade credits and advances as well as other changes (on liability side). Those changes were recorded in government deficit statistics, but changes in trade credits and advances are not recorded in government debt statistics, due to different coverage and definition of so-called "Maastricht debt", which not includes "Other accounts payable" instrument. It was the main reason to introduce a separate debt adjustment sub-category within the SFA methodological framework, in order to overbridge two non-harmonized statistics.

If we took into account development of changes in "trade credits and advances" during the 2010-2017 period, we can easily observe a correlation between trade credits and advances on the liability side (Figure 6) and Net incurrence of other accounts payable (as shown on Figure 5).

The second large impact on the DA arise from exchange rate adjustments, namely appreciation and depreciation of foreign currency debt. During the sub-period 2010-2015, exchange rate changes effect on stocks and flows of government debt was significant and positive, varying from 0.1% of GDP (in 2012 and 2015) to 0.8% of GDP (in 2011). On the contrary, exchange rate changes from 2016 onwards becomes negative (-0.6% of GDP in 2016 and -0.4% of GDP in 2017). A negative effect of exchange rate changes in 2016 and 2017 is highly correlated with the more intensive use of financial derivatives in public debt management operations, with the main aim to reduce exposure of public debt to the risk of exchange rate changes. It is also interesting that observed trends of Difference between interest expenditure accrued/paid and Issuances above/below nominal value over the time horizon are almost same in terms of size (in % of GDP), but with reversed sign, so we can conclude that "cancellation effect" exists between those two sub-category elements.

Figure 6: Stocks and changes in trade credits and advances (as part of F.8 liabilities, in % of GDP)



Source: Eurostat

5. CONCLUSION

The importance of the SFA analysis (decomposition) by Eurostat during quality checks of data for the excessive deficit procedure (EDP) provided by the member states is increasing, in order to ensure adherence to statistical rules and consistency across the reported data. Key motivation of this paper is to provide assessment of SFAs (including sub-categories) and their impact on changes in Croatian government debt. We used Eurostat Database (online) data, series gov_10dd_edpt1 and gov_10dd_edpt3 for the Republic of Croatia, period 2010-2017 for the purpose of analysis, but the main obstacle was the fact that SFA related recent literature is rare and limited. Despite of that and taking into account results of our analysis, we can generally conclude that SFA's phenomenon should be analyzed in the medium and long run, due to existence of „cancellation effect”. Croatia joined the EU at July 1st 2013 and Croatian statistical authorities provided the first official EDP reporting to the Eurostat, based on immediate adoption of the ESA95 rules and followed by quick switch to the new ESA2010 rules since September 2014. The result was a reduction of SFA during the rest of the period. Relatively small increase of deficit followed by relatively high increase in debt was result of reclassification of several important public enterprises (HRT, HŽ, HAC,...) and development bank (HBOR) to the central government sub-sector. This fact is not visible under the SFA / Adjustments / Changes in sector classification position for the period under observation, because the series were revised backwards and it should be recorded in years prior to initial year 2010. Also, one-off increase in debt

in 2013 due to privatization of Croatian shipyards and debt assumption by Croatian government resulted in low increase in deficit in 2013, while other repayments are recorded in deficit statistics during the rest of observed period. In December 2013, one part of increase in debt (F.4, loans) was connected with huge accumulation of cash (F.2 / SFA / Net acquisition of assets) by central government in December 2013. Accumulation of cash on Croatian government treasury accounts in 2013 was used as a “buffer” for government deficit financing operations scheduled for 2014. Very significant impact of F.8 Other accounts payable (trade credits & advances) is properly recorded in deficit statistics, but not recorded in debt statistics (for this reason, they are recorded in SFAs, adjustments), which emphasize a need for international statistical harmonization between deficit and debt statistics (Eurostat, IMF). Existing deficit statistics covers transactions in assets & liabilities, while debt statistics covers only transactions in financial liabilities, what means that the asset side transactions are largely covered as SFA, under the Net acquisition of financial assets. In order to improve statistical harmonization, there is a need for the use of „net debt concept”. Finally, public debt management in Croatia should be improved, due to the huge impact of debt adjustments, caused by the strong influence of exchange rate changes on foreign currency denominated debt, as well as difference between interest expenditure accrued and paid and issuances above /below nominal value. A certain part of negative impact has been offsetted with the use of financial derivatives as an instrument used for the purpose of the exchange rate risk minimization in Croatian public debt management system since 2016.

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5. EUROSTAT Online –database of macroeconomic indicators

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**SMART SPECIALIZATION OF THE EU IN THE FUNCTION OF
INCREASING NATIONAL COMPETITIVENESS LEVEL**

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Review

Abstract

The more competitive external economic environment and challenges brought by a long-term growth can only be solved by investment in research and development, innovations and human capital. Developed countries try to stimulate research and development in all important fields by forming special institutions and organizations, adopting clear policies and concrete measures. The European Union has made smart specialization strategy as platform to focus on development investments in area where Europe has critical mass of knowledge, capacities and competencies that are innovative potential for maintaining the highest positions of competitiveness at world markets. One of the most important tools in implementation of strategy are Centres of competences aimed to increase of small and medium entrepreneurship capacities that are in lack of own capacities for research and development. This paperwork will analyse how much countries are aware of importance and readiness to create national strategy of smart specialization. How ready they are to start transformation of national economies through forming and strengthening innovation chain of value i.e. how ready they are to be lead by the principle: "Research is transformation of money in knowledge, and innovation is transformation of knowledge in money." What is current condition and how are perspectives in Bosnia and Herzegovina regarding incentives for innovation and technology development, creating better business conditions of new and growing companies, promoting partnership and synergy in order to create value chains, ensuring continuous modernization of industry and

solving social and regional competitiveness that are the main challenges of the EU. Encouragement of growth and competitiveness for economic development and goals of the Europe 2020 Strategy belongs to the most important priorities of the Commission and the EU member countries after crisis. The Europe 2020 Strategy is focused on solving structural disabilities of existing growth models by creating conditions for smart, sustainable and inclusive growth.

Keywords: *smart specialization, centres of competences, R&D, innovation chain of values, competitiveness*

JEL: O31, O52

1. COMPETITIVENESS OF GLOBAL ECONOMY – CHALLENGES OF GROWTH AND DEVELOPMENT

Competitiveness can be defined as productivity by which country or company use its human capital and natural resources. – *Michael E. Porter* According to OECD definition competitiveness means ability of country under free and equal market conditions to produce goods and services that passes international market test, while maintaining and increasing in long-term real income of population. Competitiveness of a country is one of the results of globalization and has an increasing importance for each country willing to develop its industry and economy. All countries in the world today think more intense on their competitiveness and its improvement. By achieving better competitiveness position, they achieve growth and raise living standard within the country. Countries compete for markets, technologies, skills and investments that shows higher level of development and contributes to many other segments like better living standards, recognisability and image of a country.

Competitiveness is of crucial importance also for one small economy like Bosnia and Herzegovina that cannot be self-sufficient. In other words, economy of Bosnia and Herzegovina must be open to the rest of the world in order to achieve satisfactory growth for its citizens. International market represents huge potential for BH producers and creation of new jobs. Environment also represents significant potential export of financing investments necessary to increase production capacities and productivity growth. Interactions at international markets contributes to faster adoption of knowledge and technology necessary for more efficient organization and better business results. Data of the B&H Directorate for Economic Planning show that so far Bosnia and Herzegovina did not use many potentials of openness that indicates low living standard at the level of a third of the European average as consequence of high unemployment followed by low activity of working-age population. Bosnia and Herzegovina lags significantly behind not only the European average and more successful transition economies,

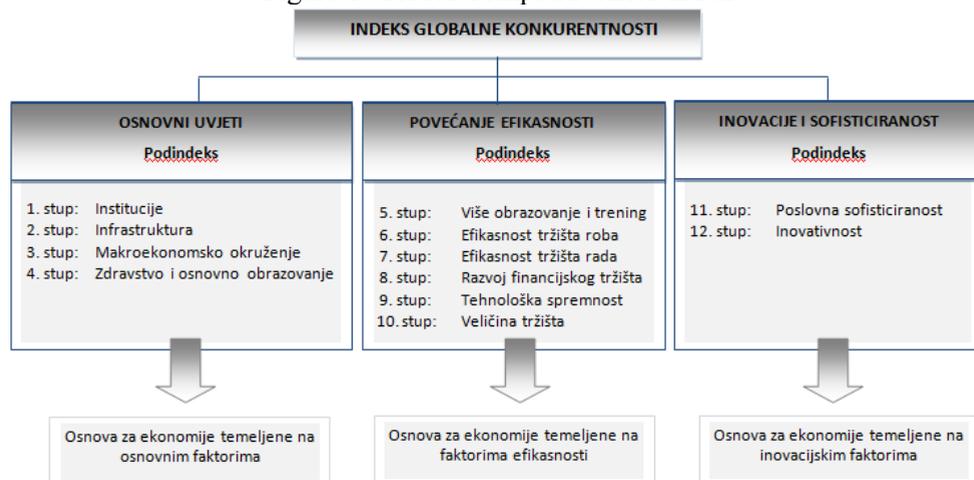
but it is also very often at the bottom of the regional list of environment of the former Yugoslavia. Poor competitiveness position is one of the main causes for extremely low living standard in Bosnia and Herzegovina comparing with the European average and average of successful transition countries in Europe. Low competitiveness of export, attraction of foreign capital with bad credit rating are among the most important indicators of low competitiveness position of Bosnia and Herzegovina. This was mostly caused by unfavourable business environments, low quality of educational system and insufficiently functional labour market with high share of grey economy. Structural changes are necessary in order to improve situation in all areas and they are mostly presented in the Reform Agenda.

Speaking about global competitiveness is mostly impossible to omit World Economic Forum and its Report on competitiveness in global frameworks. Results of the Report are based on the survey of businessmen in 14,000 companies around the world, statistic data from 2016 and 2017 and data of international organizations: World Bank, OECD, IMF, WHO, UNESCO. The Report includes 137 countries that makes 98% of the world GDP. Republic of Croatia is included in this research since 2002, and Bosnia and Herzegovina since 2005.

The Reports indicates three main challenges of the most of countries. The first challenge is financial vulnerability that represents threat to competitiveness and ability of economy to finance innovations and new technologies. The second challenge is that emerging economies become better in innovation but they have to invest more effort in innovations to develop faster and more efficiently. The third challenge is flexibility of labour market and protection of workers to increase their competitiveness at labour market and to prepare them for the fourth industrial revolution.

World Economic Forum (WEF) defines competitiveness as set of institutions, policies and factors determining level of productivity of a country. Level of productivity determines level of prosperity that economy can achieve. Methodology is based on analysis of 12 factors of competitiveness that include institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, efficiency of labour market, efficiency of market of goods, technological readiness, financial market, market size, business sophistication and innovation. Factors of competitiveness are grouped in three sub-indices: main factors, efficiency factors and innovation and sophistication factors.

Figure 1. Global Competitiveness Index



Source: <http://www.aik-invest.hr/konkurentnost/mjerenje-konkurentnosti/indeks-globalne-konkurentnosti/> (10.11.2018.)

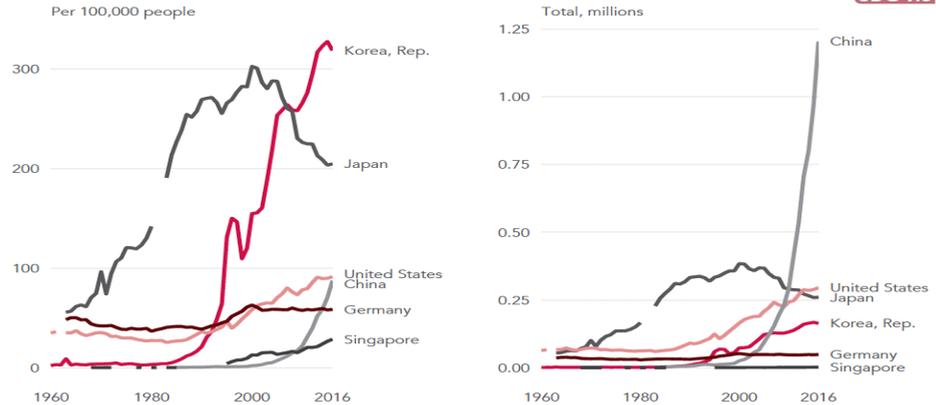
The world of new times shaped by globalization, liberalization and technological development offers to many countries worldwide progress, growth and development no matter strength and size and market winning. World market becomes available to everyone as a result of trade blocks, global companies and global economy. Aiming higher competitiveness, it gives opportunity to the smallest and least developed that can be seen in many countries that progress very fast from “world periphery” to very developed cores at global markets. The best example is Singapore that from once-poor colony become one of the richest and most developed countries in the world. In the 60s Singapore was very poor country with small prospects for success. Then with population of 1.6 million people and without any natural resources, they lived from trade and incomes of British military bases. They did not have developed industry, knowledge and own capital to induce development. They turn to creation of better business opportunities and attracted many investors. In the 80s they turn to the newest technologies. While in the 70s the main export goods in Singapore were fabrics, clothing and basic electronics. Already in the 90s pharmaceutical industry, microchip manufacturing, aviation industry etc. are developing. Today, this highly developed market economy with high level of security for investors and without corruption has GDP per capita in amount of 79,000 dollars in 2013 according to IMF data. This ranks them on the third place, just behind Qatar and Luxemburg. For comparison, GDP per capita in Bosnia and Herzegovina in 2016 was 8,516 BAM. The aim of Singapore government is to become financial and technological centre of Southeast Asia. Maintaining and increasing growth in the future the government plans to achieve by increasing digital and technological capacities, founding new funds for entrepreneurship, encouraging establishment of different companies and facilitating networking, approach to new technologies and safe financing, but also linking

Singapore's universities and companies with global centres for innovation in order to ensure and enable exchange of knowledge and skills between Singapore and world. They emphasize need to maintain relations with foreign investors who could contribute to gaining knowledge from outside. It can be seen from the next figure that progress and global competitiveness require knowledge and its application through development of new technologies.

Figure 2. Top six countries at patent development, innovation encouragement through research and development

Patents are designed to encourage innovation by providing incentives for research and development.

Patent applications, residents, top six countries in 2016



Source: WIPO, World Development Indicators (IP.PAT.RESD; SP.POP.TOTL).

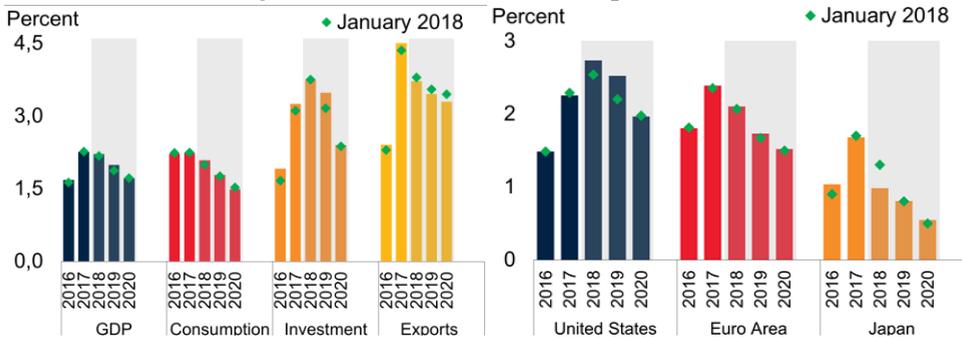
Source: World Bank, 2018

The precondition to good positioning at global market is the availability of knowledge, modern technologies and systematic research and development. This global activities cause that relation among people become more intense, almost cosmopolitan, since these activities enable free movement of capital, goods, information and people by spreading and omitting borders. Lončar (2005) defined globalization through different aspects from economic, where global markets affects course of world economic processes, gain profit and integrate planet to legal and cultural. Companies, especially multinational, include in their business millions of people around the world no matter their distance and use their scientific and professional capacities, monitor planet resources, capital and technology. Karić (2017) addresses that political field of globalization is mostly reflected in reduction of state power and autonomous decide-making on all matters within state territory. He also adds that adoption of different international documents in the second half of the 20th century put under jurisdiction of international community many issues that were exclusively under jurisdiction of state government. He continues that limitations of state government comes from different directions, like IMF and WB that condition their assistance with list of free market measures. Direct investments of transnational corporations if often caused by harmonisation of fiscal policy with

their interests. Membership in political blocks, like the EU, puts country in “causal” position. Globalization abounding with more complex threats on internal plan of weak state institution, like in many countries of the Western Balkan, can hardly be resist and deal with. In the same time, they hardly can be reliable and credible partner within international community so reaffirmation and strengthening state institutions consider to be the most real challenge of today.

While from one side under-developed countries are struggling with ordering and acting of state apparatus to ensure better position of global competitiveness, from the other side developed countries of triage, despite opposite signs, continue to record and predict growth of their economies. According to analysis of *Global Economica*, they are unstoppable followed by China that is predicted with extremely strong continuous growth of its economy.

Figure 3. Advanced economies, predictions



Source: World Bank, 2018

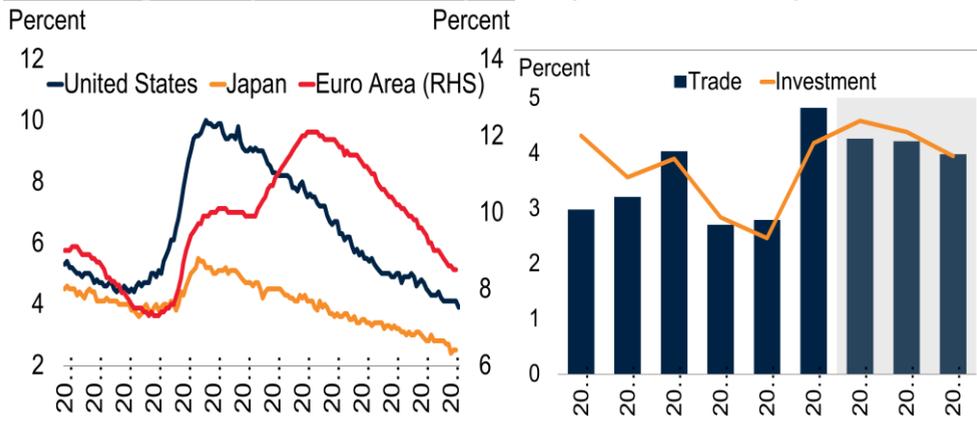
The figure shows unemployment rate in the most developed countries that is observed in April 2018 for USA, Japan and Eurozone. Trust of consumers is still large when it comes to economies of triage countries that results in continuous creation of new jobs. Globally in 2017, the increase of commodity exchange of 4.6 percent is recorded, three time exceeds dynamics observed in the previous year. This momentum is kept in 2018 that can be seen from the figure 4. Analysis of *Global Economics* shows that service trade still has the highest unused potential for further growth.

There are BRICS¹ countries that make 40% of population and more than 25 percent of planet on the other side. Also, it can not be ignored that BRICS countries in

¹ BRICS is English abbreviation and economic term that refers to growing development of economic potential of Brazil, Russia, India and China. Implicitly, it refers to economic partnership of these complement economies. The term was introduced by Jim O’Neil from corporation for global financial researches Goldman Sachs and soon it is accepted publically, especially in media to the extent that is used mostly today regarding global finances without any explications. Source: <https://sh.wikipedia.org/wiki/BRIC>

2017 have achieved 25 percent of world GDP, while IMF in its predictions states that in the next few years this percent will increase at almost 27 percent. In the last ten years, five member countries of the group have showed extreme resistance on few previous crisis, including decrease in commodity exchange in 2014 that lead to stagnation and recession in Brazil, South Africa and Russia. Growth within the group is very clear. For example, China is the biggest Brazilian trade partner that recorded growth of export in the world for 14% at the end of 2017. China also focuses on South Africa where bilateral trade between these two countries in the last decade had increased 20 times.

Figure 4. Dynamic commodity exchange and investment growth



Source: World Bank, 2018

Globalization has become a personification for competitiveness, i.e. according to economists subject of globalization lays on the fact that companies have to learn how to enter foreign markets, business globally and increase their global competitiveness. Without technological changes announced by the new industrial revolution characterized by increased convergence of digital, physical and biological technologies there is no national potential for growth. Hence, small countries characterized by relatively small internal market that want more intense to include in global courses, first have to improve their competitiveness. But also, economists agree (Zukić, Pupavac, Samardžija, 2017) they need to change managerial paradigm and development of logistic concept of business systems management and adjust institutional system to entrepreneurial environment. They also add that business networking of companies, inclusion in logistic supply chain, strategic alliances, clustering development and technological and management innovations through development and supply chain management, increase business efficiency and effectiveness, i.e. productivity and competitiveness in modern turbulent globalized business environment. We have to accept that fact that increased economic interdependence requires more decisive and coherent answer at political level, since economic reality moves faster that political as evidenced by

actual relations of the strongest at the global stage. Throne of global competitiveness shows the best turbulence of globalized business environment characterized by more complex relations of big countries like USA and China. Economists will agree that today China and USA change role and in new constellation of relations China leads American policy from the past and represents coexistence and globalization, while USA like “former” China represent even more nationalism and protectionism. The prominent European researcher Andrea Costa states in his analysis of American-Chinese relations that last decision of Beijing reveals that China has the aim to transform economic power in strategic. Together with de-americanization of the world economy, China also tends to abolish American monopoly in advanced technology and artificial intelligence that clearly could lead to future wars. The design of innovation policy is the newest trend in global economy.

Countries that want take a lead in race for global innovative advantage must shape and implement whole range of constructive policies to support innovation capacities of their economies. For this purpose, some 35 countries made formal national innovation strategies and at least 24 of them established national agencies for innovation. All this are procedures that intensified global competition for innovation leadership. These countries can not accept government policy to affect innovation recklessly and uncoordinatedly. They try to develop mechanisms that will value advantages and disadvantages of their nations, investigate policies of other nations to learn from them and revise own policies at large number of areas that could affect their innovation and competitiveness.

Countries with leading position in development of innovation policies have passed through three step process:

1. First, they recognized need for systematic approach to innovation.
2. Second, they have actively devoted attention to need for innovation through political system, imposing inspiring vision and strategy of activity filled with clearly articulated goals and ambitions. These goals and game plans for their achievement are resolved in national innovation strategies of the countries. At the end, they made hard decision, necessary not only for implementation of institutional reforms in order to encourage innovation strategies, but also for their adequate financing (including provision of tax incentives), even on the account of other issues of public expenditures and tax policy to individuals.
3. At the end, the define set of measures how process will be monitored and evaluated in broader context i.e. in the context of updating strategic decisions.

Proponents of free market ideology will say that nations should not set goals for their economies because, according to definition, whatever economy market creates, it will be correct and superior in relation to any economy where some rules

are dictated, whether they are Stalinist's Five Year Plan or market-oriented possible innovation policies. This is one of the reasons why USA did not set any goals in general related to innovations, except recent ones related to broadband internet and more clear energy. However, markets that act alone will fail when it comes to innovation and because of that at least 35 countries have implemented national innovation strategies. Within these strategies many countries with no excuse name their intention to take leadership over the world in some activities, technologies or areas of application and they are devoted to support the goals with all necessary means. These countries believe that without work on ambitious goals, private, non-profit and state sectors will not be enough motivated to take necessary steps.

Maybe, the best example of nation with ambitious goals is Singapore, whose success was explained in the previous part. Singapore openly admit that it tends to be leader of the world in biology, digital media and water and ecological industries. Ten years after, Singapore has succeeded. According to findings of Atlantic Century Foundation's Report for information technologies and innovations (ITIF), in 2009 Singapore was at the first place among 40 nations or regions in competition based on innovation. This made it second most advanced nation in the period from 1999 to 2009 (only China demonstrated faster progress).

Many nations distinguish a number of fundamental industries where they tend to achieve leadership. For example, Finland national innovation strategy recognized six key industries for its economy to their global leadership: wood industry, information and communication technologies, health care, energy and environment, construction and mechanical engineering. For each of these industries, Finland has created strategic centre for science, technology and innovation, partnership where companies, universities and research institutes agree mutual plan of technological research for industry. This indicates on technological challenges and key necessary areas for the next decades, what enlightens path towards development of technology and further phases for financing research. In general, Finnish national agency for technologies, broadband internet, advanced machine processing, production with small number of workers and innovations in services – that will be used to achieve significant advantage for its companies and activities and finances research in accordance with that. Netherland has focused on leadership in innovation in creative and financial services, pension system, logistics and management of supply chain. Denmark has focused on IT services, management of pension system and transportation.

2. ANSWER TO EU GLOBAL COMPETITIVENESS

While the world is moving forward very fast and globalization pressures constantly resources, the European Union has to, in order to maintain its position on the throne of global scale, take control over its future. That is way the Europe 2020

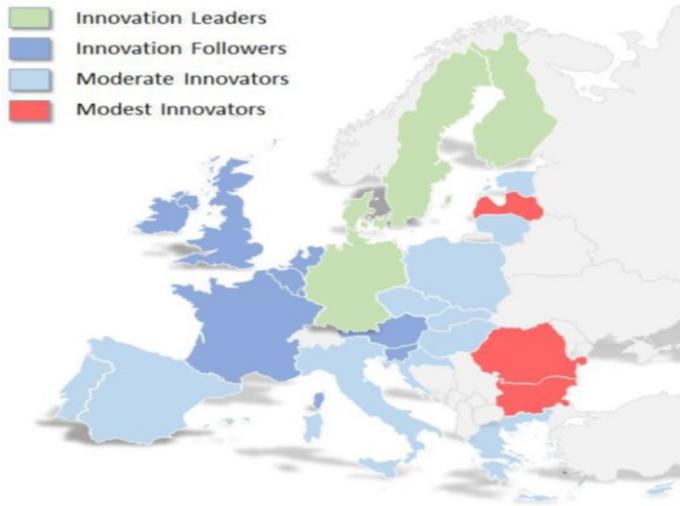
Strategy brings vision of the European social market economy for 21. century. The Europe 2020 Strategy proposes three priorities that mutually complement.²

1. Smart growth: development of economy based on knowledge and innovation
2. Sustainable growth: promoting economy that efficiently uses resources, economy that is more green and competitive.
3. Inclusive growth: nourishing economy with high rate of employment that brings social and territorial cohesion.

Just encouragement of growth and competitiveness for economic development and achievement of the Europe 2020 Strategy goals, is included in the most important priorities of the Commission and the EU member countries in the period after crisis. The Europe 2020 Strategy is focused on solving structural weaknesses of existing models of growth by creating conditions for smart, sustainable and inclusive growth. The European Union is faced with the fact that slowed growth of productivity is obstacle to stronger total economic growth, where single market still does not achieve full potential. Especially, it is addressed lag in adoption of new technologies in economy. According to expectations of the European Commission, average investment in research and development should be 3% of GDP in the European Union. Last year, autumn economic prognosis for 2017, have estimated growth of real GDP in the EU in total at 2,3%, that is slightly above expectations that were 1,9% for 2016. However, positive economic trends are still burdened by insufficient growth of productivity and permanent inequalities between member countries. Inflow of direct foreign investment, trade integration and diversification in the certain EU economies are weak. To strengthen positive trends and convergence within the EU, economies of member countries should be more competitive, more resistant to crisis and more inclusive and innovative. From the next figure, it can be seen that there are large variations in innovation in the EU. Countries that are leaders in competitiveness and economic power are also leaders in innovation, first of all Finland, Germany and Sweden.

² EC, Strategy for smart, sustainable and inclusive growth, Bruxelles, 2010

Figure 5. Innovation in the EU



Source: Restoring EU Competitiveness, 2016

Innovation environment is much weaker in south countries as well as in new members. All this confirms the fact of the European Investment Bank from 2016, that Europe will need additional 130 billion annual allocations in R&D to achieve planned level of 3% of allocations in R&D till 2020.³ Global allocations for R&D are mostly concentrated in G20 countries. In total they make 92% of all allocations for R&D.

Figure 6. World list of allocations in R&D

Country	Allocation in R&D (% GDP)
South Korea	4.23%
Japan	3.29%
Germany	2.93%
USA	2.79%
France	2.22%
Australia	2.11%
China	2.07%
Canada	1.71%
Great Britain	1.70%
Italy	1.33%
Russia	1.10%
Turkey	0.88%
South Africa	0.73%
Argentina	0.63%
Mexico	0.53%

Source: <http://www.visualcapitalist.com/global-leaders-r-d-spending/>; October, 2017

³ Restoring EU Competitiveness, 2016

Figure 7. Allocations in R&D of global companies

Company	Allocations in R&D (2016/2017)
Amazon	17,4 billion dollars
Volkswagen	15,1 billion dollars
Alphabet	14,5 billion dollars
Intel	12,8 billion dollars
Samsung	12,8 billion dollars

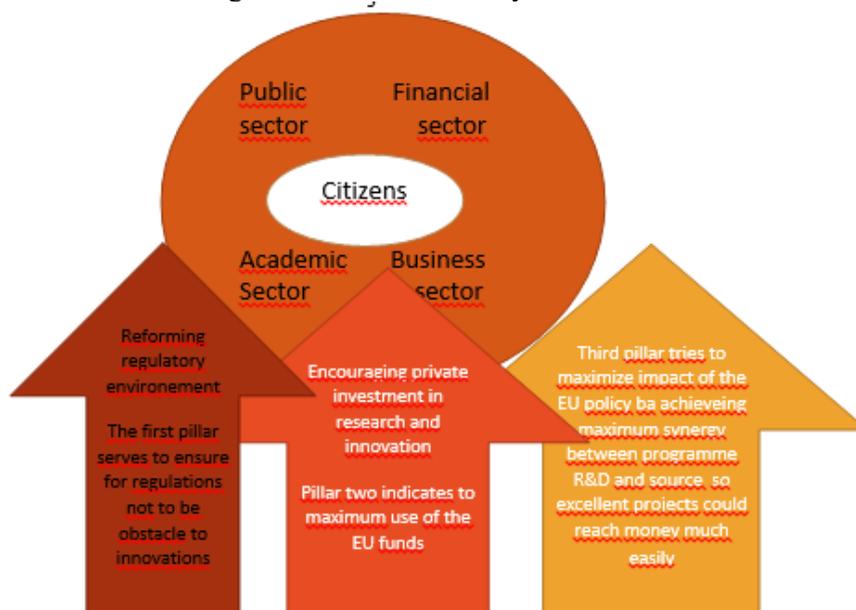
Source: <http://www.visualcapitalist.com/global-leaders-r-d-spending/> (October, 2017)

The European Commission's Report from 2017 clearly points out that even though many European regions are well positioned and use advantages of globalization, the less developed (especially in the south and east Europe) are faced with risk to loose large number of jobs as result of competitiveness, specialization and technological changes.

The European Union is still world leader in producing scientific knowledge, in front of USA. However, problem of Europe is that often its knowledge is not commercialized in Europe but somewhere else in the world. This is reason why Europe protects more *open innovations* based on transfer of knowledge, professionalism and resources of a company or research institution to another. Concept of an open innovation is constantly evolving and it moves from linear, bilateral transactions and cooperation to dynamic, networked, multi-user innovations of eco system. An open innovation assumes that companies can and need to use external ideas as internal ideas, and internal and external paths to markets since they tend to improve their performance and emphasize role of public research organizations as producers of knowledge, co-operators and generators of qualified human capital.⁴

⁴ Open Innovation, Open Science, Open World, Directorate – General for Research and Innovation, 2016

Figure 8. Innovation eco system



Source: Directorate-General for Research and Innovation, 2016, corrected by author

From the figure it is seen that *Directorate for Research and Innovation EU* emphasizes importance of acceptable environment for innovation, i.e. innovation eco system that recognized values and support wide approach to innovations. This should include users in the innovation process and encourage circulation of ideas and knowledge. In the future, it should focus on proactive solution of needs of the European companies to enable them to grow, cooperate with citizens and knowledge users, i.e. to use more efficiently knowledge base in Europe.

For insufficient success of so far EU strategies to new model of innovation development, the EU has made strategy of smart specialization as platform to focus development investments in areas where Europe has a critical mass of knowledge, capacity and competences that makes innovative potential to maintain the highest positions of competitiveness at world markets.

2.1. Smart specialization S3

Smart specialization is designed within reformed cohesion policy of the European Commission based on identification of strategic areas of intervention based on analysis of strengths and potential of economy and entrepreneurial discoveries process with large participation of stakeholders and broad view to innovations. Smart specialization means determining unique characteristics and resources of each country and region emphasizing competitive advantages of a region, gathering

regional stakeholders and resources around their vision of future based on excellence. Each region identifies key areas, activities and technologies with comparative advantages, and regional policy is directed to encouragement of innovations in the areas.

Strategy for smart specialization should be designed around the following key principles:⁵

- Smart specialization is approach based on place, what means that is built by means available to regions and member countries and their specific social and economic challenges to identify unique possibilities for development and growth;
- To have strategy means make choices for investments. Member countries and regions should support only limited number of well determined priorities for investments and/or clusters based on knowledge. Specialization means to focus on competitive powers and real results of growth supported by critical mass of activities and entrepreneurial resources;
- Setting priorities should not be top-bottom process, choosing winner. That should be inclusive process of inclusion of stakeholders focused on “entrepreneurial discover”, interactive process where market powers and private sector reveal and produce information on new activities, and government estimates results and strengthens the most active actors for achievement of the potential;
- Strategy should include broad view to innovations, following technological and practical and social innovations. That should ensure to each region and member country a shape of political choices in accordance with their unique social and economic conditions;
- Finally, a good strategy has to include monitoring system and sound evaluation, as well as revision mechanism to update strategic decisions.

Ex ante conditions of the RIS3 strategy requires that EU member countries and regions implement smart specialization based on SWOT or similar analysis to direct resources on limited set of research and innovation priorities, take care that each member country adopts framework that states available budget resources for research and innovation. Member country, also, should adopt multi annual plan for financing and determining priority investments related to the EU priorities (European Strategic Forum for Research Infrastructure – ESFRI) and sketch measures to stimulate private investment in research, technology and development and have monitoring and verification system. Indeed, key elements clearly show whether it is about process that include cyclical course.

⁵ <http://s3platform.jrc.ec.europa.eu/what-is-smart-specialisation>

Figure 9. Key elements of the Smart Specialization Strategy process



Source: Prepared by author

Step 1 – Analysis of regional context and innovation potential

Step 2 – Management: ensuring participation and “ownership”

Step 3 – Design of comprehensive vision for future of region

Step 4 – Identification of priorities

Step 5 – Definition of coherent mix of policy, action plan

Step 6 – Integration of mechanisms for monitoring and evaluation

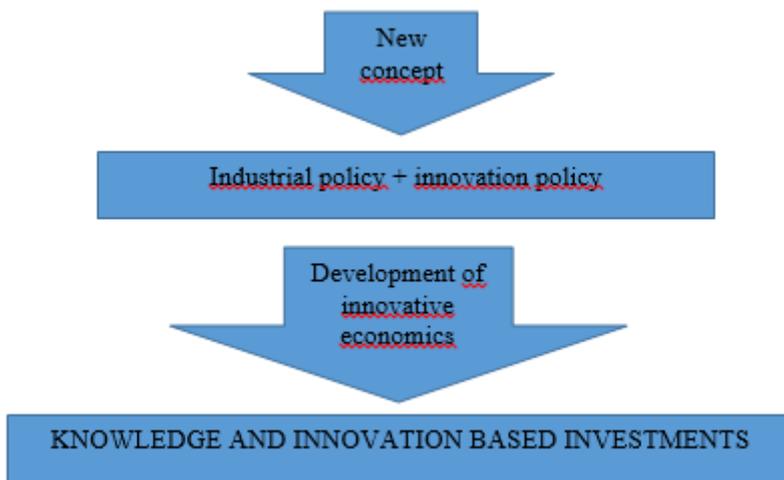
The aim is to focus member countries to make new model of economic growth that should increase total competitiveness of the EU and decrease, as much as possible, differences between economies of member countries.

Member countries are focused on making new model of economic growth that will increase the total competitiveness of the EU and decrease differences in development between economies of 28 members. The new EU Cohesion Policy for the period 2014-2020 as “ex ante” condition requires member countries to identify specialization areas that suit the best their innovation potential, and that are based on means and abilities to use EU funds in the area of research, technological development and innovation. The aim is, from the one side, to enable more efficient use of the ESI funds and increase synergy between EU funds and funds of national and regional policies. On the other hand, the aim is to create in a unique way a unique assets and abilities based on specific industry structures and knowledge base in region.

2.2. Concept of the smart specialization

New concept of the smart specialization connects industrial and innovation policy for development of innovative economics. It focuses on knowledge-based investments and innovation, and in financial perspective it is precondition for use of ESI funds for thematic goal Research, development and innovation.

Figure 10. Concept of the smart specialization



Source: made by authors

The new concept is precondition for use of the ESI funds for thematic goal Research, development and innovation. In financial period 2014-2020, in the Republic of Croatia, there is in total 10.676 billion euros available from the European structural and investment funds (ESI).

The smart specialization refers to defining territorial capital and potential of each country and region, emphasizing competitive advantages and networking of stakeholders and resources around vision of the future based on excellence. It also include strengthening national and regional innovation systems, determining and development of thematic innovation platforms and improvement of knowledge exchange as well as spread of advantages through the whole economy that enables more efficient use of the ESI funds and increase of synergy between the EU, national and regional policies.

Strategy of smart specialization should be based on available resources and potential for their use, identification of competitive advantages and technological specialization as basis for future innovations. The S3 will help member countries to enhance public and private investments in research, technological development and innovations. Instead to follow “top-bottom” approach, primarily including public

sector, it should use “bottom-up” approach in making S3 and through cooperation and mutual effort of public, scientific and research and business sector and through entrepreneurial discovering process determine own strengths and competitive advantages.

Strategy of smart specialization can enhance structural changes through modernization, diversification, transition and radical changes in all EU countries/regions. The process of smart specialization is not unified model equal for everything but an entrepreneurial process based on research of territorial capital and innovations. It is focused on economic transformation of the EU countries/regions and on bigger added value and knowledge-based activities.⁶ It also tries to reconcile logic of strategic choices, priorities and high level of targeted orientation (by government) with a logic of decentralized and entrepreneurial information and incentives not only bottom-up nor top-bottom but combination of approaches aimed at improvement of entrepreneurial activities and coordination with the framework (priorities) set by government. Fiscal measures are one of the support that governments use to enhance economic activity.

On the other hand, one of the key sectors that horizontally can be connected with almost all development sectors is IT sector. Beside, importance of the IT sector reflects in the part of digital agenda for Europe that mentions the following facts:

- Internet economy makes 5 jobs for each 2 lost offline jobs
- EU digital economy grows for 12% annually and now it is bigger than Belgian economy
- In the EU number of post-paid mobile is bigger than number of inhabitants
- There is 7 million jobs in information communication technology sector in the EU
- It estimates that half of the productivity growth is from investment in information and communication technology.

3. EX ANTE CONDITIONS AS KEY ELEMENTS OF COHESION POLICY

Ex-ante conditions (ExAC) are one of the key elements of cohesion policy reform for the period 2014-2020. They are introduced for the European structural and investments funds (ESI funds) to ensure necessary conditions for effective and efficient use of the ESI funds.

These conditions are related to⁷:

- *political and strategic frameworks* to ensure high quality of strategic documents at national and regional level that support the ESI funds and

⁶ http://www.obzor2020.hr/userfiles/obzor2020/pdfs/Strategija_pametne_specijalizacije_RH_2016_2020.pdf

⁷ https://ec.europa.eu/regional_policy/hr/policy/what/glossary/e/ex-ante-conditionalities

their adjustment with standards mutually agreed of member countries in the EU;

- *regulatory frameworks* to ensure adjustment in implementation of operation co-funded from the ESI funds with the EU acquis communautaire and
- *sufficient administrative and institutional capacities of public management and stakeholders implementing ESI funds.*

It is clear that fulfilment of ex-ante conditions shall also be met by ex-Yugoslavia countries who are preparing for full membership in the European family. When it comes to economic criteria, according to the last Report of the European Commission, Bosnia and Herzegovina is still in early stage of development of functional market economy. Certain progress is made in modernization of labour legislation, improvement of business environment and solution of disadvantages in financial sector within agreed Reform agenda.

However, public sector is inefficient and private sector develops slowly. Strong and continuous political support will be the key for fast implementation of necessary reforms in accordance with agreed Reform agenda. It is emphasized that Bosnia and Herzegovina is in the early stage of building capacity to cope with competitive pressure and market forces in the Union, what means that last observing period did not bring any progress regarding competitiveness.

The overall level of education and allocations for research and development are very low. Quality of physical capital is jeopardized with insufficient investments. Transport and energy infrastructure is under-developed. Structural adjustments are slow, even though there is certain diversification in regional trade structure of the country.

Regarding convergence to the European standards, certain level of readiness in public procurement and internal market is made. Bosnia and Herzegovina still has to adopt strategies for the whole country in the field of agriculture, energetics and life environment. Also, continuous efforts are necessary in the field of justice, freedom and security, competition, industry and SME companies, environment and policies.

When it comes to our neighbour, Republic of Serbia, the European Commission's Report as of 2018 says that this country has made good progress and moderate readiness in development of functional market economies and that they solved weaknesses of policies, especially regarding budget deficit. Still, it needs strong and preserved macroeconomic stability, controlled inflation and growth-friendly monetary policy as basis for the growth.

Also, Commission has identified improved labour market conditions. But main structural reforms are still not done like reform of public management and state-owned companies. private sector is insufficiently developed and level of investment activities is still smaller than market needs. However, it is praiseworthy that Serbia has achieved good level of readiness for the EU especially in the fields: law of legal entities, intellectual property, science and research, education and culture, customs, and it improved connection of investment planning with budget execution.

According to European Commission's Report Montenegro has made moderate readiness for functional market economy. It has strengthened its macroeconomic and fiscal stability, but still it has to make additional efforts to solve permanent challenges, especially burden of high public debt. Montenegro's economy since 2013 has steady growth trend with low or moderate inflation rates. However, weaknesses in the rule of law, including unfair competition in the form of informal economy, affects negatively business environment.

Market is faced with structural challenges that are reflected in small participation and high unemployment rates. The European Commission identifies progresses in Montenegro only as moderate readiness regarding capacities to confront with competitive pressure and market forces in the Union. Education reform in Montenegro is underway, but Commission addresses that it is important to make greater efforts to solve issue of mismatch between skills required at the market and offered skills. Small and medium companies are still facing with many challenges like financing and complexity of regulatory procedures. Continuous efforts are necessary to improve overall export results of domestic companies. The Commission emphasizes that in future period Montenegro should focus especially on competitiveness policy, strengthening administrative capacities, environment and climate changes and public procurement.

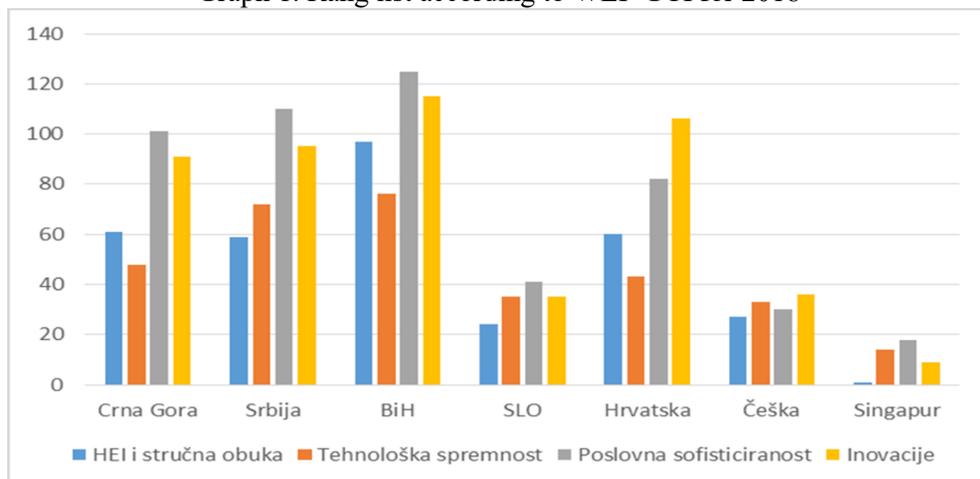
The last World Economic Forum's Report corresponds with the European Commission's Reports for mentioned countries in the region. To prepare smart specialization, it is necessary for countries to have prepared, before everyone, ex-ante conditions: political and strategic frameworks i.e. high quality strategic documents, beginning from Bosnia and Herzegovina who still has unfinished job for many sectors, regulatory frameworks and additional administrative and institutional capacities of public administration where countries have not good results. Then, it can go further to serious job to identify sector priorities and all other key stakeholders to create strategy of smart specialization.

If it is according to the following graph, problems of consistent implementation of ex-ante conditions are clear for Bosnia and Herzegovina, Serbia and Montenegro, also for Croatia who adopted Smart Specialization Strategy in 2016 and where

conditions for smart growth, according to WEF from 2018, are not at desired level (Graph 1).

In comparison to Serbia and Montenegro, Bosnia and Herzegovina records the worst position at WEF's list when it comes to higher education, technological readiness and business sophistication and innovation.

Graph 1. Rang list according to WEF GCI for 2018



Source: The Global Competitiveness Report 2017, made by authors

From the previous graph, looking at competitiveness through GCI pillars that reflect requirements of smart specialization strategy, it is clear that priorities of countries are to:

- identify sector priorities of development, public, private research sector
- invest in higher education and scientific-research work in the sense of its connection with social and economic environment, market
- necessary to create preconditions for technological changes and business sophistication from the context of technological and human resources, and
- make efficient eco system for innovation and transformation of economy.

All mentioned are preconditions for global competitiveness capacities, i.e. elements for strategic document of smart specialization, that is still to come in Bosnia and Herzegovina and other countries of the region, Serbia and Montenegro.

4. CONCLUSION

Smart specialization refers to determine areas where our long-term and sustainable growth and development can be based, based on analysis of resources and preferences and interests of citizens, entrepreneurs, education institutions, government. Decision on priorities or areas of specialization has to be made

according to partnership principle and combining approach up-bottom and top-bottom. The fact is that state should make conditions for macroeconomic development, but undoubtedly it is important to identify all capacities and values available to community from material to intellectual. This should be inclusive process involving stakeholders focused on “entrepreneurial discover”, interactive process where market forces and private sector reveal and produce information on new activities, and government estimates results and empowers the most active actors in achieving this potential.

In the context of smart specialization, regions have to focus on several areas or goals, instead of spread scope-limited investments that proved in practice as wasteful and ineffective. The choice of priorities should be result of collective thinking on future of the region.

It is important to choose priorities with innovative potentials, potentials for sector transformation or manners to establish new sectors that will be regionally recognized. The S3 goal is to determine and implement activities used for modernization, transformation and step forward and strengthen certain activity, and this again is impossible without higher education institutions and scientific and research work and its synergy with entrepreneurship. These smart specializations are important for each region. For less developed and transition regions, S3 is not replacement for existing policies focused on improvement of system but it is additional option recommended to regions. Focusing on smaller number of goals will show that region is capable to use its advantages. Bosnia and Herzegovina and its neighbours Serbia and Montenegro as well as all countries of the region still has to show and prove this if they want to keep up with the European and global competitiveness.

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USE OF (HARD AND SOFT) PEGGED EXCHANGE RATE REGIMES ON THE PATH TO EUROPEAN INTEGRATIONS IN TERMS OF CRISIS

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Review

Abstract

Important aspect of ongoing discussions on the choice of exchange rate regime is its reaction to crisis as a strong and unexpected external shock; such was the case of Great Recession from 2008.-onwards. It is generally accepted that pegged exchange rate regimes are more sensitive to external shocks that might cause their long-term destabilization. Still, the soft pegged regimes (also entitled intermediate regimes) have fewer limits, with rules that allow more maneuver space for national strategy. The group of soft pegged regimes is wider, both in structure and scope, than those of hard pegged regimes. While countries with more flexible regimes might use exchange rate fluctuations as automatic stabilisator, (hard and/or soft) pegs impose some limitations. In the first place, there is stability goal that, in combination with strict regulatory rules, limits the monetary and exchange rate policy, demanding the use of other strategies, such is the internal devaluation. Secondly, these countries do not use wide scope of instruments and their crisis strategy is more rigid than those of other regimes. Finally, there are dilemmas on the optimality of exchange rate strategy during the pre-eurozone membership period, including the euro introduction strategy. These dilemmas deepen in terms of crisis.

This paper focuses on comparison of hard and soft pegged regimes (the latter also entitled intermediate regimes) in selected European union accession countries, using „de facto“ classification scale developed by International Monetary Fund. Despite the crisis, there have not been dramatic turbulences in terms of exchange rate policy in observed countries, but the general economic indicators clearly show the real depth of crisis and slow recovery. The question open for further discussion is whether such regimes should be obtained or abandoned during the crisis and what is their contribution to national economy. Furthermore, there are pros and cons of possible strategies, considering the European integration process.

Keywords: *exchange rate regime, great recession, hard pegs, soft pegs (intermediate regimes)*

JEL: E42, E55, F33, F36

1. INTRODUCTION

For the post-transition and post-centrally planned economies, European integration is a process that includes a well-defined strategy and efforts in all aspects of national economy, including the exchange rate policy. On the other hand, the process is not isolated from endogenous and exogenous shocks, such as the global crisis that endangered stability of the global markets from 2008 onwards (also entitled Global Recession). The focus of this paper is on the hard and soft exchange rate pegs in chosen European countries, considering the importance of exchange rate policy in national economy.

Analyses of determinants of exchange rate regime success include its characteristics, influence on other economic variables and external factors. The period of Global Recession has been turbulent for post-transition countries such as for the rest of the world, including dilemmas on optimality of their exchange rate policies and European integration process dynamics (measured in terms of Maastricht criteria, additional criteria introduced by European Commission and national strategies). The sample observed in this paper covers post-transition countries with hard and soft pegs, as classified by IMF (IMF, 2017, pp 6-8), varying from official euroisation (“exchange arrangement with no separate legal tender” (IMF, 2017)) and currency board arrangement as hard pegs to some form of intermediate regime (“soft pegs” (IMF, 2017)) with certain level of sovereign and active monetary policy. Since inflation stability (measured in terms of price levels) has been the main monetary policy goal during the observed period, analyses provided in this paper also take it into consideration. Although a heterogeneous group, observed countries participate in European integration process, but are in different phases of accomplishing a full membership in European Economic and monetary union. The sample consists of countries with pegged regimes; namely, Bosnia and Herzegovina and Kosovo are potential candidates, while Serbia, Montenegro and FYR of Macedonia are candidate countries. Three countries from the sample (Bulgaria, Croatia and Czech Republic) are full members of European Union, with an “opt-in” clause for Eurozone membership. Still, they are not participating in Exchange Rate Mechanism II. Denmark (although maintaining a conventional peg, which is a form of soft peg) was not considered as a part of this sample since it participates in Exchange Rate Mechanism II.

During the global crisis, important questions were whether the national currency is over- or undervalued, does the chosen national exchange rate regime remains a good choice in terms of crisis, and whether is able to provide sustainable instruments for crisis strategy. Exchange rate fluctuations, allowed within floating regimes and partially within the intermediates, are usually considered automatic stabilizers, while the pegged regimes are more focused on retaining the stability of exchange rate and price level, with less maneuver space. Question on whether to change the pegged regime or not, and what exit strategy should be used, remains open. For the countries in the sample exit strategy is full membership in European monetary union¹. Still, considering the criteria of nominal and real convergence, exchange rate policy might contribute to the effectiveness of the process.

This paper, considering the reaction of chosen post-transition countries on Great Recession pressures, focuses on few questions, contributing to the wide literature on exchange rate regimes with an analyze on pegged regimes, considering both hard and soft pegs, the latter also entitled intermediate regimes. Besides the theoretical analyses, main economic indicators are observed, in order to analyze whether the stability and predefined goals (primary price stability) was endangered by strong external shock, such was the global crisis. For that purpose the paper first analyzes shares of the two observed groups within total IMF members, their characteristics and changes both in classification schemes and the strategies (regimes) used by countries.

Traditionally, earlier literature on exchange rate regimes, especially in late 1990s and early 2000s, is focused on choice between so called corner solutions (fixed vs. flexible regimes) but there is also a group of regimes that are intermediate², combining the characteristics of the two extremes (see more discussions on exchange rate regimes and its characteristics in, for example, Calvo and Reinhart (2002), Frankel (1999), Edwards (2001), Rogoff, et. al. (2003), Eichengreen, (2008)). Considering the IMF's classification scheme and database, these regimes (there entitled soft pegs), have the highest share in total regimes and are the most heterogeneous group, while hard pegs have the lowest, rather stable share. The sample in this paper consists of countries with hard and soft pegs, according to the IMF's de facto classification scheme, despite the (de jure) publicly announced regime. Although transition countries used different types of regimes, inflation stabilization and control of price level was the final goal for their policies. Furthermore, national authorities' efforts were oriented towards establishing the institutional framework and enhancing the monetary stability.

¹Note that some countries from the sample already are members of European Union (Bulgaria, Croatia, Czech Republic).

²In literature also entitled as „soft pegs“, according to International Monetary Fund „Annual Report on Exchange Arrangements and Exchange Restrictions“, Washington D. C., different years

The regimes are considered as of pre-crisis 2004 and post-crisis 2017, including the monetary policy framework. Although both regime groups observed are based on pegs, these intermediate (soft pegged) regimes allow some level of (controlled) fluctuation around the peg whether the target range is publicly announced or not. Although exit strategy for the countries from the sample is eurozone membership, at this moment they still have (a certain level of) monetary sovereignty.

The paper is organized as follows. After the introduction, there is a second chapter that covers theoretical background and brief literature overview. The influence of crisis is described in third chapter, which is followed by conclusion (fourth).

2. THEORETICAL BACKGROUND AND BRIEF LITERATURE OVERVIEW

Choice of national exchange rate regime and consequences on national economy is a widely discussed topic in monetary policy and international finance. Besides the scope of a particular discussion, it is generally accepted that exchange rate policy influence national economy on many different levels. Since the focus of the paper is on pegged regimes, there should be a distinction between characteristics and scope of hard and soft pegged regimes, although the classification includes also floating, market-determined regimes (floating and free floating) and residual (other managed arrangements). (IMF, 2017, pp. 1).

Precisely, hard pegs consist of currency board arrangement and regimes with no separate legal tender (official dollarization/euroisation). Soft pegs (in literature also entitled as intermediate regimes) are a wide group consisting of heterogeneous regimes as following: conventional pegged arrangement, stabilized arrangement, crawling peg, crawl-like arrangement and pegged exchange rate within horizontal bands. (IMF, 2017, pp. 1)

2.1. Some remarks on exchange rate policy debate issues – theoretical background

One of the important questions in discussion on exchange rate regime choice is the accuracy of the classification methodology that, among other, resulted in *de facto* classification system developed by IMF. Besides this classification scheme, a number of authors contributed to discussion developing the criteria and classification systems. That resulted in different models, while mostly used are those developed by Bubula and Ötker-Robe (2002), Reinhart and Rogoff (2004) and Levy-Yeyati and Sturzenegger (2005, 2016). Some authors (Eichengreen and Razo-Garcia, 2011), Bleaney, Tian and Yin (2017)) also contributed to the discussion on the optimality of exchange rate regime choice comparing different classification schemes and criterions used. An analysis of dilemmas in post-transition monetary and exchange rate policies is provided in Kordić (2015),

considering influence of global crisis on selected indicators between eurozone member countries and those that are still outside the eurozone.

There have been different opinions and recommendations for exchange rate regime optimality, including those when intermediate regimes were observed as more sensitive to speculative attacks and crisis, and others focused on its impact on economic growth (a wider discussion is given in Frankel (2003)). Relation between manipulating with national currency and economic growth is a theoretical presumption, but also a cornerstone for national strategies. In his seminal paper, Rodrik (2008) has proven that undervaluation of the currency (in terms of (higher) real exchange rate) has a positive impact on economic growth. Explanation provided in the paper is twofold, including the institutional weaknesses and product-market failures. Sosvilla-Rivero and Ramos-Herrera (2014), following aforementioned Rodrik's (2008) paper, contribute to discussion on relation between exchange rate regime and economic growth. Dataset consisted of 123 (developing and developed) countries during 1970-2010. Based on the empirical research authors concluded that the best performance was in countries with intermediate regimes, while those with flexible regimes had the smallest growth rates. Further, authors divided economies based on income, according to the World Bank classification. Following this criteria, they confirmed conclusion of growth rates in countries with intermediate regimes. There are also differences in economic growth rate within different income level groups (considering the chosen regime), which does not hold for high-income countries.

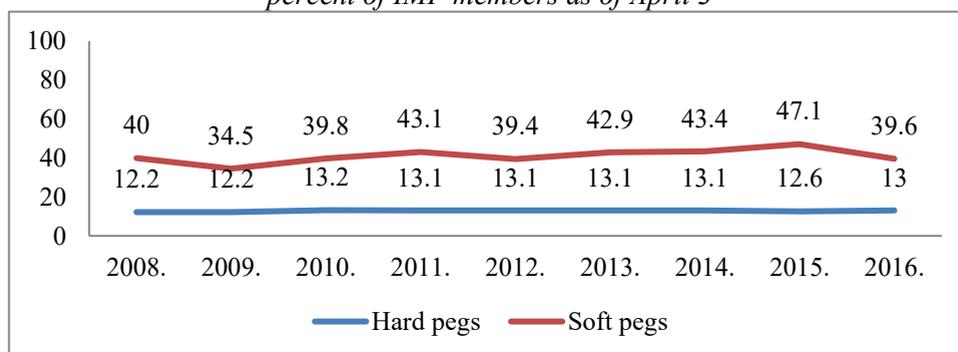
It is generally considered that hard pegged regimes are better in providing more disciplined policy, while in later stages they might be widened, allowing exchange rate to fluctuate. Exchange rate policy determines the potential level of adjustment to internal and external shocks and, consequently, the susceptibility of crisis. Chiu, et. al. (2012) analyze the distinction between hard and soft pegs in providing discipline in monetary and fiscal policy. Their work also contributed to the literature by fulfilling the gap in theory, since the focus is usually on fixed and floating regimes influence on economic indicators, with less attention on relation between hard and soft pegs. Using dataset consisted of 31 emerging markets and 32 developing countries during 1990-2003 they confirmed that hard pegs have stronger discipline impact on stabilizing money growth and inflation. On the other hand, influence of exchange rate regime on fiscal discipline was not confirmed. Combes, Minea and Sow (2016) used a panel of 90 developed and developing countries during 1980-2009 in order to analyze the relation between crisis and exchange rate regime used. They have taken into consideration different types of crisis: banking, currency and debt, testing the "bipolar view" hypothesis. In order to prevent the crisis, countries should focus more on macroeconomic policies, and less on exchange rate regime choice. Such policies that are oriented towards prevention of crisis should include limits on credit growth, avoiding debt monetization with sound fiscal policies and controlling the public debt.

2.2. Practical use of (hard and soft) pegged regimes in practice of International Monetary Fund member countries

The theoretical background for this analysis, besides the data presenting their share within IMF member countries, also includes the discussion on different (de facto) classification systems and influence of crisis on a particular regime. Although there have been developed numerous classification schemes (especially during late 1990s and early 2000s, as explained in the previous chapter), those developed and maintained by the IMF is used in this paper.

As stated before, soft pegged regimes have larger share than hard pegs but that might be explained also with the wider scope of the group. The data on share of hard and soft pegged regimes (the latter also entitled intermediate) in IMF classification scheme are presented in Figure 1 for the 2008-2016.

Figure 1. Hard and soft pegged exchange rate regimes, IMF classification scheme, 2008-2016
percent of IMF members as of April 3

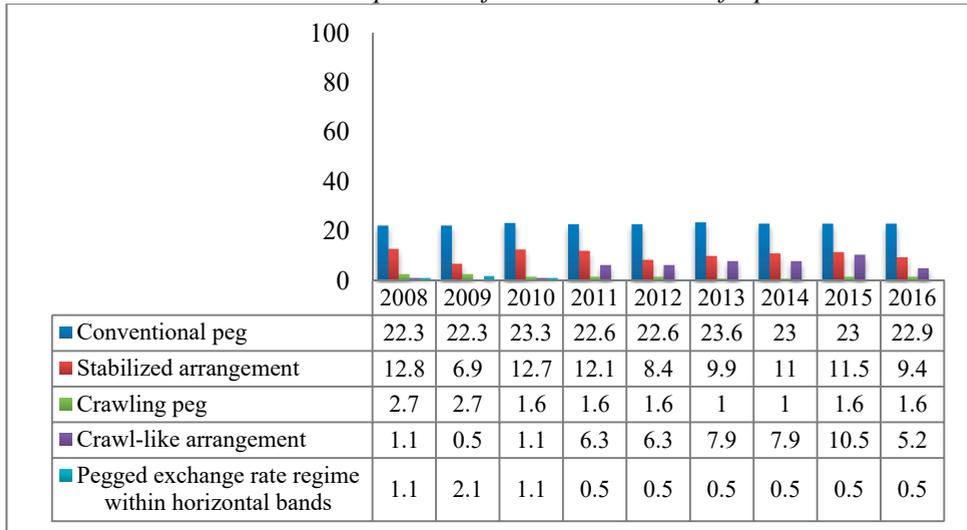


Source: International Monetary Fund, „Annual Report on Exchange Arrangements and Exchange Restrictions“, Washington, D. C., 2016, pp 8.

Besides the high share in total regimes, soft pegs had rather strong oscillations (in total and within an individual subgroup) during the period observed. As mentioned in previous discussion, this category is heterogeneous and wide, as can be observed from the data presented in Figure 2.

Within this group, conventional pegs prevailed during the observed period (with share of more than 22%), followed by stabilized arrangement, whose share varied significantly. Shares of crawling pegs and pegged exchange rate regimes within horizontal bands have been rather stable, while share of crawl-like arrangements increased significantly (especially after 2010), but also with sharp fluctuations.

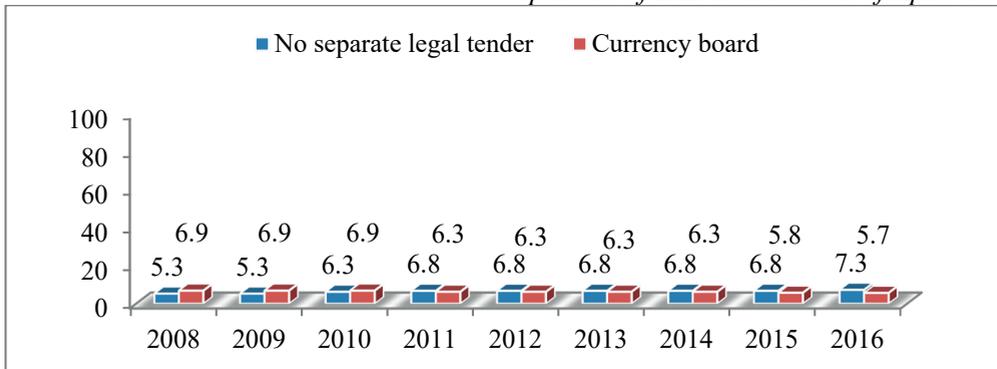
Figure 2. Soft pegged regimes by category, IMF classification scheme, 2008-2016
percent of IMF members as of April 30



Source: International Monetary Fund „Annual Report on Exchange Arrangements and Exchange Restrictions“, Washington, D. C., 2016, pp. 8.

Group of hard peggers consists of only two regimes: currency board arrangement and no separate legal tender, so their share in total regimes is smaller. (IMF, 2016).

Figure 3. Hard pegged regimes by category, IMF classification scheme, 2008-2016
percent of IMF members as of April 30



Source: International Monetary Fund „Annual Report on Exchange Arrangements and Exchange Restrictions“, Washington, D. C., 2016, pp. 8.

Practical use of intermediate regimes has widened after early 1970s and abandoning fixed regimes based on dollar/gold parity, including the debate on the optimality of exchange rate regime choice and developed de facto policy classification. Still, this debate is ongoing process with limited unique answers.

3. INFLUENCE OF CRISIS ON PEGGED REGIMES – WAS THERE A DIFFERENCE BETWEEN HARD AND SOFT PEGS

Analyses in this paper are focused on influence of external shock (global financial crisis) on hard and soft pegged regimes in European post-transition countries. It is common opinion that the fixed regimes (hard pegs) are more prone to external shock, since they lack the appropriate defending mechanism. On the other side, being allowed to fluctuate, intermediate regimes (soft pegs) are able to use more active policy that should protect them from this type of shocks.

Exchange rate regimes and monetary policy frameworks in 2004 and 2017³ according to the IMF current classification scheme are presented in Table 1. In making a decision on exchange rate policy, transition countries had some conflicting objectives (Szapáry, 2001) such were maintaining exchange rate stability in terms of volatile capital flows, controlling exchange rate appreciation respecting Balassa-Samuelson effect and achieving Maastricht criteria (especially in terms of inflation).

Countries observed in this paper are post-transition countries with hard and soft pegs: Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Kosovo, FYR of Macedonia, Serbia and Montenegro during the time scale 2004-2017. The de facto regimes and monetary policy anchors as in 2004 and 2017⁴ for countries in the sample are presented in Table 1, considering that the IMF classification scheme changed during the period observed (in 2009). Consequently, the classification of regimes varied, while for the purpose of this paper the status in 2017 has been used as a criterion. The heterogeneity of the sample (while the countries are classified in the same group) reminds that there is no unique solution, but the individual approach is required.

Table 1. De facto exchange rate regimes for selected European countries, IMF classification, 2004-2017 comparison

Country	2004.		2017	
	Exchange Rate Regime	Monetary Policy Framework	Exchange Rate Regime	Monetary Policy Framework
Bosnia and Herzegovina	Currency board*	Exchange rate anchor	Currency board	Exchange rate anchor (euro)
Bulgaria	Currency board	Exchange rate anchor	Currency board	Exchange rate anchor (euro)
Kosovo**	Managed floating with no pre-	IMF supported or other	No separate legal tender	Exchange rate anchor (euro)

³Note that IMF's classification scheme, originated in 1999, was redefined in 2009 that resulted in differences in categorisation.

⁴The latest year available in IMF statistics.

	determined path for the exchange rate	monetary program, but the euro was the most widely used currency		
Montenegro*	Managed floating with no pre-determined path for the exchange rate	IMF supported or other monetary program, but the euro was the legal tender	No separate legal tender	Exchange rate anchor (euro)
Croatia	Managed floating with no pre-determined path for the exchange rate	IMF supported or other monetary program	Stabilized arrangement	Exchange rate anchor (euro)
Czech Republic	Managed floating with no pre-determined path for the exchange rate	Inflation targeting framework	Stabilized arrangement	Inflation-targeting framework (de facto exchange rate anchor to the euro)
FYR Macedonia	Other conventional fixed peg arrangements (against a single currency)	Exchange rate anchor	Stabilized arrangement	Exchange rate anchor (euro)
Serbia**	Managed floating with no pre-determined path for the exchange rate	IMF supported or other monetary program, but the euro was the most widely used currency	Stabilized arrangement	Inflation targeting framework (de facto exchange rate anchor to the euro)

Notes: *in the Republika Srpska, the Serbian dinar circulates; **in 2004, the country was Serbia and Montenegro, while Kosovo was UN-administered province.

Source: International Monetary Fund „Annual Report on Exchange Arrangements and Exchange Restrictions 2017“, Washington, D. C., 2017., pp. 6-8, (accessed October 17 2018.) and International Monetary Fund, “Classification of Exchange Rate Arrangements and Monetary Policy Frameworks”, available at <https://www.imf.org/external/np/mfd/er/2004/eng/0604.htm> (accessed 4 May, 2018.)

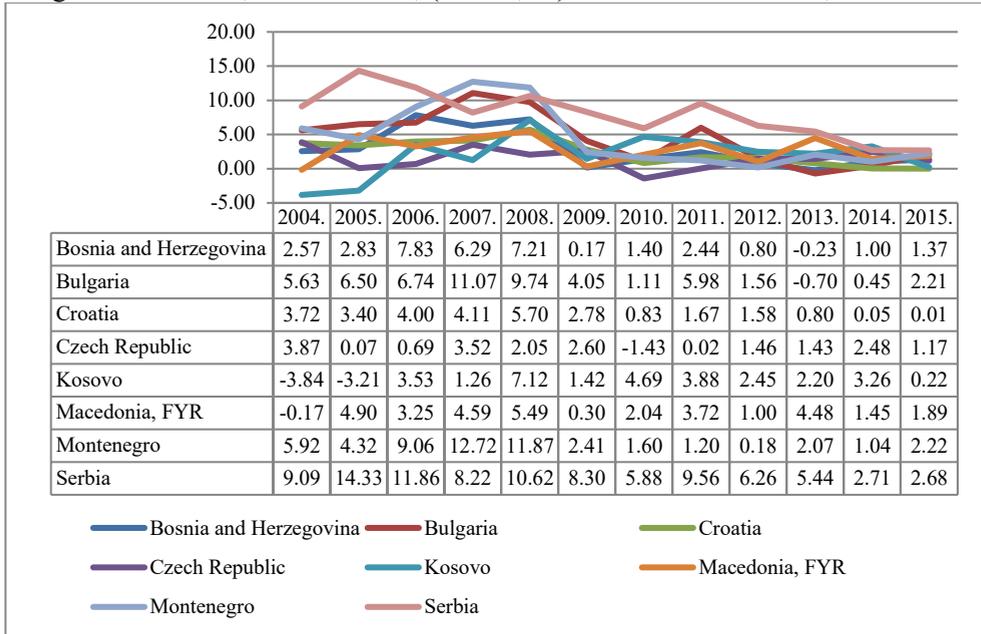
Comparing the two years (2004 and 2017) there is a change in regimes from “managed floating with no-predetermined path for the exchange rate” to hard pegged regimes in two cases –first, Kosovo and Montenegro switched to “no separate legal tender”, using euro as exchange rate anchor and being officially euroised. This was followed by political changes, since in 2004 Montenegro was not an independent country, while Kosovo was UN-administered province. In the second case (Croatia and Czech Republic) these regimes switched to stabilized arrangement. Currency board arrangements, based on euro as exchange rate anchor, remained unchanged (Bosnia and Herzegovina and Bulgaria), while Serbia switched to inflation targeting regime, with “stabilized arrangement” as a de facto exchange rate regime. Still, within the soft peggers, there is also a different level of exchange rate activities and monetary policy that includes both exchange rate anchors to euro (but still outside the ERM II) and formal inflation targeting (noting that there is a de facto exchange rate peg, even within inflation targeting as monetary policy framework).

Influence of crisis might be detected in fluctuation and derogation of main economic indicators, since the crisis was a strong external shock for national economies. One possible solution, usually recommended in crisis, is to devalue national currency, in order to stimulate national economy. But, in terms of hard peg such external devaluation is not an option considering the rules of arrangement. Alternative stabilizing mechanism is to use internal devaluation, that should protect the regime but on the high cost for national economy.

General data for countries observed are presented in Figures 4 and 5, covering inflation rate and GDP growth (both annual percentage change, using GDP deflator for inflation).

Inflation rates (Figure 4), especially considering the fact that price stability is the main goal for the monetary policy in observed countries has been rather unstable and, in some periods, higher than projected. However, despite the crisis, hard pegs were not abandoned nor replaced with more flexible regimes.

Figure 4. Inflation, GDP deflator, (annual, %) for selected countries, 2004-2015



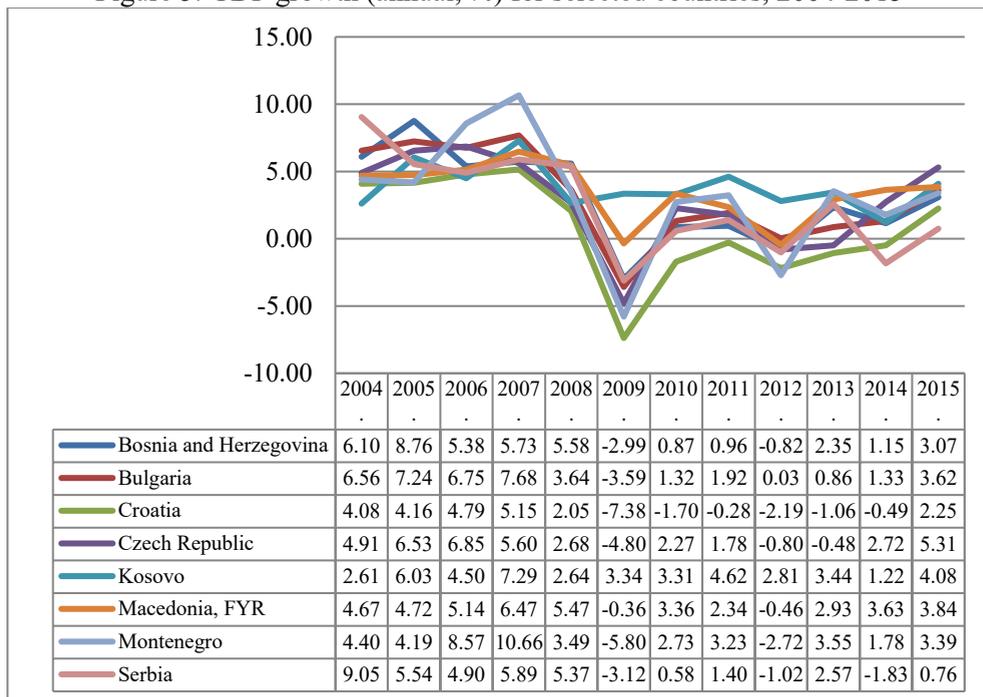
Source: World Bank, 2018.

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(accessed 24 April 2018)

Volatility of inflation included the phases of rather high rates and those with indicators of deflation. Following the deflationary trends, the rates decreased after 2012, reaching even negative values, followed by a slight recovery.

As can be observed from Figure 5, GDP annual change (%) was negative during the period of crisis, with a sharp decrease in 2009 in both observed groups.

Figure 5. GDP growth (annual, %) for selected countries, 2004-2015



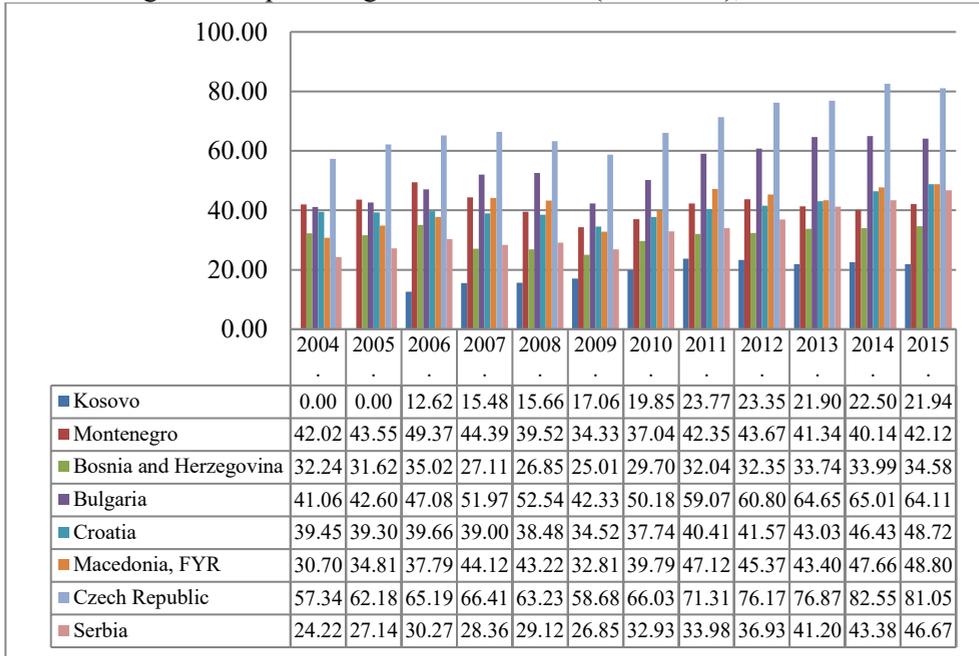
Source: World Bank, 2018.

http://databank.worldbank.org/data/reports.aspx?Code=NY.GDP.MKTP.KD.ZG&id=1ff4a498&report_name=Popular-Indicators&populartype=series&ispopular=y#(accessed 24 April 2018)

Although there is a slight recovery after the 2009, sample countries still did not reach the pre-crisis levels. According to this criterion, both observed groups followed the same trends. Still, in their study Belhocine, et. al. (2016, pp 14.) describe the different growth patterns between countries depending on the exchange rate regime choice. European countries with harder regimes (lower flexibility) recorded a boom until 2007/08crisis, followed by a recession, while the recovery in 2011-2013 was somewhat stronger than in those with more flexible regimes. But, after the mid-2013, the latter group of countries had faster growth than the other. Furthermore, their research confirmed higher growth volatility for countries with low exchange rate volatility (especially the Baltics).

Hereafter, it is interesting to observe the dynamics of exports (Figure 6) and imports (Figure 7) of goods and services (as a % of GDP).

Figure 6. Exports of goods and services (% of GDP), 2004-2015



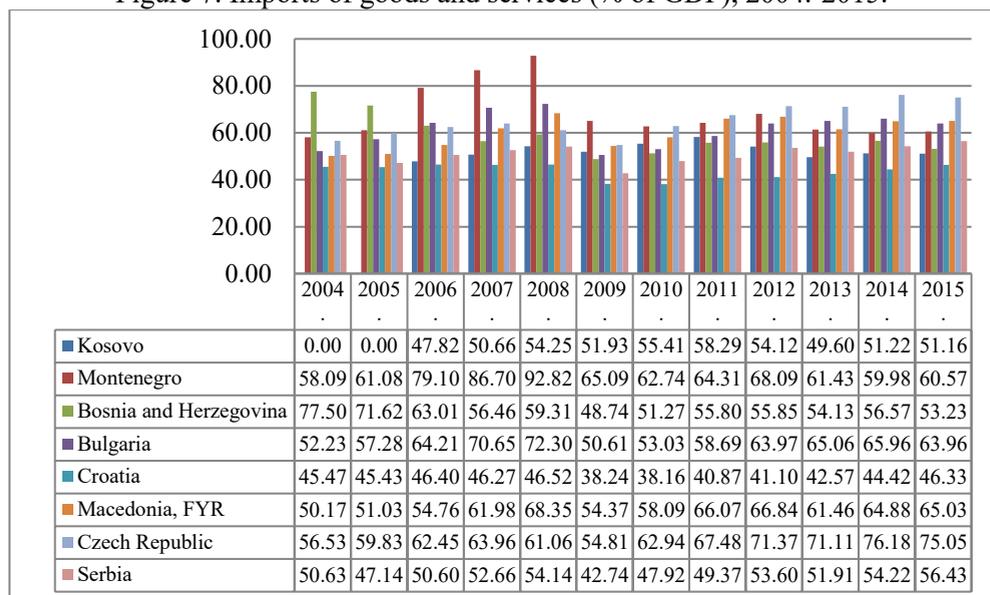
Notes: the data for Kosovo are not available for 2004 and 2005

Source: World Bank, 2018.

http://databank.worldbank.org/data/reports.aspx?Code=FP.CPI.TOTL.ZG&id=1ff4a498&report_name=Popular-Indicators&populartype=series&ispopular=y#
(accessed 24 April 2018)

Both the data for exports and imports are following the trends observed in GDP growth, confirming the strong influence of crisis and slight recovery after 2010. Still, despite the fact that observed countries belong to (hard or soft) pegged regimes, structural differences and general level of economic development are visible following the results in this category, and need to be taken into consideration when interpreting the results for a particular country.

Figure 7. Imports of goods and services (% of GDP), 2004.-2015.



Notes: the data for Kosovo are not available for 2004 and 2005

Source: World Bank, 2018.

http://databank.worldbank.org/data/reports.aspx?Code=FP.CPI.TOTL.ZG&id=1ff4a498&report_name=Popular-Indicators&populartype=series&ispopular=y#
(accessed 24 April 2018)

Since the pegged exchange rates were not abandoned and considering the fact that these regimes have less opportunities for adjustment, there is a stronger pressure on wages and employment. This is usually considered to be a part of internal devaluation strategy, opposite from adjustment using exchange rate policy (external devaluation). This is also a way to retain the peg (considering possible exchange rate fluctuations within the intermediate regimes) but on the cost in other areas.

4. CONCLUSION

The main goal of the paper is to analyze the functioning of hard and soft pegged exchange rate regimes (the latter also entitled intermediate), on a sample of post-transition countries. The sample covers the two groups of pegged regimes, hard and soft (intermediate) pegs. It has been formed using the IMF's exchange rate regimes classification scheme and dataset (IMF, 2017). Share of hard pegged regimes in total is lower than those of soft pegs, considering also that the scope of soft pegs is wider, consisting of a broader, more heterogeneous group of regimes. Two out of eight countries in the sample are officially euroised, other two have a currency board arrangement (the four of them forming a subgroup of hard pegged regimes),

while other four belong to the group of soft peggers (as presented in particular in Table 1).

The 2017 IMF's classification has been used as a criterion for creating a sample which is compared with regimes used in pre-crisis 2004 in terms of exchange rate regime and monetary policy framework, although both the classification scheme and the status of a particular country varied over time. The data presented included changes in main economic indicators (GDP growth rate, inflation and exports and imports of goods and service (both in % of GDP)), covering the 2004-2015 period in these selected European economies.

This topic is interesting on few levels. Apart from the on-going discussion on the optimality of exchange rate regime choice and exchange rate classification, observed countries are participating in different stages of European integration processes and exchange rate policy might contribute to the success of the process. On the other hand, global crisis as an external shock endangered the economic and exchange rate stability and questioned the optimality of chosen regime, potentially leading to change of policies, goals and exchange rate strategies.

The change of a regime when a crisis shock occurs would be a risky strategy that might further deepen it. Although the exit strategy for European countries includes stronger involvement in European integration process (full membership in the monetary union as a final stage) the countries either did not fulfill the formal and/or convergence criteria or individually postponed the date of full membership.

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THE MAIN FEATURE OF B&H FINANCIAL STRUCTURE AND INTEGRATION IN THE EU FINANCIAL SYSTEM

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Review

Abstract

Stabile and functional financial sector is important part for stability and development of national economy. Having on mind specific features of financial system in Bosnia and Herzegovina as bank dominated financial sector we will analyse changes in structure of financial sector and behaviour of major sector in financial system in the period from 2005 to 2017. Changes in financial sector in Bosnia and Herzegovina have been analyzed through a series of indicators for major part of financial sector banking and non-banking financial entities. Also, authors will analyses changes which are made in institutional framework for bank and non-bank financial entities towards integration in the EU financial sector.

Keywords: *financial sector, structures, integration, EU.*

JEL: G2, O52,

1. INTRODUCTION

Financial system of Bosnia and Herzegovina is “bank dominated”, which means that banks (credit institution) are dominated financial institutions in financial system. Banks have major role in financial intermediation process. However, in the last few years there is an increasing role of financial markets and other non-

banking financial institutions in the intermediation process between savers and investors. Bosnia and Herzegovina financial sector includes: banks, investment funds, leasing companies and micro-credit organisations. Table 1 presents share of assets of financial institutions in the total assets of financial sector in the period 2005-2017. Share of banking assets in the total assets of financial system reached 80% at the end of 2018 (table 1). Rising share of banking sector reflects the increasing size and development of this sector within financial system.

Table 1: Share of financial institution assets in the total assets of Bosnia and Herzegovina's financial system (in %)

	2005	2007	2017
Banks	77,30	79,9	88,3
Non-banking financial sector	22,70	20,1	11,7
Leasing	4,5	5,8	0,84
Insurance companies	4,0	3,3	2,26
Investments funds	12,1	7,2	2,76
Micro-credit organizations	2,1	3,9	5,56
Total assets financial sector	100,00	100,00	100,00

Source: Central Bank of Bosnia and Herzegovina, Financial Stability Report, Sarajevo, different years

In the last twenty years, banks dominate in financial system of Bosnia and Herzegovina, sector of micro-credit organisations proceeding intensive development. This non-banking financial institution offers products and services to small enterprises and clients with low income. According to research, which has been provided in the world and Bosnia and Herzegovina, this sector has positive impact on economic development.

2. BANKING SECTOR IN BOSNIA AND HERZEGOVINA

Banking sector in Bosnia and Herzegovina shows positive trends in financial intermediation. Share of banking assets in GDP reached 90.3% at the end of 2007 and same level of banking intermediation is recorded in 2017. Rising share of banking sector reflects the increasing size and development of this sector within the economy. Banking sector of Bosnia and Herzegovina, as many other banking sector in transition countries, passed through phase of rehabilitation, recapitalisation, privatisation, consolidation, increasing concentration on banking markets and competition.

The European Union (EU) accession and entry in the euro area will be additional actuator of these changes. Already most of the transition countries have high share of the EU ownership in the banking sector. There were 32 active banks in Bosnia and Herzegovina at the end of 2007, while in 2017 23 banks operate in banking

sector of Bosnia and Herzegovina. Changes in number of banks and ownership during the period 2005-2017 are shown in table 2.

Table 2: Basic indicators for banking sector of Bosnia and Herzegovina in the period 2005-2017

	2005	2007	2009	2010	2017
Number of banks	37	33	33	32	32
Banking intermediation	69,3	93,8	86,5	58,6	90,0
Foreign capital in total capital	67,0	83,0	86,5	85,16	90,0
ROAA	0,7	0,9	0,1	-0,6	1,5
ROAE	6,4	8,9	1,3	-5,5	10,2
CR 3	46,3	40,8	46,4	46,2	
CR5	59,3	56,7	61,8	56,6	
HHI	919	890	999	1.530	1.741,50

Source: CBBH, Annual report CBBH, different years

For Bosnia and Herzegovina, banking sector had also characteristic period of privatisation of state-owned banks and consequently rapid consolidation. The entrance of foreign banks on the market improved the soundness of financial system. In 2017, 90 percent of total capital in banking sector was foreign-owned. Banks in foreign capital ownership had share in the total assets of banking sectors of 93%. More than 50% of foreign capital in B&H comes from Austrian banks.

If we know that intermediation of complete financial sector in 2017 was 90% of GDP and in 2007 was 117% of GDP than it is obvious how banking sector dominate in financial system of Bosnia and Herzegovina. According to data from the table 2 we can conclude how banking sector in B&H records:

- increasing foreign capital in ownership structure of banks
- high profitability measured with ROAA and ROAE
- reasonable concentration of assets (concentration ratio – share three and five the biggest banks in banking sector assets), while in loans sector increasing to boarder of high concentrate market.

Total banking sector asset in Bosnia and Herzegovina in 2017 was 14.5 billion euros while at the end of 2007 was 9.9 billion euros (CBBH, different years). In the structure of banks assets credits dominate and in structure of liabilities deposits. Such structure shows that banks in Bosnia and Herzegovina are still “credit-deposit” financial institutions, without developed investment function (table 3).

Total loans amount was 10.1 billion euros at the end of 2017, while total deposits reached 10 billion euros. In the structure of deposits, short-term deposit dominates (61% of total deposits). However, they developed some new activities (e.g. leasing, custody, bank assurance).

Table 3: Structure of consolidated balance sheet of banks in Bosnia and Herzegovina in 2006

Assets		Liabilities	
Cash and cash equivalent	36%	Deposits	75%
Loans	58%	Loans and other borrowings	11%
Fixed assets	3%	Other liabilities	3%
Other assets	2%	Total liabilities	89%
		Capital	11%
Total assets	100%	Total liabilities and capital	100%

Source: Central bank Bosnia and Herzegovina, Annual report, different years

Capital adequacy in 2007 reached 17.1% and it is decreasing for 0.54 percent points. Minimum capital adequacy ratio is 12%. Total capital in banks at the end of 2007 was 1.19 billion euro and present increasing for 26.5% in comprising with 2006.

Table 3: Structure of consolidated balance sheet of banks in Bosnia and Herzegovina in 2017

Assets		Liabilities	
Cash and cash equivalent	27%	Deposits	76,50%
Loans	66%	Loans and other borrowings	4,95%
Fixed assets	3%	Other liabilities	3,44%
Other assets	4%	Total liabilities	84,89%
		Capital	14,86%
Total assets	100%	Total liabilities and capital	100%

Source: Central bank Bosnia and Herzegovina, Annual report, different years

In 2017 in balance sheet in assets, loans dominate as in 2006. Liability side of balance sheet in 2017 recorded change i.e. decreasing loans take from banks in aboard and increasing in capital position. This changes are result of impact financial crisis on banking sector of the European union and Bosnia and Herzegovina.

Analysing banking sector and macroeconomic situation, role of central bank, surplus, liquidity we identified internal and external factor in bank risk environment. Having in mind this changes, it is important to analyse and monitor banking sector characteristic and identify which elements can have impact on stability and safety of financial sector. Globalization and the EU integration process is connected with number of structural changes. Consolidation of banks, increased competition, and internalization of financial activities and establishment

of financial group or conglomerates had an impact on financial sector development in Bosnia and Herzegovina.

3. NON-BANKING SECTOR IN BOSNIA AND HERZEGOVINA

In Bosnia and Herzegovina, in the recent period we recorded development of other sub-sector of financial system. In the first place, we talk about financial markets, investment funds, and leasing, insurance and micro-credit organizations.

Financial markets in Bosnia and Herzegovina according to trading volume, market capitalization and number of participants are weak and underdeveloped capital markets. Problems are insufficient offer of financial instruments, existing entities boards, illiquidity and weak economic situation in B&H. Total market capitalization in Bosnia and Herzegovina in 2007 was increasing in comparison to previous years. Market capitalization on Sarajevo Stock Exchange (SASE) increased for 36.07%, while on Banja Luka Stock Exchange (BLSE) increased for 3.87% (table 4).

Table 4: Market capitalization in Bosnia and Herzegovina (in euros)

Sarajevo Stock Exchange Inc.				
2005	2007	2009	2012	2017
market capitalization (in millions euro)				
3.309,3	7.934,2	7.158,7	4.504,6	5.074,3
number of trade instruments (in thousands)				
64.554	70.773	25.707	35.852,1	42.105,2
number of transactions (in thousands)				
37	61	19.632,2	11.643	5.030
Banja Luka Stock Exchange Inc.				
2005	2007	2009	2012	2017
market capitalization (in millions euro)				
1.470	4.279	3.756,1	4.029,9	4.024,2
number of trade instruments (in thousands)				
360.153	702.488	81.474	136.076	250.395
number of transactions (in thousands)				
191	191	11.527	2.221	7.751

Sources: Central Bank Bosnia and Herzegovina, Annual Report 2007, Sarajevo, 2008, pp. 78.

In 2007 come to transformation of privatization investment funds in investment funds and opening possibilities for creating common equity funds. The process of pension fund reform determinates the future of investment fund . In 2007 in B&H 34 brokers' houses were operating. In the begin of 2008 two entities capital markets subscribe agreement about regional cooperation with capital markets in other countries of ex-Yugoslavia.

In 2007 in B&H 26 insurance companies were operating, while in 2017 27. In the same year they collected 16,3 million euro of premium, while in 2017 total premium was 71,4 million euro (table 5).

Table 5: Basic indicators of insurance sector in Bosnia and Herzegovina

Indicators	2005	2007	2009	2012	2017
Nuber of insurance	25	26	26	25	27
Total premium life insuranace (in mil. euros)	16,3	27,9	31,5	38,3	59,5
Total premium non-life insurance (in mil. euro)	154,8	178,3	142,1	149,1	184,2
ROAA	4,45	2,51	2,14	2,64	3,83
ROAE	11,83	7,11	6,44	8,46	15,65

Source: Office for supervise insurance of Bosnia and Herzegovina, different years

Total assets of insurance sector in 2007 was 266,6 million euros, while in 2017 it was 1,722 million euros, total revenue in 2017 was 204 million euros. In previews period, life insurance recorded higher rate of growth but share of it in the structure of insurance premium in B&H is still low. In comparison to other indicators as premium in ratio too number of citizen, Bosnia and Herzegovina is in the rank of Serbia and Romania and on list under Croatia, Hungary and Turkey. In insurance premium structure, the biggest share had premium on motor vehicle insurance.

Leasing sector in B&H has six leasing companies. Number of provider of leasing is decreased for two in comparison with 2016. In 2005 total assets of leasing sector was 289 million euros, while in 2017 was record in the amount of 133 million euros (table 6).

Table 6: Basic indicators of leasing sector in Bosnia and Herzegovina

Indicators	2005	2007	2009	2012	2017
Number of leasing companies	6	8	9	9	6
Assets (in mil. euro)	189,7	883,3	811,4	467,2	133
Loans		771,9	674,9	376,2	120,2

Financial leasing (in mil. euro)				219	90,2
Operative leasing				15,1	14,6
Gain/loos			6,36	-12,6	2,5
ROAA				-2,85	1,5
ROAE				-31,45	12,6

Source: Central bank Bosnia and Herzegovina, Financial Stability Report, different years; Banking Agency of the Federation of Bosnia and Herzegovina, Banking Agency of the Republika Srpska, Information about banking sector, different years

On credit market, microcredit organizations have a significant role. Microcredit organizations supply microcredit legal entities which can't satisfy criteria for getting bank's credit. The major part of outstanding loans was retail credits. In 2017 in B&H 25 microcredit companies operates (15 microcredit funds and 10 microcredit entities). This sector recorded funding of new entities on market, growth of credit activities and profitability.

Table 6: Basic indicators of microcredit sector in Bosnia and Herzegovina

Indicators	2005	2007	2009	2012	2017
Number of entities	46	24	26	22	25
Assets (in mil. euro)	128,2	496,6	595,2	382,3	435,6
Given loans (in mil. euro)		453,1	479,8	299,6	333,4
Recived loans (in mil. euro)		369,2	426,1	217	205,03
Gain/loos		216,7	-20,2	13,2	13,8
ROAA		22,9	-3,39	3,45	3,16
ROAE		4,9	-9,53	5,88	4,14

Source: Central bank of Bosnia and Herzegovina, Financial Stability Report, different years

97,7% of the microcredit loans are given to , most of it was approved to finance agriculture sector (37,5%), service activities 17.9%, housing needs (14,5). Major source of funds for microcredit organization are loans borrowed from banks and international financial institutions.

In 2017, there were 36 investment fund, of which 17 in F B&H and 19 in RS. Out of a total of 36 investment fund, 25 are closed-end investment funds, while 11 funds open-end investment funds. Net asset value of investment funds at the end of 2017 was BAM 423 million euros and recorded an increase for BAM 23,3 million euros (5.6%) compared to the end of the previous year.

4. INTEGRATION BOSNIA AND HERZEGOVINA FINANCIAL SYSTEM IN EU FINANCIAL SYSTEM

Impact of the European integration process on financial system of potential candidate and candidate countries can be seen through:

- current situation in the European financial integration (bank vs. market financing, efficiency of the EU banks, insolvency regime, financial innovation, corporate governance and control/ownership structure of financial intermediaries)¹
- financial system structure in Europe²
- financial linkages between the euro area/ European Union, United State, and Japan (financial and banking crises).

It is important to analyse factors that drive the process of financial integration and design financial system structure. These driving factors include competitive market forces, co-operative initiatives between market participants and policy action by policy authorities. Market forces and degree of financial integration and policies have impacts on managing market imperfections. Process of financial integration request removing obstacles in political and economy framework to financial integration:

- legal differences between candidate countries and EU,
- regulation approaches,
- countries-specific industry standards,
- corporate governance system.

In the process of integration financial systems candidate countries must specially have on mind the following: the geographical scope of banking and lending relationship, degree and implications of bank competition, determinants of bank mergers, implication of bank consolidation, international portfolio choices of institutional investors/determinants of international portfolio flows, assets process and volatility linkages across countries and their changes/contagion and crisis

¹ Financial integration and financial linkages between different geographical entities, cross-country or cross-regional linkages with in EU and linkages EU and other countries. Financial linkage are defined by relationships between prices and by relationship between quantities across the relevant geographical entities, mainly countries.

² Structure of financial system of the EU analyses in terms of the importants of different ways of financial intermediation and different sources of funding

linkages, liquidity in secondary markets and consolidation of stock exchanges, restructuring of settlement infrastructures,

Bosnia and Herzegovina bank dominated financial systems has next characteristics: first, there are deep comparative disadvantage in provision of financial services caused by the heritage of central planning and the specific role of banks in the previous socialist systems; second, banking systems are mostly foreign-owned. In addition, liberalisation, deregulation, development of the new technology, establishment of the European Economic and Monetary Union and other changes have caused increased pressures within the global financial service industry. Under the pressure of these changes, banks, insurance companies, investment companies and pension funds are trying to find a way to survive on the market by moving into each other business area. All analysed countries are under process of "inward Europeanisation".

Harmonisation of monetary policy and operational framework with the same in the Euro system, harmonisation of financial sector regulation with the EU "acquis communautaire" will additionally stimulate changes in the financial system. Internalization of financial activities and establishment of financial group or conglomerates had impact on financial sector development.

Bosnia and Herzegovina is faced with serious challenges of improving financial supervision system in the way that it will be most efficient for supervision of financial institution on the domestic market, but also to divide responsibilities for internationally active banks.

Domination of foreign capital and process of creating financial conglomerates influenced the process of supervision. It raises the need to develop consolidated supervision, improve cooperation and communication between banking supervisors in different countries. Right for supervision and all obligations has country in which bank have addressed as "home country" and not the country in which bank have their branches - "host country". Therefore, it is necessary to improve skills of staff, way of communication and cooperation with the European banks' supervisors and reform institutional and legal framework to improvement home-host supervision system. In bank dominate financial system failure to provide these services or breakdown in their efficient provision can be cost to both ultimate sources (household) and users (firms) of saving. Already most of the transition countries have high share of the EU ownership in the banking sector.

Central bank of Bosnia and Herzegovina must, with entities banking agency, work on involving in prudential regulation standards – procedures and methodologies for identification, measurement and protection from market risk (interest rate risk, foreign exchange risk, commodity risk, risk of delivered etc.) according to standards involved in the EU Directives.

National authorities in these countries must further improve financial supervision process, which includes development of three functions:

- microprudential supervision oriented on protection of solvency of individual institution rather than all financial system,
- macroprudential supervision with purpose to limit financial system distress that can damage the real economy,
- business supervision which involves monitoring potential conflicts between financial institution and their clients.

Improving risk environment in which operates financial system in Bosnia and Herzegovina requests activities in the following fields:

- developing money market in Bosnia and Herzegovina in order to better manage liquidity risk,
- integration of supervision in financial system,
- developing consolidated supervision – international banking group “home-host” supervision,
- managing banks’ credit activities and credit risk,
- creating solution for inflation risk.

5. CONCLUSION

Financial system of Bosnia and Herzegovina has experienced changes in recent years. Financial system offers new services to their clients and expand across the country. Still today, financial system sectors in transition countries are fast developing and transforming from instable to stable, strong and highly competitive system. The EU accession and entry in the euro area will be additional actuator of these changes. Process of transition opens new possibilities for the financial system development, but also presents additional challenge for the financial sector regulators and supervisors.

Process of financial integration request removing obstacles in political and economy framework to financial integration:

- legal differences between countries and EU,
- regulation approaches,
- countries-specific industry standards,
- corporate governance system.

During the process of integration of financial system in Bosnia and Herzegovina national authorities must have on mind: elements of banking market structure, geographical scope of banking and sources of foreign capital, assets process and volatility linkages across countries and their changes/contagion and crisis linkages, liquidity in secondary markets and consolidation of stock exchanges, restructuring of settlement infrastructures and etc.

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COPENHAGEN CRITERIA AND WESTERN BALKAN CANDIDATE COUNTRIES FOR MEMBERSHIP IN EUROPEAN UNION: CASE OF BOSNIA AND HERZEGOVINA

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Review

Abstract

The European Union (EU) has shown considerable interest in receiving the Western Balkan countries into the EU, as did the mentioned countries show considerable interest to join the EU. Although this is a historically very turbulent region, the EU has clearly, unambiguously and unanimously expressed the political attitude towards the Western Balkans: "The Future of the Balkans is in the European Union". In addition to goodwill, the EU is also ready to assist in this process but also each country must do its part of the job in the accession process. The very process of EU accession means defining and meeting necessary criteria for potential new EU members, as well as the process of accession negotiations for the full membership of the new member states. The main objective of this article is to indicate which expansion criteria or Copenhagen criteria will be the most critical to achieve for Bosnia and Herzegovina (B&H), as one of the Western Balkan countries, in the process of access into the EU. In the process of meeting Copenhagen criteria, unlike other Western Balkan countries, B&H shows the least success. In our research, Bosnia and Herzegovina has a problem primarily by satisfying political Copenhagen criteria and then meeting economic and legal criteria. The lack of meeting Political Copenhagen criteria is found primarily in the absence of political consensus in B&H, which stems from the special features of the Government in Bosnia and Herzegovina (two entities and Bosnia's three main ethnic populations). With the lack of political unity in B&H, it is not possible to establish stable institutions that ensure democracy, the rule of law, respect for human rights and the right to protect minorities (Sejdić and Finčić case, corruption, non-transparent elections, nondependent media and labour unions) Fulfilling the Copenhagen Economic Criteria - a functioning market economy is also dependent on political influence (which is also fractured). The economy of B&H is structurally unregulated and is based on the processing of basic raw materials without the high-tech industry in order to deal with the competition of the European Single Market. During the research, the used scientific methods (analysis and syntheses, descriptions and classifications, historical and

comparative, induction and deduction, and quantitative analysis) showed that it would be most difficult to achieve the political and economic Copenhagen criteria for the above reasons.

Keywords: *European integration, Western Balkan countries, Bosnia and Herzegovina, Copenhagen criteria*

JEL: 052

1. INTRODUCTION

Why should the countries of the Western Balkan consider and work intensively on their European integration? The answer to this question is found in the history of Europe, which unfortunately has often been marked by conflicts between major European tribes and then nations and states. From the ancient times to the present, the period of greatest prosperity and peace experienced by Europe is the period of European integration, if the 1990s Balkan conflicts that tore apart the former Yugoslavia are excluded. Although the idea of European unity can be tracked prior to the 20th century, the European integration process really began after the Second World War. European integration marked an end to the conflicts that had been tearing the European continent initiating reconciliation between France and Germany after centuries of tensions. The European Union (EU), however, is not a product of force or domination, but cooperation that was built over a period of decades and a free will of governments and peoples who had decided to unite to guarantee peace and justice, and abandon nationalist aspirations (Kandžija, Cvečić, 2010, 78). European integration can serve as a good example in context of alleviating existing tensions among the Balkan countries and peoples in Bosnia and Herzegovina (B&H), which is the focus of this paper. The process of reconciliation in Europe can serve as a bright example in context of joining efforts to ensure long-lasting peace and the EU shows how civilisation values can be promoted such as democracy development, rule of law, effective institutions and efficient economies. These are the values that a modern country should aspire to, and on which the EU is insisting, as well as on resolving international problems in terms of good neighbourly relations (regional cooperation). It is also necessary to consider globalization processes that involve countries grouped into political and economic blocs aimed at securing competitive advantage vis-a-vis rivals in the global market. It is therefore quite natural for the countries of the Western Balkans to integrate into a group with neighbouring countries on the continent to which they belong.

Considering the turbulent history of the Balkans and current situation in the region characterised by rather slow socio-economic development, it can be assumed that European integration, by its principles and resources, represents for the Balkan countries the best way to achieve democracy, rule of law, minority rights, civil

rights, economic development, good neighbourly relations, peace and stability in a colourful region such as the Western Balkans. This is the answer to the question posed in the introduction. It seems that the Balkan countries (primarily EU members: Slovenia and Croatia, and others on that path) have recognized the logic and importance of European integration as well as B&H which is the focus of this paper. This is confirmed by the official standpoint of B&H's Ministry of Foreign Affairs that B&H's strategic priority is EU membership (Ministarstvo vanjskih poslova BiH, 2015). According to the Ministry, B&H's aspiration to gain full membership in the EU is based on a consensus between political parties, which in practice is quite questionable as will be discussed in the next chapters. In January and February 2015, the Presidency and the Parliamentary Assembly of B&H adopted a *Joint Declaration of Commitment to Reforms in the EU accession process of B&H* (Ministarstvo vanjskih poslova BiH, 2015). The Western Balkan countries and its peoples are pursuing full EU membership aimed at achieving the goals of development and stability (Kandžija, Tomljanović, Kandžija, 2015, 142). Integration of Bosnia and Herzegovina is even more significant as it is viewed as an adequate solution to achieve and maintain its existence and stability, as will be provided in this paper. Moreover, it seems that the set of conditions on which the EU insists is an excellent control mechanism of action of disunited political structure in this country. In order to provide aid to the Western Balkan countries in solving their economic and political problems, the EU has created special financial instruments (Kandžija, Tomljanović, Kandžija, 2015, 142). EU funds are allocated to specific projects where each country is responsible for its own progress (Kandžija, Tomljanović, Kandžija, 2015, 142). The aim of this paper is to identify the key issues facing B&H and challenges it will face to meet the requirements of EU accession aimed at being eligible to receive EU funding. Considering the diversity of nations in Bosnia and Herzegovina, it is a country that most recalls the European Union, which is characterised by adversity of nations members of the EU. The EU has succeeded in solving the problems of different nations and states and setting the highest civilization standards and has long supported its partners in the Western Balkans, including B&H, on their respective integration paths. The paper will focus on important aspects of the European integration process such as the Copenhagen criteria for the accession of Bosnia and Herzegovina to the EU.

1.1. Research methodology

Various methods have been used in conducting this scientific research. One of the primary methods that were used was the historical method for determination of chronology and development of complex relations in B&H, which are the critical obstacles to B&H's integration. Other methods involved description and classification of the roles and criteria of European integration that may be applied to B&H. Furthermore, the method of analysis and synthesis of the influence of socio-political relations on the socio-economic structure and development of the country and its integration towards the EU was used, as well as the analysis and

synthesis of the effects of European integration and the importance of its resources for B&H. The induction and deduction method were used in creating assumptions and making conclusions based on the results of the research. The comparative method was used to compare B&H with other countries in the region and the selected EU members, based on available and relevant statistical data.

2. LITERATURE REVIEW

From the Dayton Agreement reached in 1995 to today, the Constitution of Bosnia and Herzegovina, which is an annex to the General Framework Agreement for Peace in Bosnia and Herzegovina, forms the basis of its Constitutional Law. According to Karan (2014, 161), the Constitution of B&H does not explicitly define the form of state organization, which complicates determination of constitutional and factual relationships between the entities and common institutions of the country. Kuzmanović (2004, 157) believes that B&H, which comprises of the two entities, can be a federation, confederation, confederal-federal alliance, asymmetric confederation or union, depending on how jurisdiction is divided between the state and the entities. B&H does not have a clearly defined organization - a form of state organization (federal or confederal), which means that its rule of law and political system is not satisfactory, what makes an exceptional problem with the functioning of the country. According to Aybet and Bieber (2011, 1934), the establishment of the Office of the High Representative and the fact that the Constitution of B&H was created by international civil and military organizations, with the power to implement their decisions over local elites, gives B&H an apparent form of protectorate, making performance of the functions of interest articulation difficult. The Dayton Constitution defines B&H's constitutional government and political system. B&H is composed of the official authorities at the state level and the two entities. The Constitutional Law implies equality of the two entities and three constituent peoples, with the supremacy of the Constitution of B&H. Such a constitution seems to be discriminatory against national minorities and in conflict with Copenhagen's political criteria. According to Pejanović (2017, 4), the Constitution of B&H gives primacy to the ethnic identities when forming official authorities where each entity gives primacy to the ethnic groups of which it consists in expressing their needs and demands to the government. Since the House of Representatives uses a majority vote decision rule with veto power and representatives are elected on an ethnic basis, it is difficult to achieve an absolute majority in the Parliament and the Government. According to Pejanović, such a political constellation is developed on partnerships and coalitions of different ethnic parties with completely opposite views, where reaching consensus is hard, making B&H seem a dysfunctional state in decision-making, legislation adoption and forming institutions. According to Nakić (2013, 39), B&H shows the least progress in the European integration process of all candidate countries and potential candidates, because public opinion lacks of political will. Topčagić (2016, 2) also believes that the latest application for EU membership

reflected a declarative readiness of political elites in B&H. In support of such conclusion is the fact that B&H has not yet fulfilled the requirements for the EU accession. According to Kukić and Šavija (2017), submitting application for EU membership without having fulfilled the requirements for the EU accession may be considered lacking seriousness. The key issues referred to by the European Commission are the establishment of a functional coordination mechanism (Maletić, Kandžija, 2018, 242) and implementation of the Sejdić-Finci judgment of the European Court of Human Rights, in which the Court found a violation of Article 14 in relation to Article 3 of Protocol 1 of the European Convention on Human Rights and Fundamental Freedoms where the candidates were unable to run for elections in the House of Peoples of Bosnia and Herzegovina, and a violation of Article 1 of Protocol 12, where the candidates were unable to run for elections in the B&H's Presidency (Kulenović, Hadžialić-Bubalo, Korajlić, 2011, 2). Although B&H has established an institution, which should function as a body that coordinates negotiations with the EU, the European Commission Report (Bosnia and Herzegovina 2018 Report) of April 2018 highlights that the National Program for the Adoption of the Acquis (European Commission, 2018, 5) has still not been implemented. The Sejdić-Finci judgement is a motive for analysing several aspects of the constitutional system of B&H, in which non-constituent peoples in B&H are limited or excluded from political decision-making procedures by ethnocentric elements, thus undermining the generally accepted elements of statehood (Kulenović, Hadžialić-Bubalo, Korajlić, 2011, 3). According to Kulenović, Hadžialić-Bubalo and Korajlić (2011, 3), the European Court of Human Rights has not set the time limit for the enforcement of the judgment, but the latest European Commission's report states that it is necessary to implement the judgement like in the cases of Pilav, Zornić and Šalaku, as well as the Constitutional Court's Decision to guarantee fundamental democratic rights of the citizens of Mostar in local elections, although the EU Accession and Stabilization Agreement has been signed. According to Rudolf (2011, 225) and Krešić (2014, 86), the Sejdić-Finci judgement opened Pandora's box and launched a *Croatian issue*. Two representatives of the Presidency of the Federation of Bosnia and Herzegovina are elected, and voters in FB&H are not divided based on ethnic identity. All citizens can vote for representatives regardless of their ethnic identity. In three cases, a Croatian representative was elected by Bosniaks due to their number in this entity. Political problems facing B&H are obstacles to B&H's integration process. According to Pejanović (2017, 7), any slowdown in the integration process leads to destabilization of Bosnia and Herzegovina's society and economy as well as its integrity. According to Maletić and Kandžija (2018, 264), European integration is the key to the existence of its constituent peoples, equality of the Croatian people and further development and stability of B&H. Hence, the following hypothesis is proposed in the research:

H1: Copenhagen political criteria will be viewed as the most critical obstacles to fulfilment of the requirements for B&H's European integration. The lack of

progress towards B&H's European integration is a threat to its integrity and stability, and its transformation into a modern and prosperous state based on democracy, rule of law, minority rights, transparent institutions and economy.

In addition to many political issues that tend to slow the process of fulfilment of the Copenhagen political criteria, there are also economic ones, but they can only be resolved after the critical political issues are resolved. Pejanović (2014, 25) argues that the Constitution of B&H is irrational and expensive, as the Government, entities and cantons have a huge administration that requires 6% of total funds. Negative reactions from the EU and international community and the proposal for suspension of the Interim Agreement on trade and trade-related matters and IPE funding (Krešić, 2014, 87) for non-implementation of the Sejdić-Finci judgement; reveal a serious and very negative impact of political disunity on B&H's economy. According to Palánkai (1997, 53), the implementation of Copenhagen economic criteria requires *a functioning market economy and the capacity to cope with competition and market forces*. According to Hodžić (2012, 84), Kandžija, Pucar and Tolić (2016, 90), and most importantly according to the latest European Commission Report (European Commission, 2018, 30) B&H is very far from that. The European Commission highlights the following B&H's weaknesses: ineffective rule of law, poor business environment, fragmented and inefficient public administration, large labour market imbalances associated with poor education systems, poor institutional capacities and inadequate support for improving the investment environment (European Commission, 2018, 30). Kandžija and Maletić (2018, 30) argue that B&H has not yet established the necessary structure for independently managing IPA funding. Fischer (2006, 447) and Tomaš (2013, 106) argue that partly responsible for current situation in B&H are international organizations that had participated in the creation of the state of B&H and its Constitution because it does not offer an adequate model for transition of economy. However, the co-responsibility of the international community does not diminish the responsibility of local political elites. According to data obtained from the Labour and Employment Agency of B&H (Agencija za rad i zapošljavanje Bosne i Hercegovine, 2018), Federal Institute for Pension and Disability Insurance (FZ MIO – Federalnog zavoda za mirovinsko i invalidsko osiguranje, 2018) and Fund for Pension and Disability Insurance of Republic of Srpska (Fond PIO RS – Fonda za penzijsko i invalidsko osiguranje Republike Srpske, 2018), there are extraordinary labour market imbalances and the number of retired workers is approaching the number of employed workers. The number of unemployed and retired workers in B&H has exceeded the number of employed workers. When analysing the competitiveness of B&H's economy and its investment potential, the World Economic Forum (WEF) (2017-2018 and 2018) reveals a rather unfavourable image with slow advances in competitiveness growth. Kandžija, Pucar and Tolić (2016, 90) warn of the unsustainability of its economy whose export activity is based on the export of raw materials and semi-products. Hence, the following hypothesis is proposed in the research:

H2: Political frictions in B&H, which tend to slow down fulfilment of the political criteria set by the EU have a strong negative effect on B&H's economy and implementation of urgent reform priorities.

The aim of the paper is to explore cause and effect relationships between indicators and prove the hypotheses after having established a positive approach of the EU towards all Western Balkan countries and a brief theoretical review of the accession criteria.

3. EU'S ENLARGEMENT POLICY TOWARDS THE ACCESSION OF THE WESTERN BALKANS

This chapter explores the EU's enlargement policy towards accession of the Western Balkan countries, particularly Bosnia and Herzegovina, and key accession criteria that concern those countries. The doors of the EU are open to further accessions of the countries of the Western Balkans and EU is willing to support its partners in the Western Balkans on their respective integration paths as announced in the introduction and as will be explained in more detail in this chapter. The following chapter will discuss the accession criteria that concern candidate and potential candidate countries.

3.1. Positive attitudes towards accession of the countries of the Western Balkans

EU has long supported the countries of the Central and Eastern Europe, including the Western Balkans, on their respective integration paths. Since the very beginning of European integration, positive attitudes towards EU enlargement can be found in the idea of Pan-European identity and unification of the European continent. The goal of EU is to unite European countries and peoples in particular with regard to human rights, democracy and peace (political goals) (Kandžija, Cvečić, 2010, 84). Article 49 of the EU Treaty defines that *any European country that respects the principles set out in Article 2 of the EU Treaty (human dignity, freedom and equality, democracy and rule of law, human rights and fundamental freedoms, and societies founded on pluralism, non-discrimination, tolerance, justice, solidarity and gender equality), and countries willing to promote them can become members of the European Union* (Kandžija, Cvečić, 2010, 208). The EU has shown its initiative and willingness to accept these countries by providing aid and giving loans to the former communist countries. In the period between 1991 and 1996 the EU concluded agreements with the countries of Central and Eastern Europe as well as three Baltic republics and Slovenia and promised to continue with further EU integration and providing aid (Kandžija, Cvečić, 2010, 211). European Union Association Agreements are based on the principles of human rights, democracy, rule of law and market economy, and their main objective was to prepare associated countries for membership in the EU primarily through establishment of a free trade zone for industrial products, as well as customs union

within a period of ten years (Kandžija, Cvečić, 2010, 211), which is an important step in economic integration. The European Council met in Thessaloniki on 20 – 21 June 2003. EU leaders confirmed to Balkan leaders that EU was ready to receive Balkan countries on the principles of democratic stability, rule of law and economic development (Europska unija, 2018). The Thessaloniki Summit organised under the Greek Presidency of the EU Council has strengthened the stabilization and association process with the aim of institutionalizing relationships between the EU and the Western Balkans, which is the goal of both the EU and the countries of the Western Balkans. However, it was clearly stated that the Western Balkan countries will become the institutional part of the EU only when they meet the accession criteria (Nakić, 2013, 37). At the meeting held in Salzburg in 2006, the EU confirmed that the future of the Western Balkans laid in the European Union, but also pointed out to the absorption capacity particularly regarding Turkey and Ukraine (as very complex cases) and highlighted individual achievements of candidate countries on their respective integration paths (Kandžija, Cvečić, 2010, 2017). It can be concluded that the EU has a positive attitude towards accession of the Western Balkan countries and EU enlargement but insists that candidates should fulfil their obligations regarding membership.

3.2. EU accession criteria

Apart from socio-political issues, European Union Association Agreements also involve economic ones, primarily in terms of free movement of capital investments and freedom of establishment to enable the countries of Central and Eastern Europe to get ready for competing on the EU market. It is therefore important to note the aspects of the EU Association Agreements:

- Political aspects - permanent consultation on issues of mutual interest,
- Trade aspects- creation of a free trade zone,
- Harmonization of legislation, particularly in the areas of competition and intellectual property rights,
- Economic, cultural and financial cooperation (Kandžija, Cvečić, 2010, 212).

At their Copenhagen Summit in June 1993, the EU leaders went one step further recognising that the countries of Central and Eastern Europe could join and become its full members. On 21 and 22 June 1993, the European Council defined the accession criteria or Copenhagen criteria which the candidate countries should meet for accession to the EU. The Copenhagen criteria are as follows:

- Political criterion - stable institutions that guarantee democracy, rule of law and minority rights,
- Economic criterion – a functioning market economy, capable of competing on the EU market,
- Legal criterion - undertaking obligations arising from membership involving alignment with the goals of political, economic and monetary

union or adoption of the EU's acquires as the body of common rights and obligations that are binding on all EU countries, as EU Members (EUR-Lex, 2018).

The Copenhagen accession strategy was reinforced at the Madrid Summit in 1995 by adding an administrative criterion, which implies the adjustment of administrative structures to create the conditions for the gradual, harmonious integration (EUR-Lex, 2018).

Each candidate country starts its accession process by submitting an official membership application after having fulfilled the pre-established accession criteria (Kandžija, Cvečić, 2010, 219). Considering that B&H has difficulties in meeting almost all the criteria, it still has the status of a potential candidate. In the opinion of the author, meeting the economic criterion will be the most critical in the long run, as changes in the economy require the greatest effort by all the actors in society in dynamic global market. In order to be able to deal with its economic problems, B&H authorities need to show more political maturity to achieve the necessary political consensus to reach other European countries in all categories and become eligible for EU funds to be used for implementing reforms.

4. B&H MOVING STEP BY STEP TOWARDS EU MEMBERSHIP

B&H's issues do not only arise from the diversity of its nations, cultures and religions, which, since conflicts in 1990s, affect its functionality setup. B&H is a specific geopolitical region where three different civilization groups coexist, having three different versions of history or three different views on the history of B&H, and where historians have failed to agree and lead to scientific consensus on essential issues (Šarčević, 1997, 123). Each group has its own idealized version of history neglecting the interests of other two groups, so historians fail to agree on a common point of view on historical foundations of B&H, which also carries certain implications on the political interest articulation. Therefore, in addition to the historical aspect, it is necessary to explore some of the basic problems that hinder this country on its path to the EU integration.

4.1. Specific issues and problems encountered in relation to the Constitution of B&H

A specific concern encountered in relation with Bosnia and Herzegovina is related to its Constitution, which is the highest law of a country. B&H is the only country whose constitution has not been written in the language spoken in that country. However, this is not a specific issue that is interesting for this work. A specific concern encountered in relation to the Constitutional Law of B&H lies in the fact that the Constitution of B&H was made as an annex to the Dayton Agreement, by which the international community sought to establish a lasting cease-fire as a step

towards a peace process (Karan, 2014, 157). Excluding war aspects, the most important civilian aspect of the Dayton Agreement refers to the Constitution of Bosnia and Herzegovina and return of refugees and displaced persons (Pejanović, 2017, 4), also one of the prerequisites for EU accession. Issues deriving from the Constitution of B&H are critical political and economic issues covered by the Copenhagen criteria (1993) and administrative ones defined in Madrid (1995).

According to the Dayton Constitution, B&H is composed of the official authorities on the state level and the two entities: Federation of Bosnia and Herzegovina, which comprises of 51% of the land area and Republic of Srpska, which covers 49% of the land area. The Constitutional Law of Bosnia and Herzegovina implies equality between the two entities and three constituent peoples, with the supremacy of the Constitution of B&H, which forms the basis of Constitutional Law. In addition to the two entities, the city of Brčko was granted the status of a district (Brčko District) by the international arbitration in 1999 and is united with the state-level official authorities (Pejanović, 2017, 4). Like other agreements for peace, the Dayton Agreement imposes the ethnic principle in shaping institutions of the political system, where each entity gives priority to the ethnic group it comprises of in the interest articulation (Republic of Srpska – Serbs; Federation of Bosnia and Herzegovina - Bosniaks and Croats) (Pejanović, 2017, 4). The electoral system for the Parliamentary Assembly of B&H is based on the ethnic principle. Electoral constituencies are set up within the entities (Republic of Srpska elects 14 representatives, while Federation of Bosnia and Herzegovina elects 28 representatives) (Pejanović, 2014, 25). B&H is also specific in terms of delimitation of jurisdiction between the entities and state-level authorities (Kuzmanović, 2002, 305). The House of Representatives uses a majority decision vote rule with a veto power (Pejanović, 2014, 25). For this very reason, often no political consensus could be achieved and many proposed laws were not adopted.

Pursuant to the Dayton Constitution, each entity has been granted a broad legal power while the official authorities of B&H on the state level have a restricted power (Pejanović, 2017, 4). Such a political-constitutional structure makes B&H not-functional, which results from monopolization and domination of ethnic parties in social development management (Pejanović, 2017, 4), but also dispersal of power to the state-level authorities, entities and ultimately to a range of regional units or cantons. Practice has shown that B&H's ethnic parties do not have the power to achieve consensus on major issues of the country development. The state or the entities, therefore, cannot achieve a stable majority in the Parliament or Government (Pejanović, 2017, 6). For this reason, the country and its society fell into a crisis. Moreover, relationships between local political elites and international institutions become problematic. The problem stems from the diametrically opposed views of local political elites on the state and entity involvement, which makes the official state-level authorities too weak when engaged by international institutions (Aybet, Bieber, 2011, 1937). Instead of negotiating with a single

official authority on the state level, international organizations must conduct relations with entity authorities. The European Commission had requested from B&H to establish an effective coordination mechanism as one of the conditions for starting negotiations. B&H launched a coordination mechanism in June 2017, but the European Commission Report states that the EU's *acquis* has yet to be adopted (European Commission, 2018, 5). The EU's *acquis* forms a basis of the integration process.

The Constitution of B&H does not explicitly define the form of state, which would simplify the determination of constitutional and factual relationships between entities and official state-level authorities of B&H (Karan, 2014, 161). B&H's constitutional structure looks very odd as it comprises of dominant elements of the federation together with some elements that are atypical for such a modern form of state organization (Karan, 2014, 161). Such a constitutional structure has very significant and far-reaching consequences for the state, legislation, freedom and civil rights and all social and statehood flows in B&H (Karan, 2014). Considering that the Constitution of B&H was the result of political will and *imagined* participation of B&H's citizens, it was not based on a form of popular consent (democratic legitimacy) (Karan, 2014, 157). As such, it is a product of will of the international community and a result of the compromise of political representatives of all three peoples (Karan, 2014). Bearing in mind that the Constitution is the highest law of a country, it should have been adopted according to the highest legislation standards with the widest democratic support of the people of B&H (Karan, 2014, 157). According to the Constitution, B&H does not have a clearly defined organizational form - a form of state organization (federal or confederal), which means that its rule of law and political system is not satisfactory. There are different qualifications of the form of state organization of B&H. Some argue that B&H, which comprises of the two entities, *can be a federation, a confederation, a confederal-federal alliance, an asymmetric federation-confederation or a union depending on the division of jurisdiction between the state-level authorities and the two entities* (Kuzmanović, 2004, 397). Furthermore, involvement of representatives of the international community or the High Representative gives B&H an apparent form of protectorate. B&H as an international protectorate is a result of the fact that the Constitution of B&H was created by international civil and military organizations with the power to implement their decisions over local elites (Aybet, Bieber, 2011, 1934). Some, therefore, also argue that the problems encountered in relation to the Constitution and undefined form of state tends to slow down normal functioning of B&H as a state (Karan 2014, 164). Current form of state, with many elements of ethnic federalism, atypical and hybrid, is neither a guarantee nor a condition for proper performance of the state functions (Pobrić, 2000, 324). According to Pobrić (2000, 324), to become a *regular state*, Bosnia and Herzegovina must have a different constitution. This implies that defining B&H as a form of state is a problem that carries widespread implications in terms of practical political life. Addressing this problem has a broader meaning than just

political and legal because it reflects organization, structure and general functional setup of the state and society, its perspectives, economic development, cultural progress, peace and stability, and is an essential issue (Karan, 2014, 164). In building a functioning (federal) state, it is important to resolve several key issues such as division of jurisdiction between the state-level authorities and the entities, relationships and level of cooperation between the state-level authorities and entity authorities and the issue of equality of entities.

4.2. Implications of constitutional issues on European Integration

The European Commission adopted the Enlargement Package (2010/2012), which provides guidelines for the continuation of the enlargement process based on annual progress achieved by candidates and potential candidates of the Western Balkans on their respective integration paths to the EU (Nakić, 2013, 37). Western Balkans progress reports can be considered as optimistic about the continuation of the EU enlargement process and the advances made on the road to EU integration which requires a lot of efforts. However, B&H shows the least prospects and progress. According to Nakić, public opinion in B&H lacks of adequate political support (Nakić, 2013, 39). It seems that very little changed five years after 2013, apart from slight moves towards the EU membership. Building a functioning and sustainable state is the key to start making a progress (Nakić, 2013, 39). The latest attempt to move forward was made on February 15, 2016, when Dragan Čović, Chairman of the Presidency of B&H submitted B&H's application for EU membership (Europa, 2016). However, the seriousness of the application is at least questionable because the application was filed even though B&H has not yet fulfilled the three conditions set out in the European Commission's Progress Report for 2015. Moreover, the European Commissioner for European Neighbourhood Policy and Enlargement warned that at least two of the three conditions should be met: implementation of an effective coordination mechanism and adaptation of the Stabilization and Association Agreement (SAA), upon entry of Croatia into the EU (Kukić, Šavija, 2017, 60). This reveals the problems encountered in relation to the Constitution of B&H, as discussed in the previous chapter, which involves obligations deriving from the European Court of Human Rights Decision in the *Sejdić and Finci v. B&H* case. The Court ruled that there had been a violation of Article 14 in relation to Article 3 of Protocol 1 of the European Convention on Human Rights and Fundamental Freedoms, where the candidates were unable to run for elections in the House of Peoples of Bosnia and Herzegovina and a violation of Article 1 of Protocol 12, where the candidates were unable to run for elections in the B&H's Presidency (Kulenović, Hadžialić-Bubalo, Korajlić, 2011, 2). The judgement reveals that members of non-constituent peoples are unable to run for elections in the Presidency of B&H and the House of Peoples of the Parliamentary Assembly of B&H (Kukić, Šavija, 2017, 60). This also indicates that the Constitution of B&H does not meet the main political criteria established in Copenhagen in terms of fundamental human rights and minority rights on which

the EU insists. This has been confirmed by the latest European Commission reports from April 2018, which state that B&H has built a complex institutional structure that remains ineffective and is subject to different interpretations (European Commission, 2018, 4). Furthermore, the Court used this opportunity to confirm the fundamental rule of international law implying that obligations assumed at international level cannot be avoided by invoking the contrary norms of domestic law, including Constitutional Law (Kulenović, Hadžialić-Bubalo, Korajlić, 2011, 3). This imposes the necessity of amending the Constitution. However, this judgment is not only significant in terms of the obligation to adjust provisions of the Constitution of B&H to the European Convention. The judgement is also used as a reason for analysing several aspects of the constitutional system of B&H, in which non-constituent peoples in B&H are limited or excluded from political decision-making procedures by ethnocratic regimes, thus undermining the generally accepted elements of statehood (Kulenović, Hadžialić- Bubalo, Korajlić, 2011, 3). When B&H signed the EU Accession and Stabilization Agreement in 2008, its implementation was postponed because the European Court of Human Rights Decision in the Sejdić-Fincić case was not yet implemented. Considering the attempt to enforce the decision by adoption of an amendment to the Constitution of B&H, which lasted from 2009 to 2014, was unsuccessful, the Agreement was ratified not earlier than in 2015. Only then, thanks to the reforms of the institutions of B&H (Border Service Agency, Intelligence and Investigation Services, and Police Reform- partly) (Pejanović, 2017, 6), the EU looked *through B&H's fingers*, so the Agreement was ratified. The Parliamentary Assembly of B&H failed to reach a consensus for implementation of the judgement during the above-mentioned period. Proposals for amendments to the Constitution were discussed outside the Parliamentary Assembly, among the party leaders, thus usurping the power of the Parliamentary Assembly (Pejanović, 2015, 145). This violated B&H's legal and democratic requirements, which correspond to the main political criteria of the EU adopted in Copenhagen. Therefore, B&H's integration process was suspended from 2008 to 2015. This supports the statements given in the previous chapters on a non-functional setup of the state of B&H, which is governed by ethnic political parties. Instead of parliamentary democracy, B&H's Government is a form of partocracy where one or more political parties dominate the political process (Pejanović, 2014, 25). It is important to note that the European Court of Human Rights did not offer any detailed guidelines or time limit for enforcement of the judgement (Kulenović, Hadžialić-Bubalo, Korajlić, 2011, 3), which may be entirely wrong when it comes to specific situation such as Bosnia and Herzegovina. In other words, it has already been seen in the post-Dayton years that there is a tendency to destabilize the Bosnian-Herzegovinian society and the social development of B&H, every time there is a delay in the European integration process (Pejanović, 2017, 7). Without the development of European integration there will be no favourable internal integration in B&H and its stability (Pejanović, 2017, 7). This indicates how much important is European integration for B&H and partially proves the first hypothesis. However, given the dominant political

constellation in B&H, it seems that Eurosceptics are quite right when they argue that the application for EU membership was only declarative as the political elites in B&H have not yet implemented any substantive reforms or tried to deal with any challenges on B&H's path to the EU (Topčagić, 2016, 2). This is contrary to the official standpoint of the Ministry of Foreign Affairs of B&H about the political consensus and the desire to join the EU. The current political constellation in B&H reveals a crisis in political control because the ruling parliamentary parties are unable to achieve a consensus on the development of the state aimed at achieving its economic and political sustainability and getting a green light for the start of accession negotiations. The crisis stems from the fact that national parties, which, as a coalition, manage state resources, have built their positions on an ethnic basis and they have different ethno-national politics (Pejanović, 2017, 10). Parliamentary majority is not achieved based on a program coalition but rather partnership (Pejanović, 2017, 10). This implies that the Government is formed only for the sake of power, without a concrete course or a common idea that would lead the country in the right direction, because in the territory of Bosnia and Herzegovina, ethnic political parties have quite contradictory opinions about how to manage the state. Consequently, it could be assumed that the time will continue to run until reforms take place. This is confirmed by the opinion of the European Commission on the functional setup of the B&H's Parliament. The Reform Agenda affected relationships between the dominant coalition parties, leading to a slowdown in the implementation of reforms (European Commission, 2018, 4). Insisting by certain delegates to adopt voting mechanism provisions that are not in compliance with the EU standards continues to prevent the Stabilization and Association Parliamentary Committee to adopt the Rules of Procedure and to finally commence with the board meetings (European Commission, 2018, 4). However, such a situation generates more and more problems, which can be resolved once the political problems are resolved. Political monopoly, without adequate competition, like the economic monopoly, is ineffective in its essence. Many reforms cannot be implemented because no agreement can be reached by the dominant coalition parties. Not to say that energy, employment or public finance management strategies are yet to be adopted (European Commission, 2018, 5).

The Constitution of B&H does not allow citizens who do not declare themselves Bosniaks, Croats or Serbs to run for the Presidency or the House of Peoples of the Parliamentary Assembly (European Commission, 2018, 4). The case of *Pilav v. B&H* also illustrates issues that arise from the Constitution where Bosniaks and Croats from Republic of Srpska are unable to run for elections in the Presidency or the House of Peoples even though they are members of the constituent peoples, as well as Serbs from the Federation of Bosnia and Herzegovina (*Ured zastupnika Republike Hrvatske pred Europskom sudom za ljudska*, 2016, 54). Although this case differs from the case of *Sejdić-Finci*, as it is about a member of a constituent people, the European Court of Human Rights decided that the exclusion of the applicant from the B&H Presidency election was based on ethnic origin and

residence, which is a violation of Article 1 of Protocol 12 (Ured zastupnika Republike Hrvatske pred Europskom sudom za ljudska, 2016, 54). Another case (Zornić v. B&H) illustrates the issue of discrimination in B&H elections. Mrs. Zornić was unable to run for elections in the House of Peoples of B&H because she did not declare herself as a member of any ethnic group (European court of human rights, 2018, 1). The Court found that this case was identical to the earlier case of Sejdić-Finci, since Mrs. Zorić was unable to run for elections based on her ethnic identity. The Court concluded that the continued inability of candidates to run for elections did not have an objective and reasonable justification, which makes those provisions of the Constitution discriminatory. The statements on constitutional incompatibility with the political criteria are herewith proved, but there is no end to the problems of electoral legislation in B&H. The next chapter will investigate other issues.

4.3. Case of Croats in B&H

The above-mentioned court cases, which speak of violation of democratic principles, human rights and minority rights in B&H, are not the only problems faced by the Bosnian-Herzegovinian society. This chapter discusses position and equality of constituent peoples, especially Croats, when running for elections. According to some authors, the Sejdić-Finci judgment opened the Pandora-box (Krešić, 2014, 86; Rudolf, 2011, 225). Since the Court stood in defence of the rights of other peoples in B&H, that opened the case of Croats in B&H and the fact that since 2006 Croats have been unable to choose their legitimate representative in the Presidency of B&H (Krešić, 2014, 86), although they are one of the three constitutive nations. It appears that members of the Presidency of B&H are directly elected from their entity, which would be in line with federalism, but this is not the case in B&H (Krešić, 2014, 86). In other words, elected representatives represent the constituent peoples who voted for them. Article V –1(a) of the Constitution stipulates that *Members of the Presidency shall be directly elected in each Entity (with each voter voting to fill one seat on the Presidency) in accordance with an election law adopted by the Parliamentary Assembly* (Krešić, 2014, 86). However, in B&H, a bigger nation can vote for a presidency member who belongs to another constituent people (in this case, the Federation of B&H), and, in this way, voters can select two candidates from two constituent peoples (Krešić, 2014, 86). Each voter has only one vote, but they are not divided into national electoral bodies when voting. Therefore, presidency members only formally represent their entities, having in mind that they are elected by all voters in each entity (Krešić, 2014, 86). The fact that voters in the Federation of B&H elect two presidency members leads to a discovery that the electorate is indeed divided on the national basis (Krešić, 2014, 86). Such a form of election enables bigger nation to influence the election of a presidency member from a smaller nation in Federation of B&H (Krešić, 2014, 86). Although this did not happen in the first ten years after the war, the elections in 2006, 2010 and the 2018 elections have shown that this can occur in practice.

B&H's population should be considered based on ethnic identity according to the latest population list, where of the total number of population in B&H (3,531,159), Bosniaks make 50.1% or 1,769,592, Croats make 15.4% or 544,780, Serbs make 30.8% or 1,086,733, whereas others make 3.7% or 130,054 (Popis stanovništva u Bosni i Hercegovini, 2013). When considering the cause of post-election crises, the answer can be found in this statistic. B&H is composed of three constituent peoples different in number. When using the rule of one person, one vote, Bosniaks as the biggest ethnic group could easily become the absolute hegemony in B&H (Rudolf, 2014, 225). However, B&H as a state is based on three constitutive and constituent or equal peoples and current form of elections violates rights of nations. The 2018 European Commission Report suggests that the electoral law framework needs to be amended urgently to guarantee adequate elections in October 2018 (European Commission, 2018, 2). Political leaders in B&H must assume responsibility and find an adequate solution for elections in the Federal House of Peoples. However, no change in the electoral law has yet been made. The Constitutional Court Decision from 2010 to respect fundamental democratic right of citizens of Mostar to vote in local elections is still pending for its enforcement (European Commission, 2018, 2). Here, one should recall the starting point of the paper that EU is not a product of force or domination, but cooperation that was built over a period of decades and a free will of governments and peoples who had decided to unite to guarantee peace and justice and abandon nationalist aspirations. B&H should also follow the idea of European unity and find a way to fulfil fundamental democratic rights of all its citizens. Negligence of democratic principles and human rights means violation of constitutional foundations of the state of B&H based on equality for all three constituent peoples. This issue could seriously slow down the European integration process. EU institutions are warning of the necessity of improving and expanding the rights of constituent peoples and national minorities, as well as all other B&H citizens. It can be concluded that without progress in integration processes the integrity of B&H is being questioned, which proves the first hypothesis (H1). On the other hand, solving political issues in B&H is not just about to overcome obstacles in the integration processes (in terms of fulfilment of the political criteria), but it has implications on B&H's economy. The Copenhagen economic criteria regulate a functioning economy of a country that should be considered regardless of EU integration; especially bearing in mind that EU membership is the will of the people of Bosnia and Herzegovina. The next chapter will discuss the economic criteria.

5. PROBLEMS ENCOUNTERED BY B&H IN FULFILMENT OF ECONOMIC CRITERIA FOR ACCESSION TO THE EU

The previous chapters have shown that the most critical are the Copenhagen political criteria on B&H's path to the EU integration. The analysis confirmed that there is an issue with the Constitution of B&H and that there are political problems that arise from the lack of consensus between ethnic political parties and their

inadequate action in reforming the Bosnian-Herzegovinian society into a modern European society that will rely on pluralism and democracy, rule of law and other European values. The constitutional issues also reflect on the economic situation in B&H. The Dayton Constitution in its structure is irrational and expensive, since each of the cantons in FB&H, as well as the entities, has its own parliament and government, together with the existing two-house parliament system and government at the state level (Pejanović, 2014, 25). Such huge administration requires 6% of total funds (Pejanović, 2014, 25), while, on the other hand, inadequate funds are allocated for health care, science and social welfare. It is the assumption of the author that the economic crisis in B&H is caused largely by lethargic political action and problematic constitution, which is far from meeting the economic criteria for accession to the EU. The paper will illustrate it through a few examples.

The first example describes the situation in 2013 where no agreement was reached on the continuation of B&H's integration when EU and the international community decided to react. In May 2013, Doris Pack, EU Reporter for B&H proposed amendments to the European Parliament Resolution on the progress of B&H in the EU Accession Process, suggesting suspending Bosnia and Herzegovina's membership of the Council of Europe as well as aid from the European Union pre-accession funds and the interim trade agreement between B&H and the EU (Krešić, 2014, 87). Explaining her motion to punish B&H, Doris Pack cited the inability of the Bosnian political leadership to agree on the implementation of a European Court of Human Rights ruling to eliminate from election legislation discriminatory provisions against national minorities (Sejdić-Finci case) (Krešić, 2014, 86). Although the amendments were not adopted and were more related to political criteria, B&H could lose funds needed to improve its political and economic situation. According to the European Commission Report of April 2018, since 2013 to today, political awareness in Bosnia and Herzegovina is raising very slowly. The report states that achieving a consensus on economic policy is significantly impeded by frequent political blockades and lack of political will (European Commission, 2018, 30). Despite the general acceptance of the main principles of market economy, short-term and frequent political disputes lead B&H to delays and discontinuation of the implementation of long-term reform projects (European Commission, 2018, 30). Such a political situation has had a major impact on the situation in B&H during 2017. The implementation of Reform Agenda and The Three-Year Stand-By Arrangement approved by the IMF in September 2016 significantly slowed down towards the end of 2017, after some positive events that occurred in the beginning of the year, due to the political situation in the country (EU Commission 2018 Assessments, 2018, 45). By the end of 2017 and early 2018, B&H finally adopted amendments to the Excise Duties Act, which resulted in the first review of the IMF Program. The medium-term frameworks of macro-fiscal policies and structural reform program aimed at ensuring competitiveness and inclusive growth, defined by the Economic Reform

Program¹, have been partly implemented in May 2017 (EU Commission 2018 Assessments, 2018, 45). The submission of the Economic Reform Program for May 2018 was postponed. Significant weaknesses in administrative co-ordination and cooperation, as well as policy formulation, were noted (EU Commission 2018 Assessments, 2018, 45). The described situation illustrates to what extent political frictions in the country reflect on fulfilment of the Copenhagen criteria on its path to the European membership. The next chapter will discuss the economic criteria.

5.1. Level of development of B&H's economy

Before analysing current situation in B&H in terms of fulfilment of the economic criteria set up by the EU on its path to the membership, it is necessary to give a brief description of the economic criteria. The economic criteria for EU accession reflect *a functioning market economy* and *the capacity to cope with competition and market forces* (Palánkai, 1997, 53). The whole process of accession negotiations depends on meeting the economic criteria and implementing the necessary reforms. Reforms imply a minimum level of competitiveness in the main sectors of the candidate countries, including compliance with the criteria at a level at which government policies and legislation affect competitiveness (such as trade policy, competition policy, government aids, support to small and medium-sized enterprises) and trade integration with the EU before enlargement (quantity and type of goods exchanged with Member States) (Hodžić, 2012, 84). Therefore, meeting the EU accession criteria for B&H should be viewed as the goal of transition into a functioning market economy, and not just a prerequisite for EU membership (Hodžić, 2012, 84). Implementing its institutional and structural reforms will be a lengthy process for B&H regardless of its entry into the EU. Having in mind constant political disputes discussed in the previous chapter, transformation of B&H's economy into a functioning market economy will last even longer.

5.2. Problems of transition of B&H into a functioning market economy

Current B&H's economy is a supporting argument for the statements outlined at the end of the previous chapter. B&H's economy is characterized by absence of real structural convergence, especially when it comes to its functioning market economy and competitive capacity (Hodžić, 2012, 83). The latest European Commission Report of April 2018 on B&H's economic development and competitiveness highlights that B&H has made some progress but is still at early stage of building functioning market economy (European Commission, 2018, 30). Some improvements of the business environment have been achieved and the

¹ Each country that makes part of the EU accession process is obliged to prepare annual Economic Reform Programs, which define the medium-term frameworks of macro-fiscal policies and structural reform program aimed at ensuring competitiveness and inclusive growth. Economic Reform Program forms a basis of political guidelines specific to each country.

financial sector has been strengthened (European Commission, 2018, 30). The following key issues remain unsolved: weak rule of law, poor business environment, fragmented and inefficient public administration, major labour market imbalances, poor education system, weak institutional capacities, and an unsupportive investment climate (European Commission, 2018, 30). In addition, the informal economy or grey economy remains a major factor that hampers the overall economic performance. Its consequences are manifested in tax evasion, market distortion, unfair competition, lack of social protection and insurance. Despite the intensified measures to combat the informal economy, it remains significant and accounts for about 25% of GDP. This high level of informal economy requires rates for taxes and social security contributions to be higher than would be otherwise necessary. This also adds to a significant fiscal burden affecting B&H's competitive advantage at the international level (European Commission, 2018, 32). Furthermore, a weak rule of law and inadequate judicial system remain the key weaknesses of B&H's economy where little progress has been made (European Commission, 2018, 32). There are still problems with contract enforcement, difficulties in settling commercial disputes and issues with establishing property rights (a low degree of real estate registration in some areas) (European Commission, 2018, 32). The issue of independence of regulatory and supervisory organizations remains unresolved (European Commission, 2018, 32). Although the state budget has recorded a slight surplus of funds, the quality of fiscal management remains very low. During 2017, public finances recorded a growth in revenue, reflecting steady growth in production, as well as improved tax collection measures. At the same time, government spending on public sector salaries remained the same (European Commission, 2018, 32). Despite improving the financing of the pension system, the overall quality of public sector management is exceptionally low especially in the health care sector and poor targeting of social transfers (European Commission, 2018, 32). One of the key issues remains the slowed down or delayed implementation of reforms aimed at improving efficiency of public expenditure. Although B&H's public debt dropped slightly in 2017 and stood at 38% of GDP by the first half of the year, it is partly a reflection of difficulties in accessing foreign capital markets (European Commission, 2018, 32). Macroeconomic policy takes time to implement due to slowed down reforms and lack of adequate medium-term guidelines or goals (European Commission, 2018, 32). The macroeconomic stability is maintained, but the pace of implementing reforms is too slow to achieve concrete progress in the country (European Commission, 2018, 32). Concerning the business environment, the Report highlights that regulations on entry and exit to and from the market have slightly improved, but many barriers remain (European Commission, 2018, 32). Some improvements have been achieved to reduce administrative burden and simplify business registration and support foreign investors (European Commission, 2018, 32). Although certain, but still minimal, advances in improving the business environment have been achieved, compared to other countries, the business environment in B&H has even worsened, reflecting a slow

implementation of structural reforms (European Commission, 2018, 32). The barriers to entry and exit to and from the market are still too many and time consuming thus undermining the attractiveness of B&H as a potential market for an international business (European Commission, 2018, 32).

The Government's role in B&H's economy is still very important, which conflicts with a functioning market economy. Despite efforts to reduce its impact, public expenditures still account for more than 40% of GDP, generating 22% of value added and employing 26% of the workforce in the country (European Commission, 2018, 33). State-owned enterprises as well as government aids and guarantees remain heavy burden on public finances and taxpayers (European Commission, 2018, 33). It can be concluded that the privatization process has not been completed. Attempts to privatize public companies were usually unsuccessful. A thorough analysis of the two local telecommunications companies was conducted on their respective privatization paths (European Commission, 2018, 33). Strategic sectors such as energy, transport, (and telecommunications in Federation of B&H) are still under poorly managed and often involve ineffective state-owned companies (European Commission, 2018, 33). Continuing with the process of privatization of state-owned enterprises could stimulate competition and improve the quality of services and reduce the burden on public finances (European Commission, 2018, 33), again pointing out that the privatization process has not been completed. More developed European and world economies that are still feeling the effects of the economic and financial crisis of 2007/2008 still not seeing the growth they saw before the crisis can be viewed as a very interesting field for research into structural reforms and policies as mainstream theoretical and practical economic science. When comparing those economies with Bosnia and Herzegovina, it can be concluded that B&H is at early stage of implementing structural economic reforms and that it first needs to resolve its political and institutional issues. However, it seems that B&H has not yet started to cope with implementing its structural reforms when compared to more developed countries in this region and at the global level. The above-mentioned statements correspond to B&H's key weaknesses to be taken into consideration in achieving long-term growth and development. The European Commission has proposed the following measures:

- Strengthening political intentions to foster the implementation of structural reforms through coordination and cooperation across various levels of government,
- Improving the quality of public financial management systems, adjusting and improving targeting of social expenditures aimed at developing and improving the quality of life;
- Increasing the availability and reliability of statistical data by applying European and international standards (European Commission, 2018, 30).

The key to B&H's economic development is the political will and the ability of policy-makers to establish an effective and efficient public spending system. It is important to note that B&H has not yet established an independent and effective IPA funding management system (Maletić, Kandžija, 2018, 250). This is one more motive for political synergy and responsibility, as IPA funding could be used to achieve improvements in B&H's social and economic structure. EU remains responsible for financial support, which means that the Delegation of the EU is the contracting authority and is responsible for implementing projects financed by IPA and coordinating with other Member States (Maletić, Kandžija, 2018, 250). The task of B&H is to establish effective and efficient coordination mechanisms for issues related to the EU. Also, it is necessary to set up a national strategy, which is a key prerequisite for IPA funding (Maletić, Kandžija, 2018, 250). B&H must show improvements in establishing efficient institutional structures for using pre-accession assistance instruments in rural development (IPARD) (Maletić, Kandžija, 2018, 250). It is necessary to point out that B&H has not yet adopted a rural development national strategy (Maletić, Kandžija, 2018, 250). The aim is to further enhance the harmonization process of national strategies for agriculture, food industry and rural development, as well as production of wine and organic food (Maletić, Kandžija, 2018, 250). Administrative and coordination capacities in agricultural and rural development, which include government aid measures, also need to be reinforced (Maletić, Kandžija, 2018, 250). Transition is a slow and complex process where time is crucial. The global economic environment is in a constant change in a competition in which B&H has not yet taken part. B&H's transition process is further complicated by constant political tensions, reflecting in slowed down or delayed implementation of structural policies and reforms. This is a supporting argument for the assumption of negative impact of political frictions on B&H's economy development and proves the second hypothesis (H2). Due to the absence of political integration, B&H was not able to define a consistent transition model. Other negative effects on B&H's development are inactive society, inherited from the era of socialism, economy which suffers devastating impacts during and after a time of war and strong interference of the international community in its internal politics (Tomaš, 2013, 106). This implies that the Dayton Agreement has only partially defined the transition model. The international organizations have applied a model of economic transition derived from the neoliberal ideology of aggressive capitalism, believing that the market economy, the single currency and entrepreneurial freedom with strong financial support will soon reduce the contradictions in the Bosnian society and lead to progress and economic integration in the country (Tomaš, 2013, 106). This recipe did not seem to fit the Bosnian reality (Fischer, 2006, 447). Political differences in the country are far deeper than previously thought and the international community carries a part of the responsibility for the current situation. However, all that has been mentioned so far is not a reason why B&H should not cope with its problems and try to turn its weaknesses which arise from political differences in to strengths. It first involves identifying reasons a problem exists. Critical issues in B&H's

economy that concern its competitiveness need to be identified and analysed to setup an adequate and successful strategy, which will be discussed in the following chapters.

5.3. Effects of current B&H's economy on the labour market

Before addressing the concrete problems facing B&H with regard to its competitive advantage, it is extremely important to look at and analyse the labour market that is quite difficult. The impact of the socio-economic crisis in Bosnia and Herzegovina is best described by statistics of the Labour and Employment Agency of B&H, according to which in the middle of 2018 there were 448,071 or 35.9% unemployed people (Agencija za rad i zapošljavanje Bosne i Hercegovine, 2018). The number of unemployed people decreased compared to 2017 (486,309 or 39.4%) (Agencija za rad i zapošljavanje Bosne i Hercegovine, 2018). According to the European Commission Report, the percentage of unemployed people in 2017 was 38.7%, fell down by 6.1% compared to 2016 (European Commission, 2018, 33). B&H's labour market should be viewed in terms of differences which arise when comparing registered unemployment rates and survey data showing significant weaknesses in statistical records. Also, these data reveal demographic issues and weaknesses in professional education and training (European Commission, 2018, 33). The question is whether the increase in employment rates is the result of registered employment in B&H or economic migration. In other words, the official website of the Labour and Employment Agency of B&H offers information on jobs abroad. According to the Federal Institute for Pension and Disability Insurance, the number of retired workers in B&H in August 2018 was 412,815 with a very low average pension in the amount of 400,39 KM (FZ MIO – Federalnog zavoda za mirovinsko i invalidsko osiguranje, 2018). According to the Fund for Pension and Disability Insurance of Republic of Srpska, the number of retired workers in August 2018 was 304,722 with an average pension even lower than in FB&H 366 KM (Fond PIO RS – Fonda za penzijsko i invalidsko osiguranje Republike Srpske, 2018). When the entity statistics sum up, a total of 717,537 retired workers are obtained at the state level. According to the Agency for Statistics of B&H, the total number of employed people in B&H in July 2018 was 805,715 (Agencija za statistiku BiH, 2018). The number of retired workers is drastically approaching the number of employed persons, whereas the number of unemployed people has exceeded half of the total number of employed people. When the number of retired workers and unemployed persons is summed up, a total of 1,130,352 is obtained, which exceeds the total number of employed people for 324,637. Here it is necessary to make a short digression and consider availability of statistical data that is shared by entities. In other words, statistical data are not available at the state level as was recommended in the latest European Commission Report. Such a high unemployment rate is indicative of structural unemployment. Structural unemployment is a result of the transition and transformation of the national economy, migration trends and other challenges in the labour market (Kandžija, Pucar, Tolić, 2016, 92). Although high

unemployment rate is the result of economic transition, especially in the sectors of large former social and public enterprises, B&H is also facing unemployment of young people (Kandžija, Pucar, Tolić, 2016, 92). According to the Federal Bureau of Statistics of B&H, the unemployment rate in most cities is extremely high, which also shows that unemployment is the biggest weakness in this region (Kandžija, Pucar, Tolić, 2016, 92). All the figures given above speak best about the economic and social situation in B&H, which is crying for change, but also about the fact that the change will be hard.

5.4. Macroeconomic situation of B&H

According to the European Commission Report, the macroeconomic situation of B&H remained stable in 2017, but far below its potential (European Commission, 2018, 31). Production growth remained stable with an average increase of 2.5% per year over the past five years. The driving force of growth was domestic demand, especially in personal consumption expenditures on the account of a stable inflow in the labour-force renewal rate and low inflation rate of real household disposable income (European Commission, 2018, 31). Unlike the recession period from 2010 to 2014 characterised by a very low economic growth of -1.1% in 2012 or 1-2% (in some sources 2.5%) in 2010, 2011, 2013, and 2014 (Kandžija, Pucar, Tolić, 2016, 83), the situation has slightly improved but has not changed significantly. Economic growth in 2017 resulted from increased demand, which gave an additional boost to B&H's economy (European Commission, 2018, 31). At the same time, domestic and foreign investments remained very low (2.2%) due to poor business environment and high degree of political uncertainty (European Commission, 2018, 31). GDP per capita was around 32% of the EU-28 average in 2016, which is only slightly higher than the 2012 figure of 32% (European Commission, 2018, 31). Such a low economic activity in B&H stems from its economic structure, so it needs to be analysed more closely. Since the economic structure has not changed significantly, some older but more accessible data from 2014 will be used for analysing, where 33.7% of a total of active enterprises in B&H (26,395) were located in 4 larger cities: Sarajevo (4,390), Banja Luka (2,169), Tuzla (1,216) and Mostar (2,169), revealing disparities in development between urban and rural environments. A real picture of economic activity in B&H can be obtained by comparing the number of enterprises per 1,000 of inhabitants with other countries, which was 7 enterprises per 1,000 of inhabitants (Kandžija, Pucar, Tolić, 2016, 86). If this number is compared with more developed neighbouring countries, like Croatia, which has 27 active small and medium-sized enterprises per 1,000 inhabitants, and is amongst the least developed countries of the EU, the disparity in development is more than obvious and B&H lags behind Croatia for three times (Kandžija, Pucar, Tolić, 2016, 86). Furthermore, in terms of sector structure, 35.2% of all companies in B&H deal with trade, then construction, transportation, wood processing and services. Only one manufacturing industry (metallurgy) is among the top five sectors by number of active enterprises

(Kandžija, Pucar, Tolić, 2016, 86). Trade with the largest number of active enterprises makes the largest share in B&H's total income or 48% (Kandžija, Pucar, Tolić, 2016, 90). Although metallurgy is the first among the top five manufacturing industries by the number of active enterprises, the food industry ranks first by revenue (2.06 billion KM), followed by metallurgy with 1.76 billion KM of revenue and wood processing industry with KM 1.2 billion of revenue (Kandžija, Pucar, Tolić, 2016, 90). B&H's economic structure is extremely unfavourable, where trade and services make 48.3% of the total structure with 12,763 active enterprises out of a total of 26,395, and production is characterised by low value added products. Such an economic structure affects imports of significantly more expensive goods (on average 60% more expensive by 1kg) than exported (Kandžija, Pucar, Tolić, 2016, 85) driving the trade deficit at a high level. The above suggests that B&H exports raw materials (leather, wood, metal) and imports finished products. Such an economy is not sustainable in the long run. The European Commission Report for 2017 highlights that B&H's trade deficit dropped by 5.1% in 2016 or by 4.7% in 2017, on the account of export activity increase, lower import prices and tourism activity increase (European Commission, 2018, 31). However, higher consumption-based imports are still holding trade deficits very high at 23.6% of GDP (European Commission, 2018, 31). The trade sector holds the largest share of B&H's economy and generates the highest portion of total revenue, but also records a profit rate of only 2.9% (Kandžija, Pucar, Tolić, 2016, 96). On the other hand, a significantly smaller ICT sector is ranked fourth by total revenue and first by profit rate (9.7%), which is an indicator of effective business management system and highest productivity rate (Kandžija, Pucar, Tolić, 2016, 96), but also reveals how important knowledge, and implementation of the knowledge acquired, is in production to achieve better economic results. In terms of value-added based productivity, B&H's economy, which trade activity prevails, has no competitive ability to cope with competition and market forces on the European market. This might be the most critical problem in the future. The next chapter discusses the competition aspect of the economic accession criteria.

5.5. B&H's competitiveness

After having conducted researches on competitiveness for nearly three decades, in 2004, the World Economic Forum (WEF) proposed its Global Competitiveness Index (GCI) as a universal index for measuring national competitiveness. The GCI index integrates the macroeconomic and microeconomic aspects of competitiveness into a single index (Parežanin, Jednak, Kragulj, 74 2014,). The latest WEF report proposes 12 categories - the pillars of competitiveness - that collectively make up a comprehensive picture of a country's competitiveness. GCI scores are based a set of institutions, policies and factors that determine the level of productivity of a country, which in turn sets the level of prosperity that the country can earn. The level of productivity determines the rates of return obtained by investments in an economy, which in turn are the fundamental drivers of its growth

rates (World Economic Forum, 2017-2018, vvi). In other words, developing a more competitive economy will lead to generating faster economic growth. In the period from 2015 to 2016, when the world economy was emerging from the economic crisis (caused by the 2007/2008 financial crisis), B&H was ranked very low on 111th according to the GCI (Kandžija, Pucar, Tolić, 2016, 98). When compared to Croatia, which ranked 77th or Greece, which ranked 84th, whereas both countries are amongst the least developed countries of the EU, it is evident that B&H lags far behind the least developed European economies. WEF reports for 2017(World Economic Forum, 2017-2018, 66, 98, 130) confirm that B&H has made some progress and ranked 103rd, whereas Croatia ranked 74th and Greece 86th. In 2018, B&H ranked 91st, Croatia 68th and Greece 57th (World Economic Forum, 2018, 107, 179, 247). According to the WEF report, B&H lags behind all the countries in the region: Albania ranks 76th (jumped 4 places compared to the previous year), Macedonia 84th, Montenegro 71st (jumped 2 places compared to the previous year) and Serbia 65th (jumped 5 places compared to the previous year) (World Economic Forum, 2018, 55, 336, 403, 499). In order to obtain a real picture of B&H's competitiveness, it is necessary to explore all the factors that influence its position in the GCI ranking and compare it to Croatia as its first neighbour country and EU member in order to determine how much B&H lags behind in terms of competitiveness and which economic criteria need to be met for accession to the EU. Table 1 and Figure 1 compare competitiveness of B&H and Croatia according to 2017-2018 Reports, while Table 2 and Figure 2 indicate data from 2018 Report.

Table 1. Twelve pillars of competitiveness for B&H and Croatia2017-2018

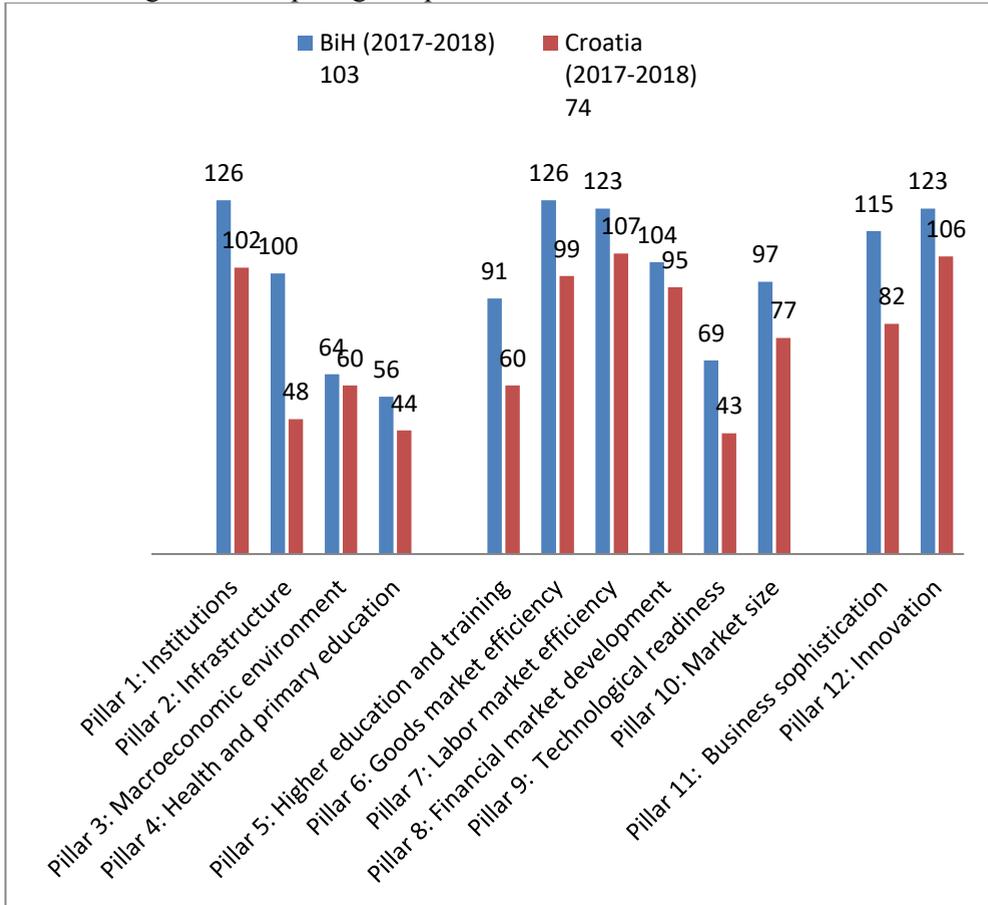
Pillars	B&H (2017- 2018) 103			Croatia (2017- 2018) 74	
Subindex A: Basic requirements	91		<	58	
Pillar 1: Institutions	126		<	102	
Pillar 2: Infrastructure	100		<	48	Top 70
Pillar 3: Macroeconomic environment	64	Top 70	<	60	Top 70
Pillar 4: Health and primary education	56	Top 70	<	44	Top 70
Subindex B: Efficiency enhancers	100		<	69	
Pillar 5: Higher education and training	91		<	60	Top 70
Pillar 6: Goods market efficiency	126		<	99	
Pillar 7: Labour market efficiency	123		<	107	
Pillar 8: Financial market development	104		<	95	
Pillar 9: Technological readiness	69	Top 70	<	43	Top 70
Pillar 10: Market size	97		<	77	

Subindex C: Innovation and sophistication factors	119		<	99	
Pillar 11: Business sophistication	115		<	82	
Pillar 12: Innovation	123		<	106	

Source: World Economic Forum, Global Competitiveness Index 2017-2018 edition, 2017

B&H ranks among the top 70 countries in the following areas: macroeconomic environment, primary health care and technological readiness, while having a low rank in the areas of institutions, infrastructure, goods market efficiency, labour market efficiency, business sophistication and innovation (below 115th). B&H ranked among the top 70 countries in three of the 12 categories of competitiveness measured. It ranked below the 115th place in 6 categories, which are very important in terms of competitiveness such as institutions and infrastructure that have an important effect on foreign investment. Such a picture of B&H's competitiveness reveals its key weaknesses and confirms the assumptions about the problems it is facing as discussed in previous chapters (institutional inefficiencies caused by political disunity, dysfunctional market economy as a result of unfinished transition process, slowed down or delayed implementation of reforms and infrastructure improvement due to the slow government response). On the other side, Croatia ranks among the top 70 countries in five of the 12 categories of competitiveness measured: macroeconomic environment, infrastructure, public health and primary education, higher education and training, technological readiness, and, unlike B&H, Croatia never ranked below the 110th place. Although Croatia as well has its weaknesses in terms of institutional issues and labour market, it ranks 20 places higher in these categories of competitiveness. The biggest difference between these two countries is manifested in the areas of infrastructure, higher education and training, technological readiness, and business sophistication. Figure 2 shows competitive differences between the two countries and how much B&H lags behind Croatia.

Figure 2. Comparing competitiveness B&H vs. Croatia 2017-18



Source: World Economic Forum, Global Competitiveness Index 2017-2018 edition, 2017

Although both Croatia and Greece are among the least developed countries of the EU, it is more useful to show a graphical representation of the gap of competitiveness between B&H and Croatia. B&H is approaching Croatia in terms of competitiveness, especially in areas of macroeconomic environment, health care and primary education, but still lags behind Croatia in all categories.

Table 2 and Figure 2 show changes in the global competitiveness scale and reveal that the countries have made some progress in 2018. WEF is making continuous improvements in measuring competitiveness, so it is easy to note that competitiveness categories differ from the previous report. The most problematic factors for doing business in B&H are: inefficiency of government bureaucracy, corruption, tax rates, political instability and weak government, access to finance, tax regulations, restrictive labour regulations, crime and theft, poor working ethics, inadequately educated workforce, inadequate infrastructure, foreign exchange

regulations, poor public health and inflation. The most problematic factors for doing business in Croatia are almost the same: inefficiency of government bureaucracy, corruption, tax rates, political instability and weak government, access to finance, tax regulations, restrictive labour regulations, crime and theft, poor working ethics, inadequately educated workforce, inadequate infrastructure, foreign exchange regulations and poor public health. The difference is that Croatia's innovation capacities are inefficient, while B&H is fighting to have inflation under control.

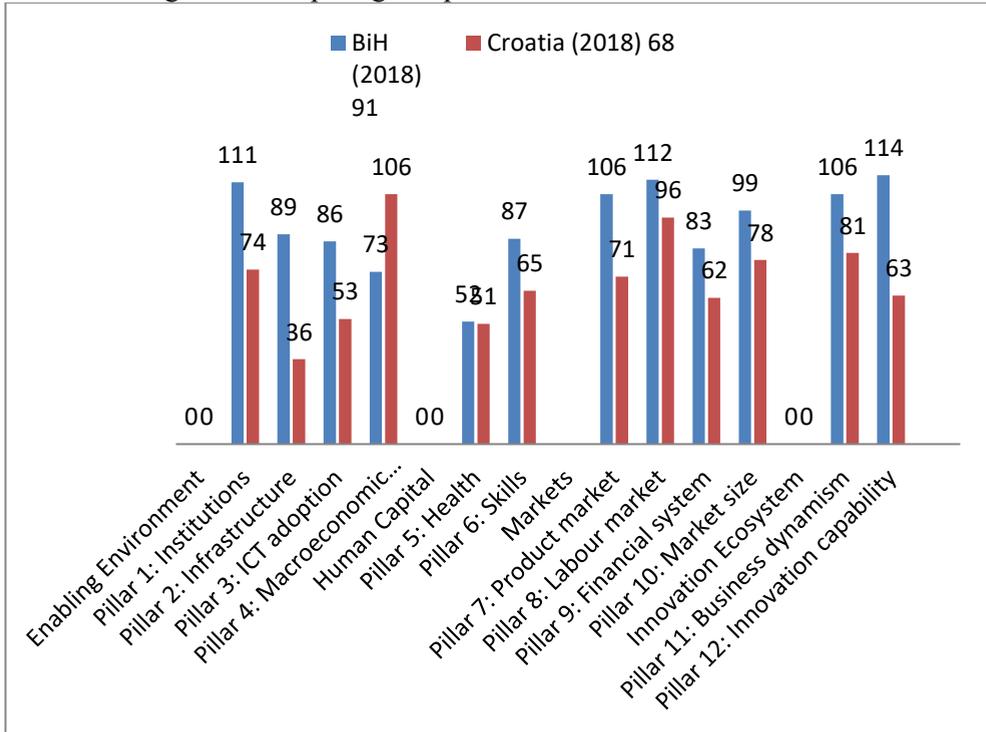
Table 2. Twelve pillars of competitiveness for B&H and Croatia 2018

Pillars of competitiveness	B&H (2018) 91			Croatia (2018) 68	
Enabling Environment	-		-	-	
Pillar 1: Institutions	111		<	74	
Pillar 2: Infrastructure	89		<	36	Top 70
Pillar 3: ICT adoption	86		<	53	Top 70
Pillar 4: Macroeconomic stability	73		>	106	
Human Capital	-		-	-	
Pillar 5: Health	52	Top 70	<	51	Top 70
Pillar 6: Skills	87		<	65	Top 70
Markets					
Pillar 7: Product market	106		<	71	
Pillar 8: Labour market	112		<	96	
Pillar 9: Financial system	83		<	62	Top 70
Pillar 10: Market size	99		<	78	
Innovation Ecosystem	-		-	-	
Pillar 11: Business dynamism	106		<	81	
Pillar 12: Innovation capability	114		<	63	Top 70

Source: World Economic Forum, Global Competitiveness Index, 2018

The table shows that B&H is ranked among the top 70 countries in only one category – health, whereas Croatia is ranked among the top 70 countries in six categories: infrastructure, ICT adoption, health, skills, financial system and innovation capability. Interestingly, according to the latest report, B&H is macroeconomically more stable than Croatia. The data is represented graphically for better visual comparison (Figure 2: Comparing competitiveness B&H vs. Croatia 2018).

Figure 2. Comparing competitiveness B&H vs. Croatia 2018



Source: World Economic Forum, Global Competitiveness Index, 2018

Figure 2 shows that even though B&H is approaching Croatia only in health category, its macroeconomic position is better than of Croatia. Both countries show some progress in the global competitiveness ranking, organized in 12 pillars of competitiveness, but the analysis reveals some weaknesses. B&H's greatest weaknesses are: organized crime, poor reliability of police services, restrictive law regulations, regulatory burden, inefficiency of legislative framework in dispute resolution processes, low E-participation level, inadequate government orientation, inefficient protection of ownership and intellectual rights, low level of application of audit standards and reports, inadequate conflict of interest rules, poor road infrastructure quality, poor rail service efficiency, poor air traffic efficiency, poor maritime traffic efficiency, low mobile phone subscription, low mobile internet subscription, inadequate professional education and training, inadequate skills of graduates, shortage of skilled workers and lack of critical thinking in teaching (all subcategories below 100th). Croatia's greatest weaknesses are: low level of social capital, low level of judicial independence, restrictive law regulations, regulatory burden, inefficiency of legislative framework in dispute resolution processes, inadequate government orientation, inefficient protection of ownership rights, low level of application of audit standards and reports, inadequate debt dynamics, inadequate professional education and training, inadequate skills of graduates,

shortage of skilled workers and lack of critical thinking in teaching, and insufficient level of digital skills (all subcategories below 100th).

The comparative analysis indicates that B&H is lagging too far behind the least developed EU countries (Croatia and Greece) and other countries in the region (candidates and potential candidates). Urgent efforts should be done to achieve improvements in the critical areas of competitiveness such as institutional system, infrastructure, health care, labour market, business dynamics, etc. The unfavourable political situation in B&H, where the country's political elites go separate ways, is emerging as the biggest obstacle to the EU accession and economic development, and the recovery will be long and painstakingly slow.

6. CONCLUSION

Globalization is the connection of different parts of the world in a whole. Countries group for political and economic reasons. Small and developing countries are facing increasing challenges on their respective paths of prosperity. Considering their turbulent history and stormy present, and economy's uncertain future, in the author's opinion that is founded on research, the future of the countries of the Western Balkans lies in European integration. A united and prosperous EU serves as an example and provides a sort of control mechanisms for improving socio-economic relations, preserving peace and maintaining stability in B&H and the entire Western Balkans region. B&H, a country situated in the Western Balkans, has its potential for development and economic growth, but shows extremely slow progress in all the categories of competitiveness. As part of the EU, Bosnia and Herzegovina will be able to constructively use its potentials arising from its diversities, like the EU did in the middle of last century. EU has long supported the countries of the Western Balkans, including B&H, on their respective integration paths. The EU has shown its initiative and willingness to accept these countries and has been providing development assistance from EU funds. In return, the EU insists that candidate and potential candidates orient themselves around the task of building effective and functioning states, employing EU control mechanisms. The first condition in the integration process is fulfilment of the Copenhagen Criteria, which should be considered more as guidelines for building an effective, functioning state, not as obstacles on the path to EU accession. Bosnia and Herzegovina needs to make changes to improve its constitutional structure and institutional system to guarantee democratic rights of all its citizens, both constituent peoples and national minorities, as proved by testing the first hypothesis. Meeting the Copenhagen political criteria and achieving progress on its path to European integration is a precondition for achieving integrity and stability of Bosnia and Herzegovina. The major problem regards fulfilment of the political criteria due to a lack of political consensus and a lack of seriousness when it comes to try and achieve it. This is illustrated by the example of non-implementation of the Sejdić-Finci judgement, which is blocking B&H's application for EU membership for almost ten years. Slowing down EU integration processes results

in the destabilization of the B&H, which emphasizes the importance of B&H becoming part of the EU. The European Court of Human Rights Decision in the Sejdić-Finci case has not yet been implemented and is the subject of all the reports of the European Commission for B&H. Moreover, the latest report included similar cases of Pilav, Zornić and Šalaku v. Bosnia and Herzegovina, involving violation of democratic rights of the citizens of Mostar and indicating a growing dissatisfaction of the Croatian people for not changing the electoral law. Every election could trigger another crisis, which proves the first hypothesis on B&H's integrity that must not be compromised by violating democratic rights of any of the three constituent peoples.

Furthermore, issues stemming from a lack of political consensus are reflected in the country as a whole and heavily affect B&H's economy. Government spending is too high (6% of GDP) and does not tend to decrease. Functions of public administration institutions are not well integrated and interlinked, nor are they well aligned to justify such expenditure. Political instability is slowing down the implementation of structural reforms to create a favourable business and investment climate and revive economy. In this way, B&H's economy is deprived of necessary resources from domestic and foreign sources to finance its activities. In addition, B&H does not have its own mechanisms for managing absorption of pre-accession funds under the IPA, but pre-accession assistance is provided under the supervision of the EU institutions. Due to differences and disagreements existing between them, the political elites in B&H limit themselves to use the funds that are necessary for their homeland. Issues of corruption, black market and non-transparency strongly affect the country's competitiveness. These problems all stem from political instability and could be resolved once political consensus is reached and once the political elites demonstrate readiness to fulfil the political criteria to enable their country deal with its economic problems such as: large labour market imbalances, excessive deficit, unfavourable export structure, and slowed-down or delayed implementation of reforms in agricultural and industrial sector. The political elites in Bosnia and Herzegovina need to act responsible and seek to achieve overall consensus to enable their country make progress towards meeting the economic criteria for EU accession. In the second hypothesis, it has been proved that B&H's political situation has negative effects on its economy in all its segments and tends to slowdown the implementation of urgent structural reform priorities. The practice shows that the process of implementation of structural reforms can be extremely difficult and lengthy, and could take almost 10 years to yield results, especially in education, which is one of B&H's major issues. It can therefore be concluded that the leadership of this country must first agree on all major issues and try to solve the problems. However, it seems that B&H has not yet started implementing its reforms, as the current political stalemate is affecting the economy of the country and there is difficulty passing laws that satisfy the needs of the people. Almost 23 years after the war and the Dayton Agreement, B&H has not succeeded to construct a functioning market economy and achieve

faster growth. Progress at raising competitiveness has been slow, showing weaknesses primarily in B&H's institutional system, infrastructure, innovation, market efficiency, etc. The EU accession process based on the fulfilment of the political and economic criteria has revealed B&H's weaknesses that need to be improved to become a functioning and competitive state, which is founded on the shared values of democracy, rule of law and market economy. The EU accession process should be considered as a stage of development on the path to European integration, which, as previously discussed, remains B&H's strategic priority to maintain its integrity and stability. Given the current situation and all the problems facing Bosnia and Herzegovina, and the slow pace of structural reforms, it can be concluded that Bosnia and Herzegovina should take the instructions received from the European Commission seriously and urgently try to deal with its problems and difficulties to speed up the European integration process aimed at ensuring its integrity, stability and modern market economy.

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**WOMEN ON CORPORATE BOARDS IN THE REPUBLIC OF CROATIA
IN THE CONTEXT OF THE EUROPEAN UNION DIRECTIVES AND
NATIONAL POLICIES**

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Review

Abstract

Gender equality is a very important topic in today's business world that involves the prevention of discrimination and different protection measures for women promotion not only in activities of human resource management such as recruitment, working conditions, training and different benefits, but also in corporate management functions, at board and top level of management. Countries take different approaches in terms of institutional support and setting quotas to increase women presence at boards and top management of the corporations. Across Europe different policies and initiatives are undertaken to increase number of women on corporate boards. In 2011 the Croatian Parliament adopted the National Policy on Gender Equality. This policy aims to create a gender balance of supervisory and management board members in the public and private sectors by ensuring that the share of the women to the Act on Gender Equality, does not fall below 40%. This Policy does not appear to be properly implemented in practice. Statistical data from 2017 shows that share of women on boards of the leading Croatian companies is 17.3%, according to the CROBEX Index which measures the share of women in management positions in the most important companies on the Zagreb Stock Exchange. In 2017 share of women in corporate boards decrease comparing with 2015 and 2016 when it was above 20%. According to the latest available data from the European Commission in

April 2016, women are most numerous on corporate boards in France (37.1%), Sweden (36.1%), Italy (30.0%) and Finland (29.8%). The aim of the paper is to analyse position of women on corporate boards in the Republic of Croatia and do the comparison among Croatia and other EU countries with the critical approach to the analysis of secondary data, European Union directives and national policies.

Keywords: *women, corporate boards, the Republic of Croatia, European Union*

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1. INTRODUCTION

World corporations need to operate in a multinational environment where diversity within corporate boards is dominant and is one of the most important topics. According to the Lansing and Chandra diversity is commonly preferable at all levels in a corporation and defined as the composition of different types of people in a corporation or a group of employees. Women on corporate boards can contribute directly and indirectly, directly as leaders, mentors and networking and indirectly by inspiring other women to fight for top management positions and to break the invisible glass ceiling (Terjesen, Sealy, & Singh, 2009, 320-337). In modern corporations the most important internal mechanisms of corporate governance is the board of directors or management board because it is responsible for strategic management processes in corporation and strategic decision-making. The role of the supervisory board is to advise and monitor top management, and for that purpose the supervisory board is typically consisted of competitive individuals who have the specific skills and all required quality information.

The aim of the paper is to analyse position of women on corporate boards in the Republic of Croatia and do the comparison among the Republic of Croatia and other EU countries with the critical approach to the analysis of secondary data, European Union directives and national policies. This paper provides both descriptive and comparative analysis and is based on the secondary research data, both from internationally and nationally respected researchers and institutions. It is divided into 5 sections. First section is introduction. A review of legislation framework in European Union is demonstrated in section 2, further followed by a legislation framework in the Republic of Croatia in section 3. In section 4, the used methodology and secondary statistical data analysis about women on corporate boards in EU28 and the Republic of Croatia is explained. Section 5 includes a conclusion and discussion with implications and proposals for future research.

2. LEGISLATION FRAMEWORK IN EUROPEAN UNION

The issue of gender diversity has become one of the most important topics for European Commission and has over the last decade tried to reach a sustainable development within the European Union where gender equality is mentioned as one of the European Union's values. The European Union created one internal market where corporations, as well as people, are assured policies of free movement and standardized legislation and rights (European Union, 2017).

In EU a lot of member states have introduced gender quotas on two different ways: a voluntary and mandatory basis. The directive evolved from when the Commission adopted the *“Strategy for Equality Between Women and Men 2010-2015* (European Commission, 2010), which emphasized the promotion of women in the decision-making field. The European Commission in 2012 has proposed legislation with the aim of a 40% on women on corporate boards in listed corporations (VrdoljakRaguž, 2017, 269-279). These voluntary targets are also to be met in year 2020 (Proposal for a Directive 2012/0299, 2012). All details about quotas in EU28 are presented in table 1.

Table 1. Statistics and national measures in place

Member State	Share of women on boards	Quotas in place	Other national measures in place
Austria	20.1 %	Yes: only state-owned companies (35 % for supervisory boards by 2018).	Self-regulation: The Corporate Governance Code of 2009 recommends representation of both genders in appointments to supervisory boards.
Belgium	26.6 %	Yes: 33% for executives and non-executives in state-owned and listed companies-by 2017 and in listed SMEs-by 2019.	Self-regulation: The Corporate Governance Code of 2009 recommends that the composition of a board is determined on the basis of gender diversity.
Bulgaria	17.9%	No	No
Croatia	22.2 %	No	No
Cyprus	10.9 %	No	No
Czech Republic	8.8 %	No	No
Denmark	27.0 %	No	Boards in state-owned companies should ‘as far as possible’ have an equal gender balance; a man and a woman

			<p>nominated for every vacancy (executives and non-executives).</p> <p>From 2013 - obligation to all companies (listed and non-listed) to self-regulate and set their own targets.</p> <p>A company can be fined if it hasn't set any target figures or hasn't submitted any reporting.</p>
Estonia	8.2 %	No	No
Finland	29.9%	No	<p>State-owned companies are required to have an 'equitable proportion of women and men'. The Corporate Governance Code for listed companies contains recommendation that 'boards shall consist of both sexes'.</p>
France	37.1 %	<p>Yes: from 2011 - 40 % by 2017.</p> <p>Applicable to non-executive directors in large listed and non-listed companies.</p>	<p>The AFEP-MEDEF Corporate Code: recommendation containing same quotas as in the Law of 2011, applicable to all board members.</p>
Germany	27.2 %	<p>Yes: from 2016 - 30 % for supervisory boards of the listed companies that are submitted to parity co-determination (the roughly 110 biggest listed companies).</p>	<p>Other companies that are either listed or fall under parity co-determination have to set individual quantitative objectives of women on boards with regard to non-executive and executive board members and senior managers below board level and deadlines to achieve them.</p>
Greece	9.4 %	<p>Yes, 33 % - only companies fully or partially owned by the State.</p> <p>Applicable to all board positions (executives and non-executives).</p>	<p>Soft positive action measures in public sector.</p>
Hungary	11.2 %	No	<p>Soft positive action measures in public sector.</p>

Ireland	16.0 %	No	A policy target of 40 % female participation on all state boards and committees. Soft positive action measures in public sector employment.
Italy	30.0 %	Yes: 33 % by 2015 for listed companies and state-owned companies. Applicable to management boards and supervisory boards (i.e. executives and non-executives).	Yes
Latvia	27.7 %	No	Soft positive action measures in the public sector.

Source: European Commission, 2016.

It is visible that research has been made regarding the development of gender equality within corporate boards in general, but not as much in the top management of businesses, in other words, within executive positions (Sjöberg, Drewniok, 2017, 1-64).

3. LEGISLATION FRAMEWORK IN THE REPUBLIC OF CROATIA

The primary sources of corporate governance legislation in Croatia are the Company Act, the Audit Act, the Accountancy Act and the Credit Institutions Act. A Corporate Governance Code was adopted by the Croatian Financial Services Supervisory Agency (HANFA) and the Zagreb Stock Exchange in 2007 and revised in 2010. In line with EU legislation, the Code is to be implemented on a "comply or explain" basis (Cigna, Djuric, Kobel, Sigheartau, 2017, 1-15).

According to the EBRD report from 2017 in the Republic of Croatia corporations can decide to be organized under a one-tier or two-tier system. The average size of a board is seven members, which is a manageable size. Boards of the largest companies show relatively high gender diversity, well above the average of EU countries in the EBRD region. Cigna, Djuric, Kobel, Sigheartau (2017) analyzed different corporate governance acts in the Republic of Croatia together with annual reports of listed corporations and concluded that corporations are required to publish their annual reports and the largest listed companies appear to comply well with this requirement. Regarding the different non-financial information in the Republic of Croatia quality of non-financial information is generally good but there are still some

key information that is not available (qualification of board members, activities and frequency of meetings of board and committees, and committees' composition). Reporting to the markets and shareholders is one of the most important activities and in the Republic of Croatia is regulated by law and is well implemented in practice. Regarding the audit, the audit committee is in charge of monitoring the robustness of the internal audit function. External auditors do not express opinion on the effectiveness of the internal control system. Insider trading is forbidden and regulated by law. The market capitalization of the Zagreb Stock Exchange is quite high but liquidity appears limited. According to Cigna, Djuric, Kobel and Sigheartau the Corporate Governance Code is an excellent complement to the law. All ten largest listed companies have published a compliance statement, however explanations provided by the companies are not always meaningful and appropriate. The regulator and the exchange have prepared very interesting statistical reports offering general overview of the corporate governance and securities market situation in the country. However, they do not monitor the quality of explanations provided by the companies. (Cigna, Djuric, Kobel, Sigheartau, 2017, 1-15).

4. WOMEN ON CORPORATE BOARDS IN EU28 AND THE REPUBLIC OF CROATIA

Over the last two decades so many different scientist and practitioners have investigated the problem of diversity in corporate boards. According to numerous studies, diversity within corporate boards contributes to different benefits in corporation including creativity, greater supervision and monitoring actions, satisfaction among stakeholders and positive business results for the corporation (Billimoria, Wheeler, 2000, Carter, Simkins, Simpson, 2003, 33-53 de Jong, Dejong, Mertens, Wasley, 2005, 473-503, Krishnan, Park, 2005, 1712-1720, Bilimoria, 2006, 47-61, Campbell and Mínguez-Vera, 2008, 435-451, Lansing, Chandra, 2012, 3-14). Billimoria and Wheeler have shown in their research that gender diversity on boards contributes to more effective corporate governance through the development and progress concerning board processes, such as improved communication. A few studies have shown that the heterogeneous and diverse boards contribute to a more varied perspective in comparison to homogenous boards, where the latter often have a narrower view (Carter, Simkins, Simpson, 2003, 33-53, Lansing, Chandra, 2012, 3-14). A study made of Campbell and Mínguez-Vera (2008) is focused on decision making processes in corporation. According to them the presence of women on boards may enhance shareholder value since women bring a different perspective to the decision-making process.

This paper examines the women presence in executive positions and CEO positions in the European Union and the Republic of Croatia and is based on the secondary data collected from different databases available at European Commission and Eurostat's websites. Using the statistical data is very important because based on them it is possible to make comparison of the data over time.

4.1. Women in European boards

Secondary data from the EUROSTAT data base show that nearly 7.3 million persons hold managerial positions in enterprises with 10 employees or more located in the countries of European Union (EU): 4.7 million men (65% of all managers) and 2.6 million women (35%) (<http://ec.europa.eu/eurostat>, 2017). It is interesting to analyse also the data of EUROSTAT that show the gender diversity among different countries in EU. Managers are mostly women only in Latvia (53%) which is followed by Bulgaria and Poland (both 44%), Ireland (43%), Estonia (42%), Lithuania, Hungary and Romania (all 41%) as well as France and Sweden (both 40%). Different situation is in Germany, Italy and Cyprus (all 22%), Belgium and Austria (both 23%) as well as Luxembourg (24%), Croatia (20%) and Greece (10%). At EU level 35% of managers are women (<http://ec.europa.eu/eurostat>, 2017). In every EU Member State there are differences between women and men in managerial positions concerning wages, male managers earn more than women managers. The gender pay gap in managerial positions is the narrowest in Romania (5.0%), Slovenia (12.4%), Belgium (13.6%) and Bulgaria (15.0%). In Hungary (33.7%), Italy (33.5%) as well as the Czech Republic (29.7%) female manager earns about a third less than her male colleague, and about a quarter less in countries such as Slovakia (28.3%), Poland (27.7%), Austria (26.9%), Germany (26.8%), Portugal (25.9%), Estonia (25.6%) and the United Kingdom (25.1%). (<http://ec.europa.eu/eurostat>, 2017).

4.2. Women in Croatian boards

The Croatian Financial Services Supervisory Agency (HANFA) and Zagreb Stock Exchange for the seventh year in a row, prepared the Annual Corporate Governance Report, in which there is a visible level of corporate governance of the issuer whose securities are listed on a regulated market in the Republic of Croatia (<https://www.hanfa.hr/media/2185/giku-2016-final.pdf>).

According to the Annual Corporate Governance Report out of 139 issuers whose shares were listed on the regulated market of the Zagreb Stock Exchange on 31st December 2016, 110 issuers submitted a filled Questionnaire. As of December 31, 2016, most of the board members (38.31%) had between 45 and 55 years, 33.87% had between 35 and 45 years, over 55 years had 22.58% of board members, 5.24% were less than 35 years of age. Most management members under the age of 35 were in the issuers of real estate and funds (five management members from a total of four issuers). Most top management over the age of 56 was with issuers from the tourism sector (13 management members out of 10 issuers). Most of the members of the board had a university diploma (95.56%), 3.62% had a doctorate degree, while 1.21% had a secondary (high school) or lower qualification. The number of women in Management Board is as following, in 2014, 16.67%, 14.75% in 2015 and 15.12% in 2016. Situation in the Supervisory Board is better if the gender balance is taken into the consideration but still not so good as in some other EU28

countries especially those with quotas. In 2014 it was 20.62%, 20.86% in 2015 and 20.37% in 2016.

According to the data of PayLab and service Mojposao the biggest differences between women and men wages in the Republic of Croatia are on the managerial level, where women are paid 17% lower than male (<https://www.paylab.com/>, <https://www.moj-posao.net/>).

5. DISCUSSIONS AND CONCLUSION

This paper focuses on the women on boards in listed corporations in EU28 and the Republic of Croatia. It contributes to the literature that analyses gender diversity in top management. The presented statistical data show us that the women are less than men present in corporate boards so it means in top management positions. Statistical data presented only the largest listed companies in each of the EU28 countries and in the Republic of Croatia. It will be interesting for the further research to include in the analysis countries outside the European Union. Then it will be possible to compare different regions and countries all over the world and get the global picture of the gender equality in corporate boards.

For future studies it will be also interesting to interview women in leading positions so that a qualitative study can be presented. With that kind of study it will be easier to understand all difficulties and obstacles that women have in corporate boards and also to have an explanation about glass ceiling and glass labyrinth in different types of corporations.

The role of female and men managers has already changed and is going to change more in the future but to succeed in that aim it is important to change the mind-set according to traditional roles of women in society. Diversity in management is one of the key variables of contemporary management that will be leading the companies to the organizational success.

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**KEY PERFORMANCE INDICATORS FOR E-GOVERNMENT:
METHODOLOGICAL APPROACH TO INDICATOR
DEVELOPMENT**

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Review

Abstract

It is often assumed that modern information technology (IT) is a source of performance improvement. Empirical research has not univocally confirmed this assumption, since complex, extensive and resource demanding IT tools require extensive organizational restructuring, in order to be properly and successfully implemented. This generates the need to create and use business intelligence and key performance indicators (KPI) to obtain a high quality basis for making decisions in real time. In this paper, authors analyze the existence of a potential relationship between the methodological approach to defining business intelligence (BI)-related KPIs and achieving business process performance, as well as the overall organizational performance. The methodological determinants of the process, in which the KPIs are defined, are empirically analyzed and associated with the two discussed aspects of performance.

The empirical analysis is conducted for the case of e-government development, with the special emphasis on countries from Central, East and South-East Europe. The E-Government development is measured by two KPIs, which have been defined, by strictly following the recommended BI methodology. The two KPIs are related to a business process, performed by the public administration, which can

be greatly facilitated by the introduction of E-Government. This is the process of opening a new enterprise, which can be also viewed as one of key measures of the national economic and entrepreneurial development. The public administration performance in serving the needs of new entrepreneurs for company registration is, therefore, considered in terms of E-Government performance. Two KPIs used measure the procedural complexity and costs for opening a new enterprise in a sample, consisting of 28 European Union member-states.

The statistical analysis uses secondary data, available from the official Eurostat Web pages. The empirical results confirm the existence of the hypothesized relationship between the methodological procedures for developing KPIs and the process performance, which affirms the need to develop both E-Government, as well as other processes in public administration, by using solid planning and methodological approaches.

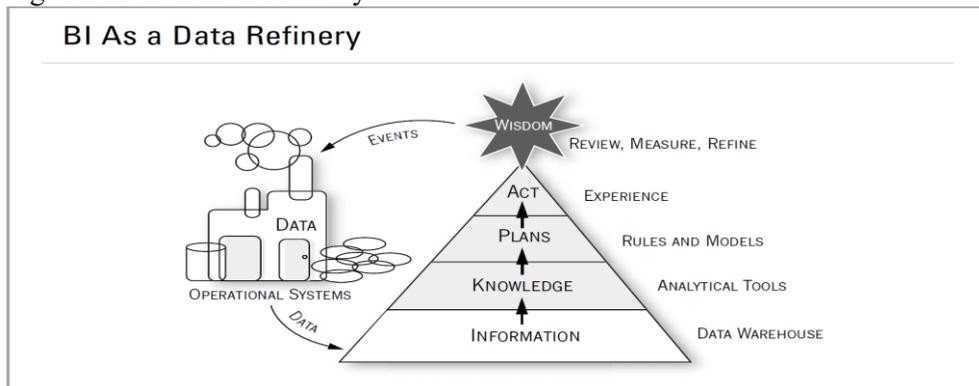
Keywords: key performance indicators, business intelligence, business processes, information technology, public government

JEL: D73, H11, L86

1. BUSINESS INTELLIGENCE AND KEY PERFORMANCE INDICATORS

„Business Intelligence“ (BI) is frequently emphasized as an important factor of business success, which is often mediated by the performance of business processes. It is used for discovering knowledge, hidden in business records, using appropriate methods, supported by contemporary information technologies (IT). Processing these resources transforms data into information, which can be used by companies' analytics to provide answers to key problems in real time and gain complex knowledge about impact to their businesses for its overall improvement.

Figure 1. BI as a ‘data refinery’

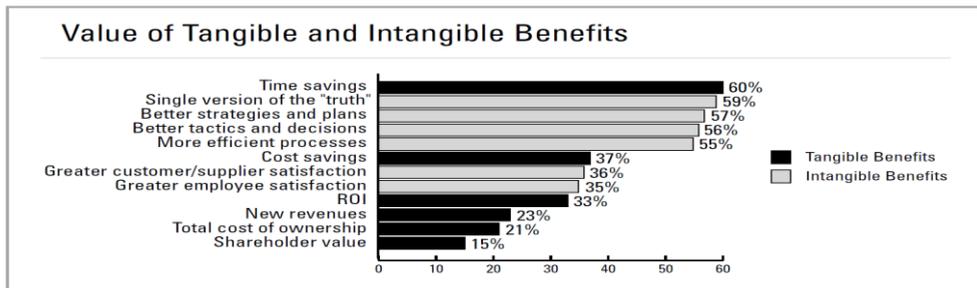


Source: Eckerson (2003), p. 4

It consequently leads to more efficient management. Practicing this has been recognized as competitive advantage, too. The most critical moment at implementing and exploiting BI advantages is defining Key Performance Indicators (KPI), showing the critical aspects of performance in the monitored period of time. They have to be appreciable and reflect the goals one wishes to achieve. KPIs are formulated by management, in cooperation with internal, or external BI specialists. BI cannot replace managers' insights, but it can develop indicators, based on stored and available data or information, which support quick decision-making, by providing quick and precise facts.

The issue of creating indicators, fitting the needs of the company, goes beyond the simple SMART (Specific, Measurable, Action-oriented, Realistic, Time-related) criteria, since those need to provide real business value. As it is often the case with complex methods, requiring a high level of IT investment, empirical research usually demonstrates more intangible, than tangible benefits. For instance, in the case of Knowledge Management implementation in Croatian companies, indirect/intangible benefits, perceived by respondents, proved to be associated with the implementation of KM, while the association of KM with financial performance proved to be elusive (Hajdić, 2015). A similar situation can be observed with BI, as demonstrated by the Figure 2.

Figure 2. A BI solution typically delivers more intangible than tangible benefits



Note: Based on 510 respondents who rated the value of the benefits as “very high” or “high.”

Source: Eckerson (2003), p. 11.

2. EMPIRICAL RESEARCH

2.1. Research topic and methodology

This topic of this study is the definition of key performance indicators (KPI), i.e. their correct modeling, according to the business needs, including the definition of the role of BI experts in the process. Data used for generating KPIs were

downloaded from the Eurostat database, related to public administration performance. EU Commission, aware of the importance of digital transformation for EU, has developed the „*eGovernment Action Plan 2016-2020*“ (European Commission, 2016), with the goal to modernize the public administration, by improving interaction with companies and citizens. Improved accessibility of public services provides faster, cheaper and users oriented e-government. Thus, we have focused to the one point of action plan, for which three KPIs will be developed, by using the BI process. This is the opening of new companies, which can be considered as one of the key outcomes of the efficient public administration, fostering the entrepreneurial development and business climate in a national economy.

We hypothesize that the quality of the BI process, used to define the relevant KPIs, will contribute to the performance of E-Government business processes.

Hypothesis. *There is a causal relationship between the correctly defined BI KPIs, developed by using a high-quality BI process, and performance of selected e-government processes.*

The survey of KPIs was conducted on the population of 28 EU countries. As a measure of the correct definition of business intelligence indicators, the data on the percentage of ICT (Information and Communication Technology) employees in total employment is used, as those have the ability and knowledge to develop, manage and maintain the ICT systems. The relationship between the quality of the KPI selection process for e-government development and the percentage of ICT employees in total employment is reflected in the fact that effective public sector management requires the use of ICT to achieve a higher level of government efficiency and improved public service for individuals and organizations. Developed economies are relatively advanced in using ICT to improve the functioning of the public sector and provide services, and have a higher percentage of ICT experts in total employment.

Due to the lack of relevant sources on the public administration processes, to be used for comparison of BI processes in public sector(s) of EU countries, used to KPIs, it was measured by the share of ICT specialists among the total number of employees (United Nations, 2012, p. 18).

In order to monitor and compare the status of e-government, as well as form public policies and strategies, it is necessary to define a set of relevant and internationally comparable indicators. Data collection for e-government is complicated and associated with a range of measurement challenges, such as statistical feasibility, relevance, cost of data collection, burden on respondents, etc. Thus, if the "*share of ICT in governmental organizations*" is to be measured, this ratio will be

comparable only for countries with similar government organization. There are also structural differences in the functions of government in different countries. For example, railway traffic in one country can be a function of general government, and in another country it can be responsibility of business (public or private) sector. Most governments have more levels of authority (central, provincial, regional, local), so the observed ratio of "*ICT officials in governmental organizations*" can lead to skewed data (United Nations, 2014, pp. 3-4).

2.2. Definition and overview of e-government KPIs in the EU

For the purpose of this study, the following KPIs were formulated, with the following characteristics: name and definition of indicator, method of data collection and what data is required for the analysis, data requirements, disaggregations, definitions of units and terms, notes, including scope of extensions to other levels of authority, statistical issues and the outline of a statistical standards statement for the purposes of international reporting (United Nations, 2012, p. 18).

KPI 1: Share of ICT specialists among the total number of employees (2016; top 3 EU-28 countries, Croatia and Slovenia).

Title: % ICT specialists among the total number of employees

Indicator definition: Share of ICT specialists among the total number of employees in EU countries. The three most advanced EU member countries, concerning the ICT specialists' share are observed. Share or percentage is calculated as a ratio of ICT specialists employed, divided by number of the total number of employees, multiplied by 100.

Data collection methods: interviewing public institutions or statistics records from the Eurostat database.

Necessary data: number of ICT employees, total number of employees in a country.

Data sorting: Indicators sorted by years and countries; 2016 was observed; presented either in percentage or thousands of employees; annually.

Model questions: How many employed people were in the observed year? How many ICT specialists were employed in the observed year? What is the share – percentage of ICT employees as a share of the overall number of employees?

Definitions of units and terms: ICT specialists are professionals with abilities and knowledge for developing, managing and maintaining ICT systems in the business and public sector.

Notes: Start and end of data collection have to be determined, especially when reporting internationally. Further division, by using the gender, the level of education and similar criteria is also possible.

KPI 2: Percentage of companies (by country), considering the number of administrative procedures as not being an obstacle to starting a new business (2016; top 3 EU-28 countries, Croatia and Slovenia).

Title: % companies (in the country) satisfied with the number of procedures to starting a new business (2016)

Definition of indicators: Percentage of the companies (by country) which consider that the number of administrative procedures is not an obstacle for starting a new business. Percentage is obtained by dividing the number of satisfied companies by total number of the companies and multiplied by 100. Top three EU countries, Croatia and Slovenia are analyzed.

Data collection methods: interviewing public institutions or statistics records from the Eurostat database.

Necessary data: number of satisfied companies; total number of companies

Data sorting: Indicators sorted by years and countries; 2016 was observed; presented either in percentage or thousands of companies; annually.

Model questions: How many companies were satisfied/not satisfied? How many companies had a neutral answer?

Definitions of units and terms: Small and mid-size companies, established since the last change of the number of administrative procedures. Number of procedures is number of administrative actions needed for establishing company.

Notes: Start and end of data collection have to be determined, especially when reporting internationally.

KPI 3: Percentage of companies (by country), considering the costs of establishing a company as not being an obstacle to starting a new business (2016; top 3 EU-28 countries, Croatia and Slovenia).

Title: % companies satisfied with the start-up costs (2016)

Definition of indicators: Percentage of the companies (by country) which consider that start-up costs are not an obstacle to starting a new business. Percentage is calculated by a ratio of satisfied companies and the total number of companies, multiplied by 100. Top three EU countries, Croatia and Slovenia are analyzed.

Data collection methods: interviewing public institutions or statistics records from the Eurostat database.

Required data: number of companies, which do not consider start-up costs as an obstacle to starting a new business; total number of companies

Data sorting: Indicators sorted by years and countries; 2016 was observed; presented either in percentage or thousands of companies; annually.

Model questions: How many companies do/do not consider the start-up costs as an obstacle to starting a new business? How many companies had a neutral answer?

Definitions of units and terms: Small and mid-size companies, established since the last change of the number of administrative procedures. The cost of procedures is the administrative cost, mandatory in establishing a new company.

Notes: Start and end of data collection have to be determined, especially when reporting internationally.

Data, analysis and graphics for KPI1 were directly downloaded from the Eurostat¹, while data for KPI 2 and 3 were downloaded from Eurostat as an Excel table², which has been further analyzed. Dashboards were created by using the BI functionalities of a corporate SAP software suite, which was kindly provided for this study by the Swiss BI consultancy DatArt SA³.

KPI1 - Share of ICT specialists among the total number of employees (2016)

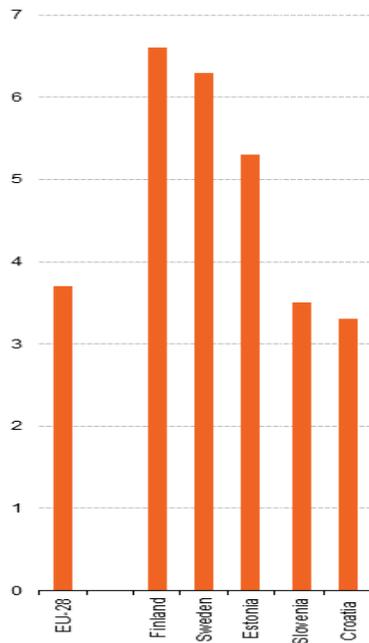
The highest values for KPI1 can be found in Finland (6.6%), Sweden (6.3%) and Estonia (5.3%) – far above the EU average of 3.7% (see Figure 3).

¹ Eurostat, http://ec.europa.eu/eurostat/statistics-explained/index.php?title=ICT_specialists_in_employment

² Eurostat, https://data.europa.eu/euodp/data/dataset/S2089_417_ENG

³ <http://www.datart.ch>

Figure 3. KPI1 values for the top 3 EU members, Croatia and Slovenia

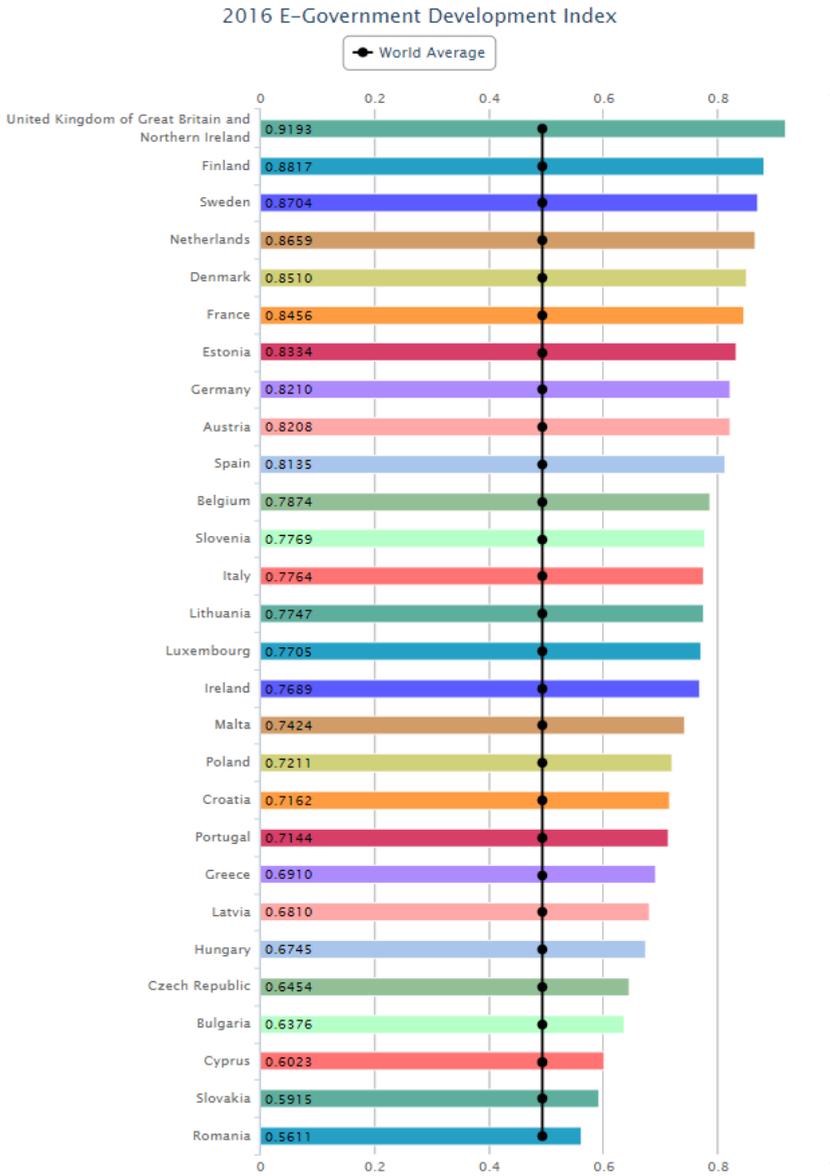


Source: Eurostat,
http://ec.europa.eu/eurostat/statistics-explained/index.php?title=ICT_specialists_in_employment

The countries with the largest share of ICT employees also have the highest value of the E-Government Development Index (see Figure 4)⁴.

⁴ UN E-Government Knowledge DataBase, 2016 E-Government Development Index, available at: <https://publicadministration.un.org/egovkb/en-us/Data/Compare-Countries>

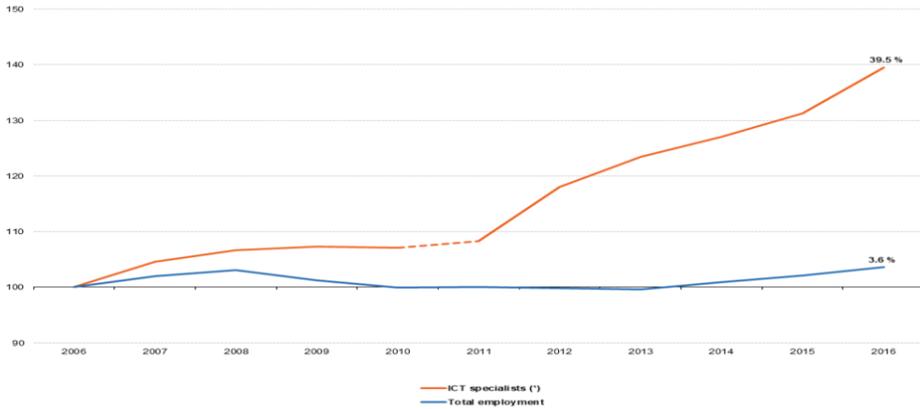
Figure 4. Index of E-Government development in 28 EU members



Source: UN E-Government Knowledge DataBase, 2016 E-Government Development Index, <https://publicadministration.un.org/egovkb/en-us/Data/Compare-Countries>

The growth of the total number of employees in EU-28 member states has been only 3.6% annually, for the 2006-2016 period, while the annual growth of ICT specialists was 39.5% (see Figure 5).

Figure 5. Annual growth of the total number of employees and ICT specialists in EU-28

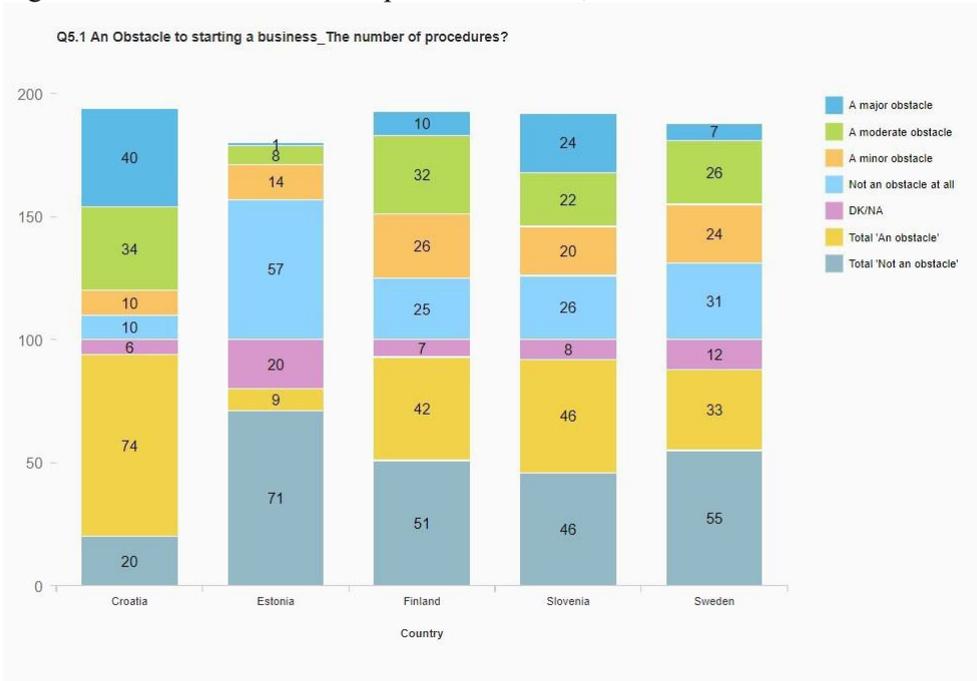


Source: Eurostat,
http://ec.europa.eu/eurostat/statistics-explained/index.php?title=ICT_specialists_in_employment

KPI2 - Percentage of companies (by country), considering the number of administrative procedures as not being an obstacle to starting a new business (2016)

The largest amount of the companies, which do not consider the number of procedures for starting business as an obstacle are located in Estonia (71%), Sweden (55%) and Finland (51%). In Slovenia, the KPI 2 value amounts to 46%, while in Croatia, its value is only 20% (see Figure 6).

Figure 6. KPI 1 values for the top 3 EU members, Croatia and Slovenia



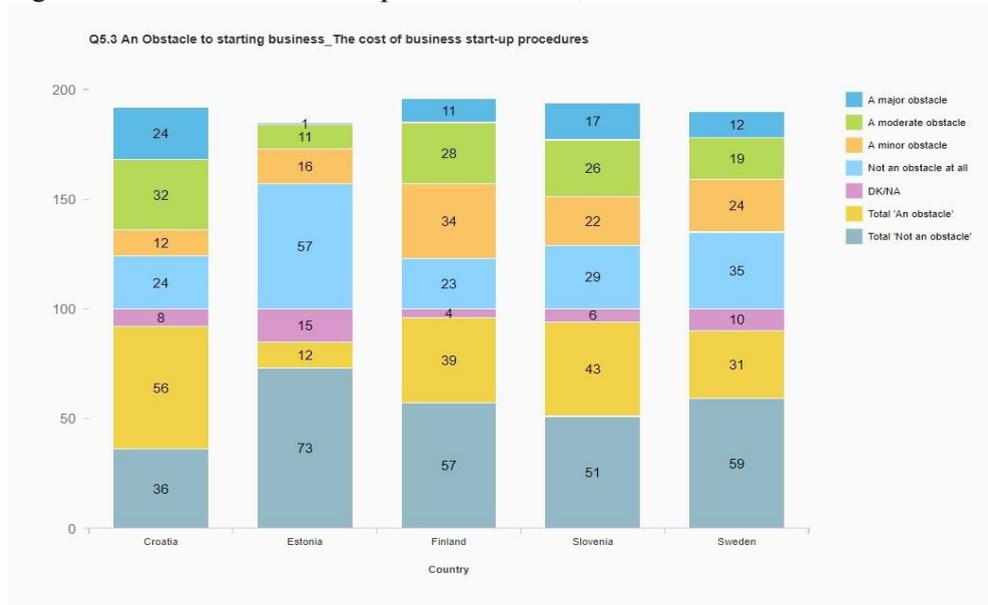
Source: Authors' analysis performed in SAP BI module⁵

KPI 3 – Percentage of companies (by country), considering the costs of establishing a company as not being an obstacle to starting a new business (2016)

The top three EU-28 countries, regarding the KPI 3 value, are: Estonia (73%), followed by Sweden (59%) and Finland (57%). Its value in Slovenia it is 51% and Croatia only 36%.

⁵ Data sources used for KPIs are coming from the European Commission data:
<http://ec.europa.eu/COMMFrontOffice/publicopinion/index.cfm/Survey/getSurveyDetail/instruments/FLASH/surveyKy/2089>;
<http://ec.europa.eu/commfrontoffice/publicopinion/index.cfm/ResultDoc/download/DocumentKy/72225>

Figure 7. KPI3 values for the top 3 EU members, Croatia and Slovenia



Source: Authors' analysis performed in SAP BI module⁶

The countries, with the highest amount of ICT employees seem to be leaders in terms of entrepreneurship development, with lowest perceived complexity and costs, regarding creation of start-ups, which is theorized to represent a lever of economic development (Kwang, 2005). However, this needs to be formally recognized by means of statistical analysis, conducted in the IBM SPSS statistical analysis tool.

The quality of BI process, as related to KPI creation, is approximated by the national share of ICT employees (cf. Olszak, 2015). The performance of E-Government processes is measured by the amount of companies, not considering administrative complexity, or costs, to represent a burden to creation of start-ups in the country.

2.3. Research results

Significant and relatively high values of correlation coefficients are found (see Table 1), which required the linear regression analysis to be performed, as to establish the causal relationship between the variables involved.

⁶ Ibid.

Table 1. Correlations between BI quality and E-Government indicators

		%ICT inEmpl
Administrative complexity not an obstacle to start-ups	Pearson Correlation	,639**
	Sig. (2-tailed)	,000
	N	28
Costs not an obstacle to start-ups	Pearson Correlation	,581**
	Sig. (2-tailed)	,001
	N	28

** Statistically significant at 1% level.

Source: Authors' analysis performed in SPSS

When using the administrative complexity as a measure of the E-Government processes, the entire model is significant at the statistical level of 1% ($F = 17,944$; $p=0.000$), with the linear coefficient being significant, as well (see Table 2). Strength of the model is illustrated by a relatively high value of $R^2=0.408$.

Table 2. BI quality – administrative complexity linear regression model

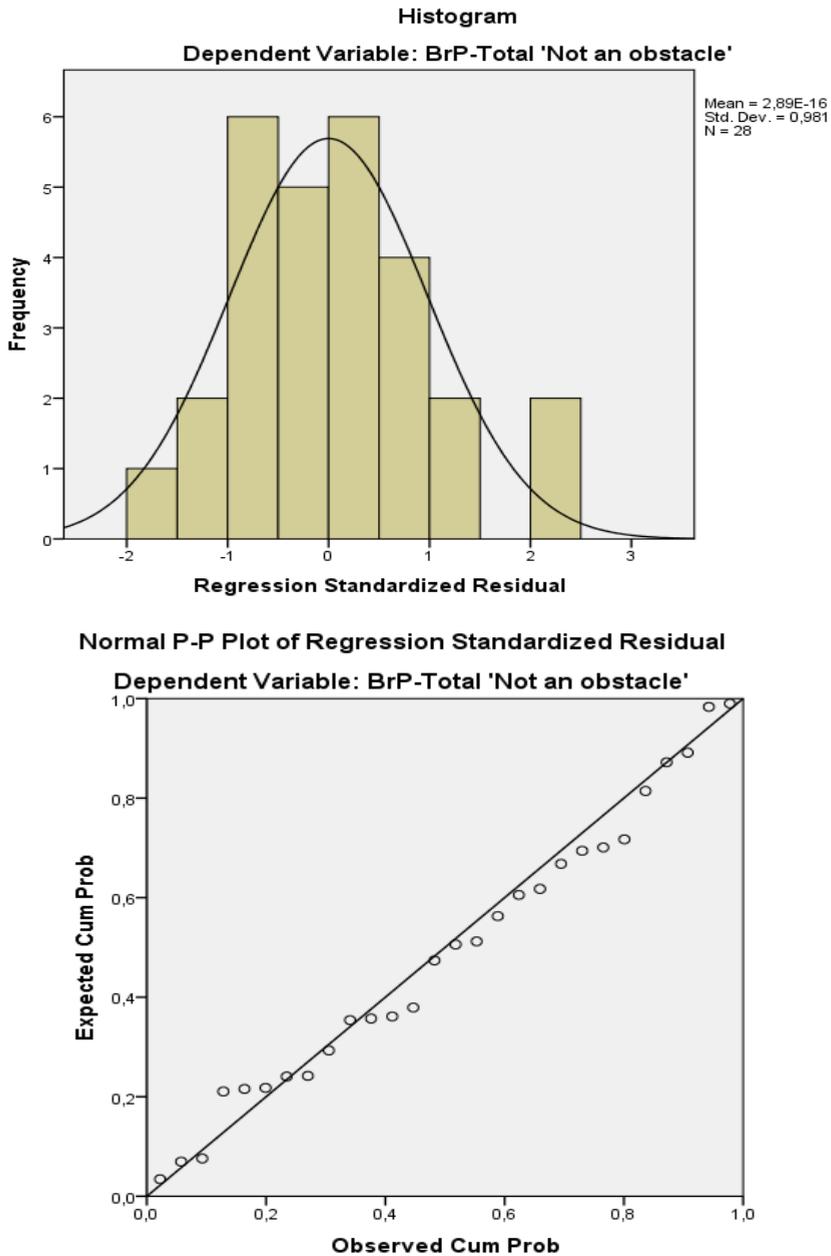
Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	3,473	7,074		,491	,628
%ICT inEmpl	7,875	1,859	,639	4,236	,000

a. Dependent Variable: Br.Proc-Not an obstacle

Source: Authors' analysis performed in SPSS

The statistical assumption that no collinearity is present is confirmed by the values of Tolerance (1, being higher than 0.2) and the factor of the variance inflation (VIF), with the value of 1.0 (being lower than 5). The Durbin-Watson (DW) value of 1,334 confirms that autocorrelation does not exist, while the normal distribution of standardized residuals has been checked visually and confirmed by the P-P plot of collected and expected values (both presented by Figure 8).

Figure 8. Histogram of standardized residuals and P-P plot



Source: Authors' analysis performed in SPSS

The assumption of the non-existing heteroscedasticity of the residuals' variance is confirmed by the non-significant nonparametric correlation among the values of absolute residuals and the predictor variable (see Table 3).

Table 3. Result of the heteroscedasticity analysis for the regression model

Correlations			BrP-Total 'Not an obstacle'	absres
Spearman's rho	%ICT inEmpl	Correlation Coefficient	,521**	-,190
		Sig. (2-tailed)	,004	,332
		N	28	28
	BrP-Total 'Not an obstacle'	Correlation Coefficient	1,000	-,112
		Sig. (2-tailed)	.	,572
		N	28	28

** Correlation is significant at the 0.01 level (2-tailed).

Source: Authors' analysis performed in SPSS

When using the start-up costs as a measure of the E-Government processes, the entire model is significant at the statistical level of 1% ($F = 13,426$; $p=0.001$), with the linear coefficient being significant, as well (see Table 4). Strength of the model is also quite high, although somewhat lower than for the case of administrative procedures, with the value of the $R^2=0.338$.

Table 4. BI quality – administrative complexity linear regression model

		Coefficients ^a				
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	12,037	7,686		1,566	,129
	%ICT inEmpl	7,351	2,020	,581	3,640	,001

a. Dependent Variable: Tr.Proc.-Not an obstacle

Source: Authors' analysis performed in SPSS

The statistical assumption that no collinearity is present is confirmed by the values of Tolerance=1 and VIF=1. The Durbin-Watson (DW) value of 1,681 confirms that autocorrelation does not exist, while the normal distribution of standardized residuals has been checked visually and confirmed by the P-P plot of collected and expected values (both presented by Figure 9).

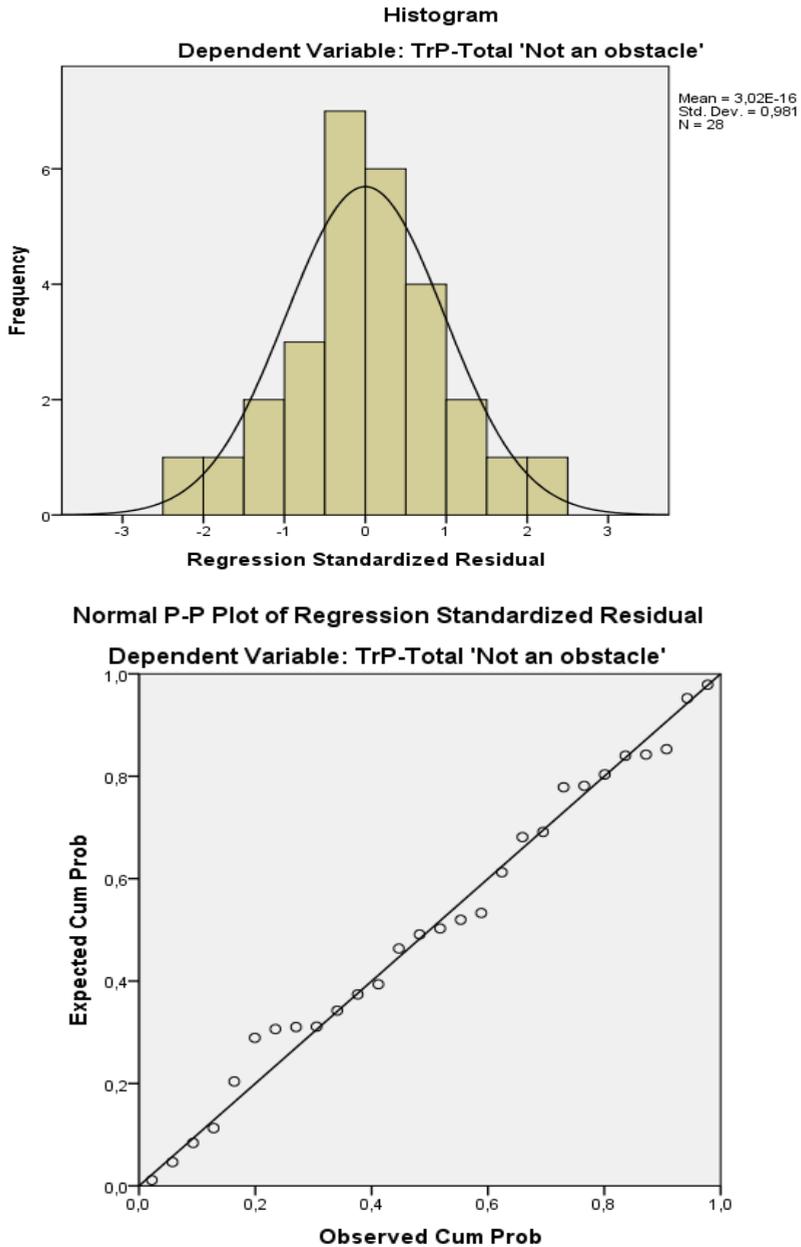


Chart 9. Histogram of standardized residuals and P-P plot

Source: Authors' analysis performed in SPSS

The non-existing heteroscedasticity of the residuals' variance is confirmed by the non-significant correlation among the values of absolute residuals and the predictor variable, calculated by using the non-parametric, Spearman correlation coefficient (see Table 4).

Table 4. Result of the heteroscedasticity analysis for the regression model

Correlations			TrP-Total 'Not an obstacle'	absres
Spearman's rho	%ICT inEmpl	Correlation Coefficient	,521**	-,190
		Sig. (2-tailed)	,005	,332
		N	28	28
	TrP-Total 'Not an obstacle'	Correlation Coefficient	1,000	-,118
		Sig. (2-tailed)	.	,551

** . Correlation is significant at the 0.01 level (2-tailed).

Source: Authors' analysis performed in SPSS

Thus, by using both administrative complexity and costs of establishing a start-up enterprise, there is an empirically verified causal relationship between the quality of the BI process and the performance of E-Government processes.

3. CONCLUSION

In this study, performance of e-Government processes, viewed from the perspective of its users, is empirically verified as being predicted by the correct KPI definition, which confirms our hypothesis. This finding demonstrates the significance of the methodological role of the Business Intelligence and Key Performance Indicators in developing the tools and approaches, to be applied in the public sector. In addition, the selected research topic emphasizes the role of e-Government in supporting the entrepreneurial development and national competitiveness.

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COMPLIANCE OF CORPORATE GOVERNANCE IN BOSNIA AND HERZEGOVINA WITH EUROPEAN UNION STANDARDS

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Review

Abstract

Corporate governance provides an answer to the question who controls the corporation and how. It involves a set of relationships between management, shareholders and stakeholders. Corporate governance in Bosnia and Herzegovina is within the legal jurisdiction of entities, and consequently there are two substantially aligned and yet completely distinct corporate governance systems, which separates Bosnia and Herzegovina as a state in the international environment into a specific category in terms of corporate governance.

This paper will analyze ownership concentration in order to identify the characteristics of the corporate governance systems, then it will present the principles on which the legal framework for corporate governance in Bosnia and Herzegovina is defined, compare the business transparency standards with the transparency directive in the EU, and measure the quality level of corporate governance in order to define key areas for improvement of corporate governance in Bosnia and Herzegovina. The development and characteristics of the corporate governance systems in Bosnia and Herzegovina will be explored and compared with the regulatory framework and standards of corporate governance in the European Union. Special emphasis is on comparing the transparency principles and standards of corporations in Bosnia and Herzegovina with corporations in the European Union. The aim of the research is to compare the regulatory framework and characteristics of the corporate governance system in corporations in Bosnia and Herzegovina with the standards in the European Union, to identify similarities and differences and to define key areas for improvement of corporate governance in Bosnia and Herzegovina.

Keywords: *corporate governance, corporate governance system in entities of Bosnia and Herzegovina, transparency in the operation of corporations in Bosnia and Herzegovina, European Union transparency directives, quality of corporate governance in Bosnia and Herzegovina, LCG index*

JEL: G28, G34, K20

1. INTRODUCTION

Corporate governance is defined as a set of processes and procedures for management and control of corporations. Corporate governance shows how rights and responsibilities are distributed among different stakeholders in corporations. Corporate governance provides an answer to the question who controls the corporation and how. It involves a set of relationships between management, shareholders and stakeholders. Corporate governance defines the framework for setting corporate goals, determining the means for achieving the set goals and monitoring performance and efficiency. This paper will explore the development and characteristics of the corporate governance systems in Bosnia and Herzegovina and compare them with the regulatory framework and standards of corporate governance in the European Union. Special emphasis is on comparing the transparency principles and standards of corporations in Bosnia and Herzegovina with corporations in the European Union.

The aim of the research is to compare the regulatory framework and characteristics of the corporate governance system in corporations in Bosnia and Herzegovina with the standards in the European Union, to identify similarities and differences and to define key areas for improvement of corporate governance in Bosnia and Herzegovina.

2. CORPORATE GOVERNANCE IN BOSNIA AND HERZEGOVINA

Corporate governance is a very broad term and there are many approaches to its definition, each being concerned with the analysis of governing structures and processes in corporations. However, one definition of corporate governance can be singled out, the definition of the Organization for Economic Cooperation and Development (OECD), which states that "*corporate governance involves ... a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders...*"¹ Through its acts, especially through the document Principles of Corporate Governance, the OECD has greatly contributed to the development and

¹ Organisation for Economic Co-Operation and Development: *OECD Principles of Corporate Governance*, OECD Publication, Paris, 2004, p. 12.

standardization of both concepts and standards of corporate governance at the global level.

Corporate governance in Bosnia and Herzegovina is within the jurisdiction of entities, and consequently there are two substantially aligned and yet completely distinct corporate governance systems, which separates Bosnia and Herzegovina as a state in the international environment into a specific category in terms of corporate governance. Here, we must also bear in mind the Brcko District, the territory of Bosnia and Herzegovina that makes this story even more complex with its separate institutional framework.

In the research section, ownership concentration will be analyzed in order to identify the characteristics of the corporate governance systems, then the principles will be presented on which the legal framework for corporate governance in Bosnia and Herzegovina is defined, the business transparency standards will be compared with the transparency directive in the EU. In the third section of the paper, the quality level of corporate governance will be measured in order to define key areas for improvement of corporate governance in Bosnia and Herzegovina.

2.1. Ownership concentration in financial and non-financial corporations in Bosnia and Herzegovina

In order to determine the characteristics of corporate governance systems in Bosnia and Herzegovina, data on ownership concentration for non-financial corporations, banks and insurance companies in Bosnia and Herzegovina will be integrated and compared (Table 1). For the purposes of this research, 87 non-financial corporations, 24 banks, and 26 insurance companies were analyzed, where their ownership concentration was determined, based on which the characteristics of corporate governance systems in Bosnia and Herzegovina were defined. The study of non-financial corporations analyzed the data of 87 corporations from the territory of Bosnia and Herzegovina whose shares are traded in the entities' capital markets, of which 49 corporations are located in FBiH, and 38 are located in RS. With respect to financial corporations (banks and insurance companies), all banks (totally 24, of which 16 are located in FBiH and 8 in RS) and all insurance companies holding an operating license issued by the competent agency (totally 26, of which 12 are located in FBiH, and 14 in RS) were examined.

Table 1. Ownership concentration in Bosnia and Herzegovina as of 31 Dec 2017

	Non-financial corporations (n=87)	Banks (n=24)	Insurance companies (n=26)	Total BiH
Owner 1	51.47	78.03	82.34	61.98
Owner 2	13.24	5.49	13.96	12.02
Owner 3	7.27	5.49	7.53	7.01

Owner 4	4.63	2.56	3.46	4.05
Owner 5	3.27	2.38	1.77	2.83
Owner 6	2.29	1.51	1.11	1.93
Owner 7	1.77	1.31	0.97	1.54
Owner 8	1.36	1.22	0.75	1.22
Owner 9	0.97	1.23	0.54	0.93
Owner 10	0.72	0.82	0.45	0.69
TOTAL				94.19

Source: Author's analysis according to the data from securities registries of FBiH and RS.

In each of the three observed cases, the first and largest owner has a share greater than 50% on the average. In a large number of corporations, the first and largest owner has a controlling block of shares. The highest ownership concentration is in insurance companies, where the largest owner on the average holds almost 3/4 of the total capital, while in banks the largest owner holds 2/3 of the capital. In the banks that were analyzed in detail, the situation is also specific in that the six largest banks have a situation that the majority owner holds more than 90% of the capital and has absolute control of business operations and management.

All this suggest that financial and non-financial corporations in Bosnia and Herzegovina have the properties of a closed corporate governance system. The fundamental characteristic of a closed system is primarily high ownership concentration, key control and power is held by the largest owner, and corporations in a closed system have a problem with lack of transparency in business operations and relations with different stakeholders.

2.2. Legislative framework for corporate governance in BiH

The legislative framework for corporate governance in all countries includes a set of laws that cover various areas of corporate governance and are supplemented by bylaws such as codes and recommendations. The complexity of the state system of Bosnia and Herzegovina has also determined the complexity of the entire legal framework. It can be said that there are three separate corporate governance systems in Bosnia and Herzegovina, and they are related to two entity systems, and the Brcko District. Both entity institutional frameworks will be analyzed in this research.

Table 2. Institutional framework for corporate governance in Bosnia and Herzegovina

State/BiH level of regulation	<i>It is related to the laws being applied equally in both entities and Brcko District. There are four laws enacted at the state level and being applied on an equal basis in both entities.</i>
Entity level	<i>It is related to 14 entity laws being applied in parallel in the Federation of BiH and Republic of Srpska entities. Each of these laws is mutually harmonized, but still significantly different.</i>
Entity-level bylaws	<i>It is related to entity-level corporate governance codes (the most important acts for corporate governance) and other bylaws and generally accepted international standards adopted at the entity level, which are concurrently applied for the regulation of certain areas.</i>

Source: Author

The institutional framework for corporate governance in BiH consists of two institutional frameworks, which have 18 different regulation areas (of which there are four organic laws at the state level and 14 entity laws), entity codes (related to stock exchanges), and International Accounting Standards and International Financial Reporting Standards. Based on all the above, it can be concluded that corporate governance in Bosnia and Herzegovina is based on two mostly aligned, but still significantly different institutional frameworks. In the true sense, that departs from the international recommendations and standards of corporate governance that advocate a single harmonized system, brought into line with international standards. This situation impedes the very research, since it opens up the possibilities of different criteria, and different approaches to the same criteria, being present in the two entities.

2.3. Compliance of transparency in the operation of corporations with European Union standards

The analysis of transparency in the operation of corporations in Bosnia and Herzegovina looked at the policy of management's relations with all stakeholders. Analyzing the policy of relations with stakeholders, it was examined how many corporations have an active website, publish general acts, publish reports on business operations in the local and foreign language, and submit reports to the entity stock exchange. The transparency analysis examines communication channels and method and contents of communication with the environment.

The analysis of business transparency of the observed corporations in Bosnia and Herzegovina looked at key business transparency standards, which are defined by the transparency directive, and these are:²

² European Parliament and Council: Directive 2004/109/EC, 2004, pp. 40-49.

- *uniform publication deadlines* - four months after the end of the reporting period for annual financial reports and two months for interim financial reports
- *annual financial statements* should include audit reports and management reports
- *semi-annual financial statements* must include an additional management report
- publications must be *available to the public for at least five years*
- *interim management reports* for share issuers should be published in the first and third quarter (refers to a business development and performance review and description of main risks facing the corporation management)
- *mandatory publication on the Internet.*

The following table analyzes the stakeholder relations policy, examining how many corporations have an active website, publish general acts, publish reports on business operations in the local and foreign language, and send reports to the entity stock exchange. In other words, it analyzes how the corporation communicates with stakeholders.

Table 3. Communication method and relations with stakeholders of the corporations in Bosnia and Herzegovina

Criteria	Non-financial corporations (n=87)	Banks (n=24)	Insurance companies (n=26)
Website	86.78%	100.00%	100.00%
Company's general acts	42.53%	53.12%	53.57%
Report on overall business operations in 2016	69.54%	93.75%	95.83%
Reports in a foreign language (English)	16.09%	35.93%	16.06%
Sending reports to the entity stock exchange	96.55%	81.25%	87.48%

Source: Author

The analysis shows that most corporations have websites (100% of banks and insurance companies and 86.78% of non-financial corporations), but as far as publishing of general acts is concerned, the percentage of corporations that publish acts is approximately 50%, while the availability of reports in foreign languages is at a very low level in all corporations. With regard to publishing of overall business reports, more than 90% of banks and insurance companies publish financial statements, while slightly more than 2/3 of non-financial corporations publish financial statements. Regarding the submission of reports to entity stock exchanges, almost 90% of corporations submit reports to entity stock exchanges.

The analysis of transparency in business operations of the observed corporations in Bosnia and Herzegovina examined the availability to the public of business goals, reports from shareholders' meetings, reports on events of particular interest and potential risks, audit reports, publishing of periodic reports and periods for which the reports are published.

Table 4. Transparency in business operations of corporations in Bosnia and Herzegovina

Criteria	Non-financial corporations (n=87)	Banks (n=24)	Insurance companies (n=26)
Business goals	64.94%	3.13%	34.51%
Reports from shareholders' meetings	62.64%	62.50%	76.16%
Reports on events of particular influence on financial operations	43.68%	34.38%	45.22%
Information on potential business risks	33.33%	0.00%	4.16%
Audit report and opinion	48.28%	53.13%	76.10%
Publication of semiannual or quarterly reports	61.49%	62.50%	91.66%
Number of years for which reports are published	<5	>5	>5
Published reports for five or more years	85.06%	90.63%	57.71%
Not having any published annual reports	0.00%	0.00%	0.00%

Source: Author

From all the observations, it can be concluded that the level of transparency in business operations in financial corporations is slightly higher than in non-financial corporations. Corporations publish all mandatory financial statements, as well as reports on overall business operations (more than 2/3 of corporations), significantly more regularly. Most corporations (more than 2/3 of financial and non-financial corporations) publish all mandatory financial statements and keep them available on websites for more than 5 years. There is not a single corporation that has not published any reports. The main reason is that publishing of these reports is mandatory, so the corporations themselves treat them in a more responsible manner in their policies.

All other reports that are in the category of voluntary and non-mandatory reports are significantly less published and presented on websites and in corporate acts. This especially applies to business goals, reports on events of particular influence on financial operations and information on potential risks, where less than 50% of the corporations fulfilled the prescribed criteria.

If we synthesize all the above and analyze the overall performance of the corporations in accordance with the transparency directive, it can be concluded that the corporations are significantly more responsible in the directive segments that are incorporated into the laws in Bosnia and Herzegovina. The corporations fulfill all that the law stipulates, and do not fulfill to a significant measure (mainly less than 50%) the other part that falls into the domain of voluntary reporting.

With regard to the transparency directive, corporations observe the report publication deadlines, publish semiannual and annual reports, publish audit reports, keep reports available on their websites for five or more years. All this is an integral part of the legal framework of Bosnia and Herzegovina (entity laws) and that is what corporations do respect, but the corporations fulfill to a significantly lesser extent and passively observe all that falls into the domain of voluntary reporting and all that is regulated by bylaws.

3. THE QUALITY LEVEL OF CORPORATE GOVERNANCE AND AREAS FOR IMPROVEMENT OF CORPORATE GOVERNANCE IN BOSNIA AND HERZEGOVINA

The quality of corporate governance is defined by the international standards (OECD Principles of Corporate Governance), entity legal framework, and corporate governance codes. This measurement approach is based on measuring deviations from the set standards, which are determined by the corporate governance quality index. The quality of corporate governance is assessed through six categories containing the analyzed prescribed criteria. The corporate governance quality assessment categories are:³

- I. Commitment to the principles of corporate governance and social responsibility,
- II. Shareholders' meeting,
- III. Supervisory board/non-executive directors,
- IV. Board of Directors – Management,
- V. Audit and internal control mechanisms,
- VI. Transparency of business operations.

³ The number and types of categories and their weights in the overall assessment are adjusted to the 2004 OECD Principles of Corporate Governance, then the Corporate Governance Standards of RS from 2011 and the Corporate Governance Code for companies listed on the market of the Sarajevo Stock Exchange from 2009. The measurement model and analysis of the obtained results were formed on the model of the Scorecard for German Corporate Governance and experiences related to indices created on the basis of the Sarbanes - Oxley Act in the United States, Combined Code in Great Britain, as well as other attempts to measure the quality of corporate governance. The weight value was determined on the basis of the existing experiences and results of studies of the importance of individual evaluation components for socio-interest groups and of their influence on the overall quality of corporate governance.

The index developed for the analysis of corporate governance in BiH is called *LCG* (*abbrev. Level of Corporate Governance*). It is developed and tested on the model of the index Scorecard for German Corporate Governance, intended for German corporations whose shares are traded on German capital markets. For the purposes of this research, the first version of the index is completely changed and adapted to the criteria set out in the 2004 OECD Principles of Corporate Governance, then the Corporate Governance Standards in RS from 2011 and the Corporate Governance Code for companies listed on the market of the Sarajevo Stock Exchange from 2009. The final form of the index structure is given in Table 5.⁴

Table 5. The structure of the level of corporate governance index in BiH - LCG index

Ser. No.	Description and method of criteria evaluation	Number of criteria in category	Share/weight in overall assessment
I.	Commitment to the principles of corporate governance and social responsibility	7 criteria	15%
II.	Shareholders' meeting	9 criteria	15%
III.	Supervisory board/non-executive directors	7 criteria	10%
IV.	Board of Directors – Management	9 criteria	20%
V.	Audit and internal control mechanisms	5 criteria	10%
VI	Transparency of business operations	9 criteria	30%
TOTAL		46 criteria	100%

Source: Author

The total and final assessment can be expressed in a number of ways, the first certainly being in the original form and values achieved by the analysis, and the other possibility is through a set of classes of the achieved values (three, five, seven

⁴ The LCG index (the first version was called BHCog) was developed and tested as part of the research for the purposes of scientific master's thesis of the author Nikola Papac on banks in BiH, and was subsequently revised and adapted to changes in the institutional framework (the second version was named the LCG Index). The BHCog index was created completely on the model of the DVFA index, while the LCG index took into account the policies and rules of the DVFA and BHCog indices, but for creating the criteria, the corporate governance codes of the Sarajevo and Banja Luka stock exchanges were precisely taken into account.

Adapted from: Matić, B. and Papac, N.: *Measuring the quality of corporate governance in the banking sector of Bosnia and Herzegovina*, Economic Research-Ekonomska Istraživanja, Vol. 27, No. 1, 2014, pp. 784–798, Published by Routledge - Taylor & Francis group, link: <http://dx.doi.org/10.1080/1331677X.2014.974338>

or ten). The achieved ratings will be accompanied by the associated comments on the meaning of rating, as well as identification of the factors that may affect the assessment. The final rating is established by summing up the values achieved by each individual category in the total rating, which could be presented in the form:

"Category 1" + "Category 2" + ... + "Category 6" = assessment of the corporate governance quality of the company according to the LCG index

The quality level of corporate governance is presented by the rate of fulfillment of the set criteria. The assessment of corporate governance, as an important non-financial indicator of business operations, in any case is not a replacement for financial business indicators, nor will it ever be; it is primarily its supplement aimed at creating and increasing confidence in the observed corporation.

The purpose of this testing is the fact that emphasizing financial business indicators and overemphasizing financial and economic results may lead the management to make short-term investments and disregard creating a long-term value. Therefore, monitoring the non-financial corporate governance quality indicators is aimed at achieving long-term business goals. Consequently, non-financial indicators are a significant supplement to financial indicators for a model of balanced goals.

The research was carried out on 87 corporations (49 in FBiH and 38 in RS) in three time periods, so that we can say that 261 project observations were examined.

Table 6. Level of corporate governance quality measured by the LCG index in Bosnia and Herzegovina

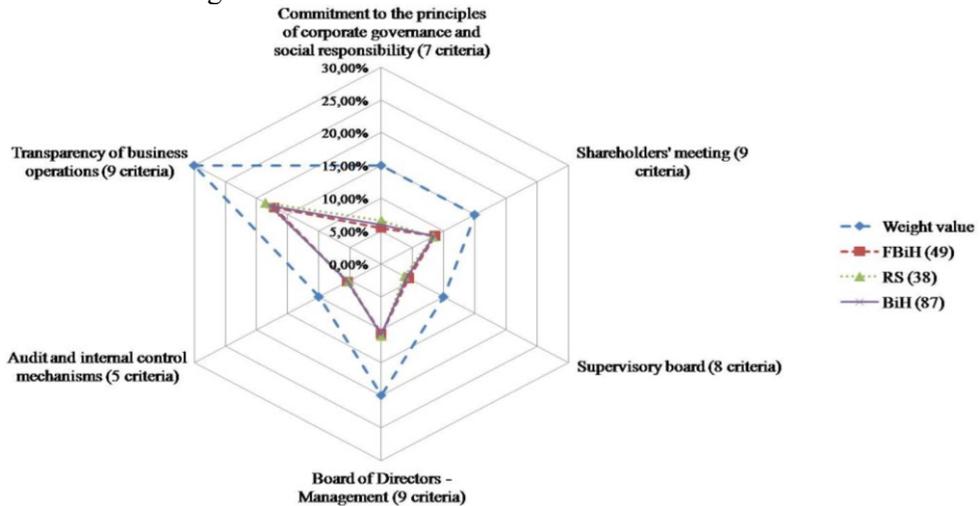
No.	Index category	Weight value	FBiH (49)	RS (38)	BiH (87)
I.	Commitment to the principles of corporate governance and social responsibility (7 criteria)	15%	5.49%	6.63%	5.99%
II.	Shareholders' meeting (9 criteria)	15%	8.60%	8.26%	8.45%
III.	Supervisory board (8 criteria)	10%	4.35%	3.72%	4.07%
IV.	Board of Directors - Management (9 criteria)	20%	10.62%	10.95%	10.76%
V.	Audit and internal control mechanisms (5 criteria)	10%	5.41%	5.23%	5.33%
VI.	Transparency of business operations (9 criteria)	30%	17.18%	18.55%	17.78%
	TOTAL		51.66%	53.33%	52.39%

Source: Author

Based on the LCG index, the overall rating of the quality of corporate governance in BiH is a 52.39% fulfillment of the prescribed criteria. This shows that only half

of the total prescribed criteria are met. The first and third category are significantly below the set standards, or at almost one third of achievement of the set standards for this category, while in all other categories, approximately half of the total prescribed criteria are met. As far as comparison of entities is concerned, Figure 1 clearly shows that the level of corporate governance in both entities is almost the same.

Figure 1. Level of corporate governance quality measured by the LCG index in Bosnia and Herzegovina



Source: Author

When analyzing Figure 1 in more detail, it can be concluded that the level of corporate governance quality by individual categories is very similar in both entities, and the existing differences for particular categories are less than 10%. The only significant difference is concerned with the first category "*Commitment to the principles of corporate governance and social responsibility*", and the author believes that the main reason of this difference (the value is greater in RS) is the fact that the Republic of Srpska earlier joined the process of developing an institutional framework for corporate governance (the first index in RS was adopted in 2006, and in FBiH in 2009).

If we observe only the descriptive statistics, we can see that values of the level of corporate governance range from 0 to 100%, and the study was conducted on 87 corporations (49 in FBiH and 38 in RS) in three time periods, so that we can say that 261 project observations were examined.

Table 7 shows the descriptive statistics for the LCG variable.

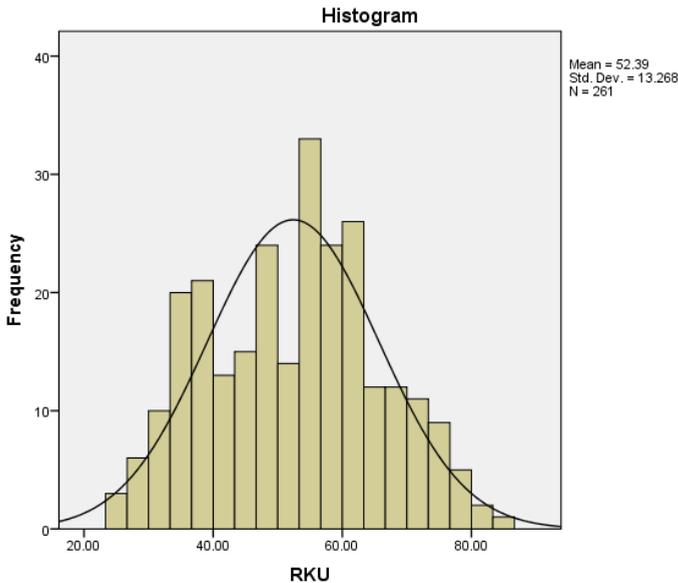
Table 7. Descriptive statistics for *LCG*

		LCG
N	Valid	261
	Missing	0
Mean		52.3898
Median		53.7500
Std. Deviation		13.26799
Skewness		.027
Kurtosis		-.732
Minimum		25.60
Maximum		86.20

Source: Author

The LCG indicators range from 25.60 to 86.20 with an arithmetic mean of 52.39. The skewness and kurtosis indices indicate that the distribution of the LCG variable frequencies has an approximately normal pattern, which can be seen on the histogram (Figure 2).

Figure 2. Histogram of LCG index results in Bosnia and Herzegovina



Source: Author

By checking the boxplot graphics, not a single outlier was observed for this variable, which could be assumed based on the presented form of frequency histogram (Figure 2), so it can be concluded that the distribution of frequencies of the LCG index values for both entities in Bosnia and Herzegovina has a normal form.

According to all the above, it can be concluded that compliance in the operation of corporations with international standards (OECD principles) is the lowest in the field of defining regulations and principles and applying international standards and principles, and the highest in the field of transparency of business operations. The main suggestion of the research is that Bosnia and Herzegovina and its entities must align their own regulations with international standards (OECD principles and EU directives). Such a step forward will contribute to the development of corporate governance, but also all the positive effects of corporate governance development on the overall market and economic development.

4. CONCLUDING CONSIDERATIONS

Corporate governance shows how rights and responsibilities are distributed among different stakeholders in corporations. Corporate governance provides an answer to the question who controls the corporation and how. This paper explored the characteristics of corporate governance systems in Bosnia and Herzegovina and compared them with corporate governance standards in the European Union. Special emphasis is on comparing the transparency principles and standards of corporations in Bosnia and Herzegovina with corporations in the European Union. The goal of the research is to compare the regulatory framework and characteristics of the corporate governance system in corporations in Bosnia and Herzegovina with the standards in the European Union, where the key objective is to identify similarities and differences and to define key areas for improvement of corporate governance in Bosnia and Herzegovina.

The ownership concentration in 87 non-financial corporations, 24 banks and 26 insurance companies from the territory of Bosnia and Herzegovina was analyzed in the first step of the research. The conclusion of the analysis is that the first and largest owner has a controlling block of shares in the largest number of corporations. The highest ownership concentration is in insurance companies, where the largest owner on the average holds almost 3/4 of the total capital, while in banks the largest owner holds 2/3 of the capital. From this it can be concluded that financial and non-financial corporations in Bosnia and Herzegovina have the characteristics of a closed corporate governance system. The fundamental characteristic of a closed system is primarily high ownership concentration, key control and power is held by the largest owner, and corporations in a closed system have a problem with lack of transparency in business operations and relations with different stakeholders.

After the analysis of ownership concentration, the legal framework for corporate governance in Bosnia and Herzegovina was analyzed. Regulation of corporate governance in Bosnia and Herzegovina is based on two predominantly aligned, but still significantly different institutional frameworks. In the true sense, that departs from the international recommendations and standards of corporate governance

that advocate a single harmonized system, aligned with international standards. Compliance of transparency in business operations with international standards and the EU directive on transparency in business operations of corporations was analyzed in the next step. Regarding the transparency of business operations, corporations observe the report publication deadlines, publish semiannual and annual reports, publish audit reports, keep reports available on their websites for five or more years. All this is an integral part of the legal framework of Bosnia and Herzegovina (entity laws) and that is what corporations do respect, but the corporations fulfill to a significantly lesser extent and passively observe all that falls into the domain of corporation's voluntary reporting.

Finally, an analysis of the quality of corporate governance in corporations in Bosnia and Herzegovina was made, and it is concerned with compliance in the operation of corporations with international corporate governance standards (OECD principles and EU directives). Compliance in the operation of corporations with international standards (OECD principles) is the lowest in the field of harmonization of regulations and principles. The main suggestion of the research is that Bosnia and Herzegovina and its entities must align their own regulations with international standards (OECD principles and EU directives). Such a step forward will contribute to the development of corporate governance, but also all the positive effects of corporate governance development on the overall market and economic development.

Based on all this, it can be concluded that improvement of the legal framework and its compliance with international standards is a key area of non-compliance that generates all other problems and discrepancies. The development and alignment of the legal framework with international standards is the key to improving corporate governance in Bosnia and Herzegovina and the foundation for achieving all the positive effects of applying good corporate governance. When it comes to Bosnia and Herzegovina, the only way to address all these problems is to continue the process of approaching the European Union as a fundamental imperative for the development of the entire society, and thereby of corporate governance too, but also for the development of the economy as a whole.

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IMPACT OF FOREIGN DIRECT INVESTMENTS ON EMPLOYMENT IN THE REPUBLIC OF CROATIA

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Review

Abstract

Globalization has enabled "joining" the rest of the modernity project. Expressive values such as knowledge, information, symbols and communication have become an imperative. Planetary power has encouraged the movement of free international capital in the global village. Digital economy and networked politics are responsible for the freedom of movement of capital that has become the part of financial globalization. From the range of stimulating factors to the free movement of international capital, the thrust of foreign investment plays an important role. The intricacy of neoclassical theory and the neoliberal political economy have enabled stronger interconnectedness and deeper integration of national economies. Consequently, there have been changes in the way of thinking of the ruling elites in terms of importance of foreign direct investment (FDI). Such awareness has also come through to the ruling elites of the Republic of Croatia who apply the strategy of attracting FDI based on pragmatic nationalism. FDIs are incorporated into the "national box" in the Republic of Croatia as one of the tools to gain advantages. In the perspective of advantages and disadvantages, the work is focused on the employment category from the perspective of the Republic of Croatia as the recipient of FDI or political foreign direct investment (PFDI). Given the importance of attracting FDI in the Republic of Croatia, the subject of the research includes consideration of the essence of Croatian FDI and employment in the Republic of Croatia in terms of identifying the attracted investments and the correlation with the growth or decline in employment. The aim of the research is to identify and deepen the topic of FDI in Croatia and its impact on employment in the Republic of Croatia. In addition, the aim is to explore and identify key FDI providers and employment impacts.

Keywords: *direct foreign investment, political foreign direct investment, employment*

JEL: F21, J2, J3

1. INTRODUCTION

Today's world is all in globalization. And it actually is that, and it is a well known fact because there are several definitions for it. In the context of this topic and in the last two decades of the 21st century, globalization is defined as "connecting" to the rest of the modernity project where ever-greater values have "expressive values". Expressive values, in this context, meaning knowledge, information, symbols and communication (Milardović, 2011, 131). From the definition it is clear that the anthropological dimension is involved. The history of globalization as well as actors over time have constructed world power. Impressing all the more modern technologies, especially IT, created a planetary power by linking the world to the global village. Such a global village also allowed free movement of international capital. In this reference framework, capital becomes part of the process of financial globalization. As such, it anticipates the termination of restrictions and rules related to free flow of capital (Grgić, Bilas, Franc, 2012, 1). From the range of stimulating factors to the free movement of international capital, the injection of foreign investment takes an important place. Foreign investment is any investment of an individual, enterprise or state in another state or in the economy of another country (Andrijanić, Pavlović, 2016, 273). According to neoclassical theory, the form of foreign investment incentives represents an additional benefit of capital liberalization, while the neoliberal political economy emphasizes the encouragement of competition in the market, leading to the creation of better quality management policies (Andrijanić, Pavlović, 2016, 18). Both theories emphasize stronger interconnectedness and deeper integration of national economies. Furthermore, such attitudes lead to changes in thinking of ruling elites and emphasis on the importance of foreign direct investment (FDI). The Republic of Croatia (RC), as a developing country, recognizes the importance of FDI and takes the position of pragmatic nationalism (Andrijanić, Pavlović, 2016, 296). The pragmatic nationalism view is reflected in the advantages and disadvantages of FDI recipients and donors (Hill, 2011, 321). The actual adaptation of the RC to such a policy results in maximizing profits and minimizing costs. Due to adaptation, the phenomenon of political foreign direct investment (PFDI) emerged in the RC as a derivative of FDI. In the perspective of advantages and disadvantages, the essay focuses on the employment category from the perspective of the RC as the recipient of FDI or PFDI.

1.1. Subject of research

The subject of research of this paper is an analysis of the impact of direct foreign investment on employment in the RC. Given the importance of attracting FDI to the RC, as presented in the introduction to the text, *the subject of the research* includes consideration of the essence of Croatian FDI and employment in the RC in terms of identifying attracted investments and correlating with growth or employment.

1.2. The aim of research

The aim of the research is to identify and deepen the topic of FDI in Croatia and its impact on employment in the RC. In addition, the aim is to explore and identify key FDI providers and employment impacts.

1.3. Methodology

The paper deals with theoretical research based on studied literature and data on foreign direct investment and employment in the Republic of Croatia. Secondary sources of data come from articles and web sites. The descriptive method describes facts, such as theoretical and professional knowledge of FDI and employment. The sequential analysis methodology covered parts of the Strategic Plan of the Investment and Competitiveness Agency and parts of the statistical data of the Croatian National Bank and the Croatian Employment Service. The macroeconomic analysis method shows FDI RC as the recipient to which the qualitative analysis method supplements. The synthesis method shows the impact of FDI on employment in RC in order to understand the interdependence of certain parts. By creative thinking about the subject of research, the author of the paper has made conclusions that represent an explicative analysis. Inductively-deductive methods yielded conclusions and deepened insights.

1.4. Expected contribution

The contribution of this paper is reflected in the presentation of the definition and essence of foreign direct investment and the attraction of FDI in the RC with the impact on the employment of the RC. Great importance is also reflected in the recognition of FDI's impact on employment in the RC. In this respect, high school students, students, teachers, professors, politicians, and scientists can use the paper to enhance the importance of attracting FDI in the RC and its impact on employment. In addition, it can provide a differentiated approach to attracting FDI to influence employment and other categories of economic growth. The results of this research can serve as an incentive for future research in the direction of deepening the obtained research results.

2. FDI OF RC AS THE STATE RECIPIENT AND ITS EFFECTS IN THE RC

Before the very beginning, it should be emphasized that by reviewing the rich literature on the definition of direct foreign investment, there is a single definition. The essence of FDI is a financial investment. Investment is considered as a direct foreign investment if an investor purchases at least 10% of shares in an enterprise of a non-resident company with a view to securing a permanent interest in that enterprise and having a significant influence on managing it (Pavlović, 2008,

15). Such investments can be in the existing companies the so-called. Brownfield investments or the incorporation of a new company called Greenfield investments. Greenfield investments represent the most desirable form of foreign investment due to the fact that new product capacities are created and consequently, new jobs enable transfer of technology and knowledge and can lead to the creation of links to the global market since an international investor is usually a multinational company (Grgić, Bilas, Franc, 2012, 90). FDI is a key driver of international economic integration that provides financial stability, improves economic development and, ultimately, the welfare of society, but under the condition of applying a proper political framework (OECD, 2008, 3). Today's stand on FDI in the RC is pragmatic nationalism that understands the advantages and disadvantages. The benefits are reflected in their positive impact such as the impact on economic growth, exports, employment and transfer of modern technology and management and marketing knowledge and skills. Disadvantages are in the pursuit of capital to maximize profits, which leads to worries about the fate of labor (Andrijanić, Pavlović, 2016, 296). The truth is that pragmatic nationalism could not have been realized without meeting the general conditions. The general condition for realizing FDI in a global village is digital economy and networked politics. Why? Because the network does not recognize boundaries. Such information, networking company functions on the connectivity, deterritoriality, networking and interactivity of all possible social arenas (Milardović, 2010, 69).

In its policies, the RC has elaborated goals and tasks of investment. The National Security Strategy of the RC recognizes threats, risks and challenges for the RC and accordingly targets are set (Hrvatski sabor, 2011, 11). For FDI and its impact on employment, the most important goals in Section B of the Strategy refer to the well-being and prosperity of citizens. In order to understand the impact of FDI in the RC on employment, it is necessary to determine what constitutes the essence of Croatian FDI.

2.1. FDI Essence in the RC

As any other state, the RC also has its roles and goals to achieve the desired scale of development. Extended Arms to the National Security Strategy of the RC are in various documents issued by the relevant ministries and government agencies. Thus, the roles and goals of the RC for a strong and sustainable economy are contained in the strategic investment and competitiveness plans announced by the Zagreb Agency for Investments and Competitiveness. Strategic plans are complementary to documents of the Government of the RC. The Digital Economy enabled the review of the Plans. By the published plans, the RC, in order to achieve the level of development of developed countries and the average of the European Union (EU) countries, has recognized the key role in attracting and encouraging foreign direct investments, particularly Greenfield investments. The general objective of the RC defined by the Plan implies the implementation of policies and

measures to increase the competitiveness of the Croatian economy with a particular emphasis on promoting investment and improving the investment environment and promoting the RC as a preferred investment destination (AIK, 2017, 1-19). By exploring the persuaded key roles and goals for the years 2014 to 2019 (after the accession of the RC to the EU) there is a uniformity in terms of the "copy-paste" format (AIK, 2014-2016, 1-19). The founder of the Agency is the Government of the RC. The goals of the Plan have been announced by the Government through the irrefutableness to support investment climate improvement and proactive approaches. In addition, all the Plans have been drawn up without the planned/achieved for the previous period. It is not irresponsible to pose a question on the basis of what the Strategic Plan 2017 -2019 has been drafted? Transparency is not questionable here in terms of document disclosure, but it is questionable in the tendency to fight for the prosperity and well-being of Croatian citizens. Such frivolity leaves the impression of the disinterest of the political elite for FDI as well as an unobtrusive strategy for attracting foreign investment. It can be concluded that institutionally the RC is ready to attract FDI. Surely investors are only institutionally prepared, but not pragmatically.

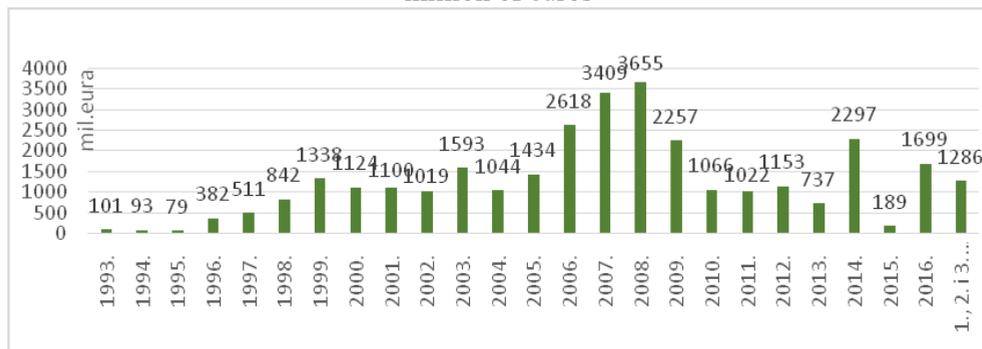
The major investors in developed countries are multinational companies (MNCs) and do not exclude the RC as well. MNCs are international companies, but not by share in the ownership, but by establishing companies in different countries (Babić, 2008, 104). 91% of all foreign investments account for them (Pavlović, 2008, 27). States and MNCs need each other. States are the source of wealth: they invest and create jobs. Just as states need MNC for their prosperity, MNCs need states because they are the ultimate guarantor of the state order (Defarges, 2006, 147). As it is in the world, so it is in the RC. All MNC activities through FDI with negative and positive consequences are part of the Croatian everyday life. FDIs are incorporated into a "national box" in the RC as one of the tools to achieve the benefits of a policy of pragmatic nationalism. MNCs are the dominant investors with different motives, and expansion is through FDI. From the presented, it is obvious that the essence of Croatian FDI is the Greenfield investment of the RC as a recipient by the MNC. Are FDI still a trap for the RC?

2.2. Influence of FDI on Croatia's Employment: Incentive or Trap

The global economy map today is the result of many years of evolution and only a historical review can help to understand the present (Dickens, 2011, 14). Creating the right image of "FDI map in the RC" is an inevitable depiction of the inflow of FDI inflows into Croatia, then defining who are the global players and who and in which year the same player contributed to the direct investment in Croatia. Figure 1 shows the inflow of foreign direct investments in Croatia from 1993 to the first three quarters of 2017. It is evident that since the independence of the RC until the end of the Homeland War in 1995 the inflow was declining. Since 1997 the inflow of FDI has been increasing steadily and the constant from 1999 to 2005 has been

observed. FDI rose sharply in 2006, when FDI rose by 82.56% compared to the previous year. Growth continues in 2007, reaching its peak in 2008 as a result of the world's economic crisis and policy-making in the RC. Furthermore, since 2009 it has been in continuous decline. The RC experienced a collapse of upward influx in 2013. In the following year, there was an increase of 2.24 million euros. The total collapse came in 2015 with a fall of 91.85%. Growth will continue in the following 2016 at the beginning of the 21st century.

Figure 1. Inflow of FDI into Croatia in the period of 1993 to March 31, 2017 in million of euros

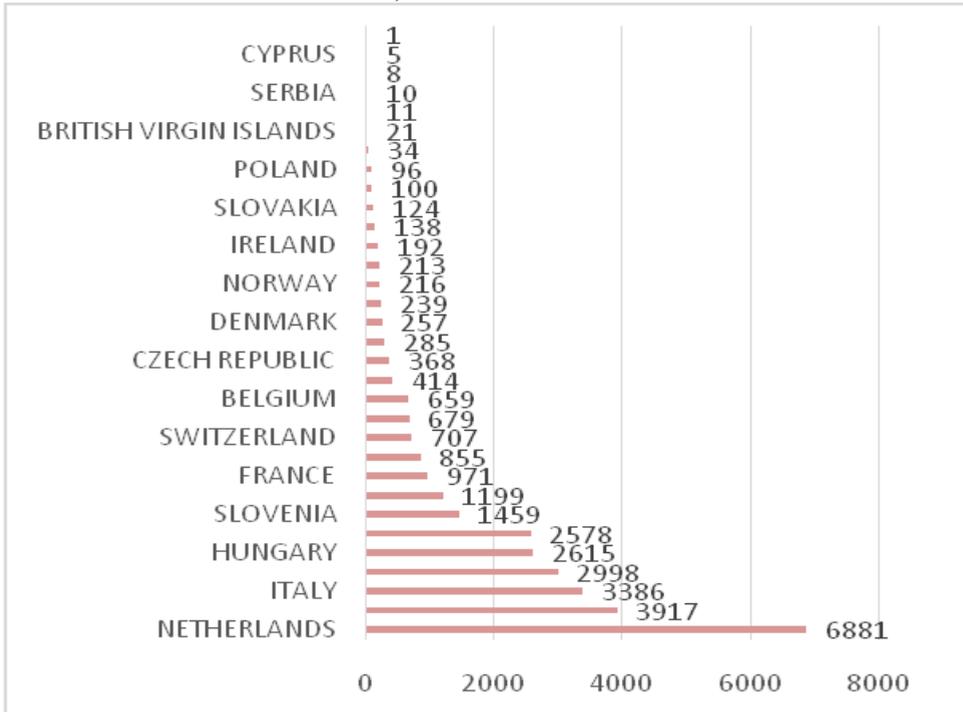


Source: HNB, (2018),

<https://www.hnb.hr/statistika/statisticki-podaci/sekter-inozemstva/inozemna-izravna-ulaganja>, (accessed 10 June 2018)

Countries that have most contributed to the inflow of FDI in Croatia are shown in Figure 2 for an identical period as in Figure 1. The total inflow in the said period amounted to 31,582 million euros (HNB, 2018, 1) while the highest inflow of FDI came from EU countries with an investment share of 89.20%.

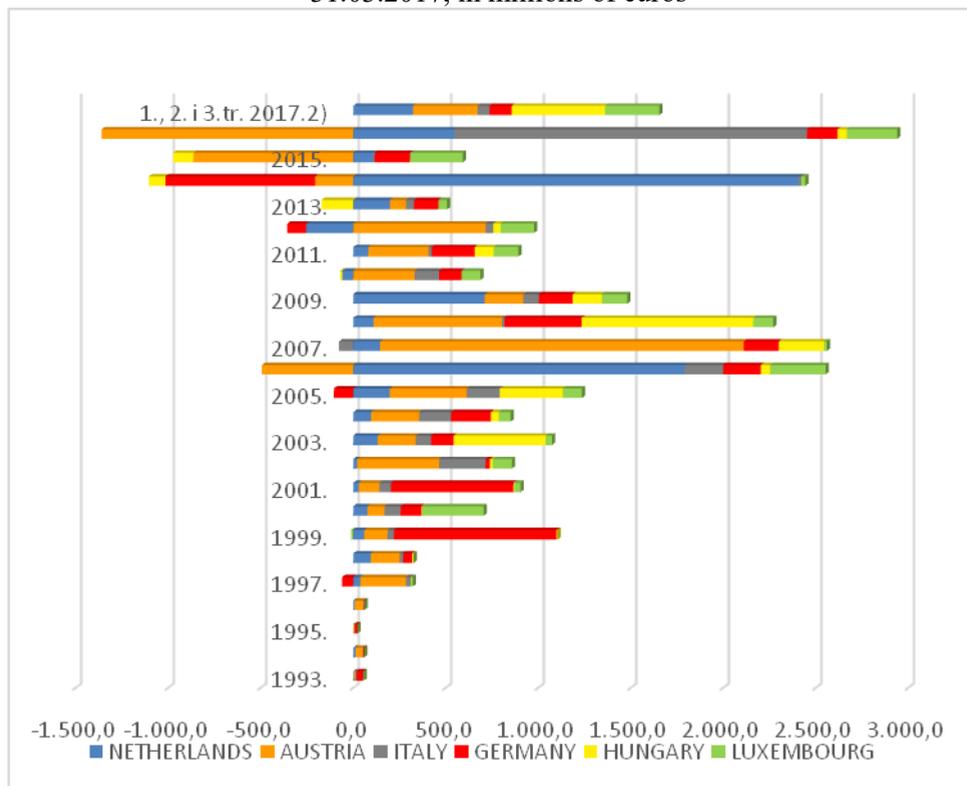
Figure 2. FDI inflow into Croatia by countries in the period from 1993 to 31 March 2017, in millions of euros



Source: HNB, (2018), <https://www.hnb.hr/statistika/statisticki-podaci/sektor-inozemstva/inozemna-izravna-ulaganja>, (accessed 11 June 2018)

The countries of the Netherlands, Austria, Italy, Germany, Hungary and Luxembourg contributed to the RC with the highest FDI in the mentioned period. The following question arises: what are the countries that invested most through FDI in Croatia? Figure 3 shows Hungary as the strongest player in 2003 and 2008, followed by the Netherlands in 2006 and 2014, and already in the first quarter of 2017, Hungary, Austria, the Netherlands and Luxembourg are ahead.

Figure 3. Overview of FDI by country and years in the period from 1993 to 31.03.2017, in millions of euros



Source: HNB, (2018), <https://www.hnb.hr/statistika/statisticki-podaci/sektor-inozemstva/inozemna-izravna-ulaganja>, (accessed 10 June 2018)

The interpretation of the same speaks in favor of the following: 2003. The Croatian government sold the company of strategic importance to the Hungarian company Mol (it concerns the company Ina dd - oil company; URL1). In the same year Ina d.d. had 16084 employees, while in 2012 the number of employees was reduced to 13852 (Marić, 2013, 1). On December 31, Ina d.d. remained with 10861 employees (URL2). In 2003 Hungarian company Aquamarine d.o.o., bought 83.1% of the shares from the Government of the RC for tourism expansion on the island of Hvar (company Jelsa d.d.; URL3).

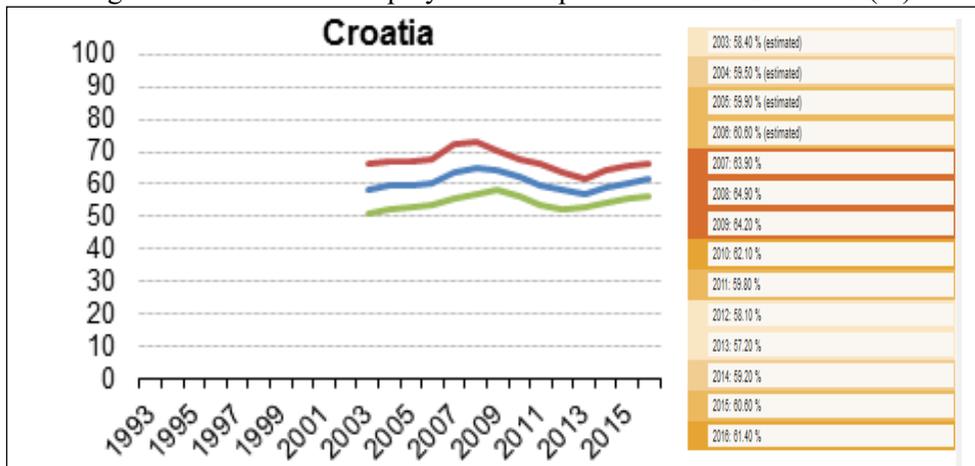
At that time, the company had 132 employees, but in 2008 the number was reduced to 80 with the announcement of the layoff of additional 30 employees (URL4). In April 25, 2016 the same company launched a pre-bakruptcy settlement (URL5). In 2014, the investment came with the opening of the Dutch company IKEA d.o.o. which employed 352 employees (URL6). On December 31, it recorded 351 employees (URL7). Impressive FDI inflows in 2014 were made by the Dutch

company Adria Group holding BV and Adria Group B.V. into the Croatian company Agrokor projects d.o.o. and thus became the main investor in the takeover of Mercator for that year (URL8). It is even more exotic to know that the owner of the company Adria group holding BV is Ivica Todorić (URL9). Also, the company Agrokor projects was established in 2011 and had no employees until the end of 2017. That same Todoric spilled "Croatian money" into the Netherlands, and with the same money he made a direct "foreign" investment in Croatia by purchasing his company. Italy was the main investor in 2016 with the acquisition of the Wood Industry Čazma (URL10). In 2014, the company had 120 employees (URL11). After the acquisition in 2016 it had 84 employees (URL12). In the first quarter of 2017, an investment was made from a Luxembourg company that appears as an investor in the strategically important company LNG Hrvatska d.o.o. founded in 2010, and in 2015 it had two employees (URL13). Data for 2018 are still not available, however, it is known that one of the well-known information companies in the RC, IN2 dd. sold to Canadian investor Constellation Software Inc. with 650 employees (Rosandić, 2018, 7). Certain time will have to pass to obtain accurate information on how many additional people are employed or dismissed. This year also announces direct foreign investment in the company Uljanik d.d. Pula which currently has 2600 employees. The future the company Uljanik anticipates with the number of employees can be assumed by logical conclusion.

Representative impacts of FDI on employment are quantitative and qualitative. Positive quantitative effects on the volume of employment include the number of newly created jobs resulting from the opening of a new branch or the promotion of suppliers and distributors to new employment; medium-term effects resulting from increased demand stimulated by increased efficiency and enterprise restructuring in the market; "Guarding" jobs by taking over businesses that are facing bankruptcy. Negative quantitative effects are the reduction of employment due to disinvestment and closure of affiliates; change in the home country strategy or company restructuring in the country of destination. Positive qualitative effects are the transfer of knowledge, skills and technology to domestic enterprises. Negative effects are manifested in lower wages in the country of destination; lower security if FDI is motivated by low labor a cost which consequently leads to changing the location of the investor. How the category of employment in the RC was moving as a regularly existent topic is presented in Figure 4 and 5. Figure 4 shows the level of employment in the RC for the period from 2003 to 2016, while Figure 5 shows the number of unemployed in RC for the period from 2004 to January 2018. By looking at the employment data, the "boom" of the level of employment that took place in 2008 ahead of the economic crisis is visible, where the share was 64.90% or the lowest number of unemployed of 236741 persons. Since 2009, there has been a decline in employment, that is, unemployment, up to 2013, when the peak of employment drops, i.e. growth of unemployment. Employment growth has been recorded from 2014 onwards. If the same is correlated with direct investment in the

RC, it can be concluded that in 2008 the highest level of investment from the very founding of the RC was recorded. This justifies the decline in employment due to the growth of investments. From the beginning of the Croatian crisis, from 2008 to 2013, FDI in 2013 was 79.83% lower than in 2008. At that time, employment was only 57.20%, i.e., 7.70% less than in 2008, and it can also be said that the decline in FDI results in a decline in employment. Namely, the lowest level of investment in the 21st century of the RC was experienced in 2015. Compared to very good 2014, the decline in investment was recorded by 91.76%. On the other hand, employment has been increasing gradually since 2013, and in 2015 the employment level was 60.60%, i.e. more by 1.40%. Based on this evidence, the likelihood of the correlation between FDI inflows in the RC and the growth of employment, i.e. the fall in unemployment, is very low. The segment of employment growth, i.e. the reduction of unemployment should also take into account the policy of the Government of the RC: how to define an employed person. A large number of people were deleted from the register of the unemployed, for one reason of "a person who does not seek a job", or the other reason - he goes abroad. According to analyzes, over the last four years, more than 200,000 of the most productive working population went abroad, due to higher wages and well-being. Wages abroad are higher, so workers can achieve higher wages in a rich country rather than in a less developed or a poor country. This confirms the Lucas rule (Grgić, Bilas, Franc, 2012, 42). In addition, the demographic aging of the population also affected the decline in unemployment (Podgornik, 2017, 1).

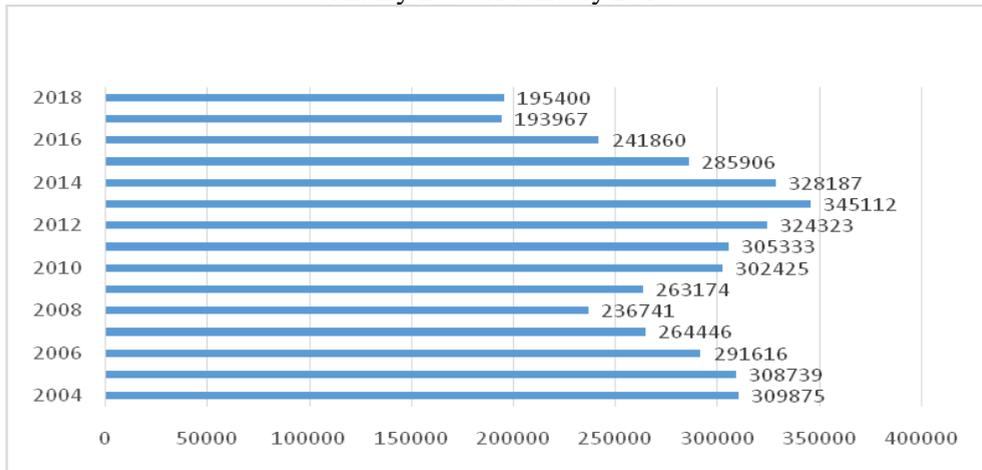
Figure 4. Overview of employees in the period from 2003 to 2016 (%)



Source. Eurostat. (2016). Statistic illustrated 2016

<http://ec.europa.eu/eurostat/web/lfs/statistics-illustrated>. (accessed 10 June 2018)

Figure 5. Overview of the number of unemployed in the Republic of Croatia, January 2004 to January 2018



Source: HZZ, (2017)

<http://statistika.hzz.hr/statistika.aspx?tipIzvjestaja=1>, (accessed 8 June 2018)

It is worth recalling the negative and positive consequences of FDI. Negative and positive consequences are questioning whether FDI and foreign trade are substitutes or complementary. The fact is, it all depends on the motives of MNC. In case the investment is made due to comparative advantages, most often cost, then foreign trade is increasing. In the case of investments due to the proximity of the market, then foreign trade is decreasing (Babić, 2008, 105). MNC motives directly affect employment in the RC. From this analysis it is clear that the RC is missing a Greenfield investment. Almost all investments are Brownfield investments. And that kind of investments? Those where MNCs invest mainly in service activities such as IT, financial services, tourism, then into commercial activities and in the exploitation of natural resources of the RC. What is the motive of MNC in the RC? By investing in Ina d.d. MNC took over power over energy. By investing in a tourist company Jelsa d.d. they did not make any additional value, on the contrary, unemployment multiplied and there was an outflow of labor. Ikea d.o.o. is currently being shown as a constant, a bright spot because as for now, the number of employees is still constant, however, there is no export because it is oriented to the proximity of the market. Who knows if the money will remain in the reinvested profit or will fly away to the mother company? Agrokor, a Croatian company that deceived its people, showed how the "best" do it. It is believed that at least a little bit of the Wood Industry of Čazma will provide a Croatian product, and not take away the raw material. LNG d.o.o. appears as a new liquefied gas company, of course imported. It is very questionable how it will be reflected in the future for employment. If 26 terminals in Europe operate with a deficit, maybe the RH still has a drug formula because the equation is easy to set. Croatian tradition of

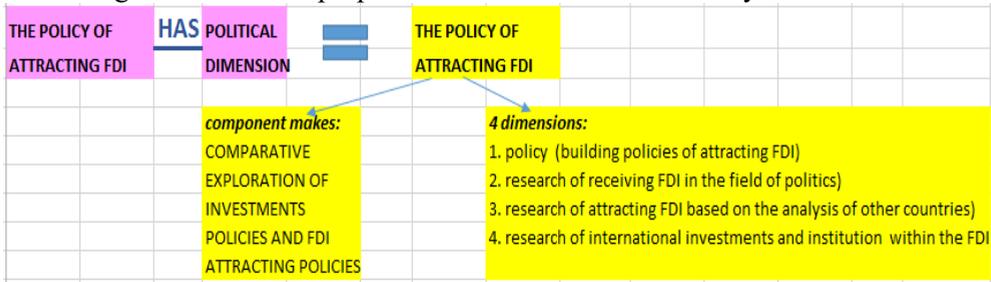
company Uljanik d.d. will probably experience the fate of the "Strategic Plan of the Agency for Investments and Competitiveness". In addition to job losses in Uljanik dd, there are job losses of cooperative companies as well as their winding-up. Unfortunately, there is a loss of Croatian identity. Uljanik d.d. is a tradition of the RC, a company founded in 1856 and has gone through all forms of political rule. The same company formed human lives and Croatian reality: opened and provided jobs, educated and branded Croatia - the city of Pula and enabled its economic growth. Will the government possibly write „lexUljanik“? It should be noted that these are companies in which the Government of the RC mediated in the provision of inflow. Such mediation leads to the emergence of a new phenomenon: political foreign investment (PFDI). Examples from the above text demonstrate political connections between companies and the Government of the RC. The impact of FDI and PFDI RC as the receiving country does not result in employment growth effects. On the contrary, the effect of "modern privatization", whose history has been known since 1991, has taken place. Privatization processes, of both production and service providers, enabled foreign investors to purchase shares in the largest and most important Croatian companies (Andrijanić, Pavlović, 2012, 286). The dominance of brownfield "general" and "political" investments in the RC does not preserve the sovereignty of neither the energy nor water supply. The fact is that each country, and the RC as well must have sovereignty in these areas with a minimum of 50% of the share. Managing and controlling major natural resources enables survival. If investment was contrary in its nature, in terms of well-established related policies, surely employment would be at a higher level. The Croatian civic (aligning the way of life with a different thinking and behavior, both for Europe and for Croatia) of being forces them to leave the trap in search of a better life. Unfortunately, a better life through the process of migration of Croatian society into "promised land" ultimately raises the level of employment. It is noted that the FDI in the RC as recipients is presented to the public as an incentive, and in fact are a trap for citizens of the RC. The fact is that these investments cannot be accepted as investments. Perhaps the Government of the RC should apply the correct unemployment theory of Economist Maynard Keynes where state measures can contribute to the return of the economy to full employment and growth (Stiglitz, 2009, 17). Can RC do better?

2.3. FDI of RC as the recipient - can it do better?

After deep thinking, it should not be held against one if one should pose a question: can RC do better? Political foreign direct investment makes the author think outside the box. One can always do better. Linked policies are needed which reflect a healthy, stable economic and political system. The method of attracting FDI in the RC is not an easy job, but it can be achieved by choosing the right strategy. Figure 6 shows a proposal for the application of the FDI Attraction Policy. The framework is presented with the conclusion that the policy of attracting FDI as a part of political science has a political dimension. Synergy creates a FDI Attraction

Policy, which consists of four dimensions: building FDI attractiveness policies; research on the receipt of FDI in the field of political aspect; investment attraction research based on analysis by other countries and the research of international investments and institutions within FDI. The compilation is a comparative study of investment policies and policies for attracting FDI.

Figure 6. View the proposal of the FDI Attraction Policy Framework



Source: Authorship, (2018), The framework was created based on the study of the methodological framework of globalization of "Simultaneous Diversity" reported by the Science and Higher Education Agency in 2018 by prof. dr. sc. Anđelko Milardović

Perhaps this framework would help the Government of the RC in drafting the eventful composition of investment incentives and hence selecting a strategy. In addition to that, perhaps it would help with exact analysis how much and how FDI affects employment in the RC and, of course, encourage changes.

3. CONCLUSION

Globalization has made it possible to “attach” to the rest of the modernity project. Expressive values such as knowledge, information, symbols and communication have become an imperative. Planetary power encouraged the movement of free international capital in a global village. The digital economy and networked policy are responsible for the freedom of capital movements that has become part of financial globalization. From a range of incentives to free movement of international capital, an important place is taken by the stimulus of foreign investment. The intricacy of neoclassical theory and neoliberal political economy has allowed for stronger interconnection and deeper integration of national economies. Consequently, there has been a change in the thinking of the ruling elites in terms of the importance of foreign direct investment. Such a consciousness has reached the ruling elites of the RC who apply the strategy of attracting FDI based on the attitude of pragmatic nationalism. FDIs are incorporated into the "national box" in the RC as one of the tools for achieving the benefits. The essence of the FDI of the RC consists of Greenfield investments presented in all strategic documents of the RC since the accession of Croatia into the EU. The research shows that all FDI inflows are predominantly brownfield by MNCs from the EU

countries provided by the Government of the RC. This created the phenomenon of political direct foreign investments. The methodology of the Croatian incentive to attract FDI created the "FDI Card in the RC", which was mediated by "modern privatization" with an effect on employment. The level of employment growth was noticed, but it was not influenced by FDI inflows. On the contrary, there has been a large amount lay-offs. In addition, the growth in employment has been supported by the Croatian policy of defining employed persons as well as migration of labor-productive into "promised lands". Unfortunately, the (aligning the way of life with a different thinking and behavior, both for Europe and for Croatia) of being of Croatian citizens with the process of migration ultimately raises the level of employment. The sources of FDI inflows in the RC affect negatively the employment in the RC, the demographic picture of Croatia and, finally, the overall economic growth of the RC. The reality of the RC shows that direct foreign investments actually seem more like "blackfield" investments. They are not an incentive but a trap for Croatian citizens. The recommendation to the ruling elites of the RC is to consider the application of a part of the Keynes theory. Apart from that, it would be worthwhile to dedicate oneself to the application of the guidance framework in the field of FDI Attraction Policy because the RC can do more and better.

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EUROZATION IN BOSNIA AND HERZEGOVINA - BARRIES AND OPPORTUNITIES FOR INTEGRATION

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Review

Abstract

Preconditions of the economic growth of the small, open economy are stable and strong currency, favourable business environment and financial stability. Financial and monetary stability is one of the key presumptions of economic growth. Bosnia and Herzegovina in financial system record significant level of eurozation. There are many reasons for eurozation in national economy. Bank deposits and loans are denominated in euro, national currency is fixed to euro through monetary regime currency board. The objective of the paper is to provide conceptual framework of eurozation and to analyse level of eurozation in Bosnia and Herzegovina. Authors in paper will analyses economic development and changes in banking sector in condition of eurozation in period before and after financial crisis.

Keywords: *eurozation, banking sector, economy, B&H, EU*

JEL: E52, E58

1. INTRODUCTION

Over the past 20 years, economies in transition countries has undergone a transformation characterised by reconstruction, privatisation, consolidation and stabilisation. For the most of transition sectors, within former centrally planned economy, mono-bank system was characteristic, with a combination of central

bank and commercial bank functions. With process of transition, in Bosnia and Herzegovina also started privatisation in national economy. Bosnia and Herzegovina has a complex social organization. Dayton Peace Agreement from 1995 has organized this country in two entities and in one district.

Currency board system in Bosnia and Herzegovina limits central bank to formulate and implement monetary policy. Central bank of Bosnia and Herzegovina (CBBH) has limited possibility to use monetary policy instruments. CBBH can not provide function of "lender of last resort". In this situation and with undeveloped money market, banks must ensure adequate liquidity and involve best practise in managing liquidity risk. Developed capital markets can protect the economy from some global financial shocks by providing them stable and secure sources of liquidity. Specially, central bank in cooperation with the Ministry of finance and public agencies has important role in developing the domestic money market (treasury bill market) and domestic debit market (government securities market). (Živko and Slijepčević, 2006).

For banking system in Bosnia and Herzegovina because of it characteristic (presence political risks, domination of foreign deposits in bank funds, majority of large banks are doing business over the entire territory of country through networks of branches, the degree of the foreign ownership in the B&H banking system is extremely high) must continue the adoption of the international standards in the supervision domain.

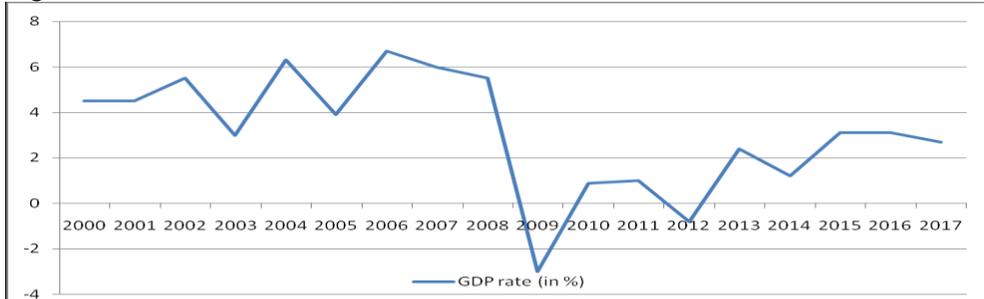
In Bosnia and Herzegovina regulation and supervision of banks has been implemented by the Banking Agencies from two entities, the one in the FB&H and the other in the RS. They conduct financial regulation and supervision in the name of the entities and they are independent in the conduct of financial supervision. Practically Bosnia and Herzegovina has got a dual and a separate system of banking regulation and supervision on entities levels. It is possible, that in this situation, two separate and independent agencies can bring different roles for the regulation and procedures for supervision in banking sector. Impossibility to provide the unique regulation for banks supervision on whole territory of the state is the largest problem. Entity's agencies have been charged to make it only on their own territory.

2. MACROECONOMIC ENVIROMENT IN BOSNIA AND HERZEGOVINA

Activities of banking sector are determinate by changing in macroeconomic environment. Between major macroeconomic indicators we can choose: growth rate of gross domestic products, balance of payment, inflation, interest rates, foreign exchange rate, credit expansion, increasing/decreasing financial assets

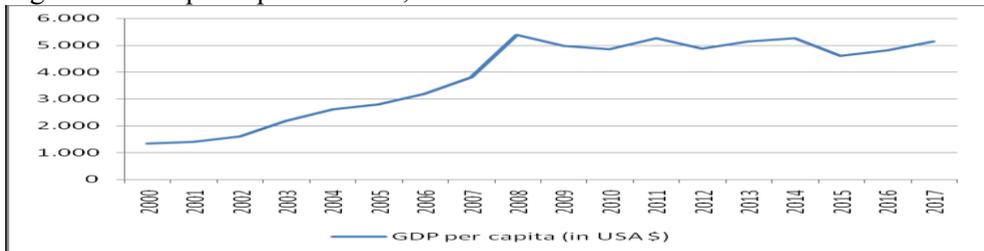
price, effect of contingent (Evens, Leone, Gill, Hilbers, 2000, 10-12). Figure 1, 2, 3, 4 and 5 present macroeconomic indicator for BH in period 2000-2017.

Figure 1: GDP rate in B&H in %, 2000-2017



Source: Central bank of Bosnia and Herzegovina, Annual report 2008, Sarajevo, 2009, pp.162, Central bank of Bosnia and Herzegovina, Annual report 2017, Sarajevo, 2018, pp.107.

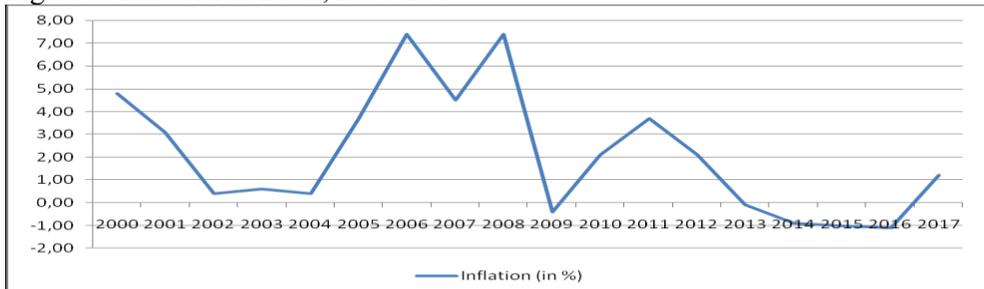
Figure 2: GDP per capita in B&H, 2000-2017



Source: Central bank of Bosnia and Herzegovina, Annual report 2008, Sarajevo, 2009, pp.162, Central bank of Bosnia and Herzegovina, Annual report 2017, Sarajevo, 2018, pp.107.

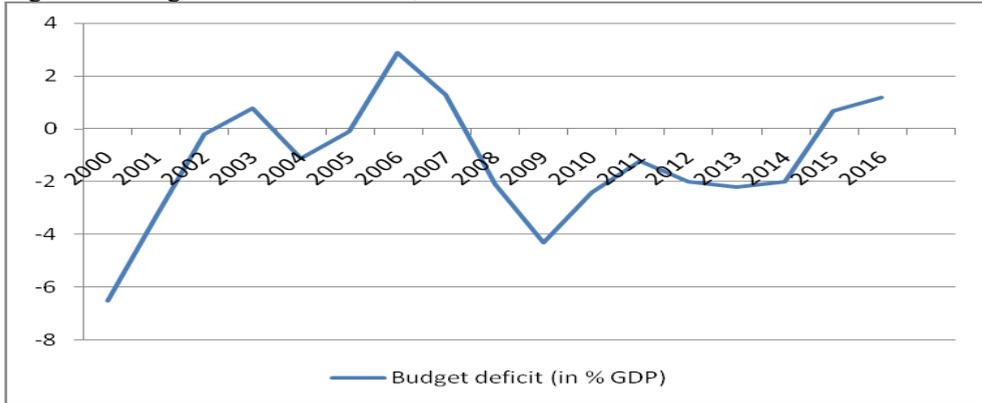
From graph 2 we can see sharp decreasing of GDP growth rate in 2009. After 2009 B&H passed through unstable period and fluctuation of economic activities.

Figure 3: Inflation in B&H, 2000-2017



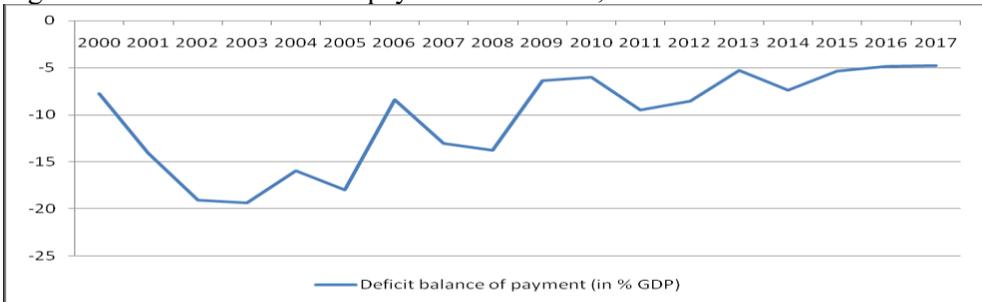
Source: Central bank of Bosnia and Herzegovina, Annual report 2008, Sarajevo, 2009, pp.162, Central bank of Bosnia and Herzegovina, Annual report 2017, Sarajevo, 2018, pp.107.

Figure 4: Budget deficit in % GDP, 2000-2016



Source: Central bank of Bosnia and Herzegovina, Annual report 2008, Sarajevo, 2009, pp.162, Central bank of Bosnia and Herzegovina, Annual report 2017, Sarajevo, 2018, pp.107.

Figure 5: Deficit of balance of payment in % GDP, 2000-2017



Source: Central bank of Bosnia and Herzegovina, Annual report 2008, Sarajevo, 2009, pp.162, Central bank of Bosnia and Herzegovina, Annual report 2017, Sarajevo, 2018, pp.107.

Through macroeconomic analyses, we can determinate problems, risks or benefits and possibilities for financial sector operating. Decreasing rate of GDP growth can mean decreasing credit standing bank's clients or increasing credit risks in bank's balance sheet. Same effect had failure problems in individual industrial sector. Domestic risk for financial sector also is identified in B&H fiscal position, significant rise of budgetary beneficiaries and a current account deficit financing. In B&H as result of financial crises, we identified problems in metal industry, industry of lather and etc. Increasing deficit in balance of payment indicate foreign capital inflows and indirectly credit booms. Financial stability in country can be determinate by structure and maturity of direct foreign investments. With inflation in country, we have volatility of financial assets prices, credit standings borrowers and volatility of collateral value. These entire events can result with problems in financial institutions liquidity and solvent position.

Figure 6: Monetary supply – M2 in period 2005-2016 (in million KM)



Source: Central bank of Bosnia and Herzegovina, Annual report, different years

Money supply increased in Bosnia and Herzegovina as result of foreign direct investment, capital transfer in balance of payment and through monetary policy decrease of requirement reserve rate.

3. MONETARY POLICY IN BOSNIA AND HERZEGOVINA

The Parliament of Bosnia and Herzegovina established Central bank of Bosnia and Herzegovina (CBBH) in 1997. The main goals and tasks of the Central Bank are defined by the Law and in accordance with the General Peace Agreement in Bosnia and Herzegovina. The CBBH maintains monetary stability by issuing domestic currency according to the Currency Board Arrangement with full coverage in freely convertible foreign exchange funds under fixed exchange rate 1 KM: 0.51129 euro. The CBBH must achieve the stability of domestic currency. The basic tasks of the CBBH are (Low, 1997):

- formulate, adopt, and control the monetary policy of Bosnia and Herzegovina
- hold and manage the official foreign exchange reserves of the central bank in a safe and profitable way
- support and maintains appropriate payment and settlement systems
- co-ordinate the activities of the BH Entity Banking Agencies which are in charge of bank licensing and supervision.

With aim to formulate and implement monetary policy the CBBH do not have possibility to manage with monetary policy instruments in relation to other central banks. Reason for that position of the CBBH is pure (orthodox) currency board system. A currency board is a monetary institution that issues notes and coins fully backed by a foreign "reserve" currency and fully convertible into the reserve

currency at a fixed rate and on demand. The reserve currency is a convertible foreign currency or a commodity chosen for its expected stability. The country that issues the reserve currency is called the reserve country. Table 4 lists differences between currency board and a typical central bank.

Table 1 Differences between typical currency board and central bank

Typical currency board	Typical central bank
Fixed exchange rate with reserve currency	Pegged or floating exchange rate
Foreign reserves of 100 per cent	Variable foreign reserves
Full convertibility	Limited convertibility
Rule-bound monetary policy	Discretionary monetary policy
Not a lender of last resort	Lender of last resort
Does not regulate commercial banks	Often regulates commercial banks

Source: adopted from Hanke, S., Schuler, K., Currency Board for Developing Countries – A Handbook, Institute for Contemporary Studies, San Francisco, USA, 1994, Access from <http://www.users.erols.com/kurrency/icegrev.html>

The CBBH has limited possibility to use monetary policy instruments. CBBH can not provide function of the “lender of last resort”. Only reserve requirement is instrument of the CBBH available for managing bank’s liquidity and restrict its credit activities. Through reserve requirement rate manipulation and changing requirement base in process of calculating reserve requirements the CBBH manage with financial stability in banking sector of B&H. Increasing in reserve requirements can be useful in one-off sterilisation of excess or otherwise inject liquidity. In table 5 we show changing in reserve requirement rate in BH in period 2000-2009.

Table 2: Manipulation of reserve requirement rate in BH 2000-2018

month, year of change	Reserve requirement rate - % change Reserve requirement base
1. January 2000.	5
1. January 2001.	5
1. January 2002.	10↑
1. June 2003.	5↓ expanding base on deposits in foreign currency
1. September 2004.	7,5↑
1. December 2004.	10↑
30. November 2005.	15↑
1. January 2008.	18↑
18. October 2008.	14↓
1. January 2009.	Differential reserve requirement

	14 – for deposits with maturity to 1 year 10 – for deposit with maturity from 1 year
1. May 2009.	Differential reserve requirement 14 – for deposits with maturity to 1 year 7 – for deposit with maturity from 1 year From reserve requirement base exclude state deposits for development
1. February 2011.	Differential reserve requirement 10 – for deposits with maturity to 1 year 7 – for deposit with maturity from 1 year From reserve requirement base exclude state deposits for development
1. July 2016.	10

Source: Central bank of Bosnia and Herzegovina, statistical portal

In the table 2 we can see activities of the CBBH in the period 2004-2008 in purpose to restrict credit expansion in B&H through increasing reserve requirements rate. Having in mind currency board limitation in using instruments for monetary policy as a solution for credit expansion, it is necessary to use combination of required reserve and prudential regulation:

- expression of concern in official letters to commercial bank
- informal contact with bank management
- thin cooperation with other supervisors
- grow sharp roles about providing «bad» loans
- prescribe or decrease loan to household to total loan ratio
- prescribe implicit credit limits (condition for hypothecs, loans in foreign currency etc.)

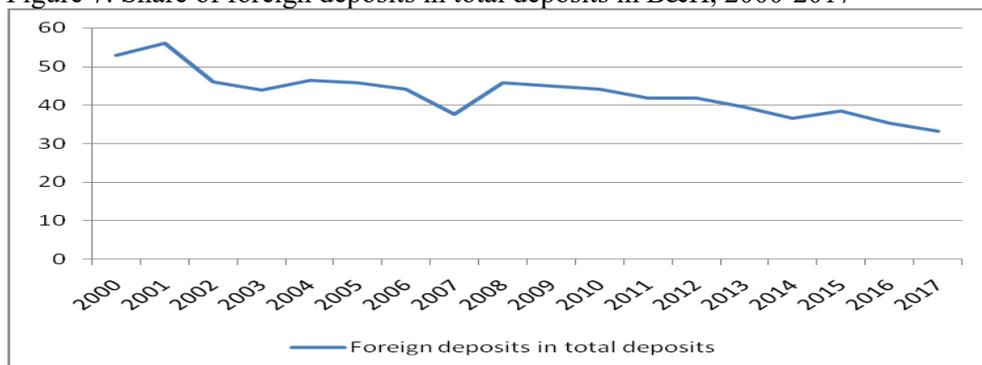
In addition, with financial crises developing the CBBH start to decrease reserve requirement rate and on that way make easy to commercial bank to deal with increasing need in liquidity. Last change of reserve rate is result of attempt to ensure through banks cheaper money to real economy.

In this situation and with undeveloped money market, banks must ensure adequate liquidity and involve best practise in managing liquidity risk. The CBBH must supervise situation with significant reduction of foreign exchange reserves which can negatively impact bank solvency. Developed capital markets can protect the economy from some global financial shocks by providing them stable and secure sources of liquidity. Specially, central bank in cooperation with the Ministry of Finance and public agencies has important role in developing the domestic money market (treasury bill market) and domestic debit market - government securities market (Živko, Slijepčević, 2006, pp. 137). The CBBH with Banking Agency on entity level must continuously supervise expose of domestic banking system to condition on home banking markets “contingent risk” and calculate stress test.

4. EUROZATION IN BOSNIA AND HERZEGOVINA - BARRIERS AND OPPORTUNITIES

Eurozation in transition countries was initially explained by the unstable macroeconomic conditions, a high inflationary environment, a loss of confidence in the domestic currency and a high degree of foreign ownership in the banking sectors. Figure 7 shows increasing dollarization ratios for Bosnia and Herzegovina between 2000 and 2017. The degree of dollarization is measured by deposits in foreign currency as percentage of total deposits.

Figure 7: Share of foreign deposits in total deposits in B&H, 2000-2017



Source: Central bank of Bosnia and Herzegovina, Annual reports, different years

From figure 7 it is clearly how B&H citizens use euro as store of value. This situation can be defined as assets submission as a form of eurozation. Assets submission describes the allocation of portfolios in assets denominated in foreign currency. By using euro, local residents try to avoid the negative impact of macroeconomic instability, inflation and depreciation of the currency. We can see from data how citizens decrease the use euro from 2001 to 2007, but as results of negative effect of financial crisis they again intensively use euro as store of value in banks. For this situation explanation we can find in historical facts unstable value of Yugoslavian dinar in ex-Yugoslavia and problems in banks and their failure in period of war which lead to distrust to the national currency.

Degree of eurozation depends on the limitations that monetary authorities impose on the circulation of foreign currency, its use in domestic transactions, alternative financial instruments in foreign currency and capital flows. In the absence of such restrictions, local residents can hold foreign currency in three ways: foreign currency in circulation, foreign currency deposits held in domestic financial institutions, and foreign currency deposits held abroad.

One of the expected benefits of full eurozation in the short run is the decline inflation rates and inflation expectations. When we analyse inflation rate in Bosnia and Herzegovina it is obvious that inflation is under control. That is result of

monetary regime which limited monetary authority in increasing monetary supply. Another benefit of euroisation is the perceived enhancement of economic policy credibility. By giving up control of the money supply, euroization encourages fiscal discipline; however, it also restricts any stabilizing response of fiscal policy to negative external or domestic shocks. Another implication of full euroisation is the restriction imposed on the monetary authority's role as the lender of last resort to the domestic banking system. An expected benefit from full euroisation is the reduction of the cost of borrowing. However, sovereign or default risk is still present and investors still respond to financial crises—real shocks as well as political and social conditions specific to a country.

Even if banks offer only deposits and not loans in foreign currency, a currency depreciation risk results from the currency mismatch of bank assets and liabilities. Another source of vulnerability for the financial system is the mismatch in the maturities of deposits and loans in foreign currency. Monetary and exchange rate policies should include the presence of foreign currency deposits.

5. CONCLUSION

Functions and operation of central bank are primarily determined with existing monetary regime in these countries. However, the CBBH has different role in banking system than other central banks in the South-eastern European region. The CBBH operates in system of currency board and has limits in its discretion monetary policy. Reserve requirement is only instrument in monetary policy in B&H. Reserve requirements present channel for managing liquidity of commercial banks and financial stability.

Paper content data about financial system structure, major indicator for banking and non-banking sector, list of internal and external risk in banks operating environment with macroeconomic environment at the end historical review of manipulation reserve requirement rate. Managing financial stability in B&H is limited. National authorities must work on improvement of existing monetary regime or creating additional channels for helping banking sector. Also solution for problem in regulation and supervision must be found. Commercial banks in such environment must carefully supervise their liquidity position and keep excess liquidity on their own or central bank accounts.

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POLITICAL CLIENTELISM AND CORRUPTION AS ECONOMIC AND SOCIAL EXCHANGE

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Review

Abstract

Althout, scientific interest in the informal economy is from a recent date, there are already serious analyzes that define its forms, as well as standardized methods that measure its scope. In this text we will point out some theoretical dilemmas concerning informal economy as a sector emebeded deeply in the society as a whole. The informal economy sector can be understood as a rational response by people to the way of life, the environment, the way in which the institutions work, the economic development of society or the culture itself - despite the fact that some consequences have an irrational character (exploitation, discrimination, violation of human rights and freedoms). Special attention is paid to political clientelism and corruption as forms of informal economy with a special focus on the situation in R. of Macedonia.

Keywords: *informal economy, political clientelisme, corruption*

JEL: E26, K4

1. INTRODUCTION

In scientific literature, as well as in social practice, are used various names for the informal economy. Researchers and other social actors use different terms, that is: gray economy, black, hidden economy, shadow economy, irregular economy, and other terms. Although each of these terms has its own specificity and different connotation, it is common for all of them that they are outside the official

accounting of a given state and belong to the informal sphere. Given the fact that it is a phenomenon that is characteristic of almost all countries in the world, and that in some countries it is more present than in others, analysts avoid giving a general definition by pointing to the need for local definitions that will express regional specifics (Schneider and Williams, 2013). Without a precise definition of the informal economy, it cannot be measured as such. According to Schneider and Williams, the informal economy refers to the deliberate concealment (hiding from public agencies) of market economic operations that are essentially legal. Such hiding is made for the following reasons:

- avoiding paying especially the VAT or some other taxes,
- avoiding the payment of social security contributions,
- avoiding achieving certain standards required by the labor market, such as minimum wages, maximum number of working hours, safety standards, etc.,
- avoidance of compliance with certain administrative obligations.

This does not include the illegal, so-called underground operations and the informal (self-sustaining) household or family economy. Within the framework of regional analyzes, there is an attempt to define the informal economy (Center for Study of Democracy, Sofia, 2011) where the following types of (in) formal economy are differentiated:

- formal economy (legal and declared/reported),
- economy for own support (legal, but undeclared): household/family production, unpaid volunteer work, self-employed persons, and small businesses,
- illegal (black) economy (illegal and undeclared) which includes illegal operations or the unlawful production of goods, as well as the economic operations carried out by illegal entities,
- undeclared (gray) economy (legal, but not reported or not fully reported); this involves non-reporting or incomplete reporting of legal business operations, failure to report all hired staff, and failure to report full income, tax evasion, and avoidance of payment of social security and healthcare contributions.

The interest in systematic study of the informal economy in the Republic of Macedonia is of recent date. The very term informal economy for many people is unknown, or rather obscure. The term gray economy is often used. According to official documents, the informal economy refers to the deliberate avoidance of declaration/reporting (registration) of legal business operations in order to avoid taxation.¹

According to Martha Alter Chen, the informal economy sector does not represent a phenomenon separate from society as a whole. The informal economy sector is not

¹ Action Plan for reducing the informal economy, 2015, Ministry of Labor and Social Policy, R. of Macedonia.

a secondary economy that would complement the primary one. It is part of the socio-economic context in highly developed, but also in less developed economies. In the post-World War II period, long-term economic growth per se was believed to lead to a reduction in the informal economy.² However, both in developed and in underdeveloped countries, a significant increase in informal employment has been registered at the end of the 20th century. The transition from mass to flexible production has increased the number of atypical jobs that are below standard working conditions and without social benefits. There is also a growing number of small businesses and workers working from home to survive. Especially in transition economies when massive bankruptcy of large state enterprises occurs, many workers would accept informal employment just to survive. The informal economy in a Macedonian context means resistance to the institutions and government-created regulations, but at the same time the opportuneness of groups close to the decision-making centers (Martha Alter Chen, 2012).

In the analysis of the informal economy, we cannot but introduce the international aspect, that is, globalization. Small and medium-sized enterprises (that is, home-based and/or family-run small businesses) are very difficult to withstand global competition, and many are limited by the closed local environment and informality. The informal economy can be viewed as a sector that gives many people the opportunity to overcome poverty (Martha Alter Chen, 2012). This is especially true for women - who due to their low qualifications and inadequate education - have hard time finding work in the formal sector. Thus, the informal economy sector can be understood as a rational response by people to the way of life, the environment, the way in which the institutions work, the economic development of society or the culture itself - despite the fact that some consequences have an irrational character (exploitation, discrimination, violation of human rights and freedoms). We find one of the examples in unpaid family workers. In the Republic of Macedonia, 50% of the respondents said that they are unpaid family workers who do not have any social benefits. From the perspective of its actors, the informal economy means flexibility and innovation.

Research in the Republic of Macedonia shows that the reasons for the informal economy lie in the low confidence of the citizens towards the institutions and the resistance to the rigid regulations created by the government. 21.6% of the respondents would prefer to be an undeclared worker with a high salary – rather than a legally declared worker with a low salary, implying formally paid social security and healthcare contributions. In addition, an important reason is the opportunism of groups connected to decision-makers (CRPM, 2015). The informal economy is based on close ties and connections and represents the continuity of the traditional economy. Informal or undeclared workers - although uninsured, low paid, and dependent self-employed - are also seen as "survival experts" or

² A concept known as the Lewis Milestone, 1954.

"entrepreneurial survivors" (Gallin, 2001: p. 531-532; Valenzuela, 2001). This is especially specific for the Republic of Macedonia and its local transitional context. According to the research on the informal economy in Macedonia, 68.5% of the surveyed citizens believe that it is an inevitable part of everyday life in the country (CRPM, 2014). This in turn tells us that the informal economy sector has legitimacy and responds to the needs of a very wide market - becoming an economy by the poor for the poor.

Business operations in the informal sector can be "economically efficient and profitable, although they are small-scale and restricted by simple technologies, small capital, and lack of connections with the other ("formal") sector" (ILO, 1973). In many cases, they help maintain the subsistence of the most vulnerable groups in society.

The data on informal economy measurements contribute significantly to the analysis of such economy. There are various methods by which its volume is measured. Among the methods used is the calculation of the consumed electricity according to which the informal economy accounts for 24% of GDP. According to the Labor Force Survey (Novkowska, 2013), the informal economy in the Republic of Macedonia is 47% of the GDP, while it is 46.3% according to the Multiple Indicators - Multiple Causes (MIMIC) model. According to the studies conducted in the Republic of Macedonia (CRPM, 2015), 40% of the respondents pointed out that they receive a substantial part of their salaries paid directly in cash, that is, not via bank account. However, it should be noted that the basic feature of the Macedonian economy is its low GDP, which is only 37% of the European Union average or mere \$4,000.

In the theoretical consideration of the informal economy, there are various theories about the causes that trigger it. According to the dominant, neoliberal paradigm, the informal economy is on the rise in circumstances when there is excessive regulation of the economy (rigid red-tape procedures). Economic operators in such circumstances - to avoid expenses (and time for registration as an expense) - operate in an informal manner. According to analysts who belong to the school favoring social regulation of the economy - the informal economy is on the rise in open and free market conditions. The Eurofound report (Eurofound, 2013) - where the link between the economic recession in 2008 and the development of the informal economy in the 27 EU member states was explored - shows that the neoliberal type of austerity measures (tax cuts, deregulation and minimal intervention by the state) is associated with the increased volume of the undeclared or unregistered economy.

2. INFORMAL ECONOMY AS POLITICAL CLIENTELISM

The informal economy becomes specifically expressed in context of political clientelism and corruption. According to Jean Francois Medard³, the term clientelism refers to an established personal relationship of reciprocity and interdependence between two individuals as such. Clientelism was mentioned even in the classical Greek and Roman period. In ancient Rome, a client was considered a person with an inferior social status in relation to his social sponsor or 'boss' from whom he received material support or other kind of protection, and in return, such client showed loyalty, gave election support, or showed public political approval/consent at the Roman forums. In the beginnings of the Western liberal democracy, the capacity of local politicians was measured according to the volume of favors that they could deliver to their local clients, that is, supported persons. Clientelism develops particularistic relationships, as opposed to the universalistic ones that are provided for by the laws. A person develops this kind of particularistic relationships because he expects a certain favor in return, because he is a kin or a member of the same group (clan, tribe, or party). A typical example of clientelism is when a poor man chooses a wealthy man for a godfather or main wedding witness; afterwards the entire family of the poor man expects social protection and social sponsorship from the wealthy man (Medard, 1976). In modern circumstances, clientelist relationships have started losing family or religious peculiarities thus becoming anonymous and mainly based on the labor market. In addition, modern clientelism has lost its personal aspects transforming itself into an impersonal political machine, that is, clientelist relationships have become institutionalized with stable expectations by the participants (S. Cvejić, 2016).

Political clientelism is the instrumentalization and introduction of personal relationships in the domain of politics. Clientelism is essentially a process of barter, trade, or rather an exchange, while political clientelism is a special kind of social exchange where there is a debtor-creditor relationship between two political entities in unequal social position. Thus, a person with a higher socioeconomic status (for example, a manager or social elite member, a 'boss') offers protection or some other favor to a person with a lower status (client) who, in turn, offers his loyalty, support or is at the personal disposal of the boss. The client - that is, the person with a lower status who receives a certain favor - loses his or her personal independence. If such relationships are practiced within the family and in context of extended family kinship and in-laws, then it is a matter of nepotism; on the other hand, if the scope of the relationship becomes very large, then one can talk about tribalism. Political clientelism thus represents an exchange of informal character and goes beyond formal principles of operation. The content of the social

³ Jean-François Médard, LE RAPPORT DE CLIENTELE, du phénomène social à l'analyse politique, Revue française de science politique, Année 1976, Volume 26, Numéro 1, pp. 103-131.

exchange varies accordingly. It could be employment, certain extraordinary income, commission fee, membership of various committees, customs relief, tax evasion, obtaining a prestigious function, and other things.

Clientelism as a concept approaches the framework described by Marcel Mauss in his book called *The Gift*. Clientelism means a reciprocal exchange between two persons, or groups that establish a personal relationship, in the past visibly based on kinship or tribal ties, on shared religious affiliation or status affiliation, as in the case of the exchange of the so-called potlatch. Although this exchange assumes a form of gift giving, that is, it is voluntary - it is nevertheless mandatory; free of charge - but with a calculated interest. According to Mauss, it is about arbitrary (informal) legitimization of the exchange in terms of the scope, type, or time of giving, which P. Bourdieu calls *symbolic* violence. The economic dimension here has variable amplitude. This kind of exchange cannot be reduced to its economic dimension, which is obvious in reciprocity - the obligation to give a gift, the obligation to receive the gift, and the obligation to reciprocate with a gift. Relationships in this traditional exchange are interpersonal, in most cases bilateral, followed by affective association, with many rituals where the usefulness comes to the foreground.

The revival of clientelism, especially present in transitional societies, is the outcome of the revival of traditional relationships in the domain of management of public goods and the way of accessing them. The transition to Western-style democracy is slow. A specific approach to institutions is characteristic - as if these institutions were constructed by an external factor, as a kind of implant that is unable to perform the right function. Here it is about the institutions of different kind: educational, health, social, and other. This approach is shared by the political elites and by the citizens who reproduce the clientelistic relationship whose intensity over time is multiplied.

According to Peter Blau, political clientelism is an exchange followed by power and debt that cannot be paid back. If there is a possibility to pay the debt, then the clientelist relationship could be terminated as such. From a psychological point of view, persons who hold some public office are, in a way, called to help, in the sense of noblesse oblige, while their clients are called to pay back or reciprocate, if with nothing else then with loyalty. In this context, operates the principle: *'I will help the one who has helped me'*. This shows the main difference that exists between the clientelism and the violent coercion, although in clientelism, compulsion is not excluded.

The terms political clientelism and corruption are often considered identical, primarily because of the effects, that is, the phenomena that they cause in social practice. The term corruption is associated with a single market transaction and basically represents an economic exchange as such. Political corruption is a

political decision so made that is aimed at gaining money, while political clientelism is an exchange of favors for the sake of obtaining votes in the elections.

The main goal of political clientelism is to maintain and be in power, as well as material benefits that are acquired at the expense of the state. Political clientelism is a kind of "disease" of the state, and therefore, there is an unproductive spending of public resources with a strong tendency to slow down the economic development as a whole.⁴ Over time, the clientelist system becomes rooted in culture, gaining legitimacy, while the entire economy is transformed into a kind of lease-and-rent-based system. In societies in which clientelism is deeply rooted in culture, economic operators, instead of investing in economic activities, tend to engage in the chain of transactions by becoming accomplices. Basically, the whole economy comes down to being a client, a mediator, an expert, or the like, to get hold of some of the public resources.

Studies carried out in African countries offer a clearer picture of the characteristic features of clientelism and its consequences. Namely, in these countries, political clientelism often leads to political crises, but also to civil violent fights. Namely, since the clientelist states lose the capacity for productive management of public spending, they show "thirst" for new resources; such "thirst" is settled by the introduction of new taxes or new foreign credits, which are followed by exercising even greater control and with new administrative repression. Under rare resource conditions, power tends to be highly centralized, down to the very leader and a narrow elitist core around him. The clientelist strategy is, in essence, severely discriminatory in relation to other people who have not become involved in the clientelist system. The exclusion from the system creates great dissatisfaction with non-clients becoming involved in the opposition, which then acquires new potential to launch a political crisis to win power and access to resources from which they were excluded. Thus, the system - where political clientelism becomes dominant - starts to crumble from within, i.e., it becomes self-destructive. This mechanism of the functioning of clientelism in Africa is recognized in our environment as well. The data and analyses of our context are not significantly different. In the transition countries, along with the development of democratic institutions, measures for strict fiscalization and income control have also been on the rise. There is a complete centralization of the budget revenues and expenditures by the executive branch and the creation of institutions for the violent collection of debts that are carried out by pressure, often of a physical nature. In essence, the weakened economy is the new energy of clientelism.

The clientelist state is a patrimonistic state. This is characterized by the privatization of the state where the holders of certain public offices (political or

⁴ Cartier-Bresson, 2010, «Le comparatisme à la croisée des chemins : La corruption entre analyse normative et positive». In: Le comparatisme à la croisée des chemins Autour de l'œuvre de Jean-François Médard. Karthala, 2010

administrative) use their position and their powers as if they were inherited, or as if they were some kind of personal property.⁵ This is about the usurpation of powers and public goods by the holders of public offices. This leads to the formation of a so-called *political class*, whose members use the state as a source of power, social status, income, wealth, and other benefits. The main goal of the patrimonistic state is to maximize the personal benefit of the so-called political class and maintenance of power by giving certain concessions to its clients. Patrimonistic states do not create their budgets according to certain economic criteria, but in context of how to maintain power (Buchanan and Wagner, 1977).

Very often as clients of political elites are the companies, that are tolerated in terms of non-payment of tax. This, on the other hand, leads to a reduction in the volume of public goods, but also to an increase in informal employment, which are seldom controlled by tax and labor inspections.⁶ According to European surveys, 9.7% (EWCS, 2013) of the respondents answered that non-registration of workers is the most serious factor of the informal economy. Salary given in cash-money envelope. According to the labor force surveys, 28.3% of the Macedonian net average salary (345 EUR) is received in cash-money envelope (CRPM, 2015).

According to studies conducted in Serbia, a significant segment of public resources is transferred into the hands of individuals via public enterprises and public procurement. Trustworthy and verified party members regardless of their education or expertise are appointed as general managers of public (state and municipal) enterprises, as well as members of their executive boards; that is, party activists who use public resources for individual gain or for the party in power (SeCoNs, 2016). Often, tenders are awarded to economic operators who are close to the political elites. There is a well-developed practice of adjusting the tender and public procurement criteria according to known and familiar participants, by informally informing such known participants about the conditions.

In the Republic of Macedonia, political clientelism is promoted by the high rate of unemployment that creates enormous pressure for employment especially in the public sector. Party-initiated employments in the Macedonian public sector set the regional records. The party headquarters, which are located in each town district, in each settlement or larger village, have become employment centers for party members and party sympathizers. This form of clientelism carries out a complete devaluation of human resources, emphasizing party loyalty and party commitment as crucial in finding a job. Informality here is reflected in the selection of jobseekers and the suspension of objective criteria. Such employment weakens the economy by stimulating the youth to be lazy and politically opportunistic, rather

⁵ Médard, J. F., D'Etat Patrimonialisé, Politique africaine, n° 39, septembre 1990, p. 25-36.

⁶ Cartier-Bresson, J., Tiers-Monde A., Corruption, libéralisation et démocratisation, 2000, Volume 41, Numéro 161, pp. 9-22.

than promoting entrepreneurship, skills development and labor productivity development. The non-clients, without alternative, are inclined to leave the state.

According to the research made by the Center for Research and Policy-Making in the Republic of Macedonia (CRPM, 2015), the country is dominated by a politically motivated economy. Thus, 33% of imports relates to companies close to the government that do not pay customs duties. In turn, they finance the political parties (CRPM, 2015). In this context, one should note that only six companies account for 50% of total imports into the country. According to the same survey, 69% of companies face informal or undeclared competition.

The reasons for clientelism are found in pre-industrial traditions and domination of the pre-modern type of logic, in the sense when Max Weber speaks about the various sources of power.

3. POLITICAL CLIENTELISM AND CORRUPTION

Clientelist relationships show corruption at the moment when clientelism - as social exchange from the domain of the private - is transferred to the public sphere (politics or administration). Corruption means the interference of private relationships in relations that need to be public. In ancient Rome, clientelism was not considered an illegitimate practice, in contrast to corruption that was illegitimate and illegal. Corruption is an exchange based on monetary transactions that take place in short time, while clientelism implies relationships of lasting character based on loyalty and friendship.

The notion of corruption is closely related to democracy, what Max Weber calls institutionalization, that is, the rule of law or the law-based state. Lack of transparency and lack of political accountability cause and trigger corruption as such. One can talk about existence of corruption in democratic states because the reasons for its existence lie in the evasion of democratic mechanisms and in the violation of human rights and freedoms by which all individuals are equal. According to Bresson, there is old and new type of corruption. The old type of corruption is characteristic of the Western states and comes to the fore at the time of state interventionism (protectionism) where it gives the right to make certain decisions for allocation of public funds to certain offices and functions. The new type of corruption is characteristic of states that adopt the Western system of democracy and allow the elites to deviate from the proclaimed goals. The two types can coexist, but in transition countries, the causes lie in poverty, the scarcity of public goods, incompetent administration, low wages in the administration, and clientelism leading to the appropriation of scant public goods.

Clientelism is based on particularism and protections that are contrary to the formal universalism of laws. Clientelism is associated with a particularistic redistribution

that deviates from the public interest. Analysts⁷ often cite the example of some African countries where the relationship between corruption and political clientelism is clearly visible. There, political power is maintained through a *rational* practice of distributing public goods (employment, protection, permits, etc.) in return for political support. The money - which the government collects from corrupt economic operations, especially through the international economy - must be reinvested in political like-minded people (that is, the political clients). If money is fully appropriated or deposited abroad without any part of them being distributed locally, then the position is threatened, and power of governments and elites becomes weaker. The stability of political power has its own dear price.

Corruption has not only an economic side, but also a political one because it supports a wide range of political clients who are necessary to support the policies of the government. When a head of state or of government appoints someone as director of a public company or a state institution, then he makes a private investment expecting broader support. When corruption assumes large scale, social ties with political supporters can break up, thus contributing to the loss of the legitimacy of this necessary core. It is thought that high corruption contributed to the collapse of ancient Rome because the clientelist relationship with the Roman military and the Roman citizens that were their supporters was terminated.

It can be concluded that corruption causes clientelism and vice versa. If corruption is widespread, it is then very difficult to recognize and define such corruption. In such a situation, it is not possible to separate the corrupted from the others who corrupt. Apart from the economic consequences of corruption that are most visible in the domain of inadequate consumption and the destruction of public goods for non-productive purposes, corruption also negatively affects the use of human resources by devaluing competences and talents. In conditions of massive corruption, quality human resources - instead of being engaged in productive (entrepreneurial) operations - are engaged in a corrupt employment system or seek a way to be engaged in transactions involving the distribution of public goods.

⁷ Médard, J. F., Clientélisme politique et la corruption, *Revue Tiers Monde* t. XLI, No 161, 2000.

Table 1. Key problems in the Republic of Macedonia (2016) (percentage of the population that identified the corresponding factors as a problem)

Category	
1. Unemployment	50.7%
2. Political instability	46.0%
3. Poverty	39.3%
4. Low income	39.3%
5. Corruption	30.9%
6. High prices	23.2%
7. Crime	17.4%
8. Ethnic problems	12.3%
9. Pollution of the environment	9.6%
10. Healthcare	7.3%
11. Education	5.4%

Source: MCIC Report on Corruption Assessment, 2016.

According to the same research, the main reasons for the prevalence of corruption are found in political elites and their thirst for rapid wealth, then in the inefficiency of the judicial system in the fight against corruption, and in the disregard of the laws. In the Macedonian case, there are not enough arguments to confirm the thesis that corruption is a phenomenon inherited from the former socialist regime, as it is the leading thesis in the Serbian research (Cvejic, 2016).

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ROMANIAN LABOUR MIGRATION IN EU AND ITS IMPLICATIONS ON ROMANIAN COMPANIES

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Review

Abstract

Romania is currently facing a labour crisis that has not ever known. The phenomenon is not new but has increased gradually so that companies operating in Romania encounter more difficulties in finding staff required for their activity. The reasons for this phenomenon are economic, plus the lack of national policies, that encourage young and skilled workforce to migrate. The article approach the migration of labour from Romania and focus on how this phenomenon affected companies' activities and solutions they initiated to counter the impact of the phenomenon.

Keywords: *European Union, Romanian companies, labour shortage, work migration.*

JEL: J2, J6, M5.

1. INTRODUCTION

Romania faces a strong workforce crisis, which is considered by some experts as the main problem of the Romanian economy. At the macroeconomic level, the employment rate indicates a positive situation and the objective that Romania has set in the Europe 2020 Strategy is close to be reached. However, Romania has a

employment rate below most of EU states. The first part of our article highlight Romania's situation in relation to other Member States in terms of employment and unemployment rates, as the main indicators characterizing the labour market. The data used for this purpose are those published by Eurostat in order to ensure comparability between countries and presenting trends in the phenomena analysed. In addition, we will use data provided by National Institute of Statistics (abbreviated as INS).

The second part of article addresses the issue of employment in terms of companies operating in Romania and who are forced to face the labour shortage. This crisis has many causes, mainly sustained by demographic change and migration of active population to other countries in the European area, due to the poor living in Romania.

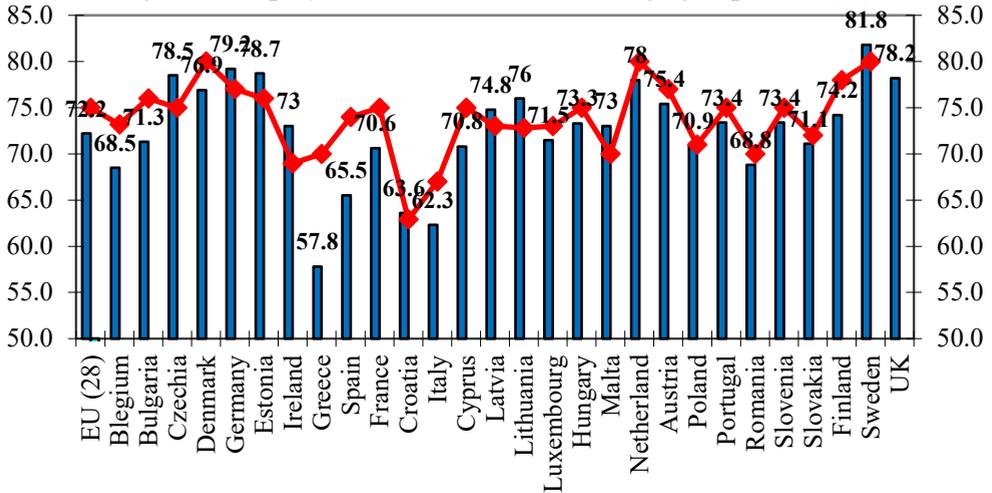
On the other hand, many foreign companies have chosen to work in Romania attracted by the low cost of manpower. As work demand decreased in number and skill level, these companies began to face difficulties in recruiting and retention of employees. Gradually workforce crisis has spread to new sectors, the lack of personnel manifesting both employees with higher education and skilled workers. As a result, we highlight the main sectors affected by the lack of manpower, personnel shortage occupations and solutions adopted by companies to cope with this phenomenon.

2. MACROECONOMIC PERSPECTIVE ON EMPLOYMENT AND UNEMPLOYMENT

2.1. Romania versus other Member States

Macroeconomic indicators characterizing labour market in Romania indicate a positive situation, ie a high employment rate for the population aged between 20 and 64 years, and low levels of unemployment. Increasing employment is one of the objectives of Europe 2020 Strategy, each Member State establishing a certain level of employment as a target by the year 2020. Regarding Romania, the target was set at 70%. Employment has a higher rate in Romania compared to countries like Greece, Italy, Croatia, Spain, Belgium, but mostly it is noted that the employment rate is close to that fixed in the Europe 2020 Strategy. Figure 1 shows, by column, the employment rate achieved in Member States in 2017, while the red line indicates the employment rate assumed by each country by 2020.

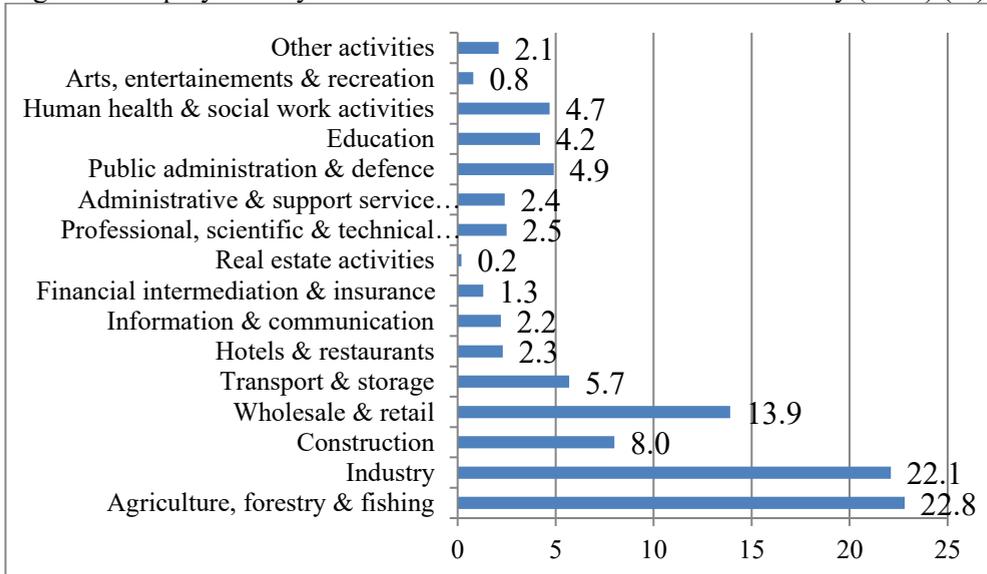
Figure 1. Employment Rate in UE in 2017, age group 20-64 (%)



Note: red line indicate employment rate targeted by each MS according to Europe 2020 Strategy. Source: Eurostat Data.

Regarding activities that have absorbed most of the workforce in Romania, industry and agriculture hold a similar proportion (22%), followed by sectors of wholesale & retail (14%) and construction (8%) (Chart no. 2).

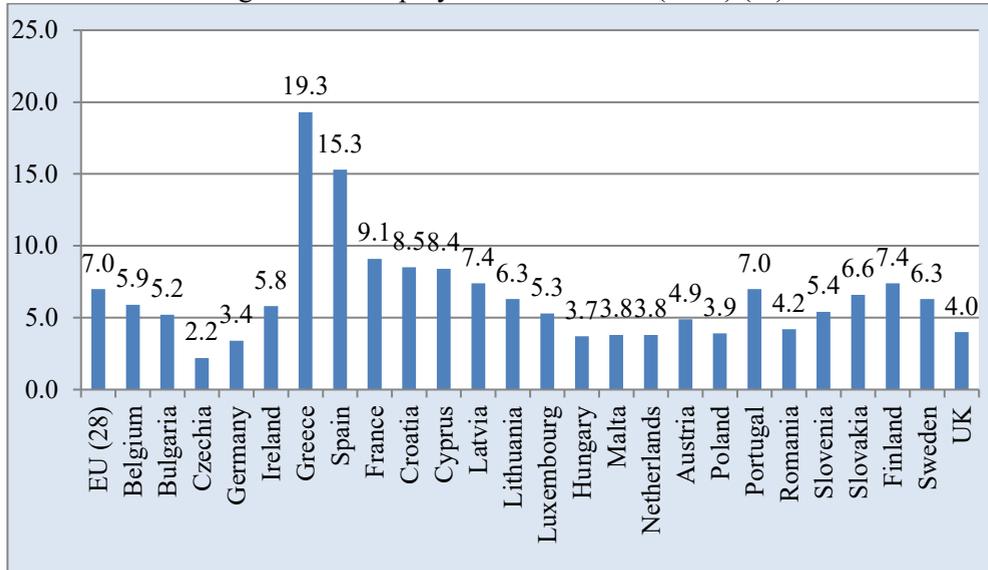
Figure 2. Employment by the Main Activities of the National Economy (2017) (%)



Source: INS (2018), "Romania in Figure", p. 22.

Regarding unemployment, Romania had in 2017 one of the lowest levels if we compare with other EU countries. Romania has an unemployment rate below the EU average and only a few countries have recorded lower rates than Romania (Czech Republic, Germany, Hungary, Malta, Netherlands, Poland, UK) (Chart no. 3).

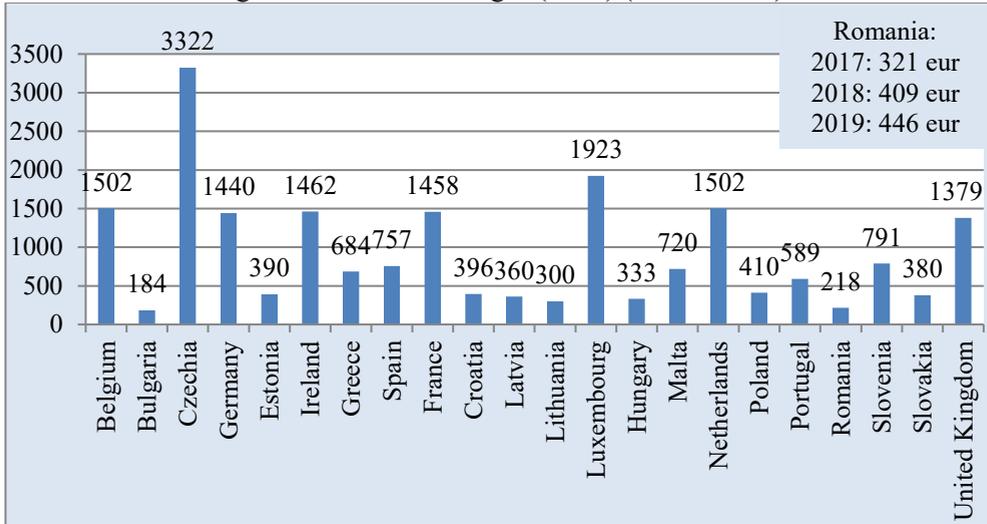
Figure 3. Unemployment Rate in UE (2017) (%)



Source: Eurostat Data.

On the other hand, Romania remains in the bottom of the EU countries in terms of monthly income. In 2015, it was 218 euro/month in Romania, only Bulgaria having a lower level (figure 4). Meanwhile, Romanian government policies have led to a gradual increase of the minimum income guarantee; the last increase is applicable from January 1, 2019.

Figure 4. Minimum Wages (2015) (EUR/month)

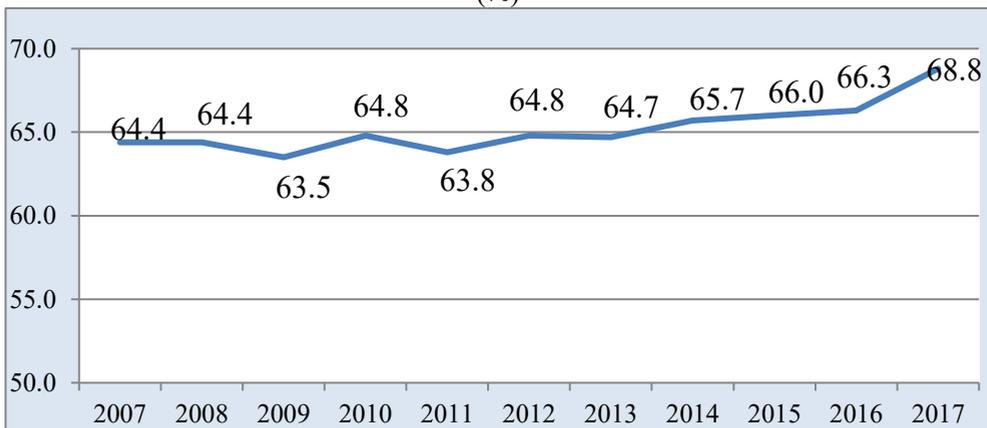


Source: Eurostat Data & Ministry of Finance of Romania.

2.2. The trend of macroeconomic indicators in Romania

We highlighted above that according to the latest statistical data on macroeconomic indicators, Romania had a positive situation relating to the labour market but the question is whether those values reflect a circumstantial situation or a constant process of improvement. From this point of view, analysis of data for the entire period that followed accession to the EU shows that the employment rate was characterized by consistent growth (figure 5).

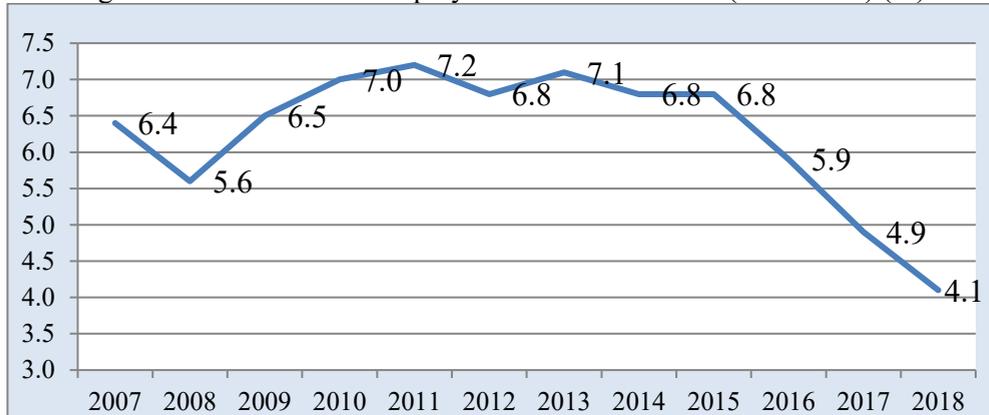
Figure 5. Romanian Employment Rate between 2007 and 2017, age group 20-64 (%)



Source: Eurostat Data.

The unemployment rate was much sinuous: after a slight decrease immediately after joining the EU, the unemployment rate increased in the period 2008-2011 in the context of economic crisis that affected Romania, fluctuated slightly between 2011 and 2014 and later fall steadily (Figure 6).

Figure 6. Evolution of Unemployment rate in Romania (2007-2017) (%)



Source: Eurostat Data.

3. LABOR SHORTAGE IN ROMANIA: CAUSES AND IMPLICATIONS AT THE MICROECONOMIC LEVEL

The significant decrease in unemployment in recent years, beyond the positive macroeconomic situation reveal a serious problem of the Romanian economy, that of labour shortage. According to the statement of the Minister of Finance in June 2018, Romania has a labour shortage of nearly one million people, while the number of unemployed recorded at the end of 2017 was less than 550,000 persons [Popa F., 2018]. The causes of the workforce crisis in the Romanian economy are manifold. It is primarily the migration of labour from Romania to other countries, especially the EU space. The migration phenomenon has manifested itself before the EU accession but stressed by the time of Eu accession. In 2016, Romania has come to occupy the 4th place in the EU after the number of citizens living abroad: about 3.4 million people, ie 16% of the population. From this point of view Romania is surpassed only by the UK (4.9 million immigrants), Poland (4.4 million immigrants) and Germany (4 million immigrants) [Protv, 2016]. The main reason for migration is the standard of living in Romania, as well as low levels of earnings. Although Romania has recorded in the last 10 years the largest increase in the minimum wage to other EU countries (an increase of 195% in 2018 compared to 2008), the wage is much lower than in Western countries [KeysFin, 2018]. In addition, specialists are looking for professional development opportunities foreseen certainly abroad (for example in healthcare or scientific research areas).

Demographic changes also affect the labor demand, as Romania is characterized by a pronounced negative natural growth accompanied by aging population. According to European statistics, Romania's population decreased by 7% in 2007-2017 and is projected to drop by 13% by 2040 (compared to 2017) and 26% in 2080 (compared to 2017) [Eurostat]. Therefore, from 21.1 million in 2007, Romanian population was 19.6 million in 2017 and will be only 14.5 millions in 2080, the phenomenon having a clear impact on the labor market.

On the other hand, most migrants are young people in the age group 30 -45 years; it is a loss of people who can contribute to population growth but also to ensure a higher level of productivity at work, and few of these people will come back to the country [wall-street.ro].

Besides labor migration another negative phenomenon became noticeable namely the low level of preparedness of those left behind. According to Eurostat, Romania is the third country in the EU by the school dropout rate, with over 18% of young people aged between 18 and 24 leaving secondary and higher education before completion [Popa F., 2018]. In addition, the gap between the education system and the labor market requirements make many of higher graduates not have knowledge and skills sought by employers, and vocational education is weak [Hostiuc C., 2018].

The main sectors affected by the lack of labor force are shipbuilding and hospitality, but the causes are different: in shipbuilding missing qualified welders because although well paid, they have already gone abroad and no one can find highly qualified personnel. In hospitality, the main cause of the lack of staff is linked to low salaries. [Bechir M., 2018]. Other areas where the scarcity of labor is significant are: manufacturing, health sector, trade and public sector [Alexe I., 2017].

In terms of qualifications, the greatest demand for labor is among specialists (such as IT programmers, engineers, finance...), plus staff for services, machinery and machine operators, assemblers for machinery and equipment and skilled workers. [Alexe I., 2017]. Demand for labor is not uniformly expressed nationally; especially big cities and Bucharest are on top.

4. SOLUTIONS ADOPTED BY COMPANIES IN ROMANIA TO FACE LABOR SHORTAGE

Romania is not the only EU country facing shortage of a skilled workforce. With an unemployment rate of only 2.2% in 2017, Czech Republic faces also a lack of manpower and the solution applied was attracting workers from other European countries, poorer, such as Romania and Bulgaria. Meanwhile, Poland has used the import of labor force, especially from Ukraine; it is estimated that were attracted about one million Ukrainians, most after the beginning of the conflicts in the

breakaway regions in 2014. To this was added workers from Asian countries (Nepal, India, Bangladesh) [Bechir M., 2018]. Romania also applied the solution of import of labor force. But given the low salaries, Romania is forced to focus on countries where earning is even lower. Thus, Romania imported manpower mainly from Asia: in 2017 most of workers came from Vietnam, while in 2016 the majority was Chinese. In addition, Romania imported labor from countries such as Turkey, India or Republic of Moldova. [Ciobotaru T., 2018]. Nationally, the quota of foreign workers for 2017, set at 3,000 people was exceeded, leading to 3211 persons. Following the acute need of manpower, the Government increased the quota of manpower imported by 7,000 people for 2018 [Lazurca A., 2018].

Workforce crisis has prompted more companies to resort to companies specialized in recruitment. Thus HR market increased from 2.06 billion lei in 2012 to 3.6 billion lei in 2017, and the number of recruitment companies increased by 20% in 2016 compared to 2012 while their net profit nearly doubled. The development of this type of activity was largely in areas economically dynamic: Bucharest-Ifov, Cluj-Sibiu, North-Eastern, Constanta-Dobrogea, Timisoara-Banat. The radiography of geographical distribution of recruitment companies outlines disparities at national level in terms of economic development: areas Moldova, Oltenia and Muntenia have fewer HR companies and these areas are also those in which most people have migrated abroad. [KeysFin, 2018].

In order to cover staff shortage, employers in Romania oscillates between attracting employees from other companies by offering advantages over competitors (practice called Head-Hunting), and the practice of human resources policy geared to maintaining its own employees and improving their training (paid internships, facilities for personal development, vocational school organized by companies). A common way to keep employees is to provide facilities such as meal vouchers, gift vouchers, bonuses depending on activity increase, holiday bonuses, medical packages or life insurance.

However, there are few companies who decide to increase the minimum wage granted as a way of attracting potential employees, and for keeping those already won. Many foreign companies choose Romania just because work force is cheap. An example is the customer support companies that prefer to open offices in Romania and hire call center or back office operators who assist clients in French, Spanish or German. On the other hand, there are companies in the retail sector who decided to increase the gross minimum wage well above the guaranteed minimum wage at national level to attract employees (for example, Lidl set this level to 750 eur compared with 445 eur how is nationally).

Another solution identified by employers is a partnership project based on outsourcing of company' services to independent specialists or to micro enterprises [KeysFin, 2018]. Beside lower cost labor, this solution has other advantages: lower

logistics costs, execution time shorter. The solution encourages people with entrepreneurial spirit, willing to work for many companies to improve earnings.

5. CONCLUSION

We have highlighted in our article that Romania has a lower employment rate than most EU countries but close to the target set for 2020, and a rather low level of unemployment. Even if this situation is positive, Romania is facing a deep crisis of labor in many sectors of national economy: manufacturing, construction, retail, HORECA, healthcare and public sector, both in terms of specialists and qualified workers. Despite this, Romania remains attractive to foreign investors, especially by low labor costs. In fact, one of the main reasons for the lack of workforce is its migration in search of earnings greater than those existing on the national market. The apparently simple solution to increase the minimum wage at national level to stop the flow of labor to other countries, and to determine a number of Romanian migrants to return home is offset by the effects that such a policy has on companies costs. As a result, there are few companies that have decided to increase the salaries and financial benefices to attract and keep employees.

In this context, macroeconomic policies need to support investments capable of ensuring the competitiveness of firms given than staff cost increase. Developing vocational education is another solution that can provide professional skills of certain groups of young people (such as those in areas with low economic development, young at risk or in dropout situation) and, on the other hand, skilled workers for trades heavily sought on labor market. Vocational schools are needed in all areas, from automotive to agriculture, from material processing to craftsmen. In the short term, however, employers are forced to continue fighting to hunt employees from competitors, to seek to import personnel from countries poorer or to form their own staff and to provide sufficient professional motivation so they can keep it as long.

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