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Barriers to cross-border trade in intermediate goods within regional value chains in the CEFTA region

Besnik Krasniqi

University of Pristina

Jasmina Ahmetbasić

Sarajevo School of Sciences and Technology

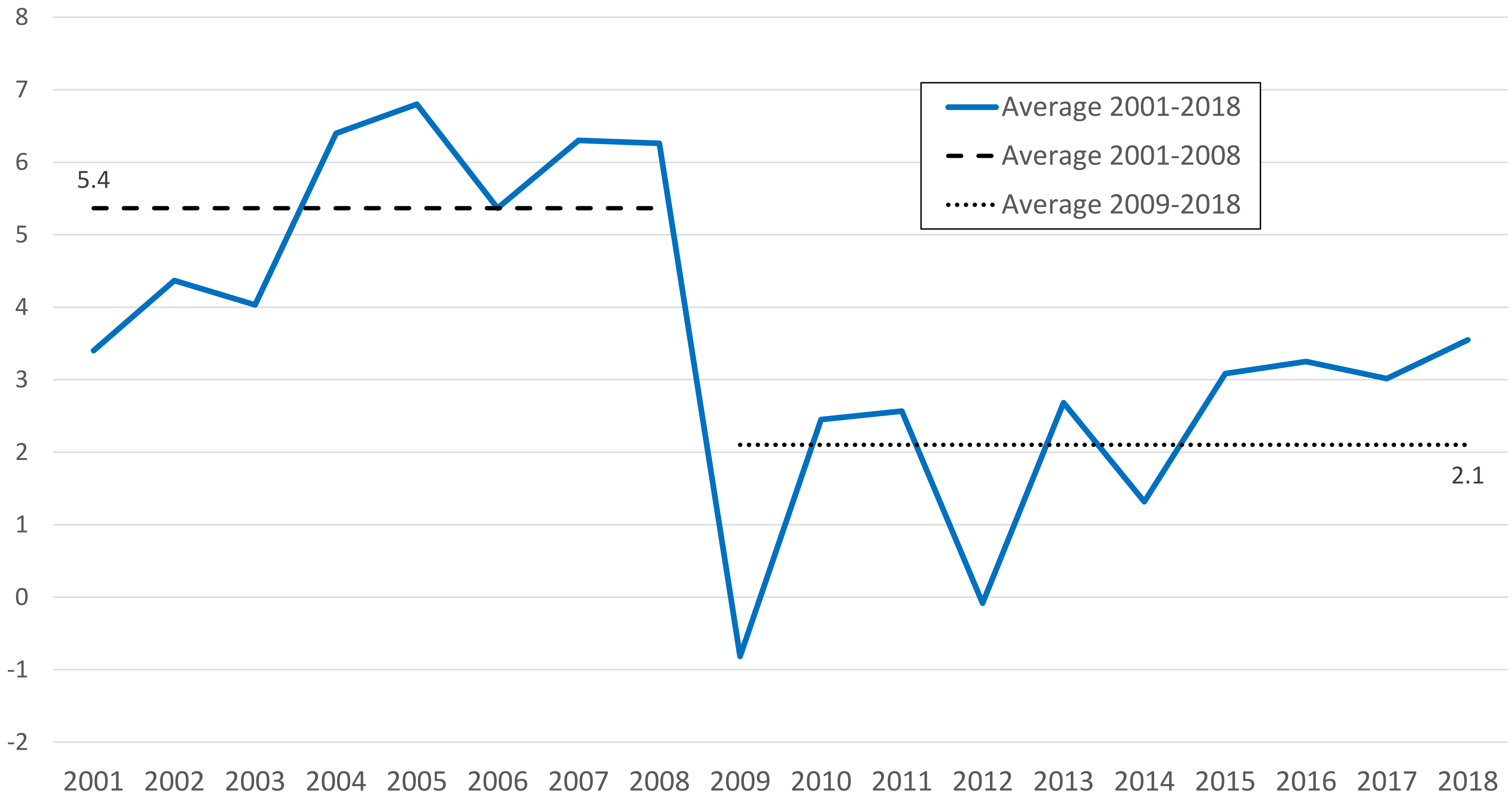
Will Bartlett

London School of Economics

Aims

- This paper investigates the barriers to the development of regional value chains that would leverage foreign investment to support the growth of regional trade through regional supply chains.
  - Specifically, we are interested in the development of regional supply chains to support foreign investors located in SEZs, as this is where much of the policy for attracting FDI has been focused.
- **I**dentify the way in which regional FTAs such as CEFTA may bring about structural change and tendencies to either convergence or divergence among partner economies.
- **A**nalyse the range of barriers to the development of regional value chains involving SMEs,
  - In-depth interviews carried out with managers of SMEs involved in supplying components to SEZ-based companies.
- Measure the volume and structure of trade of this type and its potential volume,
- Identifying where policy should be focused to best reduce barriers to regional value chains, with the aim of developing the regional supply capacity of SMEs in manufacturing industry.

Real GDP growth in Western Balkans



Convergence tendencies and FTAs

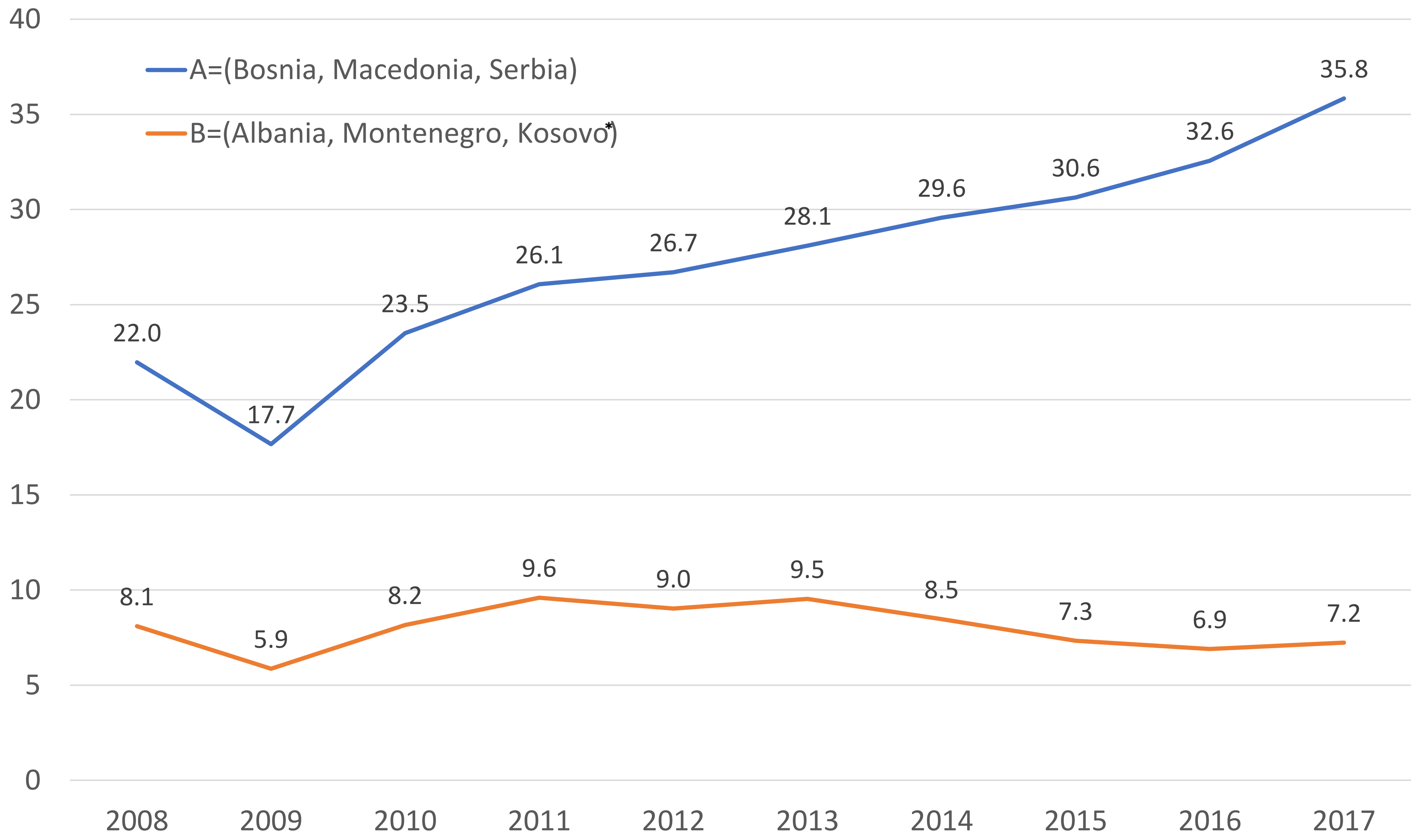
- Trade effects
  - Trade creation and trade diversion
  - But, some governments may lose tariff revenue due to trade diversion
  - Less trade diversion if low external tariff
- Scale and competition effects
  - Larger market justifies larger company size which may be more efficient
  - Producers from partner economies may compete against each other, challenging incumbent monopolies and improving competitiveness
- Benefits of FTA may not be realized if non-tariff barriers persist
  - Need for “deep integration” such as proposed in Regional Economic Area

Divergence tendencies of FTAs

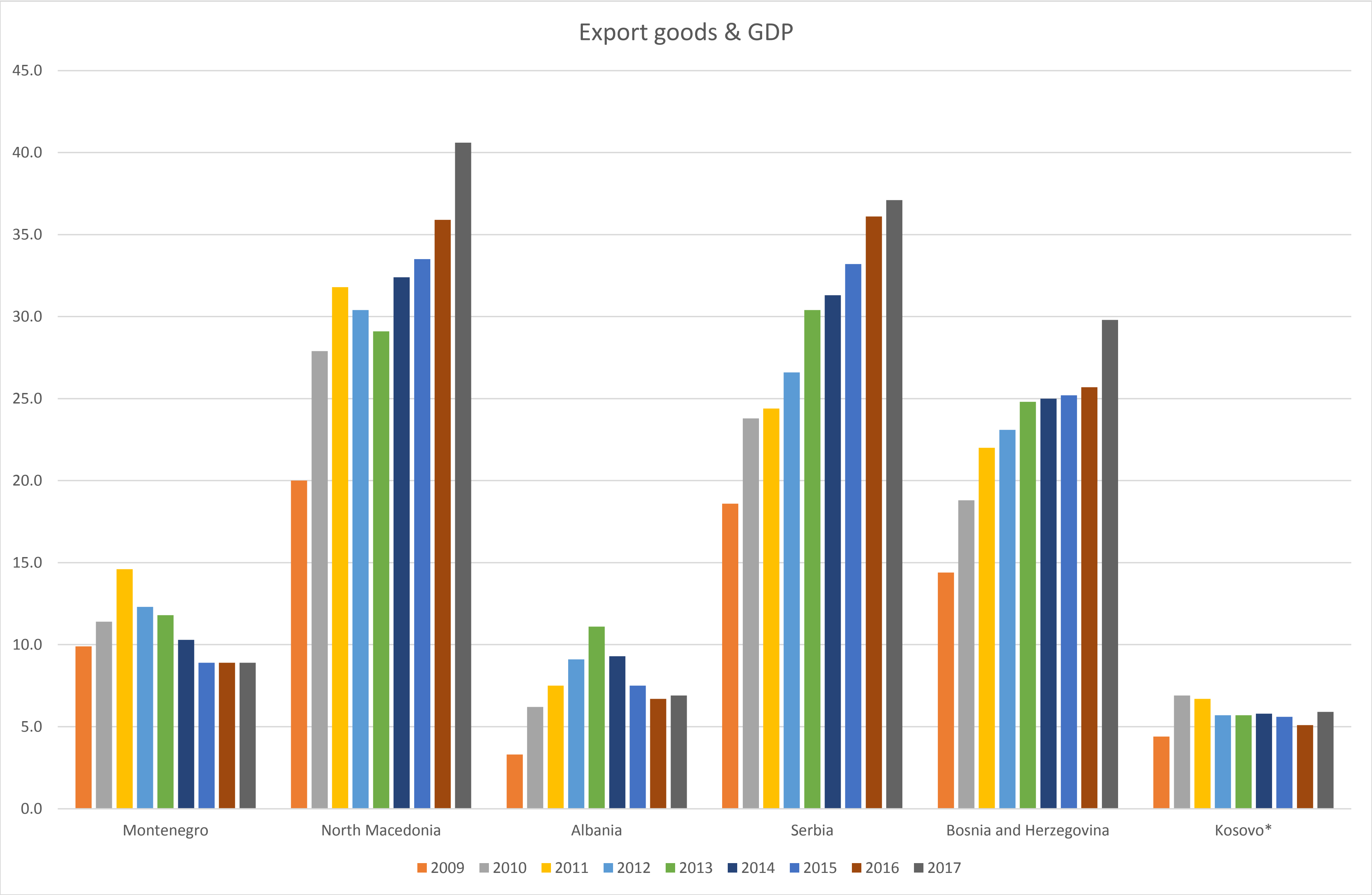
- Even if there are gains from FTA the question remains about the distribution of the gains
- If there is divergence, regional cooperation is unlikely to be sustainable in the long run
- Orthodox economics predicts convergence due to factor flows to higher earning opportunities (capital to poor economies, labour to rich ones)
- Regional economics envisages divergence:
  - Differences in competitive power of firms in different economies
  - Agglomeration effects as increasing returns to scale attract manufacturing companies to most competitive location, with skilled labour, and externalities from other firms located there

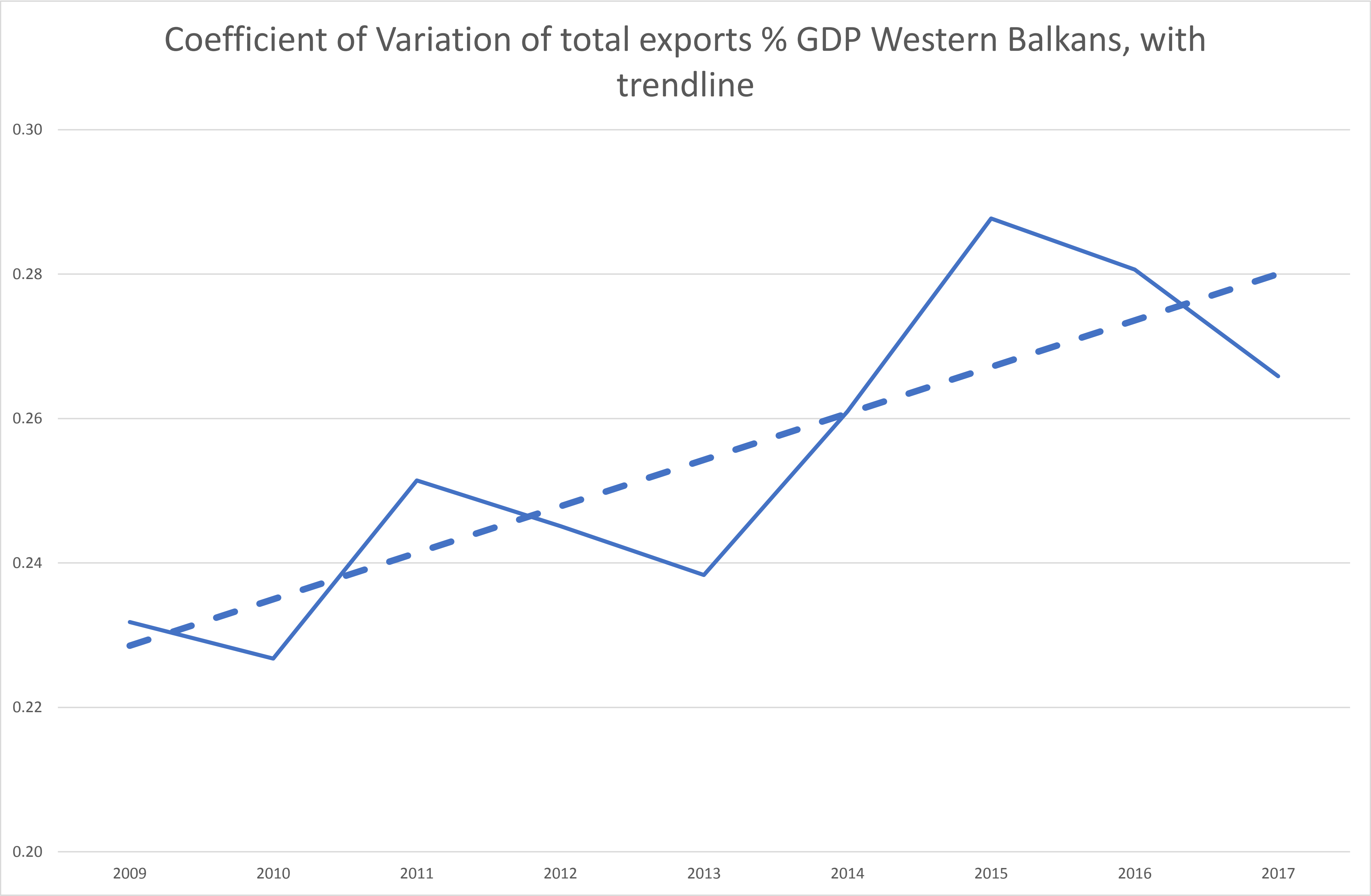
Divergence outcomes in CEFTA region

Goods exports % GDP, Groups A & B, 2008-2017



*This designation is without prejudice to positions on status, and is in line with UNSCR 1244 and the ICJ Opinion on the Kosovo Declaration of Independence


Export goods & GDP
45.0
40.0
35.0
30.0
25.0
20.0
15.0
10.0
5.0
0.0
Montenegro
North Macedonia
Albania
Serbia
Bosnia and Herzegovina
Kosovo*
2009
2010
2011
2012
2013
2014
2015
2016
2017


Coefficient of Variation of total exports % GDP Western Balkans, with trendline
0.30
0.28
0.26
0.24
0.22
0.20
2009
2010
2011
2012
2013
2014
2015
2016
2017

Uncoordinated industrial policies & divergence

Industrial policy

- Economies have tried to supplemented trade policies with industrial policies
  - Industrial policies have been oriented to attracting FDI
- In Serbia, Bosnia and North Macedonia, special economic zones have been established to attract multi-national companies
  - In the zones, foreign companies enjoy a wide range of benefits ranging from 0% VAT, 0% customs and 0% profit tax and other subsidies
- More generally, industrial policy has been based on low corporate profit tax rates, and investment and employment subsidies
  - In Serbia, state aid has been used to aggressively subsidise multi-national companies

Export Processing Zones

CEFTA Party	Name of EPZ
Albania	“Technology and Economic Development Areas” (none active)
Bosnia	“Free Zones” (4 active EPZs)
Kosovo*	“Industrial Zones” (no EPZs)
North Macedonia	“Technological Industrial Development Zones (8 active EPZs)
Montenegro	“Strategic Business Zones” (5 EPZs planned)
Serbia	“Free Zones” (14 active EPZs)

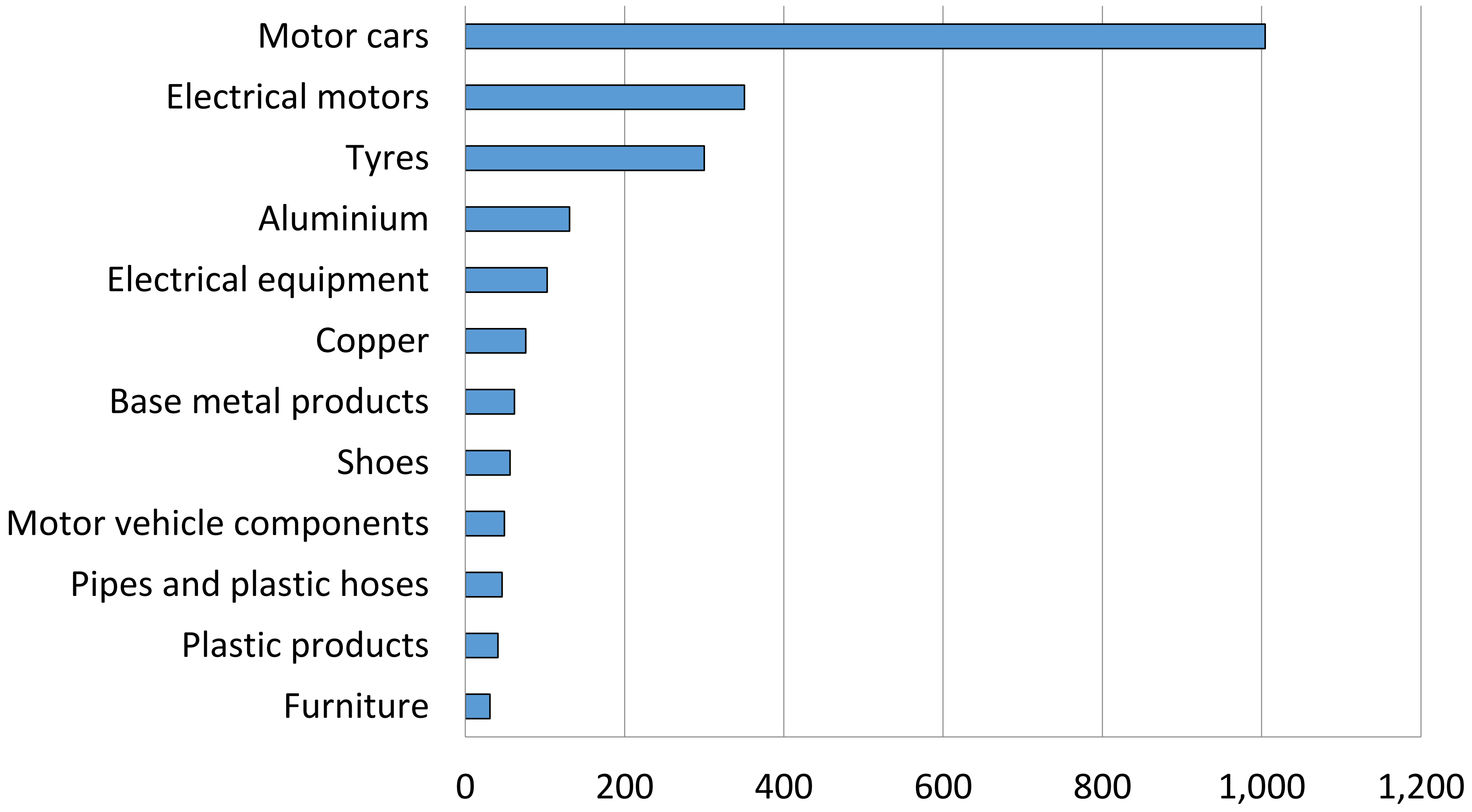
North Macedonia

- Directorate for Technology Industrial Development Zones manages the process
  - TIDZ are under state ownership
- Subsidies to attract high tech FDI companies:
  - 0% customs duties or VAT on imported goods or equipment (vs. standard 18%)
  - 0% profit tax for up to 10 years (vs. standard 10%)
  - Subsidies to build a factory up to €500,000
  - Employment subsidies up to 50% gross wage, and 50% of justified investment costs up to €50 million
- 8 active “TIDZs” with 18 active users

Serbia

- Law on Free Zones 2006 defines Free Zone as export processing zone
- Bottom-up approach, driven by municipalities, under regulation of the Free Zone Administration
  - FZs usually owned by the municipalities
- Subsidies to attract FDI companies to FZs:
  - 0% customs duties, VAT on goods or equipment (vs. 20%)
  - 0% excise duty on electricity supply
- Subsidies to FDI companies in general
  - 0% profit tax for 10 years if invest >€8m and employ > 100 workers (inside or outside FZ) (vs. standard 15%)
  - Investment subsidies (inside or outside FZs) depending on level of municipal development, investment size, number of jobs created
- 14 FZs host 240 companies

Exports from Serbian FZs by broad product group, 2016 (€m)



Origin of inputs to firms in the Western Balkans by economy (% of total inputs)

Economy	Purchased from domestic sources	Imported from the EU	Imported from the SEE region	Imported from third countries
Albania	69	4	24	3
Bosnia and Herzegovina	68	11	18	2
Montenegro	51	27	16	6
Kosovo*	65	15	15	6
Serbia	78	7	12	4
North Macedonia	82	4	8	5
SEE	**69**	**11**	**16**	**4**

Purchase of inputs from other CEFTA partners

- The table in the previous slide reveals that Albania is the largest purchaser of inputs from elsewhere in the region
  - Alania purchases 24% of its inputs from other neighbouring economies
- Surprisingly, the two economies with the most activity in the manufacturing sector and the greatest FDI in SEZs purchase the lowest proportion of their inputs from elsewhere in the region
  - Serbia purchases 12%, North Macedonia purchases 8% (of inputs) from elsewhere in the region.
  - This suggest a large scope for increasing the inputs supplied to the SEZ multinational companies from SMEs in throughout the region

International trade of Serbian SEZs and manufacturing industry (2013-17)

	2013	2014	2015	2016	2017
Exports per employee (EUR)	**SEZs**	79,656	85,567	75,350	87,679
	Manufacturing sector	31,419	33,519	35,580	37,987
Exports/GVA	**SEZs**	67.3%	66.3%	71.1%	82.2%
	Manufacturing sector	50.3%	52.8%	54.5%	45.3%
Import intensity (Imports/Exports)	**SEZs**	209.0%	134.1%	125.1%	106.7%
	Manufacturing sector	151.1%	123.1%	119.8%	111.2%
Import dependence (Imports/ Turnover)	**SEZs**	47.4%	45.3%	43.1%	44.3%
	Manufacturing sector	38.3%	38.7%	39.1%	39.1%

SEZs are creating new jobs in Serbia

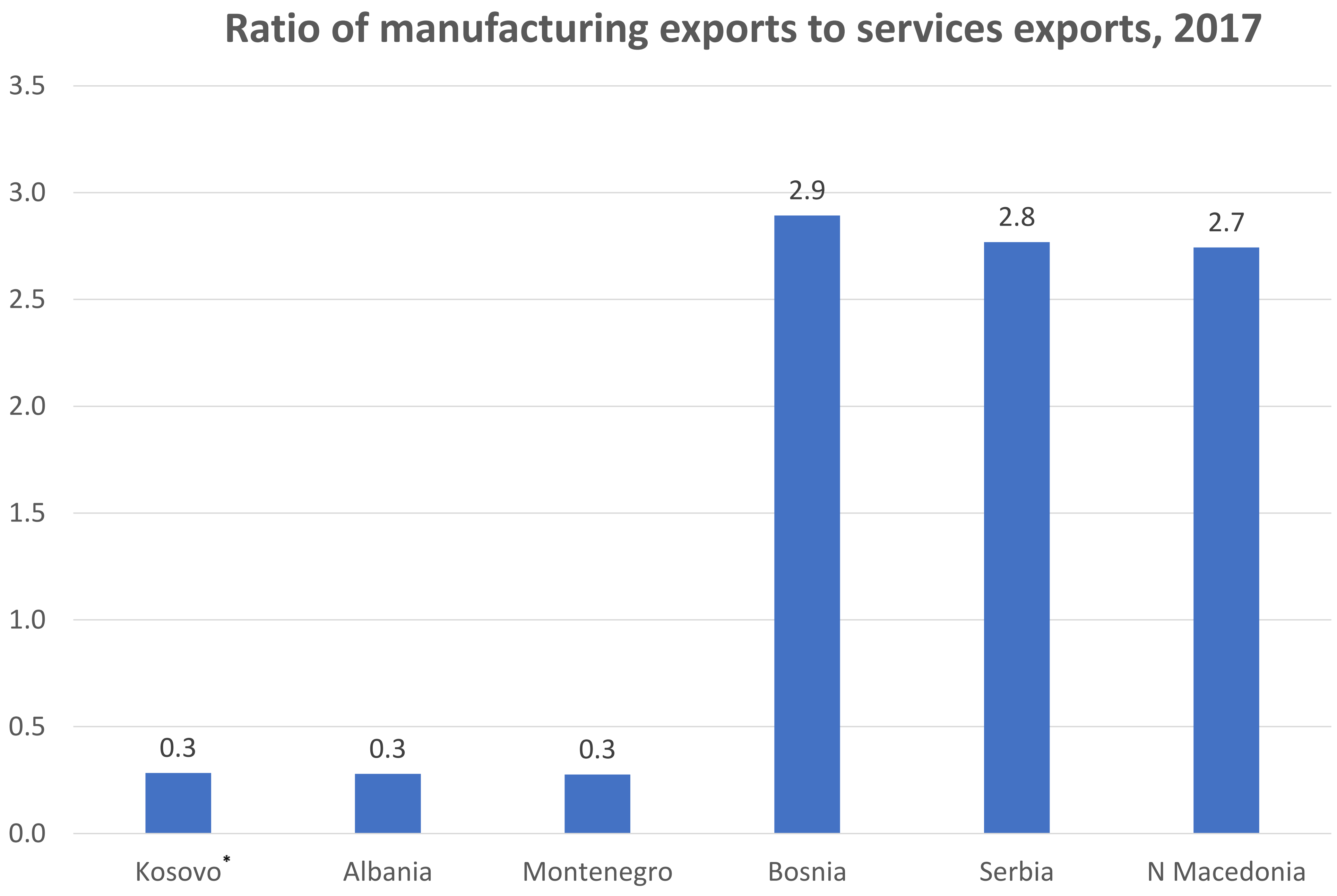
- Direct employment effects:
  - SEZ jobs increased from 14,500 in 2012 to 25,000 in 2016
  - SEZ jobs increased 5 times faster than in the whole economy
- Indirect employment effects:
  - for every job created by FDI, about 4 to 7 jobs are indirectly created in the local economy
  - I estimate that between 25% and 50% of all jobs created in last few years have been due to direct and indirect effect of SEZs

High cost of job subsidies in Serbia

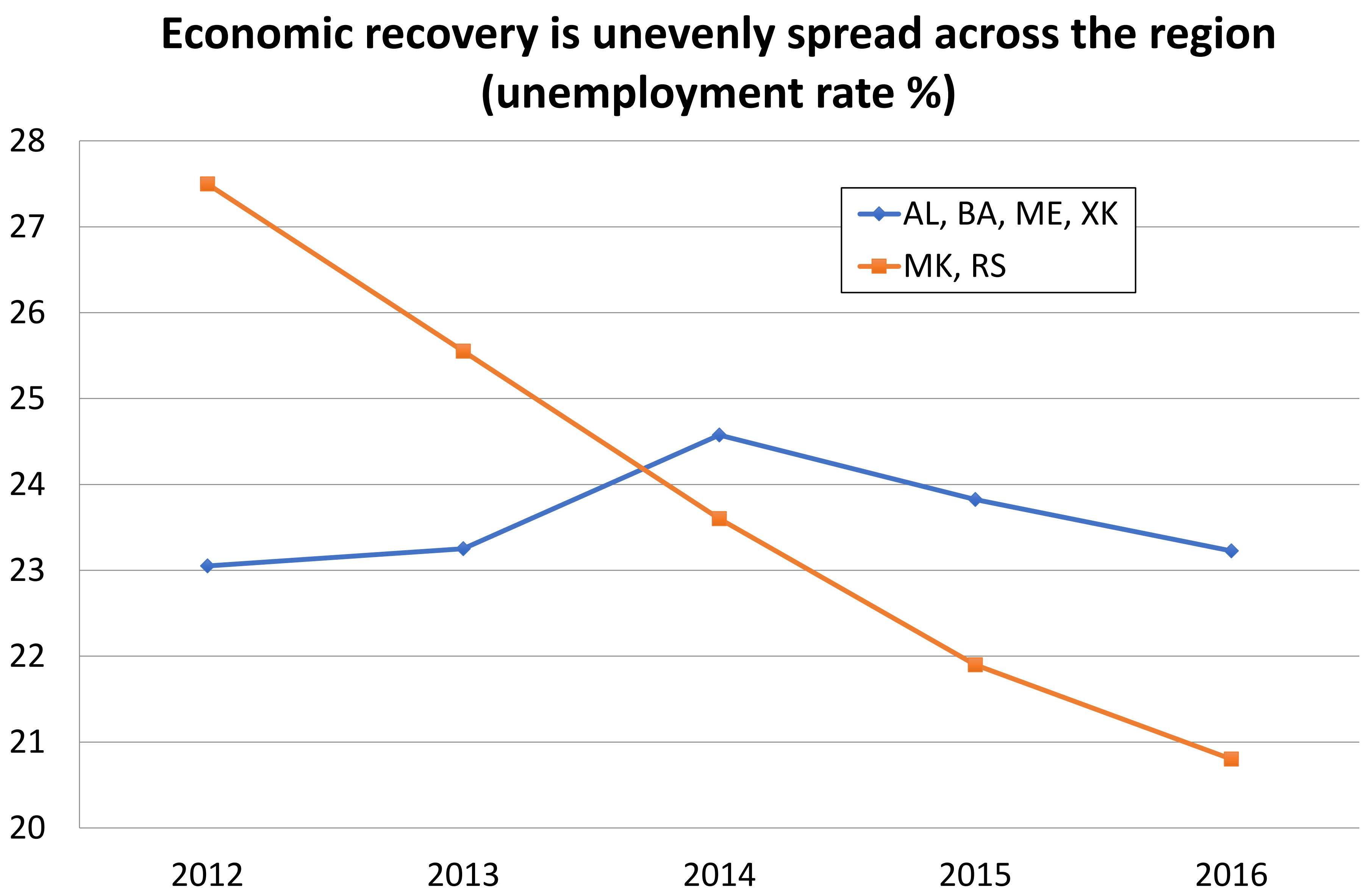
- Investors negotiate non-transparent agreements with RAS
- Average subsidy of €9,000 per job created in 2014, and €5,000 in 2016
  - Similar to investment per employee by MNCs in SEZs (2015: €7,000)
- The cost of the programme was €45 million in 2014, and increased to €85 million by 2016.

Effect of policies on economic structure


Share of exports of goods and services in GDP, 2017 (%)
60
50
40
30
20
10
0
20.8
5.9
24.7
6.9
32.2
8.9
10.3
29.8
13.4
37.1
14.8
40.6
Kosovo*
Albania
Montenegro
Bosnia
Serbia
N Macedonia
Goods exports
Services exports



Ratio of manufacturing exports to services exports, 2017
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
0.3
0.3
0.3
2.9
2.8
2.7
Kosovo*
Albania
Montenegro
Bosnia
Serbia
N Macedonia


Economic recovery is unevenly spread across the region
(unemployment rate %)
28
27
26
25
24
23
22
21
20
2012
2013
2014
2015
2016
AL, BA, ME, XK
MK, RS

Mitigating policy defects by promoting cross-border trade in regional supply chains

Linkages to the local economies

- Multinational companies based in SEZ and elsewhere are mainly engaged in export processing and have few links to local companies
- There is little evidence of spill over effects from FDI to local economic development

Use of local resources and suppliers

- Use of local suppliers varies between SEZs
  - In North Macedonia – 500 local companies supply TIDZs
    - But, only 5-10% of inputs are bought locally, usually limited to services, construction, transport, security services etc.
    - Very limited use local inputs for their core business operations
  - In Serbia – supply chain is virtually non-existent
  - In Bosnia – largest FZ Visoko, only 4% supplies sourced locally
- Large technology gaps often inhibit use of local suppliers

Findings from Field interviews with SEZs' company managers

Use local inputs and cooperation of WB value chains (materials and labour)	To what extent and in what ways do SEZs contribute to technology transfer to local companies?
• Use almost entire workforce locally, with very few exceptions for higher managerial positions • SEZs companies use outside purchasing outside WB because is difficult to find adequate inputs, • Reliability, price stability and quality standards remains the biggest concern for increasing use of local supply base • Cooperation initiatives between SEZs companies and local suppliers usually starting with small projects and gradually increasing progressively • In one case (in FYROM) the company has been able to become part of the global value chain of the FDI company in SEZs • Limited supply – there is a need for cooperation between WB6 companies in certain sector • Possibility of cooperation in ICT, textile, auto moto industry, metals ect.	• The singed contracts for sales has enabled local companies to have more risk-free expansion plans to buy new equipment • We have provided know-how for local companies, organised visits in our mother companies to have direct experience how we work and what is required • Provided training for local staff especially in engineering work

Regional Economic Area to supplement CEFTA

Regional investment reform agenda

- Vision – regional investment leads to economies of scale and more efficient allocation of resources within region
  - But this will be directed to attracting FDI
- Western Balkan economies should cooperate to promote the region as an investment destination
  - Move away from competitive FDI subsidies and tax breaks creating a “race to the bottom”
- Common platform for investment promotion
  - Presenting region as a sound investment destination to the foreign business community
- Link SMEs as suppliers to FDIs
  - with training and investment programmes

Developing a regional investment reform agenda

- Investment attraction:
  - Harmonise investment incentives at a regional level
- Investment promotion:
  - EBRD Regional Investment Platform Common platform is a useful instrument for investment promotion
- Investment impact
  - Link SMEs as suppliers to foreign investors
  - Leverage cooperation between WB6 companies to increase the supply base
    - **Likely to increase intra regional investment**
  - Provide training to supplier companies

Thank you for your attention