

EXECUTIVE SUMMARY

1. This study examines the challenges facing the railways of the Western Balkans region. The region's railways have many common problems including small size and fragmented railway service that are best addressed through common solutions. The similarities of the countries in terms of their shared history, geography, socio-economic characteristics and common aspiration to join the European Union also support a regional approach to addressing shared problems.
2. This study was commissioned to provide an outline for railway reform in the region. The study reviews the environment in which the railways operate, including the changing demand for rail services, the institutional and the macroeconomic context. It assesses the railways' financial and operational performance, benchmarked against some appropriately selected international railways. It reviews the current status of reform in each country, and outlines a broad reform strategy for the railway sector in the Western Balkans.
3. This study is intended for the Western Balkans governments, railways and other interested stakeholders including the European Union, other international financial and donor institutions, and the current and potential users of the railway networks of the Western Balkans.

THE CHALLENGE

4. In 2004, the Bank produced a regional framework paper for Southeast Europe¹, which synthesized the contents of sector reports in roads, railways and inland waterways together with ongoing work in trade and transport facilitation and road safety. A major issue that emerged in that paper was the poor performance of the railways of the Southeast Europe region, particularly in the Western Balkans countries.
5. The framework paper starkly illustrated the problem: How to sustain a railway network of much the same network density (track km per sq. km) as Western Europe, with less than half the traffic density, a third of the total labor productivity, and a fraction of the per capita income? Continuing the existing, often substantial, level of operating subsidy together with the provision of projected investments needs is becoming increasingly incompatible with the current fiscal and debt position of the Western Balkans countries.
6. In the Western Balkans region, transition, conflict and the closure of old, uneconomic, heavy industry has caused railway traffic to decline drastically. The railways of the Western

¹ World Bank, (2004c).

Balkans countries used to carry about four times as much passenger traffic as they do now—about 10 billion passenger-km in 1990 versus 2.5 billion passenger-km in 2004. In freight they handled almost 3 times as much as they do today—about 20 billion ton-km in 1990 versus 7 billion ton-km in 2004.²

7. In addition, the atomization (the ‘Balkanisation’) of the former Yugoslavian Railways (JZ) has fragmented rail service, leading to reduced competitiveness. The average length of haul for freight in the region is now very short, from 74 km for Albania to 290 km for Serbian Railways. Since rail is typically competitive with road for either very high volume movements or for long distance movements, the railways as stand-alone entities have limited competitive services, and must integrate their service offerings with neighboring railways to be competitive. This is a big challenge: a train movement from Ljubljana to Istanbul, for example, now involves four border crossings, and the co-ordination of five railways.

8. The level of competition is increasing. With rising incomes and significant investment in the road networks, freight and passengers are shifting to the road-based modes. In addition, the Western Balkan countries are adopting, as part of the *acquis communautaire*, open access regimes for their rail infrastructure. This will enable European rail freight operators to enter the market and “cherry pick” the most profitable rail traffic.

9. Railway assets were damaged in the conflict and little investment was made in the last 15 years. The railways survived by “eating” their assets, providing the lower volume of service demanded by using the youngest rolling stock and allowing the infrastructure to deteriorate. The youngest are no longer young, however, and deteriorated track impairs service quality and safety. The railways have a pressing need to renovate assets.

10. The Western Balkans railways also suffer from poor resource productivity. The railways were built and staffed to carry much more traffic than now, and the railways have failed to fully adjust resources to the reduced production. Infrastructure utilization is quite low, especially for the smaller railways. Rolling stock utilization and staff productivity is also low, compared to the European benchmark railways.

11. The railways, in their present form, are straining government budgets with their need for operating and capital subsidies. For example, operating subsidies alone to Serbian Railway consumed nearly one percent of GDP and two percent of government expenditure in 2003, with no funds available for capital investment. For Croatia, the comparable operating subsidy figures are 0.5 percent of GDP and 0.9% of government expenditure. In addition, the railway in Croatia received US\$236 million in capital subsidy in 2003, bringing the total subsidy that year to US\$378 million, or 1.3 percent of GDP.

12. Given the challenging fiscal situation, the level of public funds spent on railways is a serious concern. The level of subsidy for Western Balkans railways is comparable to benchmark European railways. Nonetheless, given that the state sector is overlarge in

² All tons and ton-km in this report are metric tons.

Western Balkans countries, and that governments have many other pressing priorities, a European level of subsidy for railways is not affordable.

THE REFORM PROCESS

13. Railway reform in the Western Balkans must balance several competing objectives. The reform should aim to reduce the subsidy needs, while:

- Providing for appropriate levels of safe and effective rail transportation to support economic activity in each country and the region;
- Allowing for efficient provision of necessary social services, e.g., passenger services or community access; and
- Producing an economically viable rail sector that is able to compete effectively and renew its assets.

14. The achievement of these objectives will be a tremendous challenge. It will require difficult choices to be made both at the organizational level and at the policy level. The following paragraphs outline a reform process consistent with these objectives.

15. ***Railway Infrastructure:*** The primary emphasis in the reform process for the network should be rationalization, cost reduction and a harmonized system of access prices. The size of the infrastructure should better reflect current and forecast traffic, with a commensurate reduction in recurrent expenditures. Infrastructure access prices should be harmonized across neighboring national networks to prevent the emergence of barriers to competition, and at a level to recover the difference between the total costs of network provision and the contribution from the national budget.³

16. ***Railway Operators.*** The primary emphasis in the reform process for the railway operators should be commercialization and/or privatization. Commercialization would include cost reduction, labor retrenchment, improved marketing, a profit center organization structure, more rigorous and objective investment planning, and divestiture of non-core activities. The government should consider privatizing the freight operators as a way to facilitate and speed these changes.

17. ***Government Support for Railways.*** The primary emphasis in reform should be improved public service tendering and contracting. To the degree affordable, government will continue to subsidize socially necessary but loss-making services. The emphasis should be on designing this process to obtain high value for public money. This is accomplished by: (a) prioritizing the social services to be provided according to economic value and only buying those with high value relative to cost; and (b) tendering the provision of those services. Before tendering provision of services, government should consider whether the service could be provided less expensively by another mode. In many low density markets, a

³ The reasons are discussed in the earlier Framework Paper, and expanded upon subsequently, in a recent paper for the ECMT, see Nash, Mathews and Thompson (2005).

tendered bus service could provide higher frequency, higher quality services for a fraction of the cost of providing rail service.

18. ***Regional Relationships.*** An additional element in the reform process should be the development/introduction of arrangements to support regional rail services. This could include contractual arrangements for the joint marketing of services, the pooling of equipment for a particular service, through running of locomotives and drivers, and/or the establishment of joint ventures to operate international services. In operations, it may range from improved document and information exchange to assigning higher dispatch priority to international train services. None of these measures would be expected to require significant investment, and all could be introduced by the railways at an early stage.

19. ***Selective investment.*** These reforms must be supported by selective capital investment that renews the “right” railway assets. The “right” assets are those that the downsized, self-sustaining railway undertakings would choose in a rigorous and objective capital planning process. Such assets will have strategic priority, and a high financial or economic return.

20. The World Bank and other International Financial Institutions (IFIs) need to ensure that their lending remains prudent and supports high yielding investments which help the railways to improve efficiency and reduce costs. For this reason, any proposed investment must be carefully scrutinized and found to satisfy quality standards within an adequate framework of sectoral reforms, regulation, and cross-country cooperation. Even after these microeconomic criteria have been met, lending decisions will also need to take into consideration the country’s macro-fiscal constraints and capacity to incur additional debt. Investments which meet these criteria should help shrink railway subsidy over time, gradually reducing the governments’ financial commitments for railways, while improving economic efficiency and growth prospects.