



Lessons Learned and Analysis
Unit of the EU Pillar of UNMIK in Kosovo



European Stability Initiative
BERLIN - BRUSSELS - SARAJEVO

Western Balkans 2004

Assistance, cohesion and the new boundaries of Europe

A call for policy reform

**European Stability Initiative
Berlin – Brussels – Sarajevo
3 November 2002**

Executive Summary

As the period of reconstruction and stabilisation draws to a close, the Western Balkans is facing a looming crisis of social and economic dislocation which puts at risk some of the European Union's most important interests in this strategic region. The crisis is emerging just as existing European assistance is being scaled down, and just as the countries of the region find themselves excluded from the European enlargement process. If the region is not to become an island of instability within the European project, existing European policy instruments need to evolve into a genuine and long-term commitment to address the region's chronic economic and social problems. The European Union should send a strong signal to the countries of the Western Balkans that the promise of Europeanisation is not an illusion.

The European Union's *Zagreb II* summit planned for June 2003 under the Greek presidency is the ideal opportunity to send such a signal, and should mark a turning point in relations between the Union and the Western Balkans:

- The European Union should announce explicitly that its commitment to economic and social **cohesion** across Europe includes the Western Balkans, and that it is prepared to help these societies keep up with the new member states after 2004.
- The Stabilisation and Association Process should be developed to include economic cohesion policies. Such a commitment would require additional efforts by both the Union and the states of the Western Balkans. It would need a reform of assistance methodologies and instruments. It would involve a reallocation of existing financial means and human resources.
- Any *future* assistance to the Western Balkans should be delivered in accordance with the development principles that underlie the European Union structural funds: local **co-financing**, **institutionalised partnership** between the Commission, national and sub-national authorities, and effective **multi-annual programming** of development efforts. These principles should be applied uniformly across the region from 2004 onwards to a growing share of European Union assistance. These principles should be de-linked from the progress of particular states towards eventual accession.
- In financial terms, the Union should make a commitment that total assistance to the Western Balkans will *not decline* as political stability is consolidated and reconstruction brought to a successful conclusion. Support to the Western Balkans should be maintained at the levels of 2000 or 2001 (around €900 million per annum). There are two sources for this: CARDS money (currently set to decline to €700 million in 2003 and €500 in 2005/6); and from 2004 some €400 million per annum from the €3 billion pre-accession allocation to candidate countries, which could become available as present candidates become full members.
- To accomplish this, the European Union would need to rethink its existing institutional tools. The states of the Western Balkans might be brought within the responsibility of a post-2004 Directorate for Enlargement. Beyond 2004, the European Agency for Reconstruction could be transformed into a *European Agency for Development*, with a different mandate extending to all states of the region. The Stability Pact might become an *Employment and Cohesion Pact*. The European Union Pillar of UNMIK in Kosovo and the Office of the High Representative in Bosnia could be given different roles. Alternatively, the Union could bring these post-conflict initiatives to an end, proclaiming their success as the region graduates into the category of pre-accession candidates.

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About the Western Balkans 2004 Campaign

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*An early version of this paper was presented at the Wilton Park conference **A New European Moment? Linking South East Europe Into the EU**, organised jointly by Wilton Park and ESI and held at Wilton Park from October 14-16 2002. This final version has been prepared by ESI for a brainstorming on Balkan policy with the European Union High Representative for Foreign Policy, Javier Solana, on 5 November 2002 in Brussels.*

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Introduction

Existing strategies of the European Union and its member states are inadequate to deal with the new set of challenges which are now emerging in the Western Balkans.

The present policy instruments have been built around the goal of post-conflict reconstruction and stabilisation. They have helped to push the threat of ethnic conflict into the background, making the region a far more promising place than it was five years ago. However, these instruments do not engage effectively with the underlying causes of instability. The danger is no longer ethnic hatred, nationalist extremism or military conflict, but a new crisis of economic and social dislocation. It puts at risk many of the European Union's most important interests in the region: effective government in Bosnia and Herzegovina and Kosovo, political stability and interethnic peace in FYR Macedonia,¹ economic and political reforms and the strengthening of the rule of law across the Western Balkans.

There are three dynamics which are converging into this "crisis of 2004". The first is the inevitable but painful adjustment required in the political and economic life of Bosnia and Kosovo as they adapt to a future without reconstruction assistance. The second is a deepening employment crisis across the region, as it becomes apparent that economic transition has triggered a dramatic collapse of socialist industries, with only a weak response from the new private sector. The third is the growing disenchantment of citizens with democratic processes which are unresponsive to their concerns and unable to reverse the social and economic decline.

The risk of further instability in the Western Balkans is a matter of deep concern to the European Union. Today, European institutions and member states are engaged in the region more intensively than ever before. They are by far the largest donors. They provide the bulk of peacekeepers in Bosnia, Kosovo and Macedonia, and are deploying a new police mission in Bosnia. The High Representative in Bosnia and the leading international mediator in Macedonia are both EU Special Envoys, and Kosovo's economy is under the trusteeship of the EU Pillar of UNMIK. Through the Stabilisation and Association Process, the Union has promised all the countries of the Western Balkans that they are "potential" candidates for membership.² As United States engagement wanes, the Western Balkans has become the testing ground for a specifically European vision of how to spread stability and prosperity beyond its borders.

At the Zagreb summit in November 2000, the European Union offered the states of the Western Balkans the vision of a common "European destination". The rhetoric of "Europeanisation" underlies many European programmes in the region, from post-conflict state building in Bosnia and Kosovo to inter-ethnic mediation in Macedonia to development and economic transition in Serbia and Albania. However, as it stands, the promise offered by Europe to the region is curiously insubstantial. The states of the Western Balkans have no early prospect of opening formal negotiations with the European Union on membership. They face sharply declining aid, whatever their formal status within the Stabilisation and Association Process. Most importantly of all, they are excluded from the larger European project of strengthening economic and social cohesion across the continent.

¹ Hereafter, "Macedonia".

² Zagreb Summit Final Declaration, paragraph. 4: "The European Union ... reaffirms the European perspective of the countries participating in the stabilisation and association process and their status as potential candidates for membership."

The challenges facing the Western Balkans in the coming period are not categorically different from those which the European Union is taking on in the new member states, or indeed those which it is has been dealing with on its own territory for many years. For several decades, the European Union has been developing the tools needed to tackled deep-seated economic and social problems in its own less-favoured regions. The soul of the European Union is its commitment not to tolerate economic and social disparities across its territory, but to make an active commitment in favour of economic and social cohesion. In pursuit of this goal, it has mobilised extensive resources and built up considerable expertise, in particular through the structural funds administered by the European Commission.

The crisis of 2004 cannot be averted through more reconstruction assistance. The structural fund methodology was designed precisely to deal with the problems of industrial decline and rural underdevelopment which dominate the Western Balkans today. The principle of *additionality* was developed in order to prevent the distortions in domestic spending patterns, which have become so apparent in Bosnia or Montenegro. Elaborate procedures for project selection were designed to foster local and regional governance capacity, and to encourage domestic authorities to evaluate their own needs and plan accordingly – urgent developmental needs across the region.

Without a serious commitment from the European Union to developing a new set of policy instruments, the region will find itself increasingly isolated from the developments unfolding all around it, from Slovenia, through Hungary, Romania and Bulgaria, and south to Greece. As its neighbours develop, the capacity of the Western Balkans to join the European project will only decrease over time. The choice facing the European Union is stark: either to make a serious commitment to addressing the root causes of instability, or to continue to spend its resources on fighting the fires of conflict as they recur across the region.

The end of reconstruction

It is noteworthy that the places where reconstruction aid has been the most generous – Bosnia and Kosovo – are also the most exposed to the crisis of 2004. The mobilisation of international resources to overcome the physical legacy of war has been remarkable, and in many respects successful. However, as the reconstruction programmes are drawing to a close, the hidden dynamics and unintended effects of this vast inflow of international assistance are only just beginning to emerge.

One of the most alarming side effects of the reconstruction programme in Bosnia has been the gross distortion in domestic spending patterns, which are now threatening the stability of the state itself. The World Bank recently reported that public-sector expenditure amounts to 63 percent of gross domestic product (GDP) – a full 20 percent higher than the regional average. This expenditure is heavily weighted in favour of wages for public employees and transfers to war invalids and the families of fallen soldiers. Operations and maintenance – namely, the delivery of services to citizens – is being crowded out. Capital expenditure has been left almost entirely to the international mission, and is therefore declining rapidly along with the aid flows.

These distortions have been made possible by the extent of direct international budgetary support to different public institutions and programs, together with the substitution effect of the international community assuming investment responsibilities on behalf of the state. The size of the substitution effect is enormous. Between 1996 and 2000, the Bosnian public sector spent US\$9.2 billion on wages and transfers, which is more than 48 percent of the average

annual GDP. If this had been kept at 40 percent (the average percentage of total public spending across the region), it would have made another US\$1.58 billion of domestic funds available for public investment over the five-year period.³ This shows the extent to which international reconstruction assistance has been diverted into building up a public administration which can no longer be sustained.

Signs of financial distress are multiplying at lower levels of the Bosnian government, in the cantons and municipalities which bear the primary responsibility for delivering public services (education; health care; what remains of social assistance). Many areas in both entities are effectively without a basic safety net for the poorest and most vulnerable – the limited data available suggests that as few as a quarter of the severely poor have been receiving cash benefits in recent years. Most cantons have terminated child-protection programmes, and there are almost no unemployment benefits. Even areas, which the entity governments once considered essential to their interests, are being cut in order to maintain public-sector salaries. More than 80 percent of the entity defence budgets are allocated to salary costs, compared to a NATO average of only 40 percent. As a result, the country is rapidly disarming through the decay of its equipment. While de-capitalisation of military hardware would be welcomed by many, it is deeply troubling when it extends to the electrical grid, transport infrastructure or enterprise sector.

Neither the entity finance ministries nor the international community have a clear idea of the scale of the public finance crisis which will emerge in the next two years. The international financial institutions have repeatedly stressed that they do not have accurate figures on the extent of arrears or public-sector indebtedness at lower levels of government and in public companies. What is known is that foreign debt servicing will climb from around €75 million in 2000 to nearly €120 million in 2003, at the same time as foreign aid flows are drastically reduced. The World Bank predicts that, even under the most optimistic growth and reform scenarios, total public spending would have to be cut by an unprecedented 6.5 percent of GDP. If that is not achieved, macroeconomic stability or the ability to service international debt would be thrown into question. It remains an open question whether Bosnia can sustain its currency under the currency board arrangement – the most important economic achievement of recent years and a symbol of Bosnian statehood.

Reconstruction aid has been crucial in helping Bosnia and Kosovo to overcome the immediate legacy of the war. However, it has also become a kind of drug, changing the behaviour and expectations of its recipients and creating a short-lived illusion of prosperity. Over the coming year, the drug is to be precipitously withdrawn with unpredictable consequences.

Transition to where?

The economic advice offered to Balkan states in recent years has assumed a certain sequence of events: first, there would be reconstruction aid to restore a pre-conflict *status quo*, and then a package of legal and institutional reforms under the heading of “economic transition” would open the way to a new prosperity driven by private-sector development. At the heart of the transition agenda lay the triple policies of stable currencies, privatisation and eliminating open or hidden public subsidies to enterprises. Today, the states of the Western Balkans are coming face to face with a reality which the instability of the past decade has tended to obscure: the extent of their economic decline. The signs are that, in the post-privatisation period, the region is sinking into a new equilibrium of low output and high unemployment.

³ These numbers are based on a weak statistical system, but they are the best that are at present available to the International Financial Institutions.

The World Bank recently offered a definition of the end of transition. Transition means placing the old socialist companies on a level playing field with new market entrants. When they no longer enjoy special benefits in the form of public subsidies or soft-budget constraints, and when differences in productivity can no longer be attributed to company history, the transition is complete.⁴ This is a useful definition, which de-couples the idea of transition from other forms of social or economic change. However, it also makes it clear that there is no necessary causal link between transition and economic growth. As the World Bank concludes, a level playing field can be achieved at any level of development or *per capita* income.

By *global* standards, poverty in South Eastern Europe is still not severe. In the cities and towns, one can still find people able to sustain the standards of living of a decade ago, particularly in places which enjoy large capital flows from abroad, either through remittances or the presence of a large international mission. However, this circle is becoming narrower all the time, and increasingly under siege. It is not poverty *per se* which threatens political stability, but the panic caused by declining social status and a lack of clear prospects for the future. With little social assistance available, people need to be employed to remain above the poverty line. Where conflict over scarce resources – such as public employment – takes on an ethnic colour, as in Macedonia in recent times,⁵ it can become a powerfully disruptive force.

The end of industrial society?

The past decade has seen a dramatic collapse of employment in the industries built up under socialism. The Western Balkans is now covered with the wreckage of once-proud industries which have been unable to survive into the new era.

The city of Zenica in Bosnia is dominated by the rusting remains of the vast steelworks, which provided the historical rationale for the development of the city itself. Capital from the steelworks funded the construction of some 8,000 apartments and provided workers with an entire social infrastructure – social and sports clubs, education, and holiday facilities. The trading arm of the steelworks, owner of the proudest high-rise building in town, once engaged in complex trade deals across the world. It now draws its income from renting out its offices and importing cosmetics and textiles from neighbouring countries. The steelworks limp along with only a quarter of the pre-war workforce still on the books, and fewer still receiving a salary.

Similar stories are unfolding right across the industrial areas of the former Yugoslavia, from Smederevo (Serbia) to Peja (Kosovo), from Tuzla (Bosnia) to Kicevo (Macedonia). In Macedonia, of 1,688 formerly socially owned enterprises, all but 85 have been sold off or liquidated.⁶ The level of interest from foreign or even domestic investors has been extremely limited. Most companies have been sold through a process of insider privatisation, with shares distributed to workers in lieu of unpaid salaries, or to managers at heavily discounted prices payable over many years. The new proprietors have predictably tried to protect their position by resisting the restructuring of the companies. Even so, industrial employment has already collapsed by more than half, and further job losses are inevitable.⁷

⁴ World Bank, *Transition – The first ten years*, 2002, p. xix.

⁵ ESI, *Ahmeti's Village*, September 2002. Available at www.esiweb.org

⁶ Macedonian Agency for Privatisation, *Status Report as of March 31, 2002*, p. 1.

⁷ See European Stability Initiative, *Ahmeti's Village*, September 2002.

The experience of Serbia-Montenegro throughout the 1990s has been one of remorseless economic decline. Michael Palaret has summed up the economic consequences of the Milosevic era:

“Capital in virtually all sectors was depleted year by year, becoming increasingly obsolete, and industrial technology declined in efficiency. The primary shift in economic activity was towards agriculture, which shifted away from livestock towards crop production, to lower technology farming techniques, and away from market production towards subsistence provision. Economic activity shifted away from industry and commercial services, and within industry away from technology driven sectors in engineering and consumer durables towards single-use consumer goods and extractive activity... The return to underdevelopment will be costly to reverse, for the reservoir of idle assets and human skills has slowly drained away.”⁸

In Republika Srpska in Bosnia-Herzegovina, the story is even more desperate. Of 66 large companies (i.e. those which entered the privatisation process with more than 400 employees), not more than 5 have been sold to serious investors, whether domestic or international. The rest have either proved impossible to sell, or have gone through a process of voucher privatisation which has attracted neither new management nor fresh capital. Notwithstanding continuing soft-budget constraints in the form of rescheduled debts and the non-collection of taxes and utility bills, the companies have become so illiquid that they are no longer able to purchase inputs, with the result that production has collapsed.

Across the region, it is common to hear enterprise managers and local politicians describe the privatisation process as “catastrophically slow”. In reality, economic transition is the future which has already happened. For most of the region’s industrial companies, whether privatised or not, the only way forward is bankruptcy, which would at least free up their assets for use by the private sector. However, across the region, few companies are being liquidated. In the political environment produced by the general employment crisis, it is very hard indeed for domestic politicians to confront their electorates with the news that the old economy is not coming back. What is at risk is not merely employment in this or that sector of the economy, but the very model of a modern industrial society.

A vibrant private sector?

A new private sector is emerging in the Western Balkans, but it is predominantly small-scale, low-capital-intensity ventures in trade and construction. Most new private businesses are based around the family as the primary business unit, the dominant form of the urban economy is the corner store, and traders are simultaneously their own bankers and insurers.

Many foreign observers were struck by the speed with which a new private sector emerged in Kosovo after the conflict of 1999. But in many respects it was a return to a private sector of the past, which had roots in pre-socialist times, persisted throughout the Yugoslav era as *mala privreda* (small business) and expanded substantially in the early 1990s, only to stagnate from 1995 onwards. In post-war Kosovo, it has been estimated that €444 million was spent in 1999/2000 on repair of housing, public buildings and infrastructure, with 21 percent of materials purchased locally. However, post-conflict construction booms are short-lived. By

⁸ Michael Palaret, *The Economic Consequences of Slobodan Milosevic*, Europe-Asia Studies, September 2001.

2001, spending on construction in Kosovo had dropped to only 40 percent of its 2000 high, and this year is expected to reach only 13 percent.⁹ Some local entrepreneurs were able to generate quick wealth as importers. However, there has been little development of long-term business structures. Apart from building materials and a small food-processing sector, there is hardly any production.

One of the major constraints on private-sector development is that the region is caught in limbo – it has neither a low-cost environment by international standards, nor the modern technology to boost productivity and allow it to compete on the European market. A recent review of the textile sector in Bosnia noted that “only those companies that are capable of sustained investment in both plant and innovative products will have a share of the international market. Commodities can be bought from low cost emerging economies in SE Asia at prices that Bosnia Herzegovina based textile producers can never hope to match.”¹⁰ If the choice is between major new investment in productive technology and allowing living standards to decline even further, rendering labour less expensive, the region seems to be heading by default towards the latter. For the foreseeable future, productivity gains in most key sectors in Macedonia, Serbia or Bosnia will come from labour *reductions* (in textiles, mining, retail, commercial agriculture).

The industrial crisis is as serious in Albania. A recent report by the European Commission stresses that the industrial sector is weak and its current contribution to the overall GDP growth limited. “Industries are often obsolete, non-viable and incapable of competing with European industry. Albania needs to develop a new national industrial basis.” Albanian transport and water supply infrastructure is inadequate and the ongoing energy crisis “a serious strain on economic prospects.” Not surprisingly under these conditions, export performance is poor and the trade deficit reached €1 billion in 2001.¹¹ As a result, Albania’s main export is labour.

The poor state of infrastructure is a serious constraint on private-sector development throughout most of the region. It is not clear that post-war reconstruction programmes have delivered *sustainable* improvements in the quality of local infrastructure. In Bosnia and Kosovo, international donors have fixed roads, electricity networks, telecommunications and water systems on a genuinely impressive scale. However, driven by the urgency inherent in a humanitarian mission, they tended to bypass widespread problems in corporate governance and financing of these systems, rather than address them. Domestic institutions are now struggling to cover basic operating expenses, making no capital investments of their own and often failing to carry out routine maintenance. Despite the massive international investment, infrastructure across the region is steadily de-capitalising.

The constraints on the new private sector are a reflection of a wider governance problem, with public institutions unable to provide the infrastructure and services essential to bring down the production costs of private entrepreneurs. The lack of clear property titles, weak legal systems, a shortage of domestic finance, underdeveloped transport, telecommunications and water systems, and a lack of effective planning capacity all add to the costs of new private businesses. However, even under the most progressive and committed of governments, it is difficult to see where the impetus would come for private-sector employment growth on anything like the scale required to make up for the effects of de-industrialisation.

⁹ CHF, *Kosovo Construction Sector Assessment Report*, January 2002.

¹⁰ FIPA, *Bosnia and Herzegovina Textile and Clothing Industries – Profile Report*, Sarajevo, 2002, p. 6.

¹¹ European Commission, *Albania Stabilisation and Association Report*.

People on the move

The impact on society of this process of de-industrialisation is every bit as radical as the arrival of socialism, with a profoundly dislocating effect on communities throughout the region.¹² The dominant social trend of the past half century has been urbanisation, with millions of people fleeing overpopulation and underdevelopment in the rural areas in search of new jobs and lifestyles in the towns and cities. This was a vast social revolution, in which the distribution of population and the expectations of new urban middle classes were shaped by the patterns of socialist industrialisation.

With industrial employment disappearing, there is little to hold people to the old industrial centres, and the population is once again on the move. For the millions displaced by the conflicts of the 1990s, their decision as to whether to return to their old homes or resettle elsewhere is increasingly determined by economic opportunity. Among those who were never displaced, neither internal nor external migration is likely to slow in the near future.

The dynamics of population movement are varied and complex. In many places, people are gravitating towards state capitals and administrative centres, drawn by the growth generated by public-sector spending and international investment. In other places, people are moving from industrial towns back to the villages their families abandoned a generation ago, where living costs are low and subsistence agriculture offers survival strategies not available in the urban areas. The dire state of the agricultural sector, however, means that it has little capacity to absorb the unemployed. The economic incentives to pursue agriculture are so low that a high proportion of agricultural land across the region has been abandoned altogether.

The other major movement of people is out of the region, mainly destined for the European Union, either permanently or as migrant workers. Across much of the region, emigration is the only escape route available for the young and unemployed, and so long as the economic decline continues, this pressure will continue to grow. Interestingly, there are parts of the region where money sent home by migrants or spent during summer vacations provides not just the means of survival for countless families, but also the most important potential source of investment capital. The effects of migration on micro-economies is a curiously understudied phenomenon, but it appears to be one of the few exogenous shocks available to break the cycle of underdevelopment in many communities.

The crisis of political representation

Throughout the region, these social and economic trends put enormous stresses on the political process. In a recent paper on the state of democracy across South Eastern Europe, Ivan Krastev writes that “the growing gap that divides publics from elites and the growing mistrust that publics feel towards democratic institutions are the most salient political facts in the Balkans today.”¹³ This deep disenchantment with the democratic process can be seen in the decrease in voter turnout with each successive election, and in the recurrent pattern of governments unceremoniously thrown out of office after their first term, irrespective of their record.

Nowhere in the world have international democratisation activities been as extensive as in the Western Balkans. The time has come to take stock of the results. As Thomas Carothers has written, offering “a smorgasbord of democracy programs based on the vague assumption that

¹² John Allcock, *Explaining Yugoslavia*, Hurst and Company, 2000, p. 4.

¹³ Ivan Krastev, *The Balkans: Democracy without choices*, *Journal of Democracy*, July 2002.

they all contribute to some assumed process of consolidation is not good enough”.¹⁴ There is an obvious need to revisit the linkage between democratisation programmes and other forms of assistance.

The collapse of industrial society and the sense of drift this has engendered among the population goes a long way to explaining the extent of disaffection with the political process. There is hardly a household which has not suffered a dramatic collapse in its living standards. The decline set in during the 1980s, eroding trust and confidence in Yugoslav communism. This decline continues to erode public confidence in the ability of new elites and democratic institutions to provide basic economic security. In the short to medium term, there are obvious limits to what any individual government can do to reverse this trend.

Strategies of international intervention in the region have further limited the room for manoeuvre of representative institutions. With most capital spending undertaken by donors, investment priorities are set outside the region. In Bosnia and Kosovo, almost all “reform legislation” is drafted by foreigners and imposed by decree. Even the Stabilisation and Association Agreements, the outcome of negotiations between governments and the European Commission, reflect external priorities and are largely silent on matters of social and economic cohesion or development. A recent evaluation of the European Commission’s Macedonia country strategy notes that existing priorities were “not based on any specific assessment” of the Macedonian situation. The key recommendation of this evaluation is for the Commission to support development at this stage, rather than adoption of EU norms: “A more effective strategy to achieve the EU political goals would be to support FYR Macedonia’s economic and social development, which in turn would lead logically to EU integration.”¹⁵

In Albania, while the Commission notes a huge infrastructure crisis in the energy, transport, water and agricultural sectors, the multi-annual programme for 2002-2004 concentrates mainly on fighting organised crime, fraud and corruption. Within the annual CARDS budget for Albania, only €10 million are devoted to improvement of small infrastructure. These are the makings of a vicious cycle: the weaker the national governments become, the more outside organisations seek to impose their own vision of policy priorities, and the more unresponsive the governments becomes to their own electorates.

For all these reasons, politics across South Eastern Europe often seem curiously insubstantial, with politicians reluctant to engage with the issues which are clearly predominant in the lives of the electorate. There is a clear incentive for the political elite to fill the public agenda with other issues, resorting to lingering historical disputes, identity politics, or simply trading allegations of corruption with their political opponents. Thomas Carothers has characterised such democracies as “feckless”.

“The alternation of power seems only to trade the country’s problems back and forth from one hapless side to the other. Political elites from all the major parties are widely perceived as corrupt, self-interested, dishonest, and not serious about working for their country. The public is seriously disaffected from politics, and while it may still cling to a belief in the ideal of democracy, it is extremely unhappy about the political life of the country.”¹⁶

¹⁴ Thomas Carothers, *The end of the transition paradigm*, Journal of Democracy, January 2002.

¹⁵ Investment Development Consultancy, France, and Development Strategies, Italy, Evaluation of EC Country Strategy: FRY Macedonia 1996-2001, www.europa.eu.int/comm/europeaid.

¹⁶ Thomas Carothers, *The end of the transition paradigm*, Journal of Democracy, January 2002.

Without a healthy productive sector to the economy, the capacity of the state to fund a modern administration and to provide a social safety net is severely limited. For the majority of citizens who are not living “on the budget”, the state appears distant, alien and largely irrelevant to the concerns of everyday life. In rural areas, the state may indeed be entirely absent, having inherited a pattern of uneven institutional and infrastructural development from the past. In these circumstances, private-sector activity tends to move into the grey economy, unwilling to pay high taxes for inadequate public services. The state increasingly lacks even basic information as to how its citizens are surviving in the real economy.

The future of European assistance

This analysis of the “crisis of 2004” has clear implications for the future of European strategy in the region. European aid has made considerable progress in providing basic stability, but over the longer term, stability cannot be achieved without development. There is a growing crisis of political representation, as weak and under-resourced public institutions have little to distribute except public employment itself, and are increasingly seen as irrelevant or even parasitic. There is also a risk that present patterns of international aid are contributing to the crisis, by distorting domestic spending priorities and political processes.

As a result, the promise of a “European destination” for the region is curiously insubstantial. There is broad consensus that the states of the Western Balkans will need a long time to adopt the rules of the common European market in any meaningful way. They have no early prospect of opening formal negotiations with the European Union on membership, with the possible exception of Croatia. They face sharply declining aid, whatever their formal status within the Stabilisation and Association Process. Most importantly of all, they are excluded from the larger European project of strengthening economic and social cohesion across the continent.

As the Treaty of Rome states, promoting harmonious development across the European Union through the strengthening of economic and social cohesion is one of the principal goals of the EU. The structural and cohesion funds have been developed to accomplish this and, together with the rules for the European common market (the *acquis*), represent the heart of European integration. These policy instruments were designed in recognition that the creation of a single market alone is insufficient to overcome disparities in regional development, without a significant commitment of development resources. In the words of the Commission, the only way to be sure of convergence is “if there is a change in the underlying conditions themselves and in relative factor endowments (in terms of capital of all kinds and different labour force skills). The primary objective of regional and structural policies is precisely to bring about such a change.”¹⁷ The impact of structural assistance in Greece, Ireland, Spain, Portugal or Southern Italy has been immense.

Cohesion policies aim to achieve higher economic growth by increasing investment. They are not social policies, and are not directly concerned either with expanding consumption or redistributing income. The goal is to increase productivity, as determined by the quality of human resources, physical infrastructure endowments and the capacity for innovation.

A key principle behind structural funds is *additionality*. Projects supported by the structural funds must be co-financed from national sources. This ensures that European funds add to,

¹⁷ European Commission, *Second Report on Economic and Social Cohesion*, 2001, page 10.

rather than substitute for, domestic investment capacity. Structural interventions by the European Union also require substantive input from local and regional governments in setting development priorities and selecting projects. This can have important consequences for the administrative structure of member states. In Greece and the United Kingdom, two of the most highly centralised states in the Union, this led over time to a significant devolution of responsibilities in the field of regional economic development. In Greece, the setting up of monitoring committees for the implementation of integrated development programmes constituted “a major administrative innovation”:

“For the first time, an authority other than a central ministry or public enterprise acquires responsibility for running a multi-project, pluri-annual programme. Local representation, geographic decentralisation, financial autonomy and an obligation to inform and motivate local populations are all novel characteristics for the Greek planning framework.”¹⁸

The first Greek regional development plan was drawn up shortly before EU accession. As Ilias Plaskovitis has noted: “Although the prospect of EC membership failed to trigger a revolution in Greek government outlook, the dynamics of integration and more specifically the implementation of EC structural policy began to force a change in government practice.”¹⁹

There is usually also a requirement that projects be developed in such a way as to mobilise local partnerships. This principle has been steadily widened, from the inclusion of regional and local authorities in 1989 to 1993, and of social partners in 1994 to 1999, to the planned inclusion of representatives of various other groups in 2000-2006. Where such programmes have operated successfully, they have done much to create a positive image of Union policy among citizens.

These features of the structural funds within the European Union are precisely what is currently missing from European assistance in the Western Balkans. The structural fund methodology was designed to deal with problems of industrial decline and rural underdevelopment. The principle of *additionality* was adopted in order to prevent distortions in domestic spending patterns. The procedures for project selection were designed in order to foster local and regional governance capacity, and to encourage domestic authorities to evaluate their own needs and plan accordingly. The challenges facing the Balkans in the coming period are not categorically different from those which the European Union has been dealing with in its own territory for many years.

The European Union and the crisis of 2004

Progress towards social and economic cohesion within Europe and the integration of societies emerging from isolation and dictatorship (Greece, Spain, Portugal) have been among the Union’s great historical achievements. It is now preparing for an even more ambitious process of extending the zone of economic stability and development across the new member states.

However, while the European Union extends its promise of economic and social cohesion towards the East, too little consideration is given to the area with the largest concentration of European policemen, peace-keepers, administrators and consultants trying to promote its

¹⁸ Ilias Plaskovitis, *EC regional policy in Greece: Ten years of structural funds intervention, in Greece and EC Membership Evaluated*, 1994.

¹⁹ *Ibid.*

stability. As the Commissioner for Enlargement recently explained to the European Parliament, “enlargement will not be over until we have Bulgaria and Romania in this chamber.” The Financial Times noted that this was hardly a good omen for Turkey.²⁰ The Western Balkans was not even mentioned. If there is no change in European strategy, the regional disparities between Europe’s 27 past and future members and the five states of the Western Balkans will widen significantly in the coming years.

Assistance to the countries of the Western Balkans under the European Union’s CARDS programmes was heavily front-loaded towards the early years of the programme, and is now declining sharply. From 2004 to 2006, most countries in the region will receive relatively little EU aid, whatever political or institutional reforms they undertake and irrespective of their progress up the Stabilisation and Association ladder. Unless something changes, there will also be little argument for taking the needs of the region seriously in the next programming cycle (2007-13). The Balkans will continue to depend on the development and humanitarian aid budget, and will find itself competing with the countries of the Southern Mediterranean and the Middle East, and with new crisis areas as they emerge around the globe.

*Table 1: Assistance to the Western Balkans from the European Union
2000-2006 CARDS budget (in Euro)*

	2000	2001	2002	2003	2004	2005	2006
Albania	35	37	45				
BiH	101	104	72	63*	58*		
Croatia	22	60	59				
Macedonia	21	56	41				
Serbia/Montenegro/Kosovo	650	385	350	305*	250*		
Total²¹	956	903	766	700	600	500	500*

* Estimates based on interviews with officials in Kosovo and Bosnia.

In the meantime, the assistance available will not require co-financing. It will not inspire the strengthening of local and regional government. It will not demand regional development plans or partnerships. For the most part, it will not even address employment growth or infrastructure directly. The CARDS programme offers no commitment, either implicit or explicit, to helping the region catch up with the economy of the newly enlarged European Union.

At the same time, the EU has committed itself to increasing assistance to the new member states and to Romania, Bulgaria and Turkey. Pre-accession aid to the ten candidate states in Central and Eastern Europe is €3 billion annually. From 2004 to 2006, the annual budget for structural and cohesion policy in the new member states is set to increase progressively to €12 billion in 2006.

Without a serious commitment from the European Union, the Western Balkans will find itself increasingly isolated from the developments unfolding all around it, from Slovenia, through Hungary, Romania and Bulgaria, and south to Greece. Its capacity to join the European project will only decrease over time. While in the enlarged Europe, the new goals will be economic cohesion, development and labour mobility, in the Balkans the focus will narrow to

²⁰ Judy Dempsey, *Financial Times*, 10 October 2002.

²¹ This also includes the grant component of macroeconomic aid, regional projects, border projects, costs for civil administration in Kosovo (EU Pillar) and Bosnia (OHR) and some technical assistance.

issues of crime, corruption and border management. If this is Europe's only response to the crisis of 2004, then the most probable future of the Balkans is to remain an island of instability in the heart of Europe, exporting migrants and importing peacekeepers.

Agenda for Change

There is, however, a window of opportunity in 2003 for giving new impetus to the European project in the Western Balkans:

- The European Union, under the Greek and Italian presidencies, could decide to build on the successes (and investments) in stabilising this region in the past decade by transforming the Stabilisation and Association Process into a framework for cohesion policies. A summit with the countries of the region could explicitly state that the objective of strengthening economic and social cohesion across Europe extends also to the Western Balkans.
- The European Union could transform the European Agency for Reconstruction into a *European Agency for Development*, with a different mandate extending to all states of the region. The Stability Pact might become an *Employment and Cohesion Pact*. Alternatively, it could bring these post-conflict initiatives to an end, proclaiming their success as the region graduates into the category of pre-accession candidates.
- The states of the Western Balkans could join Romania, Bulgaria and Turkey within the responsibility of a post-2004 Directorate for Enlargement. As in the case of Turkey, there would be no obligation to enter into real membership negotiations until these countries are ready and able to implement the *acquis*, however long that might take.²² However, in all other respects, including its eligibility for focused structural interventions, the Western Balkans would be treated as part of the European family.
- This would significantly increase the leverage of the Union as it pursues its objectives of building the rule of law and fighting organised crime. It would also ensure that the impressive political and diplomatic successes of the European Common Foreign and Security Policy in the region in recent years would be sustainable.
- While bringing the post-reconstruction CARDS programme to a conclusion, the European Union could already develop new policy instruments for structural interventions in the Western Balkans for the period 2004-2006. It could use the expertise developed in a range of pre-accession programmes for the ten candidates targeting agriculture, environment, transport, social inclusion and employment, retaining the core principles of co-financing, partnership and evaluation. It could also draw on the considerable human resources already deployed in the region, particularly in the European Agency for Reconstruction, the European Union Pillar of UNMIK and the Office of the High Representative.
- After the admission of the ten candidates in 2004, only Bulgaria and Romania will be left eligible for the €3 billion in the pre-accession budget until the end of the EU budget period in 2006. There is a potential for using some of the funds from this budget line for targeted cohesion policies in the Western Balkans.
- The Western Balkans were promised such a future at the Zagreb I Summit in November 2000. The Zagreb II summit prepared by the Greek presidency could carry these goals forward in a much more concrete way.

²² In the case of Croatia, for instance, this might not take very long.

About the European Stability Initiative

*The **European Stability Initiative (ESI)** is an independent non-profit research and policy institute based in Berlin, with regional offices in Sarajevo, Pristina and Skopje. It was created in 1999 in recognition of the need for in-depth analysis of policy issues related to South Eastern Europe. In 2002 ESI received support from the German Marshall Fund of the United States, the Swedish Government, the Swiss government, the UK Department for International Development, the Korber Foundation and the British Government.*

*The **Lessons Learned and Analysis Unit** is a joint project by ESI and the European Union Pillar of UNMIK to provide independent advise and analysis for policy makers in Kosovo and capture some of the lessons learned in this mission.*

*This report has been presented at the conference **A NEW EUROPEAN MOMENT? LINKING SOUTH EAST EUROPE INTO THE EU** which was organised jointly by Wilton Park and ESI and held at Wilton Park from October 14-16 2002. Wilton Park and ESI gratefully acknowledge the financial support of the Ministry of Foreign Affairs of Norway, and the Foreign and Commonwealth Office for the conference research.*