Innovation and investments as a cornerstone of economic performance toward European integration processes

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Abstract

Kosovo is developing country with a high rate of unemployment, the lowest income per capita in the region and a lot of socio-economic problems affecting negatively European integration process. Disregarding of the legal concerns encountered in the relation between EU and Kosovo government is more responsible for lagging behind in the process of EU integration. The Kosovo government has not approached the process of integration with due diligence and seriousness, whilst blaming EU for applying double standards for integration purposes. Thus, paper aims to provide an overview of economic performance of countries in the region, with special reflection on Kosovo's efforts toward European integration processes. Official statistical data are used for analyses of different features that helped identifying the most important reasons that causing Kosovo to lag behind in achieving its European aspirations. Moreover, comprehensive political analysis of various factors with significant impact on economic stability is conducted to be able to propose the concrete structural reforms that would secure a higher growth and progress.

Introduction

Developing economies face significant policy challenges in an environment of weak global growth and significant uncertainty. Progress on implementing structural reforms must be continued to boost long-term growth. The fragile global viewpoint makes the implementation of growth enhancing policies and structural reforms even more critical to improve the probability of achieving the World Bank objective of ending extreme poverty by 2030. .

Kosovo, as opposed to globalization attitudes, faces numerous of challenges. The rule of law in Kosovo, including judicial independence, and limited results in the fight against organised crime and corruption remains a major concern. Whilst, Kosovo is also the only European country in which the EU has experimented legally on how to relate to a state without treating it as independent and sovereign. Since 1999, relations between Kosovo and the EU are co-dependent, since the Kosovo's objective was to integrate with the EU. EU guidance and support did not yield concrete results for the integration process of Kosovo with the EU. Since 2003, compared to neighboring countries, Kosovo lags behind in the integration process falls short of its aspirations for integration, and cannot keep commitments set forth by the European Union. (World Bank, 2015)

1. Trends of globalisation

The present trend of globalisation underscores the decisive role of industrial development in minimising the level of marginalisation connected with globalisation. The process of globalisation has given increase to greater competition towards markets and investments. Changes that are sweeping rapidly across the business world have forced businesses and nations to adapt by striving to change old economic behaviours and traditions. Industrial development has become an imperative recourse for underdeveloped economies, in that it must be seen as a key component of their development process. The role of the industrial sector in the newly industrialising countries has further intensified the appeal and the compelling urge for industrialisation for the third world countries.

Foreign investments are considered to have played a very important role in rebuilding the economies of the countries of Eastern Europe and Central Europe during their transition from centrally planned economies to market economies. Of long was recognized that FDI brings benefits for these countries, FDIs are important because they include bringing new technologies and knowledge to domestic firms, increased competition, and further increasing access for exports abroad. The distribution of FDI among developing countries is irregular: some of them have more difficulties to attract foreign investment than others (E-commerce and development report, 2011).

On the other hand, today's global business must be agile and responsive to be competitive. Innovations in information and communication technology can thus be major drivers of globalisation, making possible a networked, interdependent global economy traversing nation-states (Morrison, 2012). The critics argue that today's globalization is only superficially different from the old colonialism. Trade liberalization is a key to globalization. Developing countries have not benefited from this because developed countries have raised barriers to exports from the developing countries.

2. Knowledge and innovation impact in development policies in transition countries

Governments are eager to foster innovation and creation of knowledge. Nevertheless, countries at various stages of development differ in terms of their capacity to use and create knowledge. These capacities are shaped by the quality of institutions, macroeconomic stability and the functioning of product, labour and financial markets. They are also influenced by specific circumstances that underpin countries' ability to access existing technologies, effectively absorb them and create new ones. Transition countries perform reasonably well in terms of access to technology, but lag behind advanced economies and many emerging markets when it comes to absorptive and creative capacity. The analysis of national innovation policies reveals that they appear surprisingly similar, despite the underlying differences in countries' levels of development and strategies pursued by firms to acquire knowledge (through in-house research or by purchasing patents, licences or know-how). In particular, the innovation policies in the region tend to follow trends set by countries at the global technological frontier and focus on the creation of technologies (EBRD, 2015).

However, a one-size-fits-all approach such as this may not suit the circumstances of many of the transition countries. Given that these countries are yet to close the gap with the technological frontier, policies need to prioritise improvements in countries' absorptive capacity. Such improvements can be achieved through better secondary education and professional training, better management practices and policies that alleviate credit constraints. While innovation systems should imitate the governance and general design of advanced countries' innovation policies, policy instruments and priority areas need to be tailored to reflect an individual country's specific conditions. As countries develop and approach the technological frontier, innovation policies must evolve. They need to place greater emphasis on helping firms improve their capacity to create knowledge – by facilitating the supply of specialized skills and specialized finance, strengthening competition and facilitating the entry and exit of firms. Vertical innovation policies that offer support for particular sectors require high standards of governance to be effective and may not suit the circumstances of many transition countries.

2.1 The government functions in sustaining innovation

Every country acknowledges the importance of innovation for long-term growth. This is most noticeable in countries where the easy options have been exhausted and future growth depends on more efficient ways of combining inputs or producing new or improved outputs. Furthermore, the creation and spread of new knowledge are associated with significant market failures. For example, an individual firm deciding whether to invest in research and development (R&D) may fail to take account of the potential for positive spillovers to occur as the knowledge created becomes available to the wider economy. Such externalities call for government action. Governments can support innovation directly, either by funding public research or by encouraging private investment in research and innovation (for example through support for the transfer and spread of technology, support for venture capital, seed capital and R&D, and innovation-related tax incentives or incentives fostering cooperation between industry and science). They can also foster innovation indirectly, by providing a suitable environment for firms that are willing to invest and innovate. The policy mix should take account of potential externalities stemming from innovation by individual firms, as well as the degree of competition within the relevant sector. Most policy options will favor one sector over another, and some sectors may require specific interventions.

This may force governments to make difficult choices, striking a balance between direct support for innovation and improvements in the general environment. Furthermore, the legacy of centrally planned innovation systems still looms large over much of the EBRD region – particularly in the former socialist countries, where most research work was conducted by special research institutes, rather than universities or private companies. Although the pure science and innovation that resulted from these top-down systems was sometimes very advanced, it often failed to translate into commercially viable applications, as links with industry were weak. While there are examples of innovative companies subsequently emerging from these environments, the interface between research and the rest of the economy remains rudimentary at best. (WB, 2013).

3. Investments in transition countries

Over the last decade, has felt an increased level of Foreign Direct Investment (FDI) mainly in developing countries, and since 1989, also in terms of countries of Central and Eastern Europe. FDIs in transition economies of these countries are often studied recently for its innovation as a phenomenon and for its importance in growth and development of the region.

It is long accepted that the benefits of FDIs to these countries are important and include bringing new technologies and knowledge to domestic firms, "leakage" of productivity (spillovers), increased competition, and further increase access to exports abroad. Moreover, FDI is a preferred way of financing the deficit (which is quite high in countries in transition), since FDI flows do not create debt. Thus, despite some negative effects that FDIs may have on host countries, for the countries of Central and Eastern Europe, is considered an important source to help them to rebuild the economy and pass the period of transition to a market economy. In this region, some countries have performed better than others in attracting FDI flows, especially when comparing the two main groups: Central and Eastern Europe.

With the EU expansion toward the east and the south of the continent, the Western Balkans is continuously considered from actual and potential investors as the next Europe high value location. FDIs in the Western Balkans have been drawn mostly through the privatization process, while the level of Greenfield investments has been generally low. The services sector has attracted more FDIs, while the home countries of most of the investing companies are Italy, Greece, Austria, Germany, Hungary and Slovenia (EBRD, 2015).

3.1 Evidence upon economic performance in SEE countries

The year 2014 was not a difficult one for SEE countries. The main downward revisions were in Serbia and Montenegro. In Serbia, the damage to vital sectors of the economy from major floods in May 2014 was worse than expected. As a result, GDP is likely to have dropped by about 2 % for the year as a whole. Economic performance in Montenegro has been disappointing, possibly compounded by difficulties in Serbia and Russia as well as a delayed investment agenda, and growth last year is likely to have been around 1.3 %, rather than the 3 % originally expected (EBRD, 2015).

According to EBRD report, also lowered growth estimates for Kosovo from 3.5 to 2.5 %, based on weak first quarter data and the general sluggishness of other economic indicators. On the positive side, the economy of FYR Macedonia has been powering ahead on the back of strong export performance and rising personal consumption, and growth is likely to have been close to 4 %. In Bosnia and Herzegovina, the impact of the floods in May was less severe than originally feared, and exports and retail sales have helped to maintain growth in positive territory. Looking ahead to 2015, most countries can expect a modest gain from the dramatic reduction in the oil price.

Nevertheless, the overall outlook remains subdued, reflecting country-specific constraints. The main downward revisions are in Bulgaria and Serbia. In Bulgaria, the resolution of the banking sector difficulties that occurred last year has been delayed, which is likely to limit fiscal space and credit growth in the current year. Elsewhere, are expected a rebound in Montenegro on the back of strong FDI inflows and progress on a major highway project, raising the predicted forecast from 2.5 to 3 %, and FYR Macedonia is now likely to grow at 3.5 % with continued strong export performance. Positive terms of gains are also being offset by country-specific factors and/or weak external demand outlook in Albania, Bosnia and Herzegovina and Kosovo, where given forecasts have been maintained (EBRD, 2015).

4. Overview on socio-economic site of Kosovo

Although Kosovo's economy grew uninterruptedly since 2001 much of its growth can be attributed to the low base effects as genuine sources of sustainable growth remain absent. High and persistent external imbalances, somewhat mitigated by significant inflow of worker remittances, showcase a weak production base and lack of international competitiveness. Inefficient and heavily subsidised POEs, and ad hoc decision making, characterise Kosovo's public sector. Although measures such as the introduction of the fiscal rule were enacted, their reinforcement mechanisms remain weak. The labor market is characterised by low participation and high unemployment rates. Large shares of youth, long term and unskilled unemployed show deeply embedded structural rigidities. The widespread informal economy, weak rule of law and lack of fiscal predictability remain major obstacles to doing business and

improving competition and productivity in the economy. Significant further efforts are needed to develop a competitive private sector and anchor fiscal sustainability**.**
Kosovo's economy is hampered by poor natural resources, an underdeveloped industrial sector, ageing equipment, insufficient investment, and a labor supply that exceeds demand. Still, the main problem remains that the economy relies strongly on the Kosovo-Albanian diaspora, and on the international community's assistance (EU commission 2014).

According to the NGO "Çohu", corruption has made Kosovo almost impermeable for other businesses, except for those with political connections. Publicly owned enterprises in the fields of energy, electricity, telecommunications, postal services, railways and air traffic are believed to offer ample opportunities for corruption, which created a monopoly. The privatization of public companies was fraught with irregularities, and was opposed by the public and experts, who objected that the country's economy, energy sector and citizenry would not benefit from it. Soon after the KEDS privatization decision, the Energy Regulatory Office decided to raise electricity bills by 8.9% in a country where 16% of citizens live on $1 per day, and the unemployment rate is between 40% and 45% (UNDP, 2013).

As of march 2015, government announced its objective to decrease the VAT from 16% to 8% for basic commodities. VAT differentiation by applying lower rates for the basic commodities and applying 0% rate for the primary agricultural products with the aim to increase domestic production and hence reduce imports of agricultural products. Although, a formal decision was not taken yet, decreasing the VAT threshold aims at creating fair and more competitive environment for doing business for small and medium size businesses.

4.1 Fact sheet of economy

Kosovo made limited progress on its path to become a functioning market economy. Substantial efforts are needed to tackle structural weaknesses to cope with competitive pressures and market forces within the Union over the long term.
Economic growth remained positive at 3.4 % but did not yield any improvements in labour market conditions. High external imbalances persist despite some narrowing of the trade deficit. Macroeconomic stability was broadly preserved despite significant pre-election ad hoc increases in current expenditure, in particular on wages and pensions. Such practice deteriorates the transparency, predictability and credibility of fiscal policy, complicates fiscal planning and shifts the composition of spending towards less growth-friendly expenditure (EU commission report. 2014).
Strengthening fiscal planning and effectively implementing the fiscal rule is vital. Moreover, decisions on large infrastructure projects, such as in the transport sector, should be based on proper cost-benefit evaluations to maximise economic benefits. In view of the persistent and very high unemployment, efforts should be undertaken to facilitate private-sector development through improvements in the business environment. To that end, obstacles arising from weak administrative capacities, difficult access to finance and lengthy and complex privatisation procedures should be swiftly addressed. Government must secure a properly functioning legal and judiciary system, enhance contract enforcement and effectively reduce delays in courts, as well as economic statistics need to be improved (WB, 2015).

Investments in Kosovo
Foreign investments flow to Kosovo has been declining from year to year given unfavorable business climate around the globe. Today, Kosovo is facing fierce regional competition in attracting more FDI. According to the World Bank statistics, there has been a 30% decrease in FDI flows from 2011 to

2013 in Kosovo. This trend continued throughout last year, although the official statistics have not been published yet (American Chamber of Commerce, 2012). The amount of FDI flows in Kosovo still remains one of the lowest in the region. Experience from transition economies shows that FDI is directly linked to the increase of exports and was the main contributor in the generation of new jobs, improvement of the overall economic and political stability. In order for FDI flows to increase, the investors need to gain the confidence that they can operate in an environment that is free of any undue political interference. The recent criticism of certain political figures from the local and central levels directed against a number of companies regarding compliance with environmental laws will have a negative impact not only on the protection of the environment. This is due to the fact that criticism in the form of political rhetoric that is not substantiated by facts neither improves the protection of the environment, nor helps Kosovo build an image of a country which is governed by the rule of law. According to the Business Registry data, there are over 2,000 companies of foreign and mixed ownership that have already used the opportunity to invest in Kosovo. The large amount of foreign companies operating in Kosovo is a living proof of the opportunities and benefits that the country offers, and also represents a base of quality products and a sufficient service-providing community (Central Bank of Kosovo, 2015).

Investment has shown a slight decrease in real terms in 2014. This has been observed in particular in private investments, mainly because of the uncertain political situation which persisted during June-November 2014, thus influencing the behaviour of economic agents. The latter may be opting to save instead of invest while standing by for a resolution of the political situation. This reaction is signaled by the (observed) increase in deposits within the banking system, as well as the fact that the import of investment goods (mainly construction goods) has fallen. In addition, companies'declared turnover has fallen compared to the same period of 2013, especially in trade, construction and the processing industry. On the other hand, a part of remittances goes into private investment in the form of investments in real estate, which has alleviated the effect of the aforementioned negatively contributing factors (Government of Kosovo, 2015).

4.3 Barriers to progress

The business environment in Kosovo reflects the numerous problems that relate to the degree of informality, regulatory, environment, etc. SMEs in Kosovo face with multiple barriers which inhibits starting their business or development. For greater utilization of capacity of SMEs unfair competition should be eliminated, monetary and financial policies to mitigate financial funding shortages should be implemented, stabilizing macro policies should be applied, and free trade agreement should be signed and applied with countries of the region and beyond. In order to be competitive SMEs should improve the quality of products and services by utilizing technological innovation, and stimulating qualified personnel.

On the other hand, rule of law and continuously rising rates of unemployment present a mixed picture. While labor regulations are flexible and taxes low, there are segments of business environment which are considered a significant obstacle to economic growth. For example, in the area of construction licensing, Kosovo lags significantly behind the peers in the region; more than 140 days are required to obtain a construction-related permit in Kosovo, compared to an average of around 80 days in Eastern Europe and Central Asia (BEEPS, 2013). Kosovo firms rank —practices of competitors in the informal sector as the single biggest constraint to their business growth: 57.8 % of the Kosovo firms, compared to 11% in Montenegro, 16.1% in Serbia, 19.9% in Albania and 34.8% in Macedonia.

4.4 Reforms to be done

Herein are suggested key areas of reforms relevant for the overall macro-fiscal framework and policy strategy. The short summaries are presented below:

- labour market reforms;
- make an investment and employment fund;
- proper privatisation module for public firms;
- acceleration of the private industrial sector;
- reforms aimed at improving financial stability;
- information on labour market flexibility, tax and benefit systems, and wage bargaining;
- health reform;
- increasing efficiency of public expenditure;
- information on wages and employment policies in the public sector;
- a properly functioning legal and judiciary system;

5. EU vs Kosovo concerning Stabilization-Association agreements

The first agreement ever to be offered to Kosovo, considered to have an important role in its economic development, was the trade agreement. For years Kosovo has enjoyed trade preferences within the “autonomous trade measures” the European Union announced for all countries of the Balkans region. Since production in Kosovo has not made significant progress from this unilateral liberalization, the profit was modest. Meanwhile, all other countries of the region have reached Stabilization-Association Agreements with the EU and provisional Stabilization-Association agreements. Kosovo remains the only Balkan state without such an agreement. For a long time Kosovo was cut-off “autonomous trade measures” because there lacked the consent in the EU to extend them after they expired.
The Commission admits that unilateral trade measures alone are not sufficient to stimulate the necessary investments in Kosovo’s economy and for production. The Commission reasoned in 2009 that EU Kosovo trade relations based solely on autonomous trade preferences do not offer a substantive perspective for the sustainability of Kosovo’s long-term economic development. Such a perspective can only be provided through a trade agreement between the European Community and Kosovo. A trade agreement offers important advantages for both Kosovo and the EU. An agreement provides a legal framework offering stability and predictability to investors. Kosovo received this offer with enthusiasm. In the following spring, the Kosovo government received a questionnaire. Yet, Kosovo did not treat this offer seriously. Kosovo authorities delayed drafting the required studies. However, due to the lack of unity regarding the status of Kosovo, a discussion was opened in the EU surrounding the framework for signing this agreement and the parties that were to sign it. Thus, both Kosovo and the EU lost the momentum required to reach a trade agreement. Usually such an agreement could be negotiated within several weeks.

Croatia negotiated the SAA in five months; the trade part is only one part of it. Now, more than three years after the offer for a Trade Agreement, Kosovo’s fate is unclear. Based on statements of Kosovo officials, it seems that they forfeited this offer while waiting for trade to be covered by a future SAA. This approach is imprudent because achieving the SAA might take several years and disagreements surrounding Kosovo’s status jeopardizes the achievement of a SAA (KFOS, Forum 2015).

5.1 Drama of the EU integration process of Kosovo

Kosovo’s progress lags behind other countries of the region. Consequently, there is lack of economic development in Kosovo, underdeveloped democratic standards and impeded democratic functioning of the state. Kosovo’s slower progress makes the integration process with the EU more challenging than it was for the countries in the region. One objective reason for this is because conditions for EU integration continue to increase. This is currently the case in the dialogue for Kosovo regarding visa liberalization. For example, Kosovo is asked to meet conditions at the onset of this process that, for other countries in the region, were formerly conditions to be met at the end of the process. It is likely that this will happen with the steps for the process of membership in the EU (KFOS, Forum 2015).

To become an EU member, a candidate country must translate laws, pass the laws and demonstrate a strong basis to implement them. This is challenging for an underdeveloped and poor country like Kosovo, whose GDP is lower than the 7 % average of the 27 member states of the European Union. Kosovo’s relations with the EU are as follows:

- Fourteen years after launching the SAA process, Kosovo is not formally included;
- Six years after declaration of its independence, Kosovo has no agreement with the EU that would mark first contractual relations;
- Since the declaration of independence, the gap has widened between Kosovo’s progress towards EU integrations and other countries of the region, which have moved much closer to achieving EU integration than Kosovo;
- Kosovo is the only country of the region that does not have a bilateral agreement with the EU to regulate trade;
- The EU financial assistance for Kosovo, which was considered to be the most in the world per capita, and the significant presence of EU in Kosovo have not sufficiently improved the rule of law;
- Still, there is no confidence in Kosovo authorities’ willingness to reduce corruption and organized crime;
- There is no consensus in the EU on Kosovo’s status, despite the fact that it is considered to be a priority in the common Foreign and Security Policy of the EU;
- The lack of consensus on Kosovo’s status continues to be the main political and legal obstruction to advancing formal relations between the EU and Kosovo;
- The EU member states, with some exceptions, have lost interest in engaging Kosovo in integration processes;
- Without a change of attitude from both sides realization of Kosovo’s aspirations for a European future will remain only an agenda on the table;

Conclusion

In general, SEE countries were unable to generate significant employment gains during the boom years and registered large job losses during the global crisis. A comprehensive set of reforms will be needed to address the region’s persistently high unemployment, and this paper finding of a significant positive impact of structural reforms on the probability of employment is worth highlighting.

Despite a moderate economic recovery over the last decade, Kosovo continues to face difficult economic conditions coupled with the highest rate of unemployment and the lowest rate of domestic production in the Balkans. Kosovo’s economy has continued to withstand financial turbulence in the euro area fairly well, reflecting inter alia limited integration into cross-border financial markets. Real GDP growth in 2015 is estimated at symbolic 2.8% according to World Bank prediction. Going forward, a possible deterioration in labor market conditions in central European countries where most of the Kosovar diaspora lives could negatively affect FDI and remittances.

Based on what was argued in this paper, it may be concluded that globalization events has a tremendous impact in attracting investments in transition economies. Worldwide, the link between globalization and greater economic integration has - alongside the benefits - increased vulnerabilities, whereby economic failure in one country can rapidly infect other national economies. While it is argued that the global crisis has not hit Kosovo directly, its economy has felt its indirect effects. Donor countries have shown hesitance to increase aid to Kosovo due to their own internal problems; the dramatic rise in unemployment in both Europe and North America has affected the Kosovan Diaspora. A subsequent drop in remittances from Kosovans working abroad is likely to carry a negative impact on the economy of Kosovo. Therefore, Kosovo has been quite successful in attracting investments.

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