

CHAPTER 4

Services as an Engine of Growth: The Regional Dimension of Trade in Services

Introduction

Services play an increasingly important role in the development of an economy. For SEE, the share of services in GDP rose from 55 percent in 2000 to 58 percent in 2005, but was still low compared with EU levels (78 percent in EU27 in 2006). Across countries, the share of services varies from 51 percent in Serbia and Montenegro to 65 percent in Bosnia and Herzegovina. Given their weight in the economy, services play a key role in the growth of GDP. Perhaps more importantly, services play a key role in the competitiveness of all firms, across all sectors, in open economies (Hoekman 2006). Over time, the services content of goods keeps rising, as an increasing share of the value of any product originates from R&D, finance, design, marketing, distribution, and so on. In many areas, such as business-process outsourcing, the quality of telecommunications is fundamental to the success of firms. Thus, an increase in the efficiency and productivity of services will add to economic growth, both directly through the services sector's share in GDP, and indirectly through improvements in the efficiency of the rest of the economy.

Liberalization of trade in services could become a powerful driver for growth in SEE for several reasons. First, many services sectors have traditionally been government-controlled and shielded from competition.

Hence, a liberalization of services trade could induce substantial efficiency gains. Second, most trade barriers for services come in the form of behind-the-border policies (such as a limit on the number of mobile phone operators) and thus the full liberalization of services trade includes broad domestic reforms. Third, most trade in services takes place through commercial presence and thus entails significant FDI flows and knowledge spillovers. Fourth, barriers to trade in services penalize in particular small- and medium-sized enterprises (SMEs), because SMEs are disproportionately affected by complex administrative and legal requirements. SMEs, a key driver of growth, will greatly benefit from liberalization because the present barriers mainly protect the large incumbent firms from competition. Not surprisingly, the potential gains from full liberalization in services trade are significant, and usually exceed potential gains from liberalization in merchandise trade.¹ It is important to note that full liberalization is key, because the literature suggests that what matters most in enhancing performance in any services sector is competition in general (whether domestic or foreign), complemented by effective regulation.²

Trade in services differs fundamentally from trade in goods. Since services tend to be intangible and nonstorable, their trade often requires a direct interaction between buyer and seller. As a result, there are four different modes of supply: mode 1) *cross-border supply* occurs when consumers and producers do not interact (for example, financial services transacted online); mode 2) *consumption abroad* occurs when the consumer moves to the producer (for example, tourism or port services); mode 3) *commercial presence* occurs when the producer comes to the consumer (for example, bank branches or retail outlets); mode 4) *presence of natural persons* occurs through, for instance, short-term assignments of architects or consultants. The relative importance of the four modes differs between sectors and liberalization should ideally cut across modes. Nevertheless, commercial presence tends to be the dominant mode. Consumption abroad is mainly relevant for tourism, while technological progress is increasing the feasibility of cross-border supply for a growing number of services (for example, IT-enabled services). Due to its peculiar nature, services trade entails substantial flows of capital, labor, intellectual property rights, and knowledge spillovers between jurisdictions.

Barriers to trade in services mostly come in the form of behind-the-border administrative barriers or regulations targeted at services suppliers. In contrast, the main barriers to trade in goods are tariffs and quotas

enforced at national borders. If cross-border trade in services is to be liberalized, a wide range of domestic policies need to be reformed. These include rights of establishment (for example, for foreign retailers or hotel chains), rules for market access (for example, network access for telecom operators or electricity generators), licensing regimes (for example, for accountants or medical staff), investment rules (for example, restrictions on foreign ownership or the repatriation of profits), visa regimes, and competition rules. Free trade in services requires an elimination of *discrimination in terms of nationality of ownership* and relaxation of *policies that affect entry* (such as government monopolies). In other words, many of the reforms needed for full liberalization in services trade require that domestic policy reforms address such practices as legal exclusivity rights, state-owned monopolies, anticompetitive behavior, and red tape.³

The General Agreement on Trade in Services (GATS) under the auspices of the World Trade Organization (WTO) is the main multilateral vehicle for services trade liberalization. Trade between WTO members is governed by a number of principles, such as the most-favored nation principle (no discrimination between trading partners), the national treatment principle (no discrimination between domestic and foreign firms), the transparency principle (all remaining trade barriers need to be explicit), and institutionalized dispute settlement (to enforce compliance with WTO rules). As far as services are concerned, each WTO member can select sectors for which it is willing to subject itself to GATS disciplines. For each of these “bound” sectors, all remaining trade restrictions must be explicitly listed in a country’s schedule of commitments (“negative listing”). Schedules are divided into horizontal commitments (for example, general rights of establishment) and sector-specific commitments. For each of the various sectors and subsectors, commitments can then be made for the four modes of supply (which yields a matrix of commitments). Among Western Balkan countries, Albania, Croatia, and FYR Macedonia are already WTO members, while Bosnia and Herzegovina, Serbia, and Montenegro are negotiating accession.⁴ Their GATS commitments or offers are generally quite comprehensive.

At the regional level, it is hard to undertake preferential liberalization in services except for skilled labor. In general, legislative changes to accomplish services liberalization are usually easier to do on a nonpreferential basis (Mattoo and Payton 2007). This is also implicitly recognized in the CEFTA 2006 agreement, which addresses services trade in Articles 26 to 29 but does not make any binding commitments and only declares intent

regarding a gradual liberalization of services trade. This paper suggests that skilled labor services is the one area in which preferential liberalization could be undertaken at the CEFTA level.

The underlying assumption of this chapter is that investment in services will be attracted by, and also contribute to, further economic integration. FDI in services will be attracted by a larger economic space, as well by other elements of a good investment climate (see chapter 5). Of course, the services sector itself contributes significantly to the integration of economic space (sectors such as transport, telecom, and finance are key elements of the web of economic linkages between countries). Note that services trade liberalization is also a key element in deeper regional integration.

This chapter illustrates how a focus on the regional dimension can help in the development of the services sector (referring to either the Western Balkans or South East Europe as a whole). The regional dimension can be seen as a key element in the development of services, which can be visualized in the following three-stage process: i) barriers to trade in services; ii) regional cooperation and harmonization; and iii) hard infrastructure provisions (including cooperation thereof). The targets imposed by the EU convergence agenda will need to be considered, especially in the first and second stages.

The next section examines case studies of several services sectors within the implicit or explicit framework of the three-stage process, including transport, telecommunication, energy, financial, and distribution services. Its last subsection explores the possibility of a regional market for skilled labor. The final section provides conclusions.

Trade in Specific Services Sectors

Progress varies between sectors, despite the fact that overall liberalization of trade in services in the Western Balkans is well-advanced. In financial services and tourism, most market-access restrictions have already been removed. The regional agreements on air transport and energy are expected to gradually remove most remaining barriers in those two markets. The telecom sector has seen an influx of FDI (mode three), and planned reforms should lead to a further expansion of trade (for example, liberalization of fixed-wire services, privatization of state-owned operators, and the issuance of additional mobile licenses). Distribution and construction services are also relatively open to cross-border trade, even though some restrictions continue to exist. For professional services, a lack of mutual

recognition significantly restricts trade. State ownership remains an obstacle for trade via mode three for several services sectors (for example, transport, energy, and environmental services). In those cases in which formal market access restrictions have been removed, anti-competitive behavior by incumbents still constitutes a barrier to trade. Table 4.1 shows the status of EBRD Infrastructure Reform Indicators in different sectors.

The Concessions Law provides an important support for efficient and prioritized investments and is applicable to all potential public-private partnerships in infrastructure provision. In many areas, including roads, railway operations, and airports, the private sector may wish to partner with the government if the former foresees a profit opportunity. Here, the quality of the Concessions Law is critical, as it is supposed to ensure a competitive and transparent process in the selection of the investor, and transparent provision of any government guarantees. A competitive process with minimal and transparent guarantees also helps ensure that the proposed investment is the right priority from the public point of view.

Transport

Efficient transport is a catalyst for development and deeper regional integration. It facilitates the cross-border flow of goods, tourists and business travelers, and it connects the region to its large emigrant communities.

Regional integration is also taking place within the transport sector. Unlike in the telecommunications sector, in which regional integration is primarily driven by cross-border investments, the main driver of integration in the transport sector is regulatory harmonization and coordination between authorities. The policy issues, reform challenges, and investment needs vary between transport modes (air, rail, road, maritime, and inland waterways). One of the most important sources of transport frictions in the region, however, is border crossings (see chapter 3 discussion).

Air transport—The *acquis* defines much of the liberalization agenda in air transport and contains ambitious goals. In June 2006, the EU and the countries of SEE signed an agreement to establish the European Common Aviation Area (ECAA).⁵ It commits all signatories to remove existing barriers and fully liberalize air traffic among themselves, as well as to adopt the entire aviation-related *acquis* by 2010. This will effectively extend the EU's single market for air transport to SEE. Implementing this

92 **Table 4.1. EBRD Reform Indicators and Selected Infrastructure Performance Data**

		<i>Banking reform and interest rate liberalization</i>	<i>Domestic credit to private sector (% GDP)</i>	<i>Overall infrastructure reform</i>	<i>LPI overall score</i>	<i>LPI overall rank</i>	<i>Telecom</i>	<i>Skype rates to mainline, 2007 (US\$)</i>	<i>Railways</i>	<i>Electric power</i>	<i>Electricity production per labor force participant (kWh)^a</i>	<i>Roads</i>
Albania	2000	2.33	4.6	2.00	—	—	3.00	—	2.00	2.33	5318	2.00
	2006	2.67	14.9	2.00	2.08	139	3.00	0.17	2.00	2.67	4112	2.00
Bosnia and Herzegovina	2000	2.33	40.8	2.00	—	—	2.33	—	2.00	2.33	5304	2.00
	2006	2.67	47.9	2.33	2.46	88	2.33	0.20	3.00	3.00	6168	2.00
Bulgaria	2000	3.00	12.6	2.67	—	—	3.00	—	3.00	3.33	8192	2.33
	2006	3.67	44.5	3.00	2.87	55	3.33	0.07	3.33	3.67	13127	2.67
Croatia	2000	3.33	37.4	2.33	—	—	3.00	—	2.33	2.33	9086	2.33
	2006	4.00	61.2	3.00	2.71	63	3.67	0.07	2.67	3.00	6745	3.00
Macedonia, FYR	2000	2.67	17.8	2.00	—	—	2.00	—	2.00	2.33	4467	2.33
	2006	2.67	25.9	2.33	2.43	90	3.00	0.22	2.00	3.00	7766	2.33
Montenegro	2000	1.67	—	1.33	—	—	1.67	—	1.00	1.00	—	1.67
	2006	2.67	—	2.00	—	—	3.00	0.12	1.00	2.33	—	2.00
Romania	2000	2.67	7.2	3.00	—	—	3.00	—	4.00	3.00	8316	3.00
	2006	3.00	20.0	3.33	2.91	51	3.33	0.12	4.00	3.33	5443	3.00
Serbia	2000	1.00	—	2.00	—	—	2.00	—	NA	2.00	12570	2.00
	2006	2.67	—	2.00	2.28	115	2.33	0.12	2.33	2.33	9091	2.67
Slovak Republic	2000	3.00	51.3	2.00	—	—	2.33	—	2.33	2.00	13943	2.33
	2006	3.67	36.2	3.00	2.92	50	3.67	0.07	3.00	4.00	11452	2.33
Slovenia	2000	3.33	35.8	2.67	—	—	2.33	—	3.00	3.00	3787	3.00
	2006	3.33	53.3	3.00	3.14	37	3.00	0.06	3.00	3.00	14936	3.00

Source: EBRD Transition Reports.

Note: — = not available.

a. Latest data is for 2004.

ambitious agenda will require a revision of national aviation codes, the liberalization of cross-border traffic rights, capacity building for civil-aviation authorities, and improvements in the safety and security regimes. Much closer regional cooperation will also be needed in air-traffic management (ATM), considering that planes on some routes cross five different countries in the course of an hour.

The ECAA has significant potential to reduce passenger and transport costs in the region, increase traffic flows, and thereby enhance regional integration. According to a Booz Allen Hamilton study in 2005 for the EC (quoted in Müller-Jentsch 2007a), over two-thirds of routes between city-pairs to and from SEE are served by one airline only, and most remaining routes are operated on a duopoly basis. Another important indication of the lack of competition due to market entry barriers is the lack of Western Balkan destinations on the map of Europe's low budget and charter airlines, with a few exceptions such as Dubrovnik, Split, and Zagreb. Within the EU, these airlines have played a pivotal role in the stimulation of competition and market development. International experience suggests that ECAA-induced competition should bring down airfares in the Western Balkans significantly.⁶ Also, air traffic is likely to increase significantly, because the demand is both price-elastic and income-elastic. In turn, increased business and personal traffic will facilitate regional integration and make the Western Balkans/SEE more attractive for investors. Efficient air transport is also critical for tourism, which is an important sector for the areas along the Adriatic coast. Moreover, air transport is an integral part of the multimodal system and thus the ECAA has repercussions for other transport modes.⁷

Regional cooperation (integration) will help enhance economies of scale in airport development. Many airports in the Western Balkans are close enough to national borders to serve parts of neighboring countries. Both the FYR-Macedonian airport of Skopje and the new Albanian airport of Kukes, for instance, are less than 20 kilometers from the Kosovo border and their hinterlands overlap with those of Pristina airport. In recent years, the small airport of Mostar (in Bosnia) has lost much of its traffic to nearby Split and Dubrovnik (in Croatia). Dubrovnik can also serve parts of Montenegro. Sarajevo in Bosnia and Osijek in Croatia are both close to the Serbian border. The small size of national aviation markets in most Western Balkan countries and the geographic location of many airports have implications for airport development. Thus, investment costs can be minimized if airport development is coordinated at the regional level, while allowing the market to point out which of the airports with

overlapping hinterlands should be chosen as the subregional hub(s). For this to happen, some secondary-airport expansion and construction projects would need to be reconsidered, road and rail links improved, and border-crossing procedures streamlined. Reaping such synergies will require regional coordination as well as a willingness to concede that there cannot be a hub in every country.⁸ The memorandum of understanding for the South East Europe Core Regional Transport Network, signed by national transport ministers and the European Commission in mid-2004, identified eleven priority airports, but modalities to coordinate airport development have not yet been established.⁹

Sound policies and implementation will help to attract the private sector and minimize the impact of ECAA on government budgets. With the right policy framework and a privatization of state-owned airlines and airports, the private sector should be able to provide most of the investment needs for fleet renewal and infrastructure expansion. EU state-aid rules, which are part of the ECAA package, will cap subsidies to loss-making flag carriers. Moreover, a division of labor between regional airports would reduce infrastructure costs (see below). The upgrading of air traffic control infrastructure, on the other hand, can be recovered through charges levied on airlines for the use of airspace. Examples of successful cost-recovery in air traffic management, the concession of the Tirana airport, and public-private partnerships at Belgrade airport all illustrate that it is possible to keep budgetary impact low, even after the possible initial costs associated with sector restructuring. Overall, once air traffic growth is taken into account, the impact of ECAA adoption on the fiscal space of governments could be minimal or even positive.

The small airlines pose a challenge, but also provide an opportunity to realize significant efficiency gains, in keeping with the vision of ECAA. A particular challenge will be the restructuring and consolidation of the many small national airlines in the face of impending competition. Together, the six Western Balkan flag carriers carried a total of 3.2 million passengers in 2005, about one-third the figure of Austrian Airlines. These airlines will need to be restructured in the context of ECAA, which renders the notion of flag carriers obsolete. ECAA will abolish national ownership restrictions for airlines and prohibit governments from subsidizing airlines, which should lead to the emergence of new private carriers once a level-playing field for competition is established. Interesting examples for the Western Balkans could be Central America's Grupo Taca (which consolidated existing flag carriers), Sky Europe (which was a *de novo* private airline) (see box 4.1), or the Scandinavian countries Denmark,

Norway, and Sweden, which established a tri-national “flag carrier” decades ago: the Scandinavian Airlines System (SAS).

Railways—The case for deeper regional integration in rail transport is based on the value of foregone opportunities. Railways constitute a network industry with substantial economies of scale. In small countries, seamless operations with neighboring countries are critical to profitable operations. The break-up of the former Yugoslavian railways created several small systems that are barely viable on their own. In freight traffic, rail only tends to be competitive for bulk cargo and on long-distance routes beyond 500 kilometers. The fact that less than five percent of traffic

Box 4.1

Private Sector Airlines: Grupo Taca (Central America) and Sky Europe (Slovak Republic)

Similar to the Western Balkans, Central America is a region with seven small countries, whose flag carriers were too small to compete on their own. Over the past two decades, the private El Salvadorian airline Taca acquired strategic stakes in the flag carriers of Guatemala (Aviateca), Costa Rica (Lacsa), and Nicaragua (Nica), and integrated their operations. In 2001, it also established a subsidiary in Peru. The Taca group now serves 35 cities across the Americas, has the newest fleet in the Americas (with 32 aircraft), operates three hubs in El Salvador, Costa Rica, and Peru, and plans to expand to additional countries in the region. With 3.5 million passengers a year, Grupo Taca is as large as all Western Balkan flag carriers combined. And, there is another analogy: 40 percent of its passengers are migrants (Latin Americans living in the United States).

When the Slovak Republic was left without a flag carrier after its separation from the Czech Republic, the country adopted liberal air-transport sector policies that led to the birth of Sky Europe, a private airline based in the capital Bratislava, which subsequently became Central Europe’s leading budget carrier. In September 2005, the airline was quoted on the Vienna Stock Exchange. The IPO receipts will be used to triple the fleet size from 15 to 47 planes by 2009 and increase the number of passengers from one to six million annually. Thriving in an open-skies environment, the stock-market value of Sky Europe is almost as high as that of Austrian Airlines.

Source: Frankfurter Allgemeine Zeitung (26 October 2006) and the Taca Web site.

between the EU and Turkey is carried on this mode indicates the potential loss of transit traffic by Western Balkan rail companies, a consequence of low efficiency and border-related disruptions of rail traffic. Reform challenges throughout the region include overstaffing, high costs, and a lack of modern management. The EU *acquis* will also require far-reaching adjustments, such as open network access or a separation of infrastructure from service provision. The World Bank (2005d) published a regional study on railway reform in the Western Balkans in December 2005 and has proposed a regional rail initiative in close cooperation with the European Commission. This would entail an agreement between governments on a set of common objectives as well as complementary technical assistance and investments at the national level. A working group under SEETO (South East Europe Transport Observatory) has been helping to prepare the ground for a Common Network Statement for the region. Eventual implementation of the initiative could, however, take several years.

Roads—A third priority for regional integration in the transport sector is to continue close coordination of infrastructure investments and facilitation measures along *land corridors*. The bulk of cross-border transport among Western Balkan countries and with the EU moves along a limited number of road and rail corridors. In June 2004, governments signed a memorandum of understanding on the development of the South East Europe Core Regional Transport Network.¹⁰ Based on the analysis conducted under two technical studies in 2002 and 2003 (the TIRS and REBIS studies), the core network consists of a backbone system of roads and rail lines plus the main ports and airports of the region. At the heart of this multimodal system lie the pan-European Corridors V, VII, VIII, and X, which traverse the region. As in the case of Railways, a Steering Committee of government representatives, supported by SEETO, has been established to oversee the implementation of the memorandum of understanding.

Regulatory and institutional reforms can go a long way in alleviating infrastructure constraints. The focus of the discussions to date has been on possible priorities for infrastructure investments (“hard measures”) along the core network. Although some missing links have been constructed (for example, several hundred kilometers of motorways in Croatia) or are under construction, Croatia’s experience shows the pitfalls of an excessive focus on capital expenditures (World Bank 2006). On the other hand, the less expensive but more complex coordination of the regulatory and institutional reforms (“soft measures”) that is needed to render transport flows more efficient will be a challenge. This includes a

streamlining of border-crossing procedures, more effective maintenance of existing infrastructure, the privatization of state-owned transport companies, road pricing and cost-recovery schemes, more efficient modal interfaces, and measures to improve road safety. Another challenge will be to identify parts of the core network for which private investments could be mobilized (for example, ports and airports) and to put in place the necessary regulations, an area in which Concessions Laws will be critical. A discussion of these is beyond the scope of this study, but does suggest that the regional-integration agenda on roads in particular and on transport in general recognize that coordination and regulatory harmonization (and the resultant encouragement of private investment) may be at least as important as government expenditure.

Fiscal space limitations demand strong prioritization of government expenditures. If governments do invest on their own, they would need to subject the proposed investment to rigorous cost-benefit analysis, and look at foregone opportunities. In particular, consideration would need to be given to fiscal space limitations; competing uses for government investment, especially for human development (which is a priority, see chapter 5); and the extent to which other measures outlined above can substitute for expensive investment in new roads and railways.

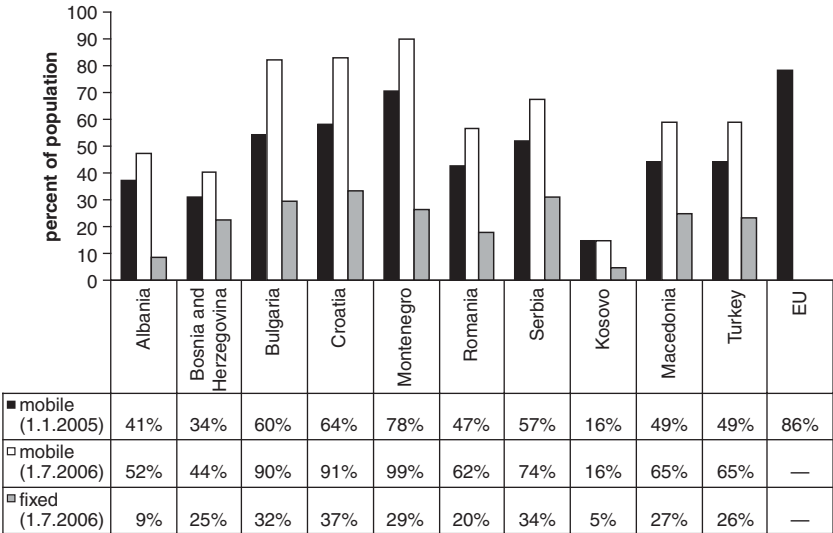
Telecommunications

Besides being an important sector in itself, telecommunications is one of the key services sectors that drives productivity enhancement and growth, and enables specialization, regional integration, and linkages with production networks. Spending on telecommunications accounted for some 4 percent of GDP in the SEE and Turkey, compared with 2.6 percent in the EU. More importantly, telecommunications is a critical input for many other industries and sectors. Evidence on productivity impact is plentiful and includes some popular examples such as the success of the Indian business-process outsourcing industry; Indian fishermen whose use of mobile phones enabled an increase of profits by 8 percent while fish prices fell by 4 percent;¹¹ and the more general Mattoo et al. (2006) finding that countries with open financial and telecommunications sectors grew, on average, about 1 percentage point faster than other countries. Development of telecoms allows an expansion of trade in services, which can be delivered through mode one, namely, cross-border trade (online transactions in business-process outsourcing, for example), as well as through mode three. It also allows regional integration (by enabling better real-time coordination and specialization in different

aspects of the business process) and better links to regional or other production networks, both in services as well as in other sectors.

The process of telecom liberalization and privatization in the Western Balkans has gathered momentum, and is most visible in mobile telephones. Mobile penetration rates (subscribers as a percent of the population) are a multiple of fixed-line penetration rates in most countries (see figure 4.1); however, in most countries, they are below the average EU level. Mobile penetration in 2006 varied from 16 percent in Kosovo (although this could be an underestimate) and 44 percent in Bosnia and Herzegovina, to 90 percent in Bulgaria, and may be as high as 99 percent in Montenegro.¹² These unfolding market dynamics are a reflection of substantial policy reforms, which have encouraged modern management and competition and thereby led to improved services and significant price declines. In the last few years, most Western Balkan governments have introduced modern telecom laws in line with EU rules, established independent telecom regulators, and liberalized market access for new services providers (see box 4.2 for a description of some of the investments that have taken place). However, it should be noted that a lack of secondary regulation can prevent laws from being implemented, as in the case of the Serbian fixed-line market. Even where implementing regulation has been enacted, such as in FYR Macedonia, implementation

Figure 4.1. Mobile and Fixed-line Penetration Rates in SEE



Source: Cullen International (2007).
 Note: — = not available.

Box 4.2**Significant Investments Have Occurred in the Telecom Sector in the Western Balkans**

Cross-border investments by a handful of European companies are driving both infrastructure modernization and the process of regional integration. Hungary's Magyar Telekom, majority owned by Deutsche Telekom, has acquired controlling stakes in fixed-wire operations in FYR Macedonia and Montenegro. Deutsche Telekom has bought a 51 percent share in Croatia's main telecom company H-HT from the government. Greece's OTE controls the largest mobile provider in Albania and the second-largest provider in FYR Macedonia, and has a 20 percent stake in Serbia's fixed-wire operator Srbija Telekom. Telecom Austria owns the second-largest mobile operators in Slovenia and Croatia, the mobile market leader in Bulgaria, and has acquired the third mobile license in Serbia and FYR Macedonia. The U.K.-based Vodafone has mobile operations in Albania and Greece. Furthermore, Slovenian Telekom bought the largest alternative operator in FYR Macedonia (On.Net) in late 2006 and has started to offer fixed-wire services. In a rare case of intra-regional FDI, Serbia's Srbija Telekom won the tender for Telekom Srpske in Bosnia and Herzegovina in late 2006.

These investments have been sizable. In August 2006, for instance, the Serbian government sold the country's leading mobile operator to Norway's Telenor for €1.5 billion. A few months later, Telecom Austria paid \$427 million for Serbia's third mobile license and plans to invest a further \$333 million in the roll-out of the network.

Further privatization is in the offing. The governments of Croatia and Montenegro plan to sell further stakes in their partially-privatized telecom companies in 2007. Serbia and Albania have been trying to sell majority stakes in their national telecom companies. Operations in Bosnia and Herzegovina and Kosovo also remain publicly owned.

and enforcement are often lacking as a result of inadequate capacity of the regulator.

Although prices have fallen, call rates are still high and internet penetration is still low. Different indicators show that there is still some work to be done in telecommunications. Table 5.2 shows the EBRD transition reform scores in telecommunications, and the cost of a one minute call to a fixed line using Skype. Figure 5.7 also shows the price of a 10-minute incoming call from the United Kingdom. Although the Western Balkans

have certainly benefited from the increased availability and quality of telecoms (see chapter 5), most telling are the substantial gaps that still exist in prices of incoming calls. This may also be reflected in Skype international-call rates to the destination countries (FYR Macedonia, Bosnia and Herzegovina, and Albania are the most expensive, falling between 17 and 22 cents). Internet penetration is also quite low compared with the EU average, especially in Albania, FYR Macedonia, and Serbia. These outcomes are mirrored, albeit not exactly, in the EBRD infrastructure transition scores, in which Bulgaria and Romania both score 3.33 and Croatia scores 3.67. All the other countries score 2.33 or 3.

Although trade in telecom services has been largely liberalized, there are still some *de facto* barriers to entry. All networks and services have been fully liberalized except in two specific cases.¹³ However, effective fixed-network competition is obstructed by lack of appropriate secondary legislation for authorization of entry into fixed-line services, very high authorization fees, or lack of a viable interconnection offering. Only Romania has fully implemented the EU framework. FYR Macedonia has created the legislation, but its implementation has been delayed. Croatia has also advanced in this process. Overall, all Western Balkan countries need to fully transpose the EU telecom *acquis* (both for market access as well as for all other areas) in order to advance in the EU accession process.

The key challenge to achieving better outcomes lies in implementation. Although there are still some issues in transposing the EU *acquis* to the different countries, the main challenges will be the effective enforcement of EU rules and the encouragement of effective competition through follow-up secondary legislation, and through independent and competent sector regulators. This is an area where much remains to be done. In this context, a specific concern relates to the advantages of incumbents. It is possible that, in some countries, concession agreements give incumbents preferential treatment compared to new operators who are regulated by primary and secondary legislation. Hence, concession agreements should be harmonized with the laws to ensure equal market access to all participants.

The private sector can provide much of the requisite investment. Trade in telecom services mainly takes place via mode three and, as outlined above, FDI in the sector is already widespread. It should receive a further boost through planned privatizations and the issuing of additional licenses. For example, even though network digitalization is well-advanced across the region, substantial (private/corporate) investments will be required to increase the availability of broadband and UMTS services.

Slovenia, Croatia, Serbia, and FYR Macedonia have already issued third mobile licenses, and Montenegro and Kosovo/UNMIK are preparing to do the same. Some countries have also started to liberalize fixed-wire services (for example, Croatia, FYR Macedonia, and Serbia). However, to achieve full benefits of increased entry, implementation of the policy agenda needs to advance.

A framework for regional coordination is already in place through EU institutions. Relevant regional institutions are already in place to help achieve economies of coordination and harmonization. The relevant bodies are the European Regulators Group (ERG) for electronic communication networks and services and the European Telecommunications Standards Institute. The ERG is intended to help encourage coordination and cooperation between national regulatory bodies, promote the internal market, and achieve consistency in application of the EU directives. The telecom regulators in the Western Balkans should aim at becoming more closely involved in the work of the ERG, which would offer a forum for them to share experiences and information and possible solutions.

Energy

Energy is potentially a major constraint to private sector development in the region. Business surveys show energy as a major barrier to doing business in Albania (see chapter 5), but this is a problem that could easily spread to other countries, given energy shortages throughout the region.

Fortunately, energy is one of the sectors in which regional integration is most advanced. Based on two previous memorandums of understanding on electricity and gas (the Athens Memoranda), the European Commission and nine SEE partners signed the Energy Community Treaty for South East Europe in 2005. A Vienna-based Energy Community Secretariat was established to oversee the implementation of the treaty.¹⁴ The agreement commits all signatories to implement gradually the energy *acquis*, which should lead to the full integration of the Western Balkans into the EU's internal energy market by 2015. The agreement is based on the entire *acquis* for electricity and gas as well as sector-related regulations on competition policy and the environment. In the *electricity* subsector, for example, the *acquis* obliges all members of the Energy Community to unbundle generation, transmission, and distribution, while establishing independent sector regulators and transmission system operators (TSOs).

This integration agenda is being supported by the development community. Especially for small systems such as those of the Western Balkans, the benefits of regional integration stem from cross-border competition, the ability to reduce expensive reserve capacity, and the ability

to trade electricity with neighbors that have different energy endowments (for example, hydro-power in Albania and lignite in Kosovo). To help unlock these synergies, the World Bank, with funding from the European Commission, prepared a South East Europe Generation Investment Study in 2004 (World Bank 2004a). Based on a demand forecast, this study mapped out a least-cost generation expansion plan for the region as well as a strategy for regional energy trade. This analytical work and the Energy Community Treaty was the foundation for the World Bank \$1 billion horizontal Adaptable Program Loan (APL). Under this APL, the World Bank is implementing a series of complementary projects at the national level, which supports sector restructuring through technical assistance and investment lending.

The standards and harmonization required for integration will be promoted by the institutional framework of the Treaty. Forging a regional energy market requires close cooperation between national regulators, and hence the policy framework for the EU Single Market in electricity has not only a regulatory but also a regional institutional dimension. As discussed in box 4.3, the UCTE ensures technical cooperation and thus the stability of the interconnected grid. ETSO facilitates cross-border network access and electricity flows. The CEER ensures the compatibility

Box 4.3

National Sovereignty and Cross-Border Institutions

If the Western Balkan countries are to develop modern market economies and comply with the EU *acquis*, they will have to establish a wide range of specialized institutions: i) *market institutions* in the more narrow sense such as stock markets and power pools; ii) *technical institutions* to ensure proper functioning of markets like air traffic control, railway network management, and electricity transmission system operations; and iii) *regulatory institutions* to tackle market failure such as competition authorities, telecom and energy regulators, civil aviation authorities, and financial sector regulators. Many of these institutions tend to be seen as quintessentially “national,” either because they execute government functions or because they relate to strategic assets (for example, domestic airspace and energy supply). In many cases, however, economic institutions that have historically been regarded as symbols of national sovereignty are better organized at the cross-border level. This holds particularly true in the case of small countries.

The EU has been a pioneer in the development of cross-border regulatory institutions. The European Commission, for instance, acts as the central antitrust authority enforcing the EU's competition and state-aid rules. In aviation, the European Aviation Safety Agency (EASA) has central oversight functions with regard to safety and security, while Eurocontrol and regional air-traffic control centers manage air traffic at the cross-border level. In financial services, cross-border stock markets such as Euronext and OMX have emerged and further consolidation is underway. In electricity, the Union for the Coordination of the Transmission of Electricity (UCTE) is responsible for the technical integrity of the European grid; the European Transmission System Operators (ETSO) coordinate economic aspects of interconnection; and the Council of European Energy Regulators (CEER) ensures regulatory cooperation. As these examples illustrate, regional markets need regional institutions.

The Western Balkan countries are gradually becoming part of these European structures. They have all joined Eurocontrol and the UCTE. With the implementation of the Energy Community Treaty, they will also join ETSO and CEER. As part of the establishment of the European Common Aviation Area, they will become members of EASA, and discussions about a regional control center for air traffic management are ongoing. Another case in point is railways, in which the EU *acquis* obliges all countries to separate rail infrastructure from operations and establish a rail regulatory authority, a rail-licensing body, a rail-safety authority, an accident investigation authority and a notified body.

Apart from regulatory institutions, SEE countries would also benefit from cooperation in operations in order to reap the benefits of scale economies. Possibilities include railways, airlines, and stock markets, all of which are small and would benefit from a regional approach. An interesting model is provided by three Nordic countries, who established the tri-national flag carrier Scandinavian Airlines Systems (SAS) five decades ago.

A recent study on the EU services market (Kox et al., 2005) found that it is not only the degree but also the heterogeneity of regulations across services industries in EU countries that hamper trade in services within the EU. Given their varying progress in transposing EU directives, Western Balkan countries would have even greater heterogeneity of regulation than within the EU. This calls for strong cooperation among national institutions that regulate services industries within the Western Balkans and SEE. In this context, intra-SEE cooperation would benefit from following an approach similar to the new Services Directive, which requires EU member states to establish one contact point where all information about services provision would be accessible (including electronically).

of economic regulation between countries.¹⁵ The countries of the Western Balkans were reconnected to the continental European grid in October 2004 (they had been cut off in 1991 in the wake of the war) and have become full members of UCTE. In due course, transmission system operators and sector regulators from the region should also join ETSO and CEER.

SEE-regional cooperation can focus usefully on capacity building for regulators, and power-sharing arrangements. Independent and strong regulators are the key to successful and sustained private interest in the power sector, as well as to protect consumers from the possibility of misuse of market power. To the extent that SEE regional cooperation allows for multiple sources of supply of power, the consumer as well as the business sector would benefit. Apart from capacity building, regulators would also benefit from regional cooperation in regulation.

Trade can take place via mode one (cross-border supply) or mode three (commercial presence). Cross-border *electricity* supply requires sufficient interconnection capacity and a regulatory regime that permits cross-border trade. Commercial presence requires governments to allow FDI in electricity sector assets. In the *oil and gas* subsectors, FDI also plays an important role, but because oil and gas are energy goods and not services, trade mainly takes place through cross-border transport (often via pipelines). Despite significant endowments of coal deposits and hydropower, the region remains a net energy importer. In oil and gas, the security of supply and cross-border pipelines is an important theme for regional cooperation. In fact, the EU has a strategic interest in diversifying its oil and gas supplies toward the Caspian region and Iran via pipelines crossing SEE. The *gas* subsector is also covered by the Energy Community Treaty, but the sector is less developed and the process of regional integration less advanced than in electricity. The World Bank plans to prepare a horizontal APL for the gas sector that is modeled on the APL for electricity, and preparation for this is ongoing.

The energy sector in the region has already attracted significant amounts of FDI. The Croatian government, for instance, sold a 25 percent stake in the oil and gas company INA to Hungary's MOL in 2003. INA owns two large refineries, a network of 400 petrol stations, and a 38 percent stake of the Adriatic oil pipeline (Janaf), which begins at an oil terminal on the island of Krk and is linked to a pipeline system extending to Hungary, Serbia, and the Slovak Republic (Economist Intelligence Unit 2006b). In 1999, Hellenic Petroleum of Greece bought a majority stake in FYR Macedonia's Okta refinery and subsequently built a 220-km oil

pipeline from the port of Thessaloniki to Okta. In December 2006, the Czech power company CEZ reached an agreement with the government of Republika Srpska to invest \$1.5 billion into a joint venture with the Serbian group ERS for a coal-fired power plant, as well as the development of a coal mine to supply it (Krosnar 2006). FDI inflows into the sector are expected to continue as state-owned energy assets are being privatized and as reformed sector frameworks open new opportunities for green-field investments.

Financial Services

The financial sector in the Western Balkans has improved significantly in recent years.¹⁶ This owes to comprehensive reforms by governments and the support of international financial institutions like the IMF, the World Bank, and the EBRD. The turbulence associated with banking crises, hyperinflation, and pyramid savings schemes have been left behind. Regulatory frameworks have been modernized and financial supervision has been strengthened. The share of bad loans has been reduced dramatically. Privatization has helped to reduce state ownership in banking down to less than 20 percent in most countries and has attracted foreign banks into the market. Branch networks are being expanded and a range of new financial products, such as mortgages and leasing, are being introduced. Thanks to these developments, financial intermediation is growing at double-digit rates and central banks have even been forced to introduce specific measures to control, for example, rapid expansion of consumer credit and foreign exchange exposure of the financial system.

Despite these positive developments, financial markets in the Western Balkans remain small, fragmented, and at an early stage of their development. In most countries of the region, banks account for over 90 percent of financial sector assets, while capital markets and insurance subsectors play only marginal roles. All banks of the Western Balkans taken together had €57 billion worth of assets in 2005 (of which Croatia alone had 60 percent), which was comparable to that of a single mid-sized bank in the EU. The total market capitalization of the nine stock exchanges in the Western Balkans amounted to €54 billion in 2006, merely a third of the already small Vienna Stock Exchange. The gap is even larger when measured by market turnover. Financial intermediation in most Western Balkan countries, measured by banking assets as a share of GDP, is still only equivalent to 40 to 70 percent. The notable exception is Croatia, where the ratio is 114 percent.

Regional integration can help financial companies achieve greater efficiency and consumers improve their choices and reduce risks. Scale economies are significant in financial markets. Hence, regional integration, especially in small countries, can help banks and insurance companies gain critical size, and the markets provide more liquidity, choice, and competition.

Financial markets have seen impressive regional integration. The main driver of cross-border linkages has been foreign direct investment by EU banks. In all Western Balkan countries, financial-sector restructuring and bank privatization has brought the market share of EU banks up to between 50 and 80 percent of banking assets. A handful of EU banks have established a presence throughout the region, including Unicredito and Intesa from Italy, Raiffeisen and Erste Bank from Austria, Société Generale from France (present in Croatia, Serbia, Montenegro, FYR Macedonia, Bulgaria, and Romania), and the National Bank of Greece. Similar developments are now underway in the insurance subsector. The market entry of EU banks has not only brought privatization receipts, but also investments into branch networks, better management, and new financial products (see box 4.4).

Complementary efforts at the policy level are needed to support and safeguard the integration process that has been driven by the private sector, and to improve efficiency and competition. Significant overseas investment in the form of subsidiaries of financial institutions falls under the host-country supervisor. However, effective supervision and control of regulatory arbitrage between jurisdictions by such multinational institutions requires close cooperation and sharing of information between financial-sector regulators. Also required is the capacity to ensure that the banking sector continues to function competitively over time in order to ensure that the high level of concentration (the market share of the top five banks in 2005 varied between 47 percent in Serbia to 77 percent in Montenegro and Albania) does not prevent dynamic market competition.¹⁷ In this context, high interest-rate spreads point to the need to further increase effective competition and improve efficiency. Interest-rate spreads in SEE range from 4.3 percent to 13.1 percent, compared with 4.1 percent in the Slovak Republic and 3.5 percent in the EU15 (NBRM Annual Report 2006). In general, regulatory priorities in the Western Balkans need to aim at basic financial and insurance sector reforms, rather than harmonization of rules with EU rules, which relate largely to developed financial markets and should have a lower priority.¹⁸ Another priority for regional integration would be closer

Box 4.4**The Knock-on Effects of Erste Bank's Entry into the Serbian Market**

As part of its privatization program, the Serbian government sold an 83 percent stake in Novosadska Banka to Austria's Erste Bank for €73 million in 2004. Novosadska is the second largest bank in the northern Vojvodina region, but with 71 branches it ranks only number 13 in the country as a whole. However, it is contiguous to Erste's existing branch networks in neighboring Hungary and Croatia, and Erste intends to use it as a launching pad for expansion across Serbia. One of its first measures was to rename Novosadska as Erste Bank Serbia. Erste launched an ambitious restructuring program soon after the takeover, focusing on organizational reform, the replacement of key managers, and the upgrading of risk management and accounting procedures to the standards of the parent institution. Erste is also redesigning existing financial products and introducing many new ones. These initiatives include the development of mortgage business and financing programs for SMEs. Investments are being made in staff training, branch refurbishing, and the modernization of the IT infrastructure. Erste aims to add 55 branches over 2006-08 and increase its Serbian market share of banking assets from 2 to 10 percent.

In many respects, Erste Bank's entry into the Serbian market is typical of the activities of foreign banks in the Western Balkans. Like other foreign banks, Erste Bank treats the region as a common market and builds a border-spanning branch network and consumer brand. It transfers know-how through the secondment of experts, the development of local staff, and the implementation of its standard business practices. At the same time, it brings considerable new investment as it recapitalizes its new subsidiary, modernizes the physical infrastructure, and expands the branch network. It also brings privatization receipts and taxes to the government budget. Other benefits include new financial products, an impetus to banking competition, a deepening of financial markets, and increased confidence in the banking sector.

Sources: Erste Bank, Annual Report 2005; Simonian (2005); and interviews with Erste Bank staff.

cooperation and, if possible, mergers between stock exchanges. In fact, Vienna Stock Exchange has already launched efforts to forge closer links with other bourses across SEE. In the longer term, the extension of the Euro Payment Area to the Western Balkan countries would be another building block for the development of a truly regional market.

Distribution

As the final stage of the supply chain, distribution constitutes a “backbone” service that facilitates deeper integration in goods markets.¹⁹ Without access to wholesale and retail distribution networks, foreign companies will have difficulties selling their wares to potential clients. Inefficiencies or constraints in that market can constitute an important nontariff barrier. Distribution is also an important sector in its own right. Trade in distribution services is mainly conducted via mode three (commercial presence) and to a lesser extent via mode one (cross-border supply). Barriers to trade include restrictions to the right of establishment, zoning laws for the construction of retail outlets, limitations on the acquisition of real estate by foreigners, or restrictive rules on the distribution of certain products. Due to significant scale economies, distribution tends to be highly concentrated and competitive in industrialized countries. Across much of the Western Balkans, however, the retail sector remains fragmented and poorly developed, despite the fact that the EU is home to important global players in the distribution sector, such as Carrefour, Metro, Safeway, Ahold, IKEA, and H&M. In the past decade, many of them have expanded their retail networks deep into Eastern Europe and some are now turning their attention to the Western Balkans. The complex logistics networks needed by these retailers create an economic rationale for regional integration at the company level. Given the nature of the industry, the market entry of foreign suppliers tends to significantly enhance competition and is associated with significant investments in infrastructure and the training of local staff.

Skilled Labor Market

CEFTA countries can try to define a regional market for skilled labor. Currently, there are no WTO or EU offers for movement of natural persons for nationals of Western Balkan countries. This report suggests that CEFTA countries try to define a preferential market for skilled labor. The key ingredient in this would be mutual recognition of professional qualifications and of training and educational institutions, followed by a CEFTA agreement on unrestricted access of defined categories of skills. Such qualifications would need to be decided on a sector-by-sector basis, but adoption of EU requirements would help set the goals. Such a regional market may be appropriate even for the new EU members, Bulgaria and Romania, because there are transition periods before their citizens will have full access to the EU labor market.

A CEFTA market for labor could help solidify specialization at the regional level. Such a market could create incentives for FDI and allow prospective investors to contemplate hiring from all of SEE, not just the host country. Conceivably, this could also promote specialization in different parts of the supply chains in different countries, although that may also require agreement between countries to not engage in incentive contests to attract FDI.

With labor skills emerging as a possibly key constraint in many countries, regionalization can help. In the short term, labor would move to countries that offer higher returns. However, the regional market could also create significant demand and incentives for better education (the market for job seekers, not just employers, would be bigger), which would help address the emerging bottlenecks in supply of skilled labor (see chapter 5).

To start the process, a market can be created with two countries, and others could join when they are ready. Because a labor market agreement needs political buy-in, it is suggested that any two countries that are ready start the process by agreeing on the categories of labor that will have unrestricted access to each other's markets. The initial agreement can be limited to certain professions and/or those with tertiary degrees. This can be accompanied by mutual recognition of educational institutions and degrees.

Cooperation can extend upstream to tertiary education. Mutual recognition of standards and qualifications as well as a regional labor market would provide a natural incentive for the private sector to invest in tertiary and technical education, given the possibility of spreading the high fixed costs. Again, different countries could specialize in different areas of technical education. Governmental involvement would be necessary to agree on a framework for such cooperation, set the standards, provide the supervision, approve the curriculum, and set limits on any budgetary support. One example in this context is the University of the West Indies (UWI), established in 1962 as an autonomous regional institution supported by and serving 15 countries in the Caribbean, and governed by a pan-Caribbean University Council (see World Bank 2005a, chapter 7 for details).

A different but not mutually exclusive approach would be temporary-worker agreements between countries, offering a win-win alternative to migration. Remittances are key to the sustainability of the current account in many countries in SEE, and Greece, Italy, and Germany are significant host countries (see box 4.5). However, this does not necessarily

Box 4.5**Temporary Worker Agreements: Win-Win**

The Western Balkans have seen some large-scale migration flows, including negative side-effects like illegal migration and human trafficking. Estimates of migration abroad include about 2 million Bosnians, 1 million Albanians (mostly to Greece and Italy) and 1 million Croatians (mostly to Germany).^a Kosovo also has a large diaspora relative to its population. Moreover, the series of wars and civil conflicts has led to the displacement of ethnic minorities within the region. An economic consequence of these migration flows is workers' remittances: in 2005, Albania received \$1.2 billion worth of remittances per year, Bosnia and Herzegovina \$1.3 billion, Croatia \$0.9 billion, FYR Macedonia \$935 million (estimated, see IMF 2007a), and Serbia and Montenegro \$1.4 billion (2004). For Albania, Bosnia and Herzegovina, and FYR Macedonia, remittances account for about 14 to 15 percent of GDP and finance a very large part of their respective trade deficits (see table 1.1).

However, continued migration can lead to skill bottlenecks in the sending countries and may also be against the preferences of potential migrants, who often prefer to accumulate human and financial capital in short stints and then return home. In the host country, too, increased migration can set off resentment and hostility and lead to more restrictive immigration policies.

Negotiations at the multilateral level on commitments on mode 4, or the "temporary presence of natural persons," have not made much progress and do not seem to hold much promise even in the Doha round. This is because the framework does not allow host countries to make binding commitments to ensure temporariness of skilled-employment contracts.

In this situation, temporary worker programs can offer "gains without pains" as an alternative way to capture gains from labor mobility and avoid the permanent loss of skills and the hostility to permanent migration. Such programs are best negotiated bilaterally, and many successful examples exist, such as agreements between the Caribbean and Canada, the Caribbean and the United States, Ecuador and Spain, Poland and Germany, and so on. Such bilateral agreements enable commitments that are harder to make or enforce multilaterally, such as source-country commitments on screening, selection, and facilitating repatriation of the temporary workers.

Sources: World Bank (2005a), Mattoo and Payton (2007), Mansoor and Quillin (2007).

a. Taken from Economist Intelligence Unit. *Country Profile Albania 2005*.

imply that more migration should be encouraged from SEE, given the emerging human capital shortages. Rather, temporary or circular migration can offer an alternative that is beneficial to both sides.

Both migrants and temporary workers can act as catalysts for deeper integration and provide a potential pool of skills which home countries can tap into. They establish border-spanning, personal networks which can facilitate the flow of ideas and business contacts. If skill shortages emerge in the home country, migrants can be induced to come back if the investment climate is exciting and growth is dynamic. In fact, returning migrants bring back not only skills but also capital, and often set up firms or work for the subsidiaries of foreign companies.

Conclusions

Services are critical for growth and development, simply because of their growing share of GDP in any economy. Apart from this, efficiency in the supply of services, especially infrastructure services, is critical to efficient production in manufacturing, other services, or agriculture. Infrastructure services are also vital for participation in production networks and the international division of labor. Fortunately for developing countries, much of the needed investment in infrastructure services can be undertaken by the private sector, provided the regulatory environment is appropriate.

The quality of services is a function of the presence of FDI, the quality of regulation, and the degree of competition. FDI in services is a key determinant of the quality of services provided, as well as a key measure of liberalization in services policy. However, FDI itself is not enough. It needs to be complemented by strong and independent regulation that is fair to both the producer and the consumer, and a pro-competitive environment with hard budget constraints.

This chapter has focused on the development of the services sector at the regional level (the Western Balkans as well as SEE as a whole). This process can be visualized in three stages: i) barriers to trade in services; ii) regional cooperation and harmonization; and iii) hard infrastructure provision (including cooperation thereof). In addition, the targets imposed by the EU convergence agenda are part of the equation, especially in the first and second stages.

The overall services trade liberalization agenda has advanced with some variation across sectors. In the sectors explored in this chapter, there appear to be no major barriers to FDI (i.e., discrimination by nationality) per se. Rather, market access is constrained for different reasons, such as

state-ownership restrictions, anticompetitive behavior of incumbents, restrictions on the number of operators, and so on. The most important restriction appears to relate to a lack of mutual recognition that limits trade in professional services. In other areas, restrictions exist, but are not as significant, or are being reduced.

The EU process defines much of the convergence agenda on liberalization and standards, but there are important degrees of freedom in many cases. In many of the sectors covered here, such as air transport, SEE has already signed on to the ECAA and committed to adopting the entire aviation *acquis* by 2010. In road and rail transport, there are no such commitments, which allows more time and freedom for the Western Balkans to choose their path. In telecoms, the potential candidate countries need to adopt the relevant telecom *acquis*. In energy, the Energy Community Treaty for SEE defines standards and harmonization requirements, with the goal of full integration into the EU energy market by 2015. In financial services, the EU is undertaking a review of those parts of the *acquis* that need to be completed by 2010.

CEFTA preferential liberalization could focus on skilled labor, a case backed by economic logic as well as room in the EU convergence agenda. At the CEFTA level, this chapter argued that preferential liberalization in services at the CEFTA level should focus on only one area, namely, professional services within mode 4 (movement of natural persons). A starting point for this would be mutual recognition of professional qualifications. Over time, this could be progressively liberalized to both skilled and unskilled labor (following the Caribbean example in the CSME), and will help the region to be seen as a single economic space, which is critical for attracting FDI. Regional cooperation can extend further upstream to the supply of skilled labor in tertiary and technical education, where different countries can specialize in different areas (given high fixed costs and hence scale economies in tertiary education).

Opportunities for regional cooperation and harmonization are significant, even in areas where the agenda is defined by commitments to the *acquis*:

In air transport, with overall liberalization defined by the ECAA, regional cooperation can help enhance scale economies in airport development, identify hubs, reduce investment costs, and therefore passenger costs. It can also encourage the formation of regional airline/s.

In rail transport, the way forward is not fully defined yet (the *acquis* defines longer-term commitments), but border disruptions in rail traffic are relatively easy to address.

In road transport, policy coordination is needed to address border-crossing procedures, improve modal interfaces, and enhance road safety. These are at least as important as capital expenditures on roads.

In telecoms, regulators in the region can gain from sharing experiences and information, because they often face similar problems that require similar solutions.

In energy, regional cooperation is well advanced. Areas where regional-level initiatives are useful include power-sharing arrangements between countries, cooperation in regulatory oversight, and creation of strong and independent regulators.

In financial services, home–host regulatory cooperation will be a significant contribution to safeguarding of the ongoing private-sector-led integration. This cooperation will need to extend not just to SEE countries but also to “home” countries such as Austria, Greece, and Italy.

In any sector in which large foreign companies can potentially crowd out competition, competition authorities can gain significantly from home-host as well as regional cooperation in information sharing, from enforcing competition rulings, and from boosting the capacity of competition authorities. Although this situation could apply to any sector, examples include distribution, energy, and telecom services.

In many cases, an appropriate regulatory framework with safeguards and regional coordination will be sufficient to attract private investment in services. Thus, private investment has been growing in financial services, telecommunications, and energy. Once ECAA is implemented, private interest is expected in the airlines business, and will be encouraged by regional cooperation that could potentially expand market size (see above). In general, sustaining private-sector interest while also ensuring that the interests of both the consumer and the investor are safeguarded will require, among other things, strong and independent regulators who are able to share information and cooperate in decision-making and enforcement on a regional basis. Coordination in specifications is also needed to ensure that the same standards are being followed (which are not defined by the EU *acquis*, or where the *acquis* standards are too high at this stage).

In other areas, such as roads, governments should subject proposed investments to rigorous scrutiny. However, in the case of roads and railways, the private sector could enter if it foresees a profit opportunity. Here, the quality of the Concessions Law becomes critical to ensuring a competitive and transparent process in selection of the investor, and to making any government guarantees transparent. If the government does invest on its

own, it needs to subject the investment to rigorous cost-benefit analysis, and look at foregone opportunities. In particular, consideration would need to be given to fiscal space limitations, competing uses of government investment, especially for human development (which is a priority, see chapter 5), and the extent to which other measures (such as better maintenance, cost recovery schemes, and streamlining of border crossings) can substitute for expensive investment in new roads and railways.

Notes

1. Also, with services accounting for an estimated 10 to 20 percent of production costs in manufacturing, the liberalization of trade in goods to historically low levels without a liberalization of trade in services may well imply negative effective rates of protection for manufacturing (Hodge 2002). For a literature review on trade in services, including its economic benefits, see Hoekman (2006). A key paper for Eastern Europe is Arnold et al. (2006), which finds a positive relationship between FDI in services and the performance of domestic firms in the Czech Republic's manufacturing sector. The paper concludes "...that the presence of foreign service providers as the measure of services policy is the most robust services variable affecting TFP in user firms" (Hoekman 2006, p. 23).
2. In developing countries, effective competition is most likely to be provided by foreign providers. This is implied in Arnold et al. (2006), see previous footnote.
3. Such restrictions do not generate fiscal revenues (as tariffs do) and thus entail deadweight loss to the economy.
4. Albania joined in September 2000, Croatia in November of the same year, and FYR Macedonia in April 2003. The accession negotiations are in their final stages for Bosnia and Herzegovina, in an advanced stage for Serbia, and at an earlier stage for Montenegro. Also, Bulgaria became a member in 1996 and Romania in 1995.
5. For details on air transport reforms and the ECAA, see Müller-Jentsch (2007a). This subsection provides a brief summary of that paper.
6. In Ireland, economy fares between London and Dublin (with three operators) were reduced by half within two years after liberalization, while those between Dublin and other European capitals (where duopolies persisted) actually increased. In Germany, fares declined by 10 to 20 percent between 1992-97 on most domestic routes where the incumbent Lufthansa encountered competition. On monopoly routes, they rose by 20 to 50 percent (see Müller-Jentsch 2007a, which quotes the U.K. Civil Aviation Authority for the data on Lufthansa).

7. At the same time, air transport should be integrated properly into the broader multimodal system. Improving hinterland connectivity by linking the main airports to the road network is key.
8. The two main airports with regional hub potential are Belgrade and Zagreb. Most other airports are either capital airports of smaller countries, airports in remoter areas, or airports near important tourist destinations. The experience in the EU suggests that the market entry of low budget airlines, which provide point-to-point services and often use secondary airports, could generate additional traffic for some of the smaller airports in the region.
9. See www.seerecon.org/infrastructure/sectors/transport/documents/REBIS/. Priority airports include all the capital airports of countries and entities (Zagreb, Sarajevo, Banja Luka, Belgrade, Podgorica, Pristina, Tirana, and Skopje) as well as two coastal tourism airports in Croatia (Split and Dubrovnik) and a secondary airport in Serbia (Nis).
10. *Memorandum of Understanding on the Development of the South East European Core Regional Transport Network*. June 2004.
11. See *The Economist*, May 10, 2007, quoting a forthcoming study by Robert Jensen in the *Quarterly Journal of Economics* and Lakshman (2007), "India's Cell-Phone Ride Out of Poverty." Calderon (2007), quoted in chapter 5, argues that the growth in output per worker was driven largely by improvements in the quality of telecommunications.
12. The high penetration rate in Montenegro (and to a much lesser extent in Croatia) is partly attributed to the purchase of prepaid cards by tourists (prepaid cards are not counted after 12 inactive months).
13. In Albania, there is no licensing category for urban areas, even though licenses have been defined for national operations and for rural areas. In Kosovo, the incumbent operator has been allowed exclusive control over international gateway access until the end of 2007. This paragraph draws from the comprehensive review of the sector by Cullen International (2007).
14. Website of the Energy Community (www.energy-community.org).
15. Websites of UCTE (www.ucte.org), ETSO (www.ets-net.org) and CEER (www.ceer-eu.org).
16. This section is based on a more detailed overview of the sector, see Müller-Jentsch (2007b).
17. Currently, as the markets are evolving, well-capitalized foreign banks are competing strongly for market share.
18. The EC is also undertaking a review of those parts of the financial sector *acquis* that need to be completed by 2010.
19. This paragraph will lay out only the issues in the distribution sector and will not discuss them in depth.