

**“Free Trade Zone in Southeast Europe:
Achieving Genuine Regional Economic Integration”**

POLICY PAPER

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Scope of the Problem

On 27 June 2001 seven countries in Southeast Europe: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania and FR Yugoslavia signed in Brussels a Memorandum of Understanding on the establishment of a Free Trade Zone in the region by the end of 2002 on the basis of bilateral trade agreements. As of October 2002, 11 new bilateral free trade agreements (FTAs) are still to be negotiated in order to consider the above process successful.

Although the negotiation process is well underway, the public perceptions on the economic implications of the regional trade liberalization processes are still skeptical. A number of questions remain open for discussion among the governments of these countries, the experts and the society. *What is the “big picture”? Can we find similar examples in Europe? What are the specific implications for each country? What can be learned from the experience of other countries facing similar developments? How long it will take to catch up with the EU Member States?*

The author argues that the dynamics of mutual consent achieved in the process of negotiations of the SEE framework of FTAs should be maintained. One the most sensitive mutual problems that request special attention is the struggle for sustainable economic growth. In order to achieve this objective the SEE governments must develop a common agenda to sustain and even accelerate the present economic growth rates. One possible solution to the mutual problems experienced by the seven SEE governments can be the creation of *a roadmap of SEE countries for achieving sustainable growth*. The roadmap for sustainable growth can be the next step after the liberalization of trade towards achieving genuine regional economic integration.

Trade relations of Bulgaria with the SEE countries

The anticipated effects of trade liberalization among the seven SEE countries can be considered as rather diverse. Trade liberalization means not only changes in the business environment, which leads either to boost in the economy or to increased external competition for a number of industry sectors. It means also changes in social and cultural attitudes. Trade liberalization has many faces and by looking at the region as a whole some specifics of trade relations may be omitted or underestimated in the analysis of the anticipated effects.

Future trade liberalization in Southeast Europe will be largely in favor of Bulgarian export to the countries in the region. The most important trading partners of Bulgaria within the region are Romania, Yugoslavia and Macedonia. Trade turnover with Albania, B&H and Croatia is still insignificant and trade opportunities are to be further explored. The further reduction or eliminations of trade barriers will provide for more opportunities for Bulgarian companies looking for expansion in Southeast Europe. As remaining obstacles to trade can be pointed out: lack of sufficient infrastructure, low purchasing power of end consumers in the region, general political and economic instability present in some of the SEE partner countries.

Although a number of infrastructure projects are well under way successful finalization of these projects can be expected in the medium term. The struggle for better living standards and against the instability will remain a major challenge for the policy makers in these countries in the medium and long run. On the other hand, changes in existing trade regimes have to be made only after consultations between the relevant governments in order to avoid misunderstandings (for example the conflicts between Bulgaria and Macedonia).

Successes and failures of trade liberalization in CEE: the case of CEFTA

Successes and failures of the 10-year long history of CEFTA are overlapping in a number of ways and produce a mixed picture of skepticism, humble enthusiasm and half smiling faces. It is the year 2002 and it seems that trade barriers within CEFTA do not exist any more. “What a success!” – the optimists would say, “But achieved for almost 10 years” – the skeptics would claim.

Successes, failures and reasons

Undoubtedly, achieving a high level of trade liberalization within CEFTA countries can be claimed a success. The main objective of formation of CEFTA – acceleration of accession to the European Union is closer than ever. The Czech Republic, Hungary, Poland, Slovakia and Slovenia are expected to join the EU in 2004, while Bulgaria and Romania has received roadmaps identifying the route of the prospective membership after 2006. On the other hand, CEFTA has been for all its members a useful exercise preparing them for entering the common market of the EU and strengthening their administrative capacity.

The main failure of CEFTA was the lack of enthusiasm in achieving fast track trade liberalization. The officials within CEFTA member states seemed to underestimate the political and economic effects from the formation of this new trade block and mutual efforts have not achieved spectacular results. Liberalization of trade on agricultural products was remarkably slow, which contributed to the perception of CEFTA as half-success.

The reasons for the failure of some of CEFTA objectives can be summarized in the following way:

- Fears within the political elites of allegations with CMEA (Council for Mutual Economic Assistance).
- Fears that regional economic integration will be one of the reasons for delayed EU membership;
- Fears that scarce administrative resources will be diverted in a less beneficial direction in terms of political and economic outcomes;
- Lack of understanding on the effects of free trade on economic performance on a macro level and the functioning of market economy in transition periods;
- Lack of experience in dealing with trade negotiations in free market conditions.

The above list is of course not exhaustive. Within the years of functioning of CEFTA government officials had various prejudice related to the operation of the free trade block, depending on their personal preferences and driven by the dynamics of the political agenda. However, from the current standpoint we can claim that none of fears (reasons) underlying the slow pace of trade liberalization was completely justified. CEFTA has not been perceived as an alternative of EU membership by the EU member states and fears from allegations with CMEA were overestimated.

CEFTA versus the Free Trade Zone in SEE

Irrespective of whether CEFTA will continue to exist or not, what can now be observed in Southeast Europe strongly resembles the history of CEFTA. Even worse, as far as CEFTA members are more economically developed in comparison to most SEE states, the process of EU integration of the SEE states cannot be foreseen to accomplish within 10-15 years (except for Bulgaria, Romania and may be Croatia).

This fact will arguably bring much more fears within the political elites of the members of the free trade zone in Southeast Europe, than in the CEFTA case. The main concerns are currently observed among the more developed states: Bulgaria, Romania and Croatia.

The fear from delay in the EU accession process due to the increase of the group of “second wave” countries – i.e. with Albania, Macedonia and Croatia would have cemented the undergoing liberalization of trade in region as regards to Bulgaria and Romania. Fortunately, the final declaration of Copenhagen Summit as of 13 December 2002, secures the entry of Bulgaria and Romania into the European Union in 2007 if both countries complete their preparation for accession. Although, the guarantee made by the European Union is quite vague it will inevitably calm down the political uncertainty in the region and will make the governments of Bulgaria and Romania more cooperative with the other SEE partners.

The lessons learned from the 10-year history of CEFTA should be considered carefully in view of the prospective establishment of the Free Trade Zone in Southeast Europe. Although the internal political fears cannot be completely alleviated, the European Commission and international financial institutions should carefully monitor the related processes and take proper action in order to avoid the potential exposures. Prospective NATO membership of Romania and Bulgaria will undoubtedly add pressure and the existing interest on the formation of the Free Trade Zone will be hardly balanced.

Foreign Direct Investments and Tax Incentives

The relationship between foreign direct investments (FDI) and tax incentives are subject to a continuing debate. Experts from the international financial institutions support the notion that the tax incentives lead to the erosion of the tax base and create macroeconomic instability, which does not lead to a substantial increase in FDI.

However, even in the European Union a number of tax incentives exist, and the Member States are somewhat reluctant to eliminate the grounds for tax competition among themselves. This fact sharply contradicts the requirements of the EU towards the appropriate tax policies in EU candidate countries. In addition, in six of the seven SEE countries of the Free Trade Zone (excluding Albania) there exist a number of corporate tax incentives, which have not actually attracted significant FDI inflows by the moment.

The following table provides general information on the existing tax rates within the SEE countries and availability of tax preferences:

Table 1: SEE-7 Tax Systems in 2002

	Corporate Rate	VAT	Double Tax Treaties	Tax Holidays
Albania	25	20	16	n.a.
B&H	30/10*	n.a.	1	Yes
Bulgaria	23.5	20	51	Yes
Croatia	20	22	30	Yes
Macedonia	15	19/5	23	Yes
Romania	25	19	67	Yes
S&M**	20	n.a.	20	Yes

Source: Investment Guide for Southeast Europe 2003/ Seeurope.Net.

Notes: * The lower rate applies for Republika Srpska

** As of March 2002, Serbia and Montenegro apply separate tax legislation. The information above refers to FR Yugoslavia.

The lowering of the trade barriers as a result of the formation of the Free Trade Zone will most likely lead to more acute tax competition among the SEE governments. Substantial customs revenues will no longer be available as their value will most likely be reduced over the coming several years. In addition, the world economic situation is not improving at the anticipated speed and GDP growth rates within the Euro Zone (the main trading partner of the SEE countries) are likely to remain rather low. Thus, even if foreign investors are granted a full corporate tax exemption (and most of the SEE countries do) large foreign investments can hardly be attracted in the short run.

A way out of the situation is the gradual reduction of the most generous tax incentives, focusing of the efforts of SEE governments on macroeconomic reforms, intensified capacity building of tax and customs administration and further educational reforms. As long as the corporate income tax rates are already rather low and tax preferences are wide spread (see Table 1), the SEE governments should avoid the temptation of continuing tax competition. Instead of engaging in even more aggressive tax competition the governments should try to coordinate from now on their tax legislative reforms as far as they are to become equal partners within the Free Trade Zone.

High Achievers and Slow Performers in Southeast Europe

GDP growth rates among the countries of Southeast Europe are rather diversified and have changed quite a lot over the last five years. For 1997, Albania, Bulgaria and Romania have experienced negative growth rates. In the year 2000, Albania and Serbia and Montenegro (FR Yugoslavia) showed very high levels of GDP growth, Bosnia & Herzegovina, Bulgaria and Macedonia maintained a modest level of GDP growth, while Romania and Croatia are a little bit lagging behind.

GDP growth rates and living standards

For the year 2001, growth in terms of GDP as compared to 2000 levels has slowed down in Albania and Bosnia & Herzegovina and has increased in Romania and Serbia and Montenegro (FR Yugoslavia). On the other hand Macedonia has experienced a negative GDP growth rate for 2001. Bulgaria and Croatia have maintained relatively similar growth rates as compared to 2000 at approximately 4%.

Table 2: SEE-7 GDP and growth rates for 2001

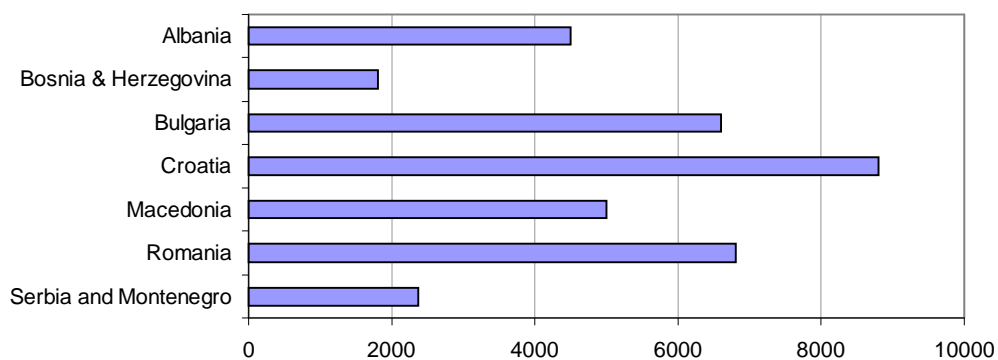
	GDP (USD million)	GDP real change (%)
Albania	4,186	6.5
B&H	4,638	2.3
Bulgaria	13,555	4.0
Croatia	19,533	3.8
Macedonia	3,426	(4.6)
Romania	39,714	5.3
S&M*	10,500	6.2
SEE – 7	95,552	4.5

Source: wiiw database incorporating national statistics 01/2003

Notes: * Data for FR Yugoslavia

However, it should be noted that high growth rates do not represent automatically better living standard for the average population. If we analyze the GDP per capita estimated at purchasing power parity (PPP), we will see that only Croatia maintains a comparatively high level of this ratio – approximately USD 8,800. For Serbia and Montenegro the ratio does not exceed USD 2,500. Albania's GDP per capita is USD 4,500, while Bulgaria and Romania levels are below USD 7,000.

Table 3: SEE-7 GDP per capita PPP in USD'000

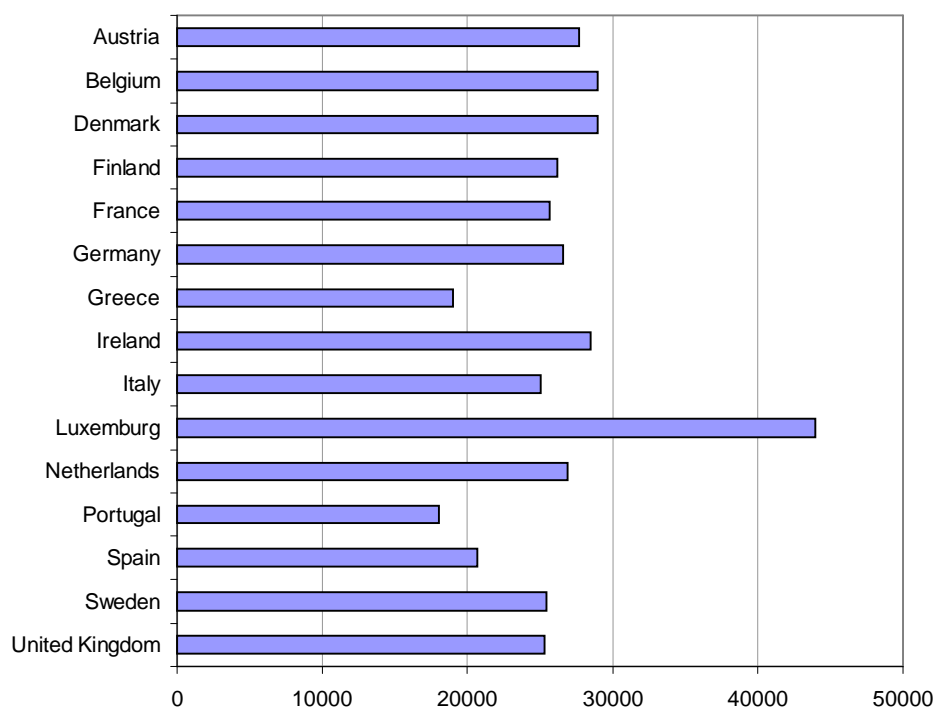


Source: CIA – The World Factbook 2002

Note: Data for Bosnia & Herzegovina and Romania for 2001.

If we compare the levels of the GDP per capita in terms of PPP with levels of the current EU Member States such comparison will look rather disappointing.

Table 4: EU-15 GDP per capita PPP in USD'000



Source: CIA – The World Factbook 2002

How the Free Trade Zone in SEE affects economic growth?

If the present levels of the growth rates are preserved, it is not very likely that these countries will soon catch up even with the poorest EU Member States. *What is the effect of liberalization of trade in Southeast Europe on GDP growth rates?* The following table presents information on SEE intra regional trade:

Table 5: SEE-7 intra regional trade for 2001 in USD million

	Export to SEE	Import from SEE	Balance
Albania	8	74	(66)
B&H	343	893	(550)
Bulgaria	500	216	284
Croatia	788	249	539
Macedonia	497	419	78
Romania	366	227	139
S&M	547	414	133
SEE – 7	3,049	2,492	557

Source: wiiw database incorporating national statistics 01/2003 and author's calculations

The balance of trade for the SEE seven countries is positive USD 557 million. If we calculate the weight of intra regional trade balance to overall GDP (as per Table 2 above) the weight will be 0.58% (USD 557 million/ USD 95,552 million). Based on this figure we can estimate the additional effect of trade liberalization on GDP growth rate: the weight of SEE intra regional in SEE – 7 GDP (0.58%) is multiplied by the SEE – 7 GDP real change (4.5% as per Table 2 above). Thus, the average effect of SEE trade liberalization on future GDP growth rate of each SEE country is approximately 0.026%.

Although the figure is based on 2001 figures of import, export and GDP for the seven SEE countries when trade among SEE countries was not fully liberalized, in the subsequent analysis it will be used as the minimum addition to the estimated GDP growth rates of the countries. It can be anticipated that the impact of future liberalization of trade among SEE countries will further increase the ratio through increased weight of intra regional trade on GDP. However even if intra regional balance of trade doubles in value in the medium run the ratio's value is not likely exceed 0.05%.

It should be noted that the establishment of the Free Trade Zone itself in combination with the SEE cheap labour costs would be an additional incentive for foreign investors, which can ultimately boost economic growth due to the increased intra regional trade. Nevertheless, the real effect from the creation of the Free Trade Zone on regional economic developments can only be estimated within a period of 3 to 5 years from the start of the free trade in Southeast Europe.

Is cohesion with the EU Member States possible?

The present research findings suggest, that the process of catching up (cohesion) of the levels of GDP per capita (PPP) with the present levels within the EU may take up a significant number of years even generations.

The following table provides a general idea of how long it will take for each SEE country to catch up with the *poorest* EU Member State – Portugal considering three scenarios of average annual GDP growth in SEE: slow performers (GDP growth 2%), moderate performers (GDP growth of 4%) and high achievers (GDP growth of 8%). The anticipated effect of SEE trade liberalization in terms of additional 0.026% annual GDP growth is also considered to obtain a full picture of the impact of the Free Trade Zone on the cohesion process.

Table 6: SEE years of cohesion with present level of GDP per capita (PPP) of Portugal

	Slow performers (GDP growth 2.026%)	Moderate Performers (GDP growth 4.026%)	High Achievers (GDP growth 8.026%)
Albania	2072	2038	2021
B&H	2118	2061	2033
Bulgaria	2053	2028	2016
Croatia	2039	2021	2012
Macedonia	2067	2035	2020
Romania	2052	2028	2016
S&M	2104	2054	2029

Source: Author's calculations

Note: Portugal's GDP per capita in terms of PPP for 2002 is USD 18,000. The starting (base) year is 2003.

The results look rather unpleasant even for the 2007 EU accession countries: Bulgaria and Romania. The high level of base GDP of Croatia gives undoubtedly the country a steady lead as compared to the other SEE countries.

If we try to calculate the anticipated year of cohesion of arguably the *richest* EU Member State the outcome will be even more discouraging:

Table 7: SEE years of cohesion with present level of GDP per capita (PPP) of Luxembourg

	Slow performers (GDP growth 2.026%)	Moderate Performers (GDP growth 4.026%)	High Achievers (GDP growth 8.026%)
Albania	2117	2061	2033
B&H	2162	2084	2044
Bulgaria	2098	2051	2028
Croatia	2083	2044	2024
Macedonia	2111	2058	2031
Romania	2096	2050	2027
S&M	2149	2077	2041

Source: Author's calculations

Note: Luxembourg's GDP per capita in terms of PPP for 2002 is USD 44,000. The starting (base) year is 2003.

Given the above, in case the GDP growth rate in the region slows down it may take from 80 to 145 years to the region to catch up with the present level of Luxembourg's GDP per capita (PPP).

Obviously, the higher growth rate a country maintains the quicker cohesion with a more developed state will be achieved. A web based simulation model is developed to estimate the years in which each country can achieve a reasonable level of living standards in terms of GDP per capita (PPP). The simulation model also considers the long-term economic effects of the establishment of the Free Trade Zone in Southeast Europe as a separate process. For more calculations on your own, please follow the link: www.policy.hu/ranchev

Undoubtedly, cohesion of SEE countries with the current European Union Member States will not be achieved in the short run as desired by most local politicians pressed by the electoral limits. However, the struggle for sustainable growth within the SEE should proceed further and be stimulated by the international community and financial organizations. The slow down of the economic growth in the euro zone represents an additional challenge to the SEE – 7 countries. On one hand cohesion date seems closer, on the other hand as the EU is the main trading partner of the countries in Southeast Europe the recession in the EU may have a spill over effect on the region as a whole. So far, the global economic crisis has not affected significantly the seven SEE countries – growth rates are above the average ones within the euro zone and projections for the economic development still look encouraging. As FDI on a global scale is decreasing and investors become more and more precautionous, the impact on SEE FDI inflows and their input on medium and long term GDP growth are definitely uncertain.

Although, the direct impact of the establishment of the Free Trade Zone on GDP growth and finally on the acceleration of cohesion is not significant, the liberalization of trade has indirect effects which will contribute to sustainable growth in SEE. Such effects should by no means be underestimated – increased regional security, minimization of trade costs, creation of a single market of over 55 million people, which can attract fresh FDI inflows, etc.

So, is distant cohesion date really a problem for the SEE countries? The author is of the opinion that the short answer is - not at all. As long as the countries sustain their growth rates and continue their economic reforms cohesion will come sooner or later. The problem really is how to sustain the economic growth. In order to maintain the present GDP growth rates and even to exceed them, each SEE country should develop *a roadmap for achieving sustainable growth* on the basis of an analysis of their relative strengths and weaknesses. The deepening of trade liberalization in the region will continue to be high on the agenda of the struggle for sustainable growth and is for sure a comparative strength rather than a weakness.

Avoiding the Traps

The process of the establishment of the Free Trade Zone in Southeast Europe is almost finalized. The following table provides information on the existing (concluded) Free Trade Agreements (FTAs) among the SEE – 7 countries that have signed the Memorandum of Understanding.

Table 8: Existing SEE-7 FTA network as at 4 March 2003

	ALB	B&H	BUL	CRO	MAC	ROM	S&M**
ALB		YES*	YES	YES	YES	YES	YES*
B&H	YES*		YES*	YES	YES.	YES*	YES
BUL	YES	YES*		CEFTA	YES	CEFTA	YES*
CRO	YES	YES	CEFTA		YES	CEFTA	YES
MAC	YES	YES	YES	YES		YES	YES
ROM	YES	YES*	CEFTA	CEFTA	YES		YES*
S&M**	YES*	YES	YES*	YES	YES	YES*	

Source: Stability Pact

Notes:

* Only initialed according to latest information

** Serbia & Montenegro started negotiation process when it was known as FR Yugoslavia

As at 4 March 2003, out of 21 FTAs necessary for the completion of the Free Trade Zone in SEE, only six FTAs have been agreed (initialed) but are not signed yet. The remaining 12 FTAs and the three agreements within CEFTA are formally signed and most of them already apply. Undoubtedly, the small delay in the establishment of the Free Trade Zone of several months cannot cast a shadow on this huge success.

For less than 2 years the seven countries signatories to the Memorandum of Understanding have finalized the negotiation process. Within these two years the international financial institutions, the European Union and especially the Stability Pact have intensified gradually their pressure on the SEE – 7 governments and the final objective was reached. *The question is: what comes next?*

The next steps: avoiding the traps

In his speech at an investment promotion event organized by the Serbia Foreign Investors Council and the OECD within the framework of the Stability Pact, Mr. Erhard Busek - Special Coordinator of the Stability Pact hailed the formal completion of the negotiation process (see Stability Pact press release of 4 March 2003). However, Mr. Busek explained that the political act of negotiations is only the beginning. Implementation, promotion and dispute settlement are now the challenges ahead. “At the end of the day” Busek said, “individual businesses and traders must know about the new free trade regime and the governments duty will be to instruct its customs and export authorities accordingly”.

The business community and the society are just beginning to realize the impact of the Free Trade Zone. No doubt, the undergoing process of trade liberalization will lead to the formation of interest groups, which will try to influence the implementation process in order to preserve some of the existing tariff and non-tariff barriers.

Thus the main objective of the seven SEE governments, in addition to further deepening of the trade liberalization process, will be the withstanding of the pressure from the affected corporate interests. The current practices (see trade relations between Bulgaria and Macedonia in Part One of the present research) show that the SEE governments cannot be considered immune from such attempts. However, such trade conflicts should be avoided as much as possible in order to keep the fragile balance achieved between the SEE – 7 governments, the international financial institutions and the society.

On the other hand, the SEE governments are doing nothing or almost nothing to spread the news of the establishment of the Free Trade Zone within their own countries. It seems that the Free Trade Zone in Southeast Europe has received much more international attention instead of intra regional interest. So there is much to be done by the public authorities with regard to the promotion of the new terms of trade within the SEE countries.

It should be noted that the formal completion of the framework of the FTAs necessary for the operation of the Free Trade Zone does not necessary entail full trade liberalization. The speed of achieving full trade liberalization is one of the most important steps that must be taken in the following several years. The monitoring of the speed of the process will remain once again much a responsibility for the Stability Pact and the European Union.

Achieving genuine regional economic integration

The establishment of the Free Trade Zone in Southeast Europe should be considered as one of the most important stages for achieving genuine regional economic integration. *Will such integration be achieved prior to the entry of the seven SEE countries in the European Union or afterwards?* This is a question that remains open for debate. However, the SEE countries should build upon the success of the Free Trade Zone project the milestones of their future cooperation. Undoubtedly, all SEE countries should continue their efforts to develop stable business environment, more attractive conditions for foreign direct investments, sound macroeconomic policies and social reforms.

The dynamics of mutual consent achieved in the process of negotiations of the framework of FTAs should be maintained. One of the most sensitive mutual problems that request special focus is the struggle for sustainable economic growth. The SEE governments must develop a common agenda to sustain and even accelerate their economic growth. High levels of economic growth are among the most important prerequisites for social cohesion with the European Union Member States and prospective accession into the Union. Thus the common goal and problems should be dealt through mutually coordinated efforts.

Recommendation and implementation issues

One possible solution to the mutual problems experienced by the seven SEE governments can be the creation of a roadmap of SEE countries for achieving sustainable growth. Such roadmap for sustainable growth can be the next step after the liberalization of trade towards achieving genuine regional economic integration.

The roadmap can focus on the following major prerequisites for achieving sustainable growth:

- Setting strict limits for budget deficits;
- Streamline measures to attract foreign investments including developments in infrastructure and legislative environment;
- Coordinate tax and customs reforms;
- Focus on local educational, health and social security reforms;
- Setting up a working group of SEE experts to monitor the reforms regularly;
- Exchange of information on the progress made and problems solved;

The above ambitious objective can be achieved only through the coordinated efforts of the seven SEE governments and sustained support from the EU and the international financial institutions. Given the shifted international priorities, i.e. the Iraq crisis, it seems that the focus on the economic and political developments in the SEE region is gradually drawn away. This fact represents a significant challenge to the practical implementation of the efforts in creating of the roadmap.

In order to secure a continued attention from the EU and the international financial organizations, a highly reputable organization should champion the idea, create and monitor developments. Although the creation of a *roadmap for sustainable growth* is not explicitly listed as one of the current six core objectives of the Stability Pact (local democracy and cross border cooperation; media, energy, trade and investment; fighting organized crime; managing and stabilizing population movements) it is undoubtedly in line with most of its activities. Undoubtedly, the Stability Pact for Southeast Europe can undertake the crucial role of coordination of the sustainable growth efforts. Moreover, such a new focus can help the Stability Pact remain one of the most essential instruments for assuring continued political attention from the international community to the SEE region.