Making sense of competitiveness indicators in south-eastern Europe

Peter Sanfey and Simone Zeh

Abstract
This paper sifts through a variety of competitiveness and business environment indicators to assess the state of reforms in south-eastern Europe (SEE). While common themes emerge, such as corruption, weak tax administration and the lack of availability of skills, there is a clear gap between those countries in the region that have joined, or are about to join, the European Union, and the remaining countries. The World Economic Forum's Global Competitiveness Index signals some similarities across the region, but other sources of information, such as the World Bank's *Doing Business* reports and the EBRD/World Bank Business Environment and Enterprise Performance Survey, show up marked cross-country differences. We conclude with a number of targeted recommendations for policy reforms in areas such as cross-border trade and investment, tax administration and the development of new skills and innovation.

Keywords: south-eastern Europe, competitiveness, reforms, transition

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1. Introduction

The transition economies of south-eastern Europe (SEE) have been deeply affected by the global economic crisis and its aftermath.[1] Economic growth in the past few years has been weak or non-existent, unemployment and poverty levels have risen, and investment and confidence have tumbled. The region is also heavily exposed to the eurozone sovereign debt crisis, which has the potential to spill over into SEE countries in a highly negative way, possibly causing deep damage to the region's economies. Even under a relatively favourable resolution of the eurozone's troubles, growth in SEE is likely to be marginal at best in the short term.

Many of the region's problems cannot be solved, or even alleviated, unless robust economic growth returns. But the pre-crisis growth model, which was built largely on booming credit growth and huge inflows of cheap capital from abroad, cannot be a suitable basis for future growth, and foreign investment is likely to stay well below levels seen in 2005-08, at least for the foreseeable future. Meanwhile, many foreign-owned banks, which dominate the financial sectors of the region, are trying to reduce their balance sheets – or "deleverage" – to more manageable levels. At the same time, there is very little scope for fiscal or monetary stimulus. So how can sustainable growth be achieved?

The answer could be that authorities across the region must show a much greater commitment than before to deep structural and institutional reforms. It is generally accepted that reforms and growth have gone hand-in-hand in transition economies.[2] However, although there is much talk since the global crisis unfolded of the need for a new "growth agenda", there is little agreement on what this agenda should be or which reforms are most important. There is a plethora of cross-country indicators that try to measure concepts such as competitiveness, ease of doing business, transition gaps and the like, but the results and relative rankings they generate are often confusing and sometimes appear to be mutually inconsistent. This is a headache for analysts and policy-makers who need to diagnose the problem correctly before they can propose and implement an appropriate solution.

The main aims of this paper, therefore, are to summarise several well-known competitiveness and business environment measures and to explain what they are trying to capture. To the best of our knowledge, this is the first time that anyone has tried to compare and contrast some of the most prominent cross-country indicators and to point out both the strengths and the weaknesses in one self-contained paper. We also try to draw some policy implications from the analysis. Our paper is not meant to be a reform blueprint for the region, but rather a helpful pointer towards concrete reform measures in areas such as trade, access to credit and cross-border cooperation. An annex provides a handy tabular guide to the indicators – sources, coverage, objectives, strengths and weaknesses.

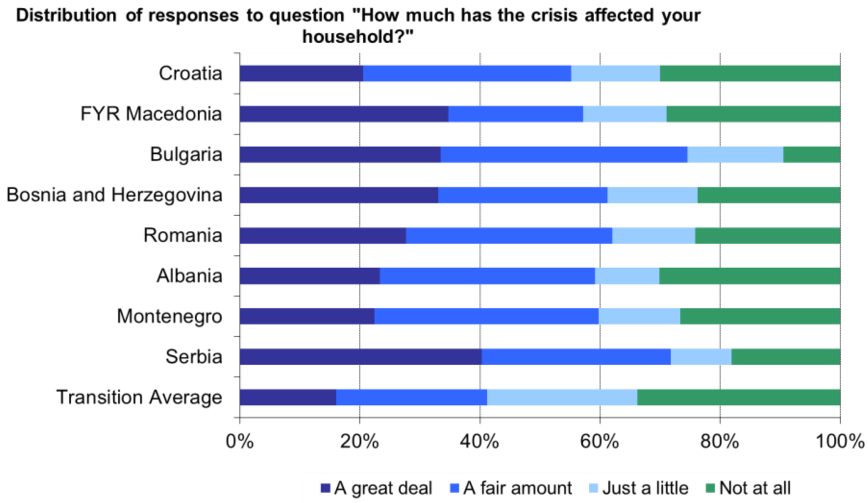
[1] In this paper, "south-eastern Europe" refers to Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Montenegro, Romania and Serbia.
[2] See, for example, Falcetti et al. (2006).

2. Impact of the crisis

The full impact of the global crisis on SEE is only now becoming clear.[3] At the start of 2011 it seemed that SEE had been no worse hit than most other transition sub-regions. The real GDP drop in 2009 – around 5.5 per cent on a weighted average basis – supported this view. Towards the end of 2010 some tentative signs of recovery started to emerge.[4] By early 2012, however, the short-term prospects still looked bleak. Most independent forecasters, and even national authorities, predict minimal growth at best for the region in 2012.[5]

Beyond the basic GDP figures, there are at least three facts that help to explain why SEE is struggling so badly.[6] The first fact is that the estimates of growth decline in the crisis do not accurately convey how badly people suffered in the crisis. Evidence from the second round of the EBRD/World Bank Life in Transition Survey (LiTS), carried out in late 2010, backs up this assertion. In this survey, people were asked how much the crisis had affected their household in the past two years. Chart 1 shows that, in all SEE countries, the majority of respondents said that it affected them a great deal or a fair amount, compared with a transition region average of just over 40 per cent. This finding may also help explain why self-reported life satisfaction in the LiTS is so low in SEE.[7]

Chart 1: Impact of the crisis



Source: EBRD/World Bank Life in Transition Survey – see EBRD (2011a).

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[3] Several recent papers analyse the impact of the crisis on SEE, including Bartlett and Prica (2011), Cocozza et al. (2011) and Sanfey (2011).

[4] Two edited volumes on the region produced in late 2010/early 2011, one by the London School of Economics and one by Oxford University, capture this nascent sense of optimism with their titles: "South Eastern Europe after the Crisis" and "From Crisis to Recovery" respectively. See Bartlett and Monastiriotis, eds. (2010) and Anastasakis, Bastian and Watson, eds. (2011).

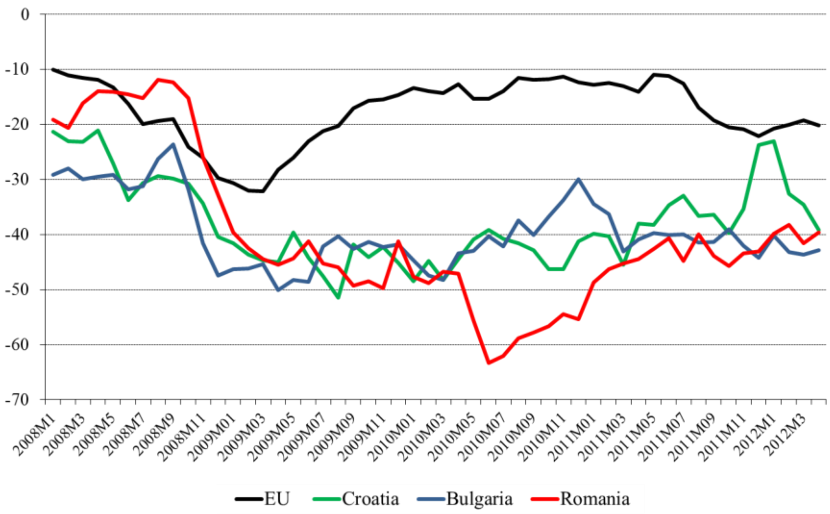
[5] The EBRD's May 2012 forecasts for the entire transition region, including SEE, can be viewed at: http://www.ebrd.com/downloads/research/REP/regional-economic-prospects1205.pdf.

[6] Other factors behind SEE's recent malaise include the tight linkages of the region with problematic euro area banking groups and the close trade links to troubled southern European economies.

[7] For example, in the 2010 round of the EBRD/World Bank Life in Transition Survey, only 18 per cent of respondents in Romania – the lowest percentage across the whole transition region – declared themselves to be satisfied with life (see EBRD, 2011a).

The second fact is that consumer confidence remains well below pre-crisis levels, and has even been falling again in recent months, as shown by evidence from three countries in the region – Bulgaria, Croatia and Romania – where such surveys are carried out regularly according to a standardised Eurostat methodology (see Chart 2). The gap in confidence between these countries on the one side and the EU average on the other widened significantly during the crisis and remains large in Bulgaria and Romania despite a partial recovery in the first half of 2011.

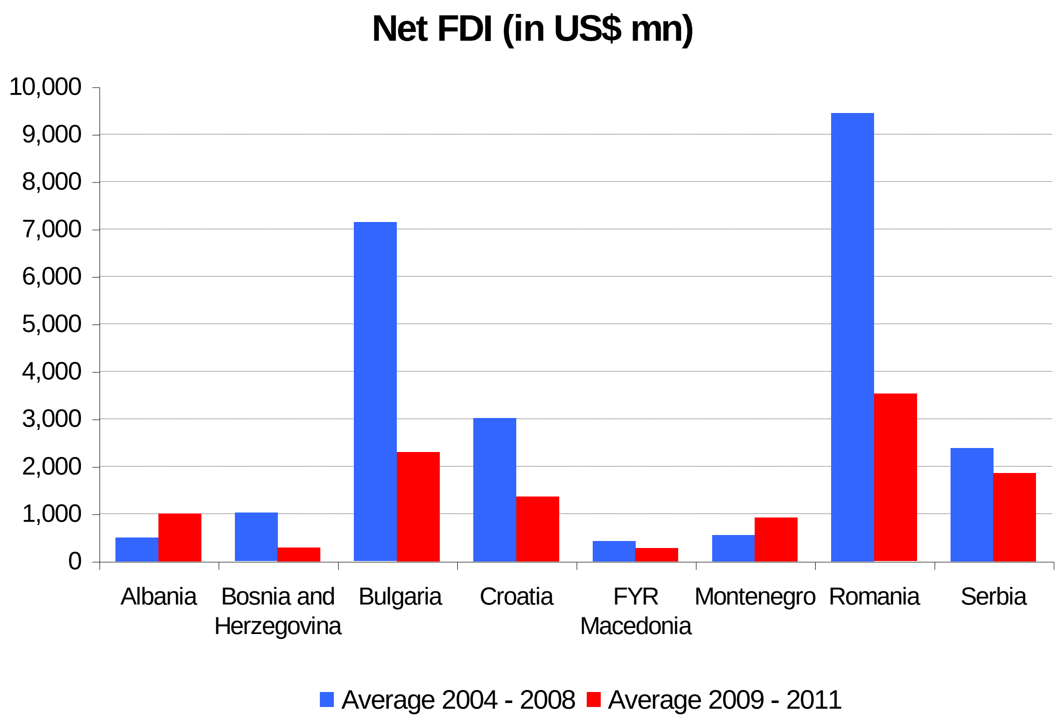
Chart 2: Consumer confidence (seasonally adjusted), selected countries



Source: Eurostat.

The third fact is that the region has suffered a major drop in foreign direct investment (FDI), not just in 2009 but continuing into the following two years. During the pre-crisis period, the region was attracting around US$ 25 billion (in net terms) annually; compared with just US$ 12 billion in annual flows in 2009-11 (see Chart 3). Only Albania and Montenegro saw any increase between the two periods, and this can be mostly explained by a couple of large privatisations. The steep fall elsewhere is hardly surprising given the sharp drop in investors' appetite for risk.

Chart 3: Net FDI, 2009-10



Source: National authorities via CEIC data service.

3. Cross-country indicators

While short-term prospects are gloomy, the medium- to long-term outlook for SEE should be a bright one. The region has plenty of catching up to do when it is viewed in relation to the main trading partners in western Europe; GDP per capita (in purchasing power parity terms) is less than half the EU average in all countries except Croatia.[8] A basic tenet of standard economic growth theory is that capital should flow from rich to poor countries, enabling the latter to grow faster than the former, provided the right conditions are in place for growth to occur. The key proviso is the phrase "right conditions" – what does it mean, and how far behind does the region lag in terms of putting these conditions in place?

This paper will try to answer these questions, drawing on a range of existing surveys, measurements, subjective judgements and other information. There is a wealth of different, and sometimes contradictory, cross-country indicators at hand. Some of them have a global coverage and are therefore potentially useful for showing how SEE compares with other regions around the world at a broadly similar stage of economic development, as well as with the rich countries of the OECD. Others are restricted to the transition region, in which case the most suitable comparators for SEE countries are the central European and Baltic states (CEB).

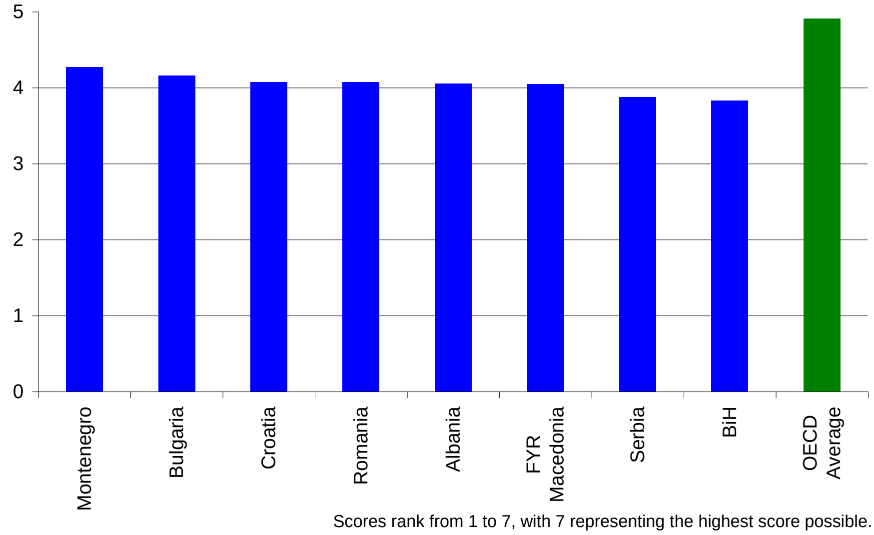
How competitive is south-eastern Europe? Our starting point for answering this difficult question is the World Economic Forum's comprehensive annual indictor – the Global Competitiveness Index (GCI) – which is currently compiled for 142 countries. Based on an assessment of various weighted indicators along 12 pillars, it measures the fundamentals required for a competitive environment, such as the institutional framework, quality of infrastructure and macroeconomic stability. It further looks at efficiency-enhancing indicators, primarily education and labour-market policies, as well as innovation factors. The indicators are built upon both hard data and the results of an executive opinion survey, which combines the perceptions of executive managers (a median of 89 in each country) on issues related to public institutions, corruption, infrastructure and the environment.[9]

Chart 4 shows the relative ranking of each SEE country, on a scale of 1 (lowest) to 7 (highest). Perhaps surprisingly, there appears to be little variation within the region. On this measure, Montenegro is the most competitive country in SEE, with a score of 4.3, followed by Bulgaria 4.2, and then Albania, Croatia, FYR Macedonia and Romania all on 4.1. Serbia and Bosnia and Herzegovina lag behind on 3.9 and 3.8 respectively. The average (unweighted) score of the region is 4.05, compared with the OECD average of 5.0.

[8] Based on eurostat estimates: see http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tec00114.

[9] For further information on the methodology of the WEF Global Competitiveness Index, see www3.weforum.org/docs/WEF_GCR_Report_2011-12.pdf.

Chart 4: Global Competitiveness Index 2011-12



Source: World Economic Forum.

The fact that the overall scores do not vary much within SEE is an interesting finding. A closer examination of the components of this index reveals a number of similarities across the region, and points to a general problem that SEE countries are facing. According to the GCI's analysis, all countries score particularly poorly with regard to innovation and sophistication factors, with a regional average of only 3.2, while conversely, they perform comparably well with regard to fundamental macroeconomic requirements.

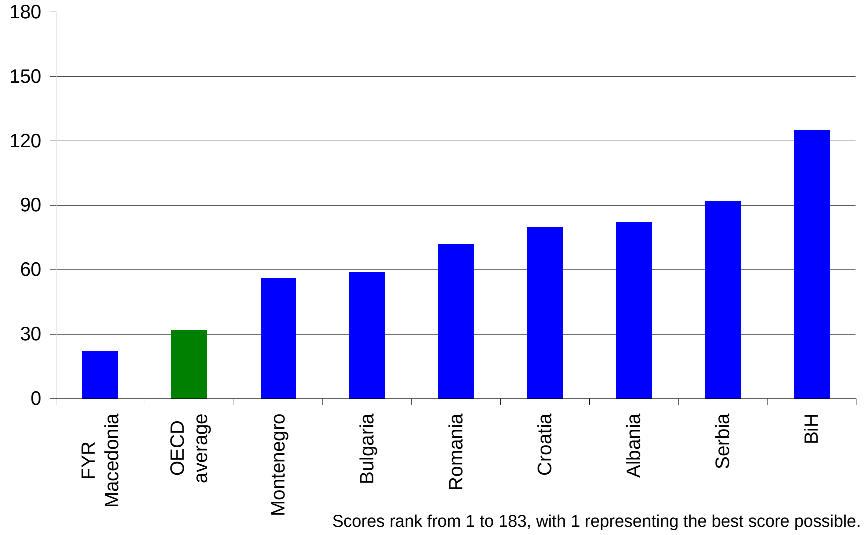
It is questionable, however, how much value can be attributed to this broad index, especially the part relating to the executive scores, as the sample size for most countries is quite small. The GCI is a useful starting point that provides "the big picture" but has limited value for policy-makers who wish to diagnose the problems and propose solutions. In order to make better use of the large variety of surveys available, and to get a closer picture of the strengths and weaknesses of the economies of south-eastern Europe, this paper will explore some key elements of competitiveness, such as the overall business environment, trade, infrastructure, human capital development and the institutional framework.

Business environment and corruption

Some observers claim that a major source of SEE's economic problems lies in the difficulties private companies face in operating an enterprise. There are two main approaches to measuring the quality of the business environment. One way looks at objective indicators associated with starting up a business and trading, both internally and across borders. This involves measurement of such factors as the length of time it takes to establish a company, the number of permits required, the difficulty of getting credit, and so on. This is the approach adopted by the World Bank in its annual *Doing Business* report, which was started in 2002 and now covers 183 countries around the world.[10] Its Ease of Doing Business index is an average of 10 different indicators and is widely used in cross-country comparisons.

Chart 5 below shows the Ease of Doing Business 2012 ranking of the SEE countries compared to the (unweighted) OECD average. The relative ranking within the region is quite similar to that of the GCI (above), but FYR Macedonia stands out as a top performer on this measure at 22nd place in the world. In contrast Bosnia and Herzegovina is placed at the bottom on the list in 125th position. Although it is difficult to assess progress of the rankings across time due to a frequent change in the methodology, the sub-indicators have also tended to gradually improve as all SEE countries have made progress in their legislative framework, including through gradual alignment with the EU *acquis*. FYR Macedonia and Montenegro are notable for their efforts to create a business-enabling and investment-friendly environment and both countries have implemented several "guillotine" projects in order to tackle red tape and excessive administrative barriers in recent years.

Chart 5: Ease of Doing Business 2012



Source: the World Bank.

An alternative method for assessing the quality of the business environment is to ask businesses directly about the problems they face in their day-to-day operations, and to get their subjective assessment of whether a problem is major or minor. The biggest survey of this type is the EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS), carried out every three to four years across virtually all transition countries. As part of a wide-ranging questionnaire, the BEEPS presents interviewees (owners or senior executives of a company) with a list of potential obstacles and asks them to rate the severity of each one on a scale of 0 (no obstacle) to 4 (very severe obstacle). This allows one to construct numerical averages by country and thereby get a sense of subjective perceptions of businesses about the difficulties they face.

Table 1 shows the average score in 2008/09, by country, for 13 different obstacles. The final column presents the average score across countries and shows that the biggest problems at regional level appear to be taxes (both the level and the

[10] For further information on the methodology of the Word Bank *Doing Business* Report, see www.doingbusiness.org/.

administration), political instability and corruption. Limited access to finance was also an important impediment even though the global crisis had not yet unfolded in the region by the time the latest round of the survey was carried out. An inadequately educated labour force and a weak court system also figure prominently among the complaints of businesses. The average size of obstacles was perceived to be higher in SEE than in CEB in the majority of cases, with the difference being particularly marked when it came to corruption, such as illustrated below.[11]

Table 1: Regional business environment scores by country and obstacle

	Albania	BiH	Bulgaria	Croatia	FYRoM	Montenegro	Romania	Serbia	*SEE Average*	*CEB Average*
Tax rate	1.55	2	1.74	2.1	1.62	1.15	2.73	1.59	*1.81*	2.21
Political instability	1.97	2.11	1.61	1.78	1.71	0.42	2.17	2.3	*1.76*	1.76
Corruption	2.07	1.71	1.63	1.62	1.52	0.59	2.34	1.76	*1.66*	1.38
Tax admin	1.29	1.58	1.45	1.95	1.23	0.76	2.36	1.04	*1.46*	1.37
Access to finance	1.35	1.56	1.36	1.48	1.67	0.85	1.87	1.62	*1.47*	1.23
Labour Force	1.41	1.14	1.21	1.43	0.93	0.73	2	1.15	*1.25*	1.17
Courts	1.36	1.26	1.31	1.85	1.64	0.46	1.7	1.19	*1.35*	1.05
Business licensing	0.98	1.2	1	1.14	1.07	0.51	1.77	0.95	*1.08*	1.03
Electricity	2.42	1.03	1.27	0.7	1.23	1.27	1.42	1.1	*1.31*	1.32
Crime	0.89	1.08	1.48	1.38	1.26	0.4	1.49	0.92	*1.11*	1.27
Labour regulation	0.88	0.88	1.02	1.32	0.74	0.51	1.5	1.02	*0.98*	1.17
Access to land	1.33	0.65	0.76	0.77	1.04	0.43	1.33	0.9	*0.90*	0.81
Transport	0.8	0.76	1	0.77	0.84	0.62	1.23	0.88	*0.86*	0.98
Customs &Trade	0.71	0.78	0.56	0.86	0.87	0.44	1.14	1.07	*0.80*	0.53

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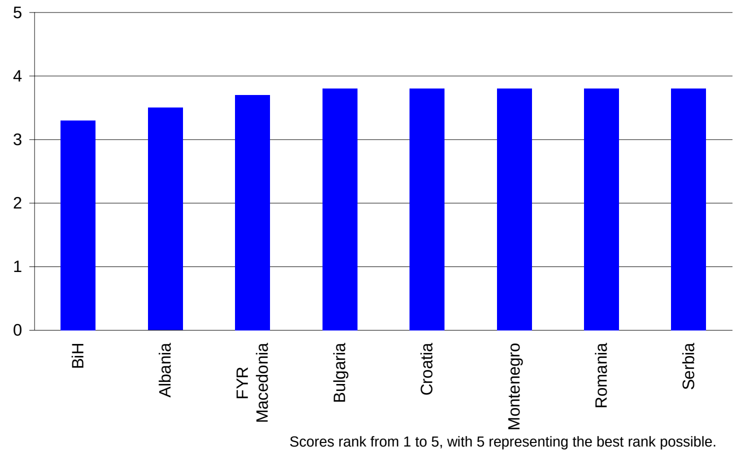
Source: EBRD/World Bank Business Environment Performance Survey, 2008/9.

Two other cross-country indices can provide important further insights into the quality of the business environment: the OECD's Investment Reform Index (IRI), last published in 2010, and Transparency International's Corruption Perceptions Index (CPI). The IRI looks at the ability of the region to attract investment, and assesses the institutional framework and policies of the countries of SEE. The evaluation is based on a qualitative evaluation of seven aspects that enable an investment-promoting environment, including policies, human capital development, access to finance and tax policies. The IRI uses a mix of inputs from the public and private sector, as well as from independent experts, and this information is benchmarked against international best practice.[12]

[11] See Berglof et al. (2012). The exceptions, where the average size of the obstacles was lower in SEE were: crime, theft and disorder; electricity; inadequately educated workforce; labour regulations; tax rates; and transport.
[12] For further information on the methodology of the IRI, see www.oecd.org/document/28/0,3746,en_2649_34893_40349212_1_1_1_1,00.html.

Chart 6 shows the overall scores by country. The results show very little difference among the EU member and candidate countries of the region, with Albania and Bosnia and Herzegovina (neither yet an EU candidate) lagging behind.

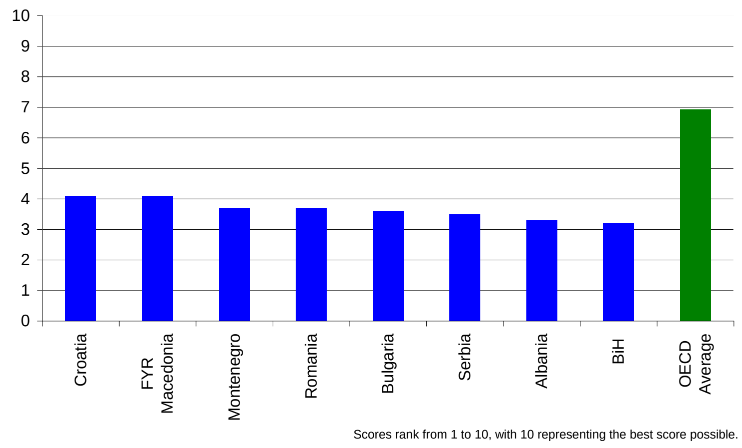
Chart 6: Investment Reform Index, 2010



Source: OECD.

With regard to corruption, the most popular cross-country index is the Transparency International Corruption Perception Index (CPI), which rates the level of perceived corruption on a scale of 0 to 10, with a higher score signifying less corruption. Even in the economically more advanced countries in the SEE region the perceived level of corruption seems to be substantially higher than in the OECD countries (see Chart 7). With a score of 4.1, Croatia and FYR Macedonia are viewed as the least corrupt countries in the region, while Albania and Bosnia and Herzegovina are perceived to be the most corrupt.

Chart 7: Corruption Perception Index 2011



Source: Transparency International.

What are the relevant strengths and weaknesses of these different approaches to measuring the business environment? The World Bank's *Doing Business* (DB) report has attracted significant criticism from a number of sources, including a report from the World Bank's own Independent Evaluation Group.[13] The main problems, as identified in this report, include the fact that the DB is largely about laws on the books and formal regulations rather than about their compliance and practical implementation and the operational environment more generally. Most of the indicators assume that less regulation is preferable to more, regardless of where a country is starting from. The sample size of country-level informants is sometimes very small. For these reasons (among others) the DB indicators can give a misleading picture of the true situation. It is hard to believe that FYR Macedonia, for instance, is the 22nd easiest country to do business in globally, notwithstanding the genuine efforts in recent years of the authorities to improve the situation on the ground.

The BEEPS and the CPI have their own problems, too. They are largely survey-based, so one must be careful in making cross-country comparisons because individuals in one country may have different reference points when it comes to judging the severity of a problem compared with those in another country. For example, when it comes to rating infrastructure as an obstacle, those businesses that live in a country with very poor roads, say, may have adapted their mode of working over time and may not, therefore, perceive this to be an obstacle. Simultaneously, more open economies with a strong focus on exporting require more trade facilitating regulations than economies less focused on export activity, and therefore view obstacles to trading relatively more severely than others. Another problem is that a perceived worsening of a public good like infrastructure may reflect congestion effects in a growing economy rather than any deterioration in the inherent quality of the service. Lastly, the OECD's IRI can be a useful tool for identifying deficiencies relating to investment climate, but the consensual nature of the index weakens the force of the message and the absence of a similar index in other regions limits the possibility of learning from best practice of others.

Once one allows for the limitations and possible biases of the different measures, however, a fairly clear picture emerges concerning the importance of competitiveness and business environment issues throughout the region. There is clearly a disconnection between regulatory reforms, where progress is visible in many countries (often with the encouragement and support of international institutions), and the experience of businesses on the ground. It is possible that too much emphasis has been based on ticking boxes of reforms without a deeper examination of the more fundamental causes of SEE's relatively poor economic performance. The indicators discussed below help to bring out this point more sharply.

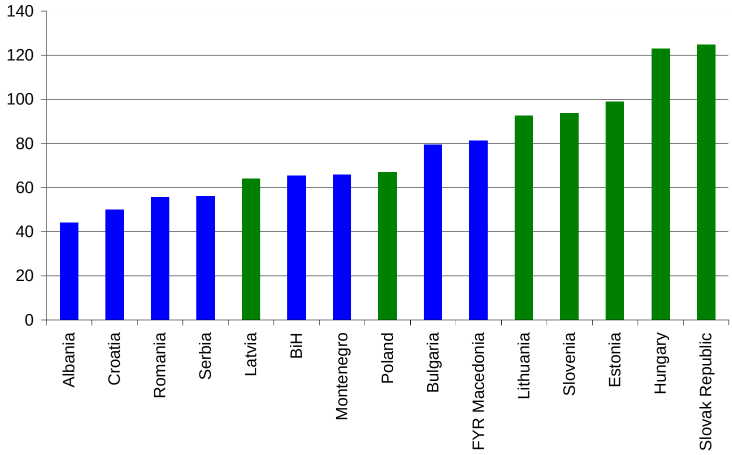
Trade

Businesses in SEE appear to have a problem with trading freely across borders. Although intra-regional trade has increased substantially in recent years and the European Union remains the region's most important trading partner (more than 60 per cent of exports from the region go to the European Union), overall trade activity remains below the level that is typically seen in economies of this size. Chart 8 compares the level of trade openness of the SEE economies with those of CEB, using the standard measure of the sum of exports and imports divided by GDP. The result

[13] The report is available at: http://go.worldbank.org/SKWPK59XU0

shows that even in the two existing EU member states Bulgaria and Romania, trade activity remains relatively low.

Chart 8: Trade openness 2010



Source: National authorities.

What could account for the low level of cross-border trading activity? It cannot be explained by lack of access to EU markets. Bulgaria and Romania are already fully integrated into the EU single market, and the remaining SEE region enjoys almost unlimited duty-free access to the European Union since 2000.[14] Furthermore, the non-EU member states of the region, together with Moldova and Kosovo,[15] are signatories of the Central European Free Trade Agreement, CEFTA 2006, which envisages the elimination of quotas and tariffs and other barriers to trade. It seems therefore that the removal of tariffs and quotas for SEE's key trading partners in recent years has been largely offset by more subtle obstacles to trade and non-tariff barriers (NTBs), such as sanitary and phytosanitary standards, extensive documentation and licensing requirements, and lack of available information on custom procedures. The hope is that these barriers will be alleviated over time as countries become more closely integrated with the European Union.

A comparison of the World Bank's Doing Business scores on trade and the BEEPS can provide further insight into this issue. Chart 9 shows that there is a clear distinction between countries of SEE (mostly in the right-hand ellipse) compared with CEB, with the former more constrained by formal customs and trading procedures, as measured both by the *Doing Business* report and by the subjective perceptions captured in the BEEPS. It is notable that the SEE countries – with the exception of Montenegro, which is positioned among the top 40 countries – have continuously performed poorly in the Trading Across Borders sub-indicator of Doing Business.[16] In addition, corruption on the border continues to be a substantial hindrance to trading.[17]

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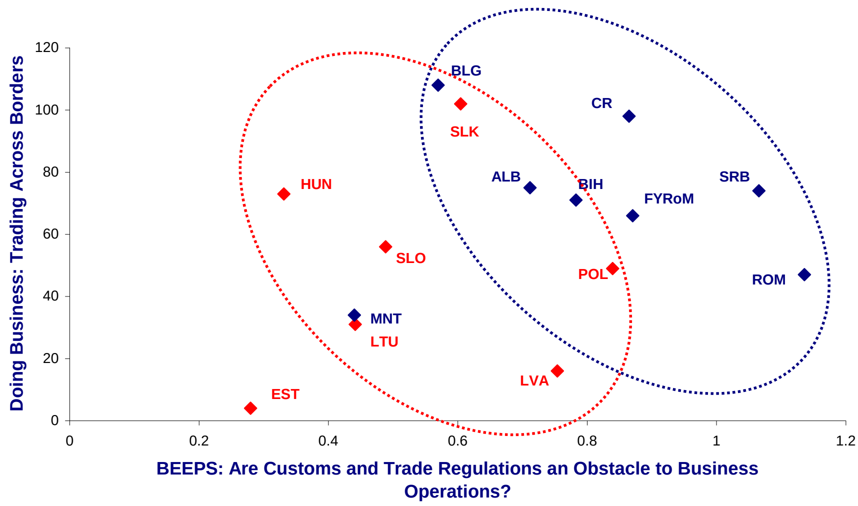
[14] Exception to these EU Preferential Trade Agreements include wine, sugar, baby beef and certain fishery products, which may enter the Single Market under preferential tariff quotas. The preferential agreement for Western Balkan countries was first agreed in 2000 and reaffirmed in January 2012.
[15] Under UNSCR 1244.
[16] The Doing Business Trading Across Borders Indicator measures how much time, how many documents and the cost required to trade by ocean transport.
[17] For an elaboration of this argument, see EBRD (2010).

Chart 9: Obstacles to trading across borders, CEB vs. SEE

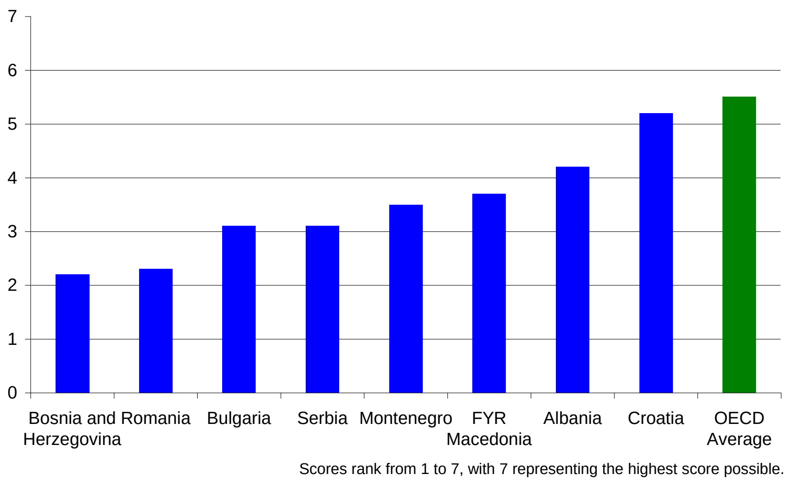


Source: World Bank and EBRD.

Infrastructure

Another major factor constraining cross-border trading in SEE remains the significant infrastructure deficit. The presence of motorways remains limited even in the more advanced countries in the region, and the railway network is underdeveloped. The World Economic Forum's Competitiveness (sub-)index on Infrastructure illustrated in Chart 10, takes into account the quality of the road and railway infrastructure and air transport, electricity supply and communication technology penetration, and underlines these shortcomings. With the exception of Croatia, the quality of the overall infrastructure in SEE requires significant upgrading in order to match the standards in Western Europe.

Chart 10: Quality of infrastructure 2011-2012



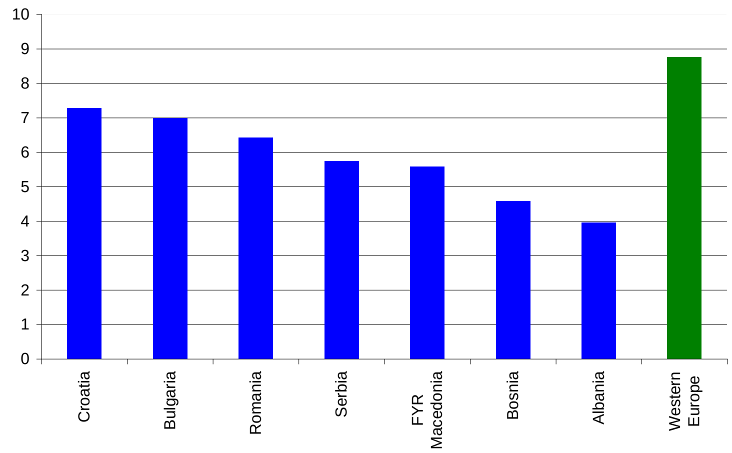
Source: World Economic Forum.

Skills and education

The current structure of the economies in the SEE region is dominated by services, particularly driven by wholesale trade and retail trade and real estate, and which on average accounts for more than 50 per cent of total economic activity. In addition, the production of goods and services remains at the lower end of the value chain, largely based on cheap (relative to Western Europe) and unskilled labour. So far, little focus has been paid on shifting towards a more knowledge-based economy, that is, one where knowledge is a key engine of growth and where the appropriate institutions are in place to enable and encourage the use of existing knowledge and to foster innovation and the development of information and communications technologies.[18]

The World Bank's Knowledge Economy Index (KEI), presented in Chart 11, measures a country's potential to generate knowledge and underlines the gap in this area in SEE. All countries in this region lag significantly behind the western European average, though there are significant differences among the countries. The new EU member states of Bulgaria and Romania as well as Croatia are relatively advanced in terms of developing a knowledge economy. Conversely, the knowledge economy remains at infancy in the rest of the region, notably in Bosnia and Herzegovina and Albania, thus suggesting that more efforts are needed to respond to the increasing demand for high-skilled labour.

Chart 11: Knowledge Economy Index 2009



Source: World Bank.

As discussed above, the BEEPS results also highlight the prominence of lack of skills and education as a source of problem for many businesses in SEE. This raises a question about the quality of education in the region. The OECD Programme for International Students Assessment – better known as the PISA study – suggests that the region has some catching up to do in providing high quality primary and secondary education, which is the fundamental basis for fostering research and development and innovation-driven economic activity. The PISA study assesses the ability of 15-year old pupils in 65 economies in reading and mathematical and scientific literacy.[19]

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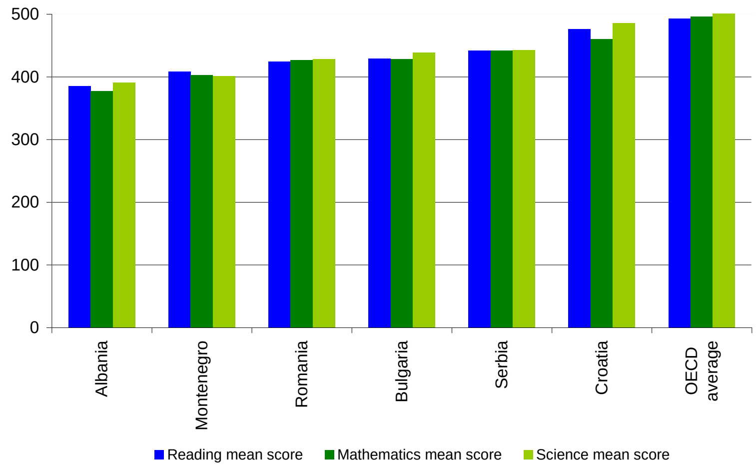
[18] See Chen and Dahlman (2005) for a discussion of the concept of, and methodological issues surrounding, the knowledge economy.
[19] Not all SEE countries are included in PISA.

Chart 12 shows that pupils in south-eastern Europe under-perform those in the OECD member states. Confirming the results of the KEI, Croatian students seem the most advanced in the domains assessed by PISA and have achieved results close to those of the OECD countries. However, the performance of the remaining SEE countries clearly indicates that the education gap between the region and the industrially advanced countries is sizeable.

Chart 12: PISA results 2009



Source: OECD.

Transition reforms and market-supporting institutions

In the past two decades policy-makers across the region have attempted, with varying degrees of commitment and success, to introduce transition-related reforms, involving measures such as price and trade liberalisation, privatisation and the introduction of market forces into areas that were previously immune to such policies. At the same time, a large political economy literature has emerged that emphasises the importance of inclusive institutions as the fundamental source of long-term economic growth.[20] As with many of the concepts discussed above, measuring either the extent of reforms or the quality of institutions is inherently difficult. Nevertheless, a number of attempts have been made to impute numerical scores of reform progress to the transition countries, including those in SEE. More recently, efforts have been made to quantify the extent to which effective institutions are present and able to support the interplay of market forces. This section will explain how one international organisation, the EBRD, has developed numerical indicators to tackle these problems.

The EBRD's annual transition indicators, first formulated in 1994 and refined several times since, are a well-known set of reform indicators in the region. They have been widely used in academic research that focuses on the link between reforms and other variables such as economic growth.[21] The indicators were initially scored on a 4-point

[20] For an overview of the literature, see Acemoglu et al. (2005). Two of these authors develop the argument, using numerous historical examples, in a recently published book (Acemoglu and Robinson, 2012).

[21] Previous research on the link between reforms and growth using the EBRD transition indicators includes Berg et al. (1999), Havrylyshyn and Van Rooden (2000), Falcetti et al. (2002) and Falcetti et al. (2006). A more recent example is Eicher and Schreiber (2010).

scale, from 1 to 4, where 1 represented little or no progress in reform and 4 meant that a country had made major advances in transition in a particular aspect. From 1997, pluses and minuses were added to allow for finer distinctions, meaning that 2+, for example, could be coded as 2.33 and 2- as 1.67. As of 2011, there are six country-level transition indicators: three covering aspects of enterprise reform (small-scale privatisation, large-scale privatisation, and governance and enterprise restructuring) and three relating to markets and trade (price liberalisation, trade and foreign exchange system, and competition policy).[22]

Table 2 shows the scores for the SEE countries, along with a simple average of the six indicators. Most SEE countries perform well with regard to small-scale privatisation, price liberalisation and trade and foreign exchange system – the so-called first-stage or "market-enabling" reforms.[23] In a number of cases, a score of 4+ has been achieved, suggesting that there is little or nothing else to do in terms of moving towards the standards of a hypothetical advanced, well-functioning market economy. The scores on the other three indicators are typically lower, and with greater variation across countries. Neither fact is surprising: reforms in these areas are harder to achieve and politically more sensitive, but the three countries in the region that are either EU members or very close to membership (Bulgaria, Romania and Croatia) have made much more progress than the remaining countries.

Table 2: Country transition indicator scores 2011

	Albania	BiH	Bulgaria	Croatia	FYRoM	Montenegro	Romania	Serbia
Large-scale privatisation	4-	3	4	3+	3+	3+	4-	3-
Small-scale privatisation	4	3	4	4+	4	4-	4-	4-
Governance and enterprise restructuring	2+	2	3-	3+	3-	2+	3-	2+
Price liberalisation	4+	4	4+	4	4+	4	4+	4
Trade and foreign exchange system	4+	4	4+	4+	4+	4	4+	4
Competition policy	2+	2+	3	3	3-	2	3+	2+

Source: EBRD

Although the EBRD's country-level transition indicators have gained wide currency, their drawbacks have become increasingly apparent.[24] The biggest problem is that they take insufficient account of the institutional framework surrounding private sector development and the creation of markets. While most people would agree that a successful transition involves reducing the role of the state and encouraging private ownership and market forces, it has become increasingly recognised that markets cannot function properly unless there are well-run, effective public institutions in place. That is why the EBRD developed a new set of sectoral-based indicators.

[22] In previous years there were transition scores for financial markets and several infrastructure sectors, but these have now been folded into a broader set of sectoral transition indicators, explained in more detail later in the paper.
[23] The term "market-enabling reforms", as applied to these three indicators, was introduced in EBRD (2007).
[24] See EBRD (2010), Chapter 1, and Besley et al. (2010) for a fuller discussion.

The new approach examines 16 sectors – covering the corporate, energy, infrastructure and financial areas – in each country and makes a judgement about the size of the remaining transition "gaps", or challenges. That is, an assessment is made about what needs to be done, in terms both of changing the market structure and developing market-supporting institutions, to bring standards up to those of a hypothetical well-functioning market economy. The information used is a mixture of laws and regulations "on the books", as well as a judgement about how well they are being implemented. Based on this, the transition gaps for both market structure and market-supporting institutions are classified as "negligible", "small", "medium" or "large". These gap scores are then combined to give an overall numerical score to the sector, on a scale of 1 to 4+, with the exact score determined both by the data and an element of judgement.[25]

Table 3 presents the scores for each sector in each SEE country, as well as the average regional sector transition score for CEB. Although less pronounced in the new EU member states of Bulgaria and Romania, as well as Croatia, there is still a considerable gap between the CEB and SEE region.[26] This suggests that the need for structural reforms in SEE is still significant.

Table 3: Regional sector transition scores 2011

	Albania	BiH	Bulgaria	Croatia	FYRoM	Montenegro	Romania	Serbia
Agribusiness	3-	3-	3	3	3-	2+	3-	3-
General Industry	2+	2	3+	3+	3	2+	3+	3-
Real estate	3-	2-	3+	3+	3-	2+	3+	3-
Telecommunications	3+	2+	4-	4	4-	3+	3+	3
Natural resources	3-	2	3+	4-	2+	3+	4-	2
Sustainable energy	3+	2	3-	3-	2+	2	3+	2
Electric power	3	2+	4-	3	3	2+	4-	2+
Water and wastewater	2+	2	3	3+	2+	2	3+	2+
Urban transport	3-	2+	3+	3+	3-	3	3+	3-
Roads	3-	3	3-	3	3-	2+	3	3-
Railways	2	3+	3+	3-	3-	2	4	3
Banking	3-	3-	3	3+	3-	3-	3	3-
Insurance/ Financial Services	2	2+	3+	3	2+	2+	3+	3
MSME Finance	2+	2+	3-	3-	2+	2+	3-	3-
Private Equity	1	2-	3-	2+	1	1	2+	2-
Capital Markets	2-	2-	3	3	2-	2	3	3-

Source: EBRD

A close look at the sectoral scores reveals that the biggest gaps are in the energy sector (especially electric power and sustainable energy), the water and wastewater sector, and in the non-bank financial sector, with particularly big gaps in capital markets and private equity. The whole topic of energy efficiency and sustainability is becoming increasingly urgent in SEE because this is a region that is likely to be affected in a major way by global warming. In the pre-crisis boom years, when foreign banks poured into the region and fought aggressively to build market share, the non-bank financial sector was somewhat neglected. It is for these reasons that many countries are making a major effort, with strong support from international

[25] For further information on the methodology of the EBRD sector transition indicators, see www.ebrd.com/downloads/research/transition/tr11.pdf.
[26] See EBRD (2011b), Chapter 1, for the sector transition scores in all transition countries.

financial institutions such as the EBRD, to develop local capital markets and a greater use of lending in local currency. This initiative is welcome but is likely to take time to bear fruit.

4. Lessons for policy-makers

The analysis has demonstrated that south-eastern Europe is clearly lagging behind, not just in economic development but in a range of competitiveness, business and investment environment, and institutional reform indicators. The main point of this paper is that, while we can draw lessons and useful information from each of the indicators described above, a narrow focus on a particular one to the exclusion of others could give a misleading impression of where a country stands. The real added value of these indicators comes from analysing them jointly in order to draw policy-relevant conclusions. We hope, therefore, that this paper will dissuade others from making confident assertions about the competitiveness or investor-friendliness of the region based on just one or two cross-country measures.

When all indicators are viewed simultaneously, and at the risk of simplification, it appears that a rough three-way division can be made. According to the analysis above, the best-placed economies in the region appear to be the three EU member or near-member countries (Bulgaria and Romania as members and Croatia which has signed the EU accession treaty and expects to join the European Union in July 2013). The three EU candidate countries (FYR Macedonia, Montenegro and Serbia), with some exceptions, follow next, while the third group consists of Albania and Bosnia and Herzegovina, both of which lag behind on most indicators. The correlation between progress on broad market reforms and EU integration, or approximation, is not a coincidence, because the European Union has clearly been a vital anchor for reform throughout central and eastern Europe.

What advice can be offered to policy-makers beyond the general exhortation to try harder and be more like the rich western European countries? As we noted in the introduction, we do not wish to attempt to offer a comprehensive blueprint for reform in this paper, partly because this would involve a much more exhaustive and rigorous investigation of the current obstacles to investment and growth, including factors not considered explicitly in this paper such as the fiscal framework, wage and employment policy, the quality of public administration and other variables. However, there are some recommendations that can validly be drawn from the analysis above, among which are the following.

Reform tax administration and lessen corruption by learning from other countries

Both the Doing Business survey and the BEEPS point to problems with tax administration in the region. In the last round of the BEEPS, it was identified by businesses as the most important obstacle in five out of 29 transition countries, four of which are in SEE.[27] However, transition countries can learn from the experience of others in this regard, and can implement reforms relatively quickly in this area. In 2000, Estonia implemented a major overhaul of its tax administration, introducing modern innovations such as e-filing of taxes which greatly improve efficiency and reduce the scope for bureaucracy and corruption. As a result, businesses in Estonia complain very little in the BEEPS about tax administration as an obstacle. Estonia can

[27] The four countries were Bosnia and Herzegovina, Croatia, Montenegro and Romania – see EBRD (2010, Chapter 5).

also serve as a useful example to others in terms of successfully implementing comprehensive and effective anti-corruption policies.[28]

Focus on removing non-tariff barriers in order to facilitate cross-border trade and investment

As indicated in the analysis above, trade activity in the SEE region remains below its potential and falls short of that of CEB. The umbrella of the CEFTA 2006 Secretariat serves as a useful tool to further stimulate exports and imports. Trade policy should envisage the mutual recognition of certificates and a strengthened institutional framework for accreditation, for instance. In addition, at national level, an expanded budget could be allocated to national export promotion agencies to enhance internationally accepted standards and best practices to facilitate trading across borders, while transparent and easily accessible information on trade regulations and procedural requirements should be made available to exporting enterprises. Lastly, by implementing EU-required sanitary and physiosanitary measures, the region will gradually align with international standards, which will further support exports to the region's key markets and boost its attractiveness to investors.

Adopt a more strategic and cooperative approach to cross-border investment

A more strategic approach is also needed both by regional governments and the international community to address the large infrastructure deficit the region is restraining, as illustrated in Chart 10. Cross-border projects to upgrade the road and railway infrastructure, such as the pan-European corridors that run across the SEE region, already receive large support from the European Union, the EBRD and other international financial institutions (IFIs). The success of these large-scale IFI interventions, however, is determined by the commitment of the region's governments to cross-border cooperation. This includes ensuring smooth and easy border crossings, cooperation of the various contractors and regional coordination of the programmes. In addition to the (re-)integration of south-eastern Europe into the wider pan-European infrastructure network, however, attention must also be paid to maintaining and further developing a regional network of road and railways in order to connect more remote areas with regional hubs, for which private sector involvement should be further encouraged. One option largely unused until present is the utilisation of EU structural and cohesion funds, that are available to the EU members Bulgaria and Romania, and soon also for Croatia. At present, both Bulgaria and Romania are struggling to absorb EU funds, although strong efforts are under way in both countries to improve the situation. In this regard, more expert help and streamlining of regulations may be required from Brussels in order to increase the absorption capacities of fund-receiving countries.

Allocate more funds to secondary and tertiary education

A major competitive advantage of the region in the past has been the relatively cheap labour which has attracted a number of foreign investments. However, as wages a bound to increase in the medium-term, increasing the quality of the education system is crucial for moving towards a knowledge economy and enhancing the growth potential of an economy. The PISA results show that substantial shortcomings remain in the SEE educational system. Previous research has shown that a strong focus on tertiary education in particular is required, which in the long-term, generates the

[28] See EBRD (2010, Chapter 5) for further discussion of this argument and example.

science and research that aids enterprises to foster innovation.[29] As the scope for increasing government spending on education is limited in the short-term, the private sector may play an increasingly important role in training and skills acquisition, for instance by enabling more on-the-job training opportunities and funding university scholarships. Lastly, the implementation of international standards on tertiary education within the framework of the Bologna Process will help the region to introduce more quality assurance and curricular alignment, and should lead to increased labour market mobility.

Mobilise funds for innovation

The BEEPS shows that access to finance continues to be a major obstacle to business development in the SEE region, and may be preventing efforts to establish and foster innovative and export-oriented enterprises. This is particularly evident in the small and medium-sized enterprises (SME) sector, which numerically dominates the private sector in all SEE countries, but currently contributes little to GDP or exports. A recent example of fostering more sophistication and value-added in the SME sector is the Western Balkan Enterprise Development and Innovation Facility (EDIF), better known as the SME Platform, which on the initiative of Serbia, the EBRD and the European Investment Fund has been established within the framework of the multi-donor-funded Western Balkans Investment Framework (WBIF). It will provide financing to innovative and high growth potential SMEs and includes a technical assistance component to help the region to develop further private sector supporting policies, which in the long term will contribute to more business sophistication in the region.[30]

[29] See EBRD (2008), Chapter 3.
[30] For further information see www.wbif.eu/Private+Sector+Development/.

5. Concluding remarks

The analysis above has suggested a variety of starting points and diagnostics to tackle the shortcomings and constraints to future growth in south-eastern Europe. It has also concluded that, on an individual basis, available competitiveness and business environment surveys have limited value for analysts and policy-makers, but that taken together they can provide a valuable instrument.

Although this paper has made the deficiencies of the region clear, we believe that SEE has the potential to become globally competitive, and we have outlined several propositions to address deficits in the regulatory and institutional framework and obstacles to trade, as well as to foster a more competitive, innovative and export-oriented private sector. However, none of the above can be fully achieved without enhancing cross-border cooperation within the region, which has become increasingly prominent in recent years. A number of initiatives to promote trade, financial linkages and broader regional cooperation have already been mooted, and in some cases implemented.

In conclusion, a fully-fledged commitment by the national authorities to not only intensify the sometimes difficult reform process, but also maintain good neighbourly relations and improve cross-border exchange on best practices and lessons learned is vital to unlocking the region's potential and helping overcome the legacy of the past.

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Annex: Overview of surveys and indices used to measure competitiveness and the business environment in south-eastern Europe

Name	Source	Coverage	Frequency	Objective	Methodology	Main strengths	Main weaknesses
World Economic Forum Global Competitiveness Index (GCI)	www.weforum.org/issues/global-competitiveness	Global, 142 countries	Annual	Provide a comprehensive measure of a country's competitiveness.	Uses a mix of hard data and an executive opinion survey, which includes manager's perception on competitiveness. Scores countries on a scale of 1 to 7.	A comprehensive mix of many different indicators relevant to a country's competitiveness.	Small sample size in some countries. Possible lack of objectivity of executive survey. Data quality for some parts of the index is uncertain.
World Bank Doing Business	www.doingbusiness.org/	Global, 183 countries	Annual	Assess the regulatory framework for supporting a business-friendly environment, summarised in an Ease of Doing Business Index.	Gathers information on 10 indicators, covering laws, regulations and procedures, based on factual data obtained from surveys of experts on the ground. Provides ranking of countries on different	Comprehensive analysis of regulatory framework critical for a business-enabling environment.	No measurement of extent to which laws are actually applied. Small number of data points for certain indicators in some countries.

					indicators and on overall ease of doing business.		
World Bank/ EBRD Business Environment and Enterprise Performance Survey (BEEPS)	www.ebrd.com/pages/research/analysis/surveys/beeps.shtml	Regional, 29 countries in the transition region	Periodic – usually every 3-4 years (last round in 2008-09).	Measure the overall quality of the business environment and the severity of obstacles, as perceived by owners and senior managers of enterprises.	Survey-based, assessing perceptions of more than 11,800 enterprises in the last round. Obstacles can be coded on a five-point scale from 0 (no obstacle) to 4 (very severe obstacle).	Captures the reality of business environment problems as perceived by business people on the ground.	Cross-country comparisons are problematic because of different reference points. Subjective opinions may be only loosely related to objective conditions.
OECD Investment Reform Index (IRI)	www.oecd.org/document/28/0,3746,en_2649_34893_40349212_1_1_1_1,00.html	Regional, 10 countries in south-eastern Europe	2006, 2010	Assess eight policy dimensions that shape investment policies, including investment promotion policy, human development, SME development and infrastructure for investment.	Uses a mix of government self-assessment, independent expert groups and working groups with private sector representatives to score policy developments in each dimension from 1 -5.	Strong focus on investment and synthesises a range of views about the necessary reforms.	Consensual nature of discussions can lead to bland policy recommendations. No obvious benchmark outside SEE.

TR Corruption Perception Index (CPI)	http://cpi.transparency.org/cpi2011/results/	Global, 183 countries	Annual	Measure the perceived level of corruption.	Survey-based, assessment of perceptions, drawing on 17 data sources from 13 institutions on a scale from 0 (most corrupt) to 10 (no corruption).	Only index of its kind and uses a variety of perception surveys.	Possible lack of objectivity. Uses only proxies for corruption.
World Bank Knowledge Economy Index (KEI)	http://info.worldbank.org/etools/kam2/KAM_page5.asp	Global, 146 countries	Annual, 1995-2009	Assess a country's ability to generate and adopt knowledge.	Based on 14 variables along four pillars: economic performance; economic incentive and institutional regime; education and human resources; and innovation systems. Includes quantitative data and a mix of other existing indices. Scale from 0 to 10.	Useful mixture of sources and information relevant to an increasingly important sector.	No longer updated. Great variety of methodologies, making cross-country comparisons difficult.

OECD PISA	www.pisa.oecd.org/pages/0,2987,en_32252351_32235731_1_1_1_1_1,00.html	Global, 75 countries	Triennial	Measure the quality of the secondary education system	Assignment-based, assessing the ability in reading, mathematics and science of more than 520,000 15-year old students in the last round. Scores for each indicator are based on a scale of 0 to 600.	Especially useful for cross-country comparison. High level of objectivity. Studies show the results have strong predictive power for long-run economic growth.	Not all SEE countries covered. Neglects aspects of educational attainment, such as vocational training.
EBRD Country Transition Indicators	www.ebrd.com/pages/research/economics/data/macro.shtml	Regional, 29 countries in the transition region	Annual	Summarise a country's progress to a well-functioning, market-based economy on broad, country-level indicators.	Uses a mixture of factual information and judgement to score countries, on a scale of 1 to 4+, for progress on small- and large-scale privatisation, price and trade liberalisation, corporate governance and competition policy.	Handy snapshot of a country's progress in transition. Empirical evidence suggests the indicators can help predict other variables such as economic growth.	Insufficient attention to the institutional framework necessary for markets to function.

EBRD Sector Transition Indicators	www.ebrd.com/pages/research/economics/data/macro.shtml	Regional, 29 countries in the transition region	Annual	Measure progress towards the standards of a well-functioning market economy in 16 different sectors.	Uses a range of data, combined with judgement, to rate progress in reform, on a scale of 1 to 4+, in 16 different sectors, covering the corporate, infrastructure, energy and financial sectors. Scores are based on an assessment of the transition gaps in both market structure and market-supporting institutions.	Detailed sectoral assessment can help identify significant transition gaps and investment needs by sector.	Scoring system still has a strong element of subjectivity. Link between closing transition gap in a sector and boosting economic growth is unclear.