SLOWDOWN, CREDIBILITY AND EU ANCHORING OF STRUCTURAL REFORMS IN THE WESTERN BALKANS

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Abstract

The EU integration has been an important process of economic, political and social transformation of the Western Balkans and its convergence with the European Union. According to empirical evidence and the international reform indicators in the recent years the pace of structural reforms is slowed down in the Western Balkan countries and the catching-up after the global economic crisis is slower compared to the New Member States of the EU. The aim of this paper is to answer the question of how to accelerate economic growth and convergence with the EU by accelerating structural reforms and their credibility. The empirical analysis shows positive impact of structural reforms and EU integration on convergence with the EU. In order to draw recommendations for policy makers in this analysis, we develop a theoretical model for the political economy of structural reforms for the countries of the Western Balkans in the process of EU accession. The model suggests that in a dynamic world with rational expectations, the credibility of policymakers is crucial in accelerating reforms and joining the EU, especially given the temporal inconsistency and trade-off between short-term costs and long-term benefits as well as the redistributive effect of reforms in the society. We find that the EU can play a role in increasing the credibility and pace of reforms for countries in the Western Balkans through EU anchoring of reforms within policy rule framework or through the influence on the following policy channels within policy discretion framework: increasing the government's reform preferences; reducing the government's populism; reducing public's short-termism (public's reform sensitivity); increasing the credibility of the EU accession process; and reducing the government's credibility gap. In addition, the empirical and theoretical analysis of this research as a recommendation to the European Commission indicates that when designing an EU enlargement strategy consideration should be given to the endogenous convergence, the political economy of structural reforms for EU integration, and the strengthening of the credibility of the process of the EU enlargement in the Western Balkans.

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INTRODUCTION

The European Union has contributed to peace and reconciliation, democracy and human rights in Europe. Similarly, European enlargement has played a significant role in integrating and democratizing the transition countries of Central and Eastern Europe. The same we may say for the Western Balkans, where the EU contributed towards peace and stability after decades of conflicts, among others, mainly due to the promise for a better future with political stability and economic prosperity.

Following the global financial crisis and the problems that emerged with the economies of the Eurozone, the issue of structural reforms has re-emerged in the international policy agenda. In the case of transition countries and countries belonging to the EU pre-accession process – such as those of the Western Balkans – the pace and commitment to reforms in these countries has subsided after the crisis (EBRD, 2013; Kovtun et al, 2014; IMF, 2015a). Recent developments in the European Union, with the Eurozone crisis and the rise of Euroscepticism, as well as in the Western Balkans, with the political challenges that emerged recently (Carpenter, 2017), raise questions about the pace and credibility of the EU integration progress in the Western Balkans. A recent paper by the European Parliament's Policy Department makes this clear: "Despite initial success, the current approach to enlargement has reached its limits, as it seems to be slowing down the integration process rather than accelerating it. In the meantime, in addition to the democratic and economic setbacks in the region, renewed tensions are threatening to undermine fragile regional stability. Moreover, the EU's unfinished business in the Balkans opens the door to various political, economic and security alternatives […] The current autopilot mode of enlargement cannot continue." (DGEP, 2015). Indeed, according to international reform indicators, in recent years the pace of structural reforms in the Western Balkan countries has slowed down and catching-up after the global economic crisis is slower compared to the New Member States (IMF, 2015a). The accent on enhancing structural reforms is made on the EU Enlargement strategy documents and the respective progress reports for the Western Balkans (EC, 2015a, 2015b, 2016a and 2016b).

A large literature exists that discusses the problems of institutional transformation and political and economic reforms in the region exactly under the prism of pre-accession conditionality and the so-called 'EU transformative power' (Grabbe, 2006 and 2014; Gateva, 2015; Sanfety et al, 2016). Drawing from earlier contributions concerning the experience of the 2004 Enlargement (Hughes et al, 2004; Schimmelfennig and Sedelmeier, 2005) and building on earlier analyses about the problems of transition in the region (Kuzio, 2001; Anastasakis and Bechev, 2003), this literature attributes the origins of reform delays, or reform failures, in the region on two sets of factors. On the one hand, problems emanating from the side of the EU, including its 'ambivalence' (lack of clarity with regard to the rules of EU accession or of commitment to enlargement – Grabbe, 2014; Börzel and van Hüllen, 2014), its inattention to local institutional conditions and to buying-in local actors and elites (Noutcheva, 2009; Vachudova, 2014), and its reform targets which may be too strict or unrealistic (Uvalic and Cvijanovic, 2018; Noutcheva and Aydin-Düzgit, 2012). On the other hand, problems specific to the region, such as the unresolved ethnic and statehood issues (Borzel, 2016), vested national and sectoral interests (Vachudova, 2014) and the absence of a "robust local demand for change towards Europeanisation" (Noutcheva et al., 2013).

These issues noted, the wider literature recognises that the EU is a significant stimulus for growth and convergence for associated countries. The substantial institutional transformation, fast economic restructuring and sustained income growth of the CEE countries provides ample evidence for this (for recent causality inferential evidence on this see, inter alia, Monastiriotis et al, 2017, and Campos et al., 2018b). In this regard, it is widely acknowledged that the EU has not only an autonomous effect on growth for the associated countries (e.g., through economic integration and membership) but also, if not most importantly, by incentivising structural reforms.

2. Structural reform slowdown and the impact on convergence

In the last 25 years the evidence from both the Western Balkans and Central and Eastern Europe shows that there has been significant convergence with the EU average level of living standards both during the transition period of the 1990s and later through the EU integration process (IMF 2015a and World Bank, 2017). However, in recent years convergence has slowed down, while after the economic crisis catching-up is slower in the Western Balkans compared to the New Member States. To demonstrate this, we plot in Figure 1 the evolution of GDP per capita in the Western Balkans (WB) and New Member States (NMS) expressed as a share of the EU average, comparatively, where the left axis scale is for WB and the right axis scale is for NMS. As can be seen, convergence to the EU average has slowed down across the Western Balkans. What is also important, growth trajectories in the Western Balkans compare unfavourably also in relation to those in the NMS. Over the period 2004-2008 the Western Balkans have followed a flatter growth trend than the NMS and this discrepancy has, if anything, intensified since 2009.

Figure 1. GDP per capita Convergence & Catching-up

Data source: Eurostat, GDP per capita in PPS as a share of EU-28 average
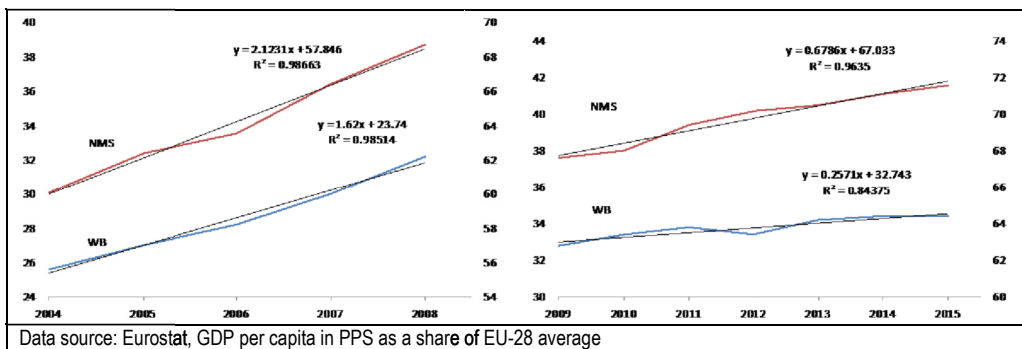
Data source: Eurostat, GDP per capita in PPS as a share of EU-28 average

There is growing literature on the impact of structural factors on convergence, but most often on larger panels of countries. Thus, the IMF (2015b) found a positive relationship of structural reforms with productivity and convergence, while in the rest of the literature (Acemoglu et al., 2005, Aghion et al., 2005, Campos and Coricelli 2002, Che and Spilimbergo 2012, Ciccone and Papaioannou 2009 Dabla-Norris et al. 2016; IMF 2015a and Fung 2009), in addition to the positive correlation they summarize that the reform priorities for maintaining convergence differ in terms of the level of development of the country. Looking at longer time horizons, empirical analyzes reveal that the positive correlation with productivity and economic growth is different according to the type of reform and over time. The results also suggest that the benefits of the reforms tend to become more prominent when the reforms are packaged together.

Following the above, and our previous research (Besimi and Monastiriotis, 2018), we continue with regression analysis of the impact of structural reforms on convergence. To investigate that impact we examined seven panel data regressions as the high correlation in the reform indices requires them to enter the regressions one at a time (similar approach practiced by Dabla-Norris, 2016). Thus the regressions will not account for reform complementarities, so we examined separately the effect of the world governance indicators: VA- voice and accountability; PS - political stability and absence of violence; RQ - regulatory quality; GE - government effectiveness; RL - rule of law; CC - control of corruption; WGI - world governance index. Also, we examined the impact of the EU membership on convergence in order to check about the endogeneity of the integration process. The panel data regression involves 16 countries (Western Balkan and New Member States of the EU). Since, we consider dynamic panel data we also introduce lags of the dependent variable for better specification of the model, as follows:

Table 1. Structural reforms impact on economic convergence

Dynamic Panel Data Regression (Generalized Methods of Moments)							
Dependent variable: GDP15							
Variables/Regressions	VA	PS	RQ	GE	RL	CC	WGI
L.GDP15	1.287***	1.271***	1.317***	1.300***	1.322***	1.323***	1.264***
	(0.0539)	(0.0541)	(0.0559)	(0.0462)	(0.0516)	(0.0428)	(0.0552)
L2.GDP15	-0.340***	-0.334***	-0.354***	-0.361***	-0.370***	-0.367***	-0.337***
	(0.0539)	(0.0514)	(0.0555)	(0.0469)	(0.0475)	(0.0429)	(0.0531)
Structural Reform	1.522***	1.228***	0.560*	1.010***	0.734**	0.671**	1.845***
	(0.3810)	(0.4600)	(0.3170)	(0.3150)	(0.3100)	(0.3200)	(0.4130)
EU	0.520***	0.817***	0.701**	0.929***	0.739***	0.863***	0.565***
	(0.1640)	(0.2060)	(0.2920)	(0.1970)	(0.2260)	(0.2440)	(0.1290)
Constant	1.667***	2.302***	1.424***	2.240***	1.959***	1.843***	2.611***
	(0.2720)	(0.5160)	(0.2420)	(0.4360)	(0.4660)	(0.4450)	(0.4040)
Observations	208	206	207	207	208	208	208
Number of country	16	16	16	16	16	16	16
ar1p	0.00149	0.00117	0.00163	0.00174	0.00213	0.00255	0.00131
ar2p	0.049	0.0488	0.0497	0.0422	0.0504	0.0553	0.0425
chi2p	0	0	0	0	0	0	0
hansenp	0.48	0.402	0.52	0.352	0.315	0.386	0.485
sarganp	0	0	0	0	0	0	0

Robust standard errors in parenthesis (*** p<0.01, ** p<0.05, * p<0.1)

Variables: GDP15 - country's GDP per capita as a share of GDP p.c. of EU-15 average; L.GDP15 and L2.GDP15 - first and second lag of gdp15; VA - voice and accountability; PS - political stability and absence of violence; RQ - regulatory quality; GE - government effectiveness; RL - rule of law; CC - control of corruption; WGI - world governance index; EU - membership in EU.

Countries: EU-15 (Austria; Belgium; Denmark; France; Finland; Germany; Greece; Ireland; Italy; Luxembourg; Netherlands; Portugal; Spain; Sweden; and United Kingdom); NMS (Bulgaria; Croatia; Czech Republic; Estonia; Hungary; Latvia; Lithuania; Poland; Romania; Slovak Republic; and Slovenia); and WB (Albania; Bosnia and Herzegovina; Macedonia; Montenegro; and Serbia).

Years: 1996-2016; Data source: World governance indicators (World Bank); GDP (IMF, WEO).

The results suggest the following three findings: Convergence is persistent and stable long-term process; Structural reforms have positive impact on convergence; and EU membership enhances convergence. First finding indicates that convergence is persistent process with significant impact of lags from the first two years for world governance index. The cumulative effect of the lags (L.GDP15+L2.GDP15<1) indicates that convergence is a stabile process. The second finding indicates that structural reforms' impact on convergence is positive and statistically significant in all reform indicators. The impact of reforms on convergence becomes significant when introducing more lags of the convergence to control for autocorrelation effect. This assumes that the impact of reforms is stronger when we control for the persistence effect. The coefficient in front of the world governance index, suggests that an increase of the index for one score will increase convergence for 1.8 percentage points (similar interpretation will be for all reform indicators). Further, through a simple calculation we can see that the long-run coefficients of structural reform impact on convergence is high, meaning that an improvement of world governance index for one percentage point increases the convergence for 25.3 percentage points in very long-run (1.845/[1-(1.264-0.337)]=25.3). Based on this indication about the stronger long-run impact of structural reforms, we may speculate with the arguments we make later in our theoretical model that policymakers face a trade-off between costs in the short-run and long-term benefits of

reforms, due to political impact and distribution effects of reforms for certain interest groups in the society. This may explain also the credibility and time-inconsistency which results with reform gap and delay. The third finding indicates positive impact of EU membership on convergence, namely countries after becoming EU members perform better with the convergence that indicates the endogeneity of EU integration process. This will have also policy implication that will be considered in the following sections of this research and opens the space for considering the role of EU integration in enhancing structural reforms in the western Balkans.

3. Structural reform credibility and EU anchoring

The main hypothesis of the EU enlargement process is that implementation of the convergence criteria and reforms enhance economic growth and catching-up with the EU living standard. This should increase the support by citizens and economic agents for reforms and EU integration of candidates and potential candidate countries. However, in the recent years the evidence shows a delay in structural reforms and slowdown of the EU integration progress in the Western Balkans.

The intention of theoretical analysis in this section is to explain what relies behind this reform slowdown and the role that the European Commission can play in enhancing the credibility of structural reforms and accelerating the EU integration process in the Western Balkan. More specifically, the model intends to explain the political economy of the EU integration for the politically sensitive reforms that have costs for certain interest groups that further has an impact to the support and political power of the political elite. This further implies time-inconsistency due to the trade-off policymakers faces between short-run cost and long-run benefits from reforms. Typically, the main resistance to the adoption and implementation of structural reforms stems from the vested interests of affected groups in society. Besides this, the possible short-term economic and fiscal costs of structural reforms are also sometimes mentioned as a reason for postponing their adoption, suggesting a short-term trade-off between fiscal consolidation and reforms (ECB, 2015). The documented costs include reduced employment, loss of government revenue, undesirable distributional consequences and political instability (Babecky and Havranek, 2014; Campos et al, 2018). The political impact of economic reforms changes the distribution and rents in the society (Acemoglu and Robinson, 2013; Alestin and Rodrik, 1994).

Departing theory for designing our model is the policy choice in a dynamic world with rational expectations taking into consideration the credibility and time-inconsistency of the policymaking (Kydland and Prescott, 1977) and (Barro-Gordon, 1983). In the standard Barro-Gordon model the policy constraint is represented by a simple Phillips Curve relationship connecting output (or, inversely, unemployment) to inflation (more precisely, the deviation of inflation from expected inflation) and the objective function is represented as standard quadratic loss function. In our case, the policy constraint does not concern directly economic outcomes (output, unemployment), but rather political and policy variables – namely, political (or electoral) support for the government and structural reforms.

4.1. The model setting

The model that we design in this section intents to explain the political economy of the reform process during the EU accession of the candidate countries from the Western Balkans. The assumption is based on the context that countries from the region have already made their strategic political decision of joining the EU and they are in the ongoing process of EU accession as candidate or potential candidate countries, while some of them have already started the negotiations with the EU. The model considers three parties in this process: European Commission representing the EU; the government representing the national policymakers; and the public representing the business community, civic sector and citizens. The rationale behind this is that the government negotiates with European Commission the reform agenda for EU accession, while for it's implementation government is interested on the public support, as well.

The government decides on its reform policy/effort on the basis of its objective function that considers both, reforms and support, which we assume – following standard practice and for simplicity – to be a standard quadratic loss function of the form:

$$W = -\frac{1}{2}\alpha(r_t - r^{eu})^2 - \frac{1}{2}\beta(s_t - s^o)^2$$

(1)

where, r is the extend of reforms undertaken by the government, reu is the policy reform objective (the reform package that government negotiates with the EU), s is the (political) support that government have from the public, so is government's support objective, α is a parameter showing the weight the government assigns to reforms, noted as 'reformism' ($\alpha{\geq}0$), and β is a parameter showing the weight the government assigns to support, noted also as 'populism' ($\beta{\geq}0$). The quadratic loss function assumes government neutrality with respect to reform and support, namely government faces similar welfare loss from under- and over-performing reforms, as well as, higher and less support relative to the respective targets. In addition, as you will see in Figure 2, our illustrated model is focused in the region 0≤r≤reu and 0≤s≤so and that makes the interpretation of the objective function more intuitive – any reform or support lower than their respective targets will reduce the welfare. As can be easily inferred, point (s=so, r=reu) represents the 'bliss point', i.e., the point where there is zero loss and thus welfare of the government is maximized (W0=0).

According the default, we will expect that support from the public to be positively correlated with the reforms due to the positive impact of structural reforms on productivity, competitiveness and economic growth in the long-run (explained in the empirical section). A contrary, our model focused on the specific case, where the public is reform sensitive, namely due to sectorial and time variation of reforms, the policymakers face trade-off between short-term costs and long-term benefits and the redistributive effects of reforms. Following the above, the constraint to the government's objective, namely the (political) economy of the reform process in our hypothetical country from the Western Balkan, is represented by the following simple relationship about the behaviour of the public support for reforms:

$$s_t = s^n - \gamma\left(r_t - r^e_{t-1,t}\right)$$

(2)

where s and r stand for (political) support and reforms as explained in equation (1), sn is some level of the 'natural' support of government by the public and it is determined exogenously to our model, re is the ex-ante reform expectations held by the public and the European Commission (formed in time t-1) and γ is a parameter showing the sensitivity/reaction of the public support to actual reform deviation from what is expected, which can also be interpreted as a 'short-termism' of the public for reforms given the short-term costs versus long-term benefits in some of the reforms.

According to the above setting of the model, the government optimization of the reform policy will be obtained by substituting equation (2) into equation (1):

$$W = -\frac{1}{2}\alpha(r_t - r^{eu})^2 - \frac{1}{2}\beta\left[s^n - s^o - \gamma\left(r_t - r^e_{t-1,t}\right)\right]^2$$

(3)

Then we differentiate equation (3) with respect to reform (r), namely minimize welfare loss with respect to reforms (r):

$$\frac{\partial W}{\partial r} = -\alpha(r_t - r^{eu}) - \beta\gamma\left[\gamma\left(r_t - r^e_{t-1,t}\right) + s^o - s^n\right] = 0$$

(4)

Solving equation (4) for reforms (r), gives the following solution for the optimal reform policy:

$$r_t = \frac{\alpha}{\alpha + \beta\gamma^2}r^{eu} + \frac{\beta\gamma^2}{\alpha + \beta\gamma^2}r^e_{t-1,t} + \frac{\beta\gamma}{\alpha + \beta\gamma^2}(s^n - s^o)$$

(5)

The above equation is important for understanding reform policy of the candidate countries during the EU accession process. Further, this explains reform delays, under-performing or delays in implementation of reforms and also it helps identify the policy transmission channels to enhance or accelerate credible reforms. This is important for the EU as relevant party in EU accession process within it's EU Enlargement Strategy in the Western Balkans. Hence, in addition to the role of national policymakers, the model is expected to provide policy recommendations but also for the European Commission how to play a more effective role in increasing the credibility and accelerating reforms in the candidate countries of the Western Balkans, which also can be further developed for other cases with similar setting.

Before technically elaborating the policy scenarios, we will illustrate graphically the above model as follows:

Figure 2.

The Model
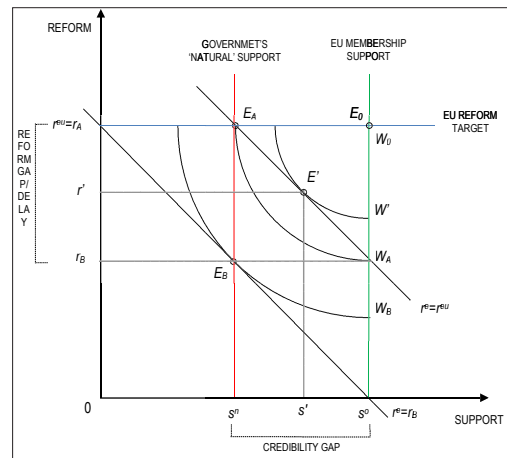
The model is designed in a diagram where in vertical axis is the reform (r) and in horizontal axis is the public support (s) as presented in Figure 2. The welfare is represented by the indifference curves (W) of the government's preference for reforms and public support. The maximum welfare is the 'bliss point' with reforms at the level negotiated with the EU (r=reu) and support target by government (s=so). The 'natural' level of support of the government is noted with vertical line (sn) and it's difference from the targeted level of support (so) represents the credibility gap of the government (κ=so-sn). The lack of credibility is the key generator for the inconsistency-problem under the constraint of reform-averse public in short-run. The political constraint (the line with negative slope) represents the trade-off that government faces in the short-run between reforms and public support due to the public's short-termism (view-span) of the reforms' impact on distribution and rents of certain interest groups in the society. The figure illustrates the policy mechanisms for achieveing the equilibrium level of reforms and support for different scenarios: EA=(sn,reu); and EB=(sn,rB).

4.2. Policy scenarios

In order to develop the above model and understand more specifically the policy implications, we will consider two different cases/scenarios with different assumptions about policy commitments by government in a world with rational expectation: Policy rule (ex-ante commitment); and Policy discretion (no commitment ex-ante).

A. Policy rule (ex-ante commitment): Assuming that the government sticks to their ex-ante reform target (r=reu), and since expectations are rational (re=r), thus also public trust the government for the policy target (re=reu). Namely the assumption is:

$$r_{t,A} = r^{eu} = r^e_{t-1,t} \tag{6}$$

From equation (6) we obtain equilibrium reform:

$$r_{t,A} = r^{eu} \tag{7}$$

Note that this is not time-consistent solution for reforms, namely by substituting equation (6) into equation (5) we find that the equilibrium reform deviates (there is a reform gap) from the expected target reform (r≠re=r^eu). So, ex-post there is an incentive for government to deviate from the announced target (r=r'<r^eu in Figure 2).

The equilibrium support we obtain by substituting equation (6) into equation (2):

$$s_{t,A} = s^n \tag{8}$$

To calculate the equilibrium welfare we substitute the equilibrium values for reform and support form equations (7) and (8) respectively into equation (1):

$$W_A = -\frac{1}{2}\beta[(s^o - s^n)]^2 \tag{9}$$

which is obviously sub-optimal from the government's point of view as it produces some welfare loss (WA<0), namely, since β≥0 and [·]2≥0 thus WA≤0.

Note that, interestingly, this welfare loss is increasing in correlation with the increase of populism (higher β) and increase of credibility gap (higher difference so-sn).The above equation suggests that under policy scenario of policy rule, the government is better off if they are less populist and if they enjoy higher credibility.

B. Policy discretion (no commitment ex-ante): Assuming as previously that the government is willing to deviate from their ex-ante reform target (r≠reu), but this time the public has rational expectations and anticipates that (so that re=r≠reu). Namely, the assumption is:

$$r_{t,B} = r^e_{t-1,t} \neq r^{eu} \tag{10}$$

Substituting equation (10) into equation (5) we obtain equilibrium reform:

$$r_{t,B} = r^{eu} - \frac{\beta\gamma}{\alpha}(s^o - s^n) \tag{11}$$

Substituting equation (10), namely the assumption for rational expectations (re=r), into equation (2), we obtain equilibrium support:

$$s_{t,B} = s^n \tag{12}$$

To calculate the equilibrium welfare we substitute the values for equilibrium reform and equilibrium support from equations (11) and (12) respectively into equation (1):

$$W_B = -\frac{1}{2}\beta\left(\frac{\alpha + \beta\gamma^2}{\alpha}\right)(s^o - s^n)^2 \tag{13}$$

It can easily be seen that welfare loss in this scenario is larger than that of scenario A (meaning that WA>WB). To evaluate and compare the welfare from scenario B (WB) vis-à-vis scenario A (WA), we subtract equation (9) from (13):

$$W_B - W_A = -\frac{1}{2}\left(\frac{\alpha + \beta\gamma^2}{\alpha}\right)(s^o - s^n)^2$$

(14)

Given that $\alpha \geq 0$, $\beta \geq 0$ and $\gamma \geq 0$, we have $[(\alpha+\beta^2)/\alpha]>1$, thus $[(-1/2) (\cdot) [\cdot]2]<0$, namely (WB<WA), which means that scenario A is more preferable than scenario B in terms of government's welfare.

As discussed in the original Barro-Gordon model, this outcome for the government's welfare and hence reform policy is determined by the assumption that a European Commission driven by rational expectations will pre-discount the reform gap by the governments (e.g., in their negotiations) and thus will reduce the rewards for accession accordingly. Namely, in Figure 2 it shows that the political constraint line shifts downwards with respect to the expected reforms (from re=reu to re=rB), which determines then the equilibrium level of reforms along the 'natural' support line for the EU accession process, resulting thus with the reform gap (rB<reu).

The above solutions of the model for the policy scenarios, we may summarize in the following table:

Table 2. Comparison of policy scenarios at their equilibrium levels

Scenario	I t	twy RUt	I zŁwwz	twy vł I iwz
R Is	$r_t = r_t^{eu}$	$r_{t,A} = r_t^{eu}$	$r_{t,B} < r'_t < r_t^{eu}$	$r_{t,B} < r_t^{eu}$
U Ii	$s_t = s^o$	$s_{t,A} = s^n$	$s^n < s'_t < s^o$	$s_{t,B} = s^n$
W t I	$W_0 = 0$	$W_A < W_0$	$W_A < W' < W_0$	$W_B < W_A$

From Table 2, we can conclude that the most preferable scenario in terms of government's welfare is the ideal with zero loss, thus welfare is maximized (W0=0). However, the 'bliss point' E0=(so,reu) falls outside the policy constraint and it is thus unattainable as can be easily demonstrated in the case with rational expectations (re=r) by substituting it into equation (2) and getting (s=sn<so). Next, comparing scenarios with policy rule versus policy discretion, as can be seen also from equation (14), the policy rule is more attractive than policy discretion with an equilibrium at higher welfare of the government (WA>WB). At that point, reforms are achieved at the level as negotiated with the EU (rA=reu) with 'natural' support level of government (sA=sn).

Following the above, we should expect the government to choose policy rule against policy discretion. This assumes a full commitment from the government in implementing the reforms (rA=reu). However, this scenario does not have a time-consistent equilibrium, given that the government facing the constraint of public support (equation 2) and support target higher than it's natural level (so>sn), it will have an incentive to delay the reforms (r'<reu), thereby increasing its welfare and moving from point EA to point E' in Figure 1 (W'>WA). However, this holds only in the case of naíve or adaptive expectations, assuming that the government will be able to surprise with reform delay after expectations are set by the public and the EC (during the initial stage of negotiation). We call this as transition equilibrium, since it is unsustainable in the world with rational expectations, as been explained in policy discretion scenario, namely the EC during the initial stage of negotiations will anticipate this behavior of the government, hence incorporate that in it's conditionality scheme by reducing the accession rewards for the country, which further reduces support from s' to sn and the equilibrium is achieved at lower level (rB<r'), and lower welfare for the government (WB<WA). This reflects more closely the reality of the recent slowdown in the reforms and the EU accession process in the

Western Balkan countries. Also, this may explain incentives behind the lack of transparency, the influence to the media and populism that government's practice to influence expectations make them deviate from rational (according to the theory of limited rationality in decision-making this is due to limitation of information, limitation of capacity/knowledge to understand the complexity od implications and limited available time for decision-making: this goes beyond this research and may be of interest for another research: Thaler and Sunstein, 2008).

In order to hold, policy rule scenario assumes full commitment and full credibility of the reform process, namely strong institutional/legal binding of the reform agenda. In our analysis of the EU accession process this means an EU anchoring of the reform agenda for the Western Balkans, which explains also the effect of the endogeneity of the integration process, in other words why countries are better performing once they become members (found also in the empirical analysis in comparing the performance of the new member states of the EU and the candidate countries for the Western Balkan). In terms of the reform performance and the government's welfare this scenario is more favorable than the scenario with policy discretion, while paradoxical, the later reflects more closely the current reality with reform and EU accession delay in the countries from Western Balkan. Following this explanation, the scenario under consideration for policy implications will be the scenario with policy discretion and addressing the research question - how to accelerate and enhance the credibility of the reforms in the Western Balkan during the EU accession process and what role can play the EU?

5. Policy Implications

EU integration process has played important role in convergence of the Western Balkan countries with the European Union. However, the long-lasting process of EU integration affects the pace of the structural reforms thus slowing down the reforms which after the crisis was slower compared to the new member states. This indicates the endogeneity effect of the EU integration process, which seems to have positive impact on convergence. Convergence is a persistent process with positive impact of structural reforms in long-term suggesting faster reform process in order to accelerate the catching-up process of the Western Balkans with the EU living standard. However, the structural reforms impact in long-run creates a space for policymakers to refocus on short-term effects (with fractional negative impact on the support by certain interest groups due to distribution effect of reforms), hence being time-inconsistent in policymaking that considers both structural reforms and political support. Further, to consider is that the political economy can help explain the reform delay, which implies that there should be reflected the political implication of reforms, namely the political cost that policymakers face in short-run by certain interest groups in implementing reforms. A contrary, ignoring the political economy effect while setting the reform package (agreement) between European Commission and the national government's will lead to non-credible reform policy which will result with a reform delay/gap.

Based on the above model, we may say that the ideal scenario with the 'bliss point' at the EU reform target and policymaker's support target is not attainable and scenario with naíve expectations is not realistic. The next scenario that assumes reforms at EU targeted level is the policy rule scenario with ex-ante full commitment by the government for implementing reforms, which is time-inconsistent under lack of credibility. Thus, the most likely scenario is discretionary policy that may explain the reality with the recent slowdown of the reforms and EU accession process in the Western Balkan.

Once we have identified the policy scenario that explains the reform delay, namely scenario B, the next step is to identify the policy implications and recommendations, so we rewrite the optimal reform policy as described in equation (11):

$$r_{t,B} = r^{eu} - \frac{\beta\gamma}{\alpha}\left(s^o - s^n\right)$$

From the equation we can identify five policy transmission channels: government's reform preference, 'reformism' (α); government's local support preference, 'populism' (β); public reform sensitivity, 'short-termism' (γ); government's credibility gap (so-sn); and EU reform target (reu), which in this specific case we may interpret as a proxy for EU accession credibility (the rationale is that higher credibility implies the possibility for higher reform targets). Hence, reforms are enhanced ($\uparrow r$): when the government pays more attention to reforms ($\uparrow\alpha$); when the government is less populist ($\downarrow\beta$); when the public is less short-termist ($\downarrow\gamma$); when there is lower credibility gap of the government ($\downarrow$[so-sn]); and when the EU accession credibility is higher, hence reform target is higher ($\uparrow$reu).

From the above presented policy transmission channels we may draw the following policy recommendations for the EU in order to enhance reforms in the Western Balkan:

First, the EU should encourage governments to pay more attention to reforms (α). It should be noted, however, that this will not achieve full compliance; it will simply reduce the discrepancy between the reforms (r) and agreed reforms with the EU (reu). This will be achieved through Europeanization and an increase of national ownership of the EU accession process with credible and fair conditionality model.

Second, the EU should influence to reduce the government's populism (β). As above, this will only reduce the discrepancy between the support (s) and the objective (so) rather than eliminate (unless, that is, the EU successfully manages to bring β to zero). Note, however, that in practical terms, making the government more unresponsive to public demands may not be politically optimal (or even desirable), as it will evidently be (perceived as) undemocratic. This can be achieved through higher transparency and inclusiveness of EU accession process and proactive role of the EU with effective incentive based conditionality model.

Third, the EU should influence reducing the short-termism of the public (γ), namely reducing the public's aversion to reforms. As we mentioned earlier, at the extreme the policy problem can become trivial if the EU succeeds in making the public obtain pro-reform preferences. This can be achieved through a socialization process, transparency and inclusiveness of the public with the reform and EU accession process.

Fourth, the EU should focus on increasing the credibility of EU accession process and negotiate higher level of reforms (reu). Namely, promoting transparent, fair and competitive EU accession process and by communicating more effectively the benefits from accession to the public.

Fifth, the EU should influence reducing the credibility gap of the government (so-sn). This can be achieved through an increase ownership of national authorities about the accession process and the reform agenda, which should be accompanied with the well designed conditionality model with conditions, incentives schemes and monitoring.

The above implies that reform process may leverage from EU accession process. Namely, through different policy transmission channels, European Commission can play a role in increasing the credibility of the reform policy and accelerate the reform process in the Western Balkans. The EU can play a role in anchoring reforms, through a legally binding policy rule or systematic impact through policy channels within the national discretionary policy framework. This assumes an appropriate design of the EU enlargement process and its mechanisms by the European Commission in order to address the above possibilities in a comprehensive framework due to the complexity, complementarity and interconnection of different policy measures and instruments. Taking that into consideration, for simplicity reasons we will summarize in the following groups the policy tools:

First, it is important to have an effective implementation of the comprehensive staged-structured conditionality model: conditions; incentive structure (rewards: accession advancement rewards & financial rewards; and threats: explicit and implicit) and monitoring. This is very important to be merit-based process, so will increase the credibility of the EU accession process and enhance reforms. Second, inclusiveness and transparency of the EU accession process will create the opportunity for discussion, participation and better monitoring of the process. Third, Europeanization and socialization is expected to increase the ownership, hence the support and the credibility of the EU accession and the reform process. Fourth, policies that will increase

EU optimism vs EU scepticism in the EU member states and the Western Balkans are essential for the role of EU accession process in advancing the reform process and its transformation power in the Western Balkans. Fifth, in accordance to the above, the 'New approach' of EU integration for the Western Balkans should consider also political economy implications of the reforms, namely being more flexible into setting-up reforms and conditionality, while being strict in implementation. Sixth, it may also consider transparent and cross-country competitive and comparative process. This will increase the competitive based reform performance process by the governments of the countries of the Western Balkan. Seventh, enhancing regional cooperation and promoting new initiatives will increase EU enlargement optimism and enhance credibility and the pace of reforms (e.g. Berlin process, Regional Economic Area of the Western Balkans). Finally, endogeneity suggests that reforms can leverage form the EU accession process, namely countries are more likely to perform better with reforms as they progress with accession process: candidate status, opening of negotiations and membership.

6. Conclusion

The main hypothesis of the EU enlargement process is that implementation of the convergence criteria and reforms enhance economic growth and catching-up with the EU living standard. This should increase the support by citizens and economic agents for reforms and EU integration of candidates and potential candidate countries. However, in the recent years the evidence shows a delay in structural reforms and slowdown of the EU integration progress in the Western Balkans.

Empirical evidence and literature review suggests that there is e positive impact of structural reforms on convergence, but this impact is changing across the reforms and the time span from short- to long-term. The reform impact is also varying among different level of institutional quality and the development level of the country. Similarly, the results from empirical investigation of this research suggest positive correlation of structural reforms and economic convergence of the Western Balkan countries with the EU average. Further, it suggests that the impact of EU membership is positive on convergence, thus implicitly addressing the endogneneity effect of EU integration process, but also indicating the role that EU can have in increasing the credibility of structural reforms and enhancing the convergence process. The possible policy recommendation from empirical results have to consider that the results do not examine the complementarities of the reforms while in practice reforms are implemented in a package and also the impact of policy reforms may have nonlinear effects that can be contingent on the quality of political and economic institutions.

In addition, in our research we design a theoretical model with an intention to explain the reasons behind the reform gap/delay, while addressing policy implications and recommendations for accelerating reforms in a world with rational expectations. The model prefers policy rule over policy discretion, since in the first scenario there is no reform delay and in the last scenario there is reform delay under the same level of political support for the policymakers. Although paradoxical, the less preferable scenario with policy discretion seems to reflect more closely the reality with the reform slowdown in the Western Balkans. This is mainly a result of the time-inconsistency of the reform policy due to the lack of credibility by policymakers under the political economy constraint of the trade-off between short-term cost and long-term benefits as well as the distribution effect over different interest groups in the society. The policy rule scenario advantage over the discretion implies the effect of the endogeneity of the EU integration process, since once countries become members of the EU, the institutional/legal binding of the reform policy becomes stronger and there is an anchoring of the credibility of the EU for the national policymakers. The scenario that our analysis focuses on is the policy discretion which reflects the current situation with reform delay the accession process. In order to enhance reforms, the model implies five policy channels: increasing reform preference of governments; reduce government's populism; reduce public's short-termism (or reform political sensitivity); increase the credibility and reforms of the EU accession process; and reduce the credibility gap of the national policymakers. In addition, the model suggests that it is important to be considered the political impact of the reform process in policymaking, which assumes that during the negotiations it is relevant to consider the national

political constraints (interests) of the governments in order to have credible reform policy, in other words, being flexible in setting the reform agenda while strict in implementation. Further, the policy recommendation suggests: an effective implementation of the comprehensive staged-structured conditionality model (conditions; incentive structure - rewards: accession advancement rewards & financial rewards; and threats: explicit and implicit - and monitoring); inclusiveness and transparency of the EU accession process; Europeanization and socialization is expected to increase the ownership; policies that will increase EU optimism vs EU skepticism; promoting new initiatives of regional cooperation and cross-country competitive and comparative process; and merit-based progress with the accession process will improve the reform performance as countries are more likely to perform better with as they progress within the accession process: candidate status, opening of negotiations and membership.

The above framework we consider to contribute to the policy and academic discussion on the needed structural reforms in the Western Balkans countries and their impact on economic convergence. The avenue for further research is the empirical investigation of the policy channels about reform process and it's optimization by both European Commission and governments (policymakers) of the Western Balkans. Also, policy scenarios in a world with bounded rationality might be of interest for further analysis of policy implications for accelerating reforms and increasing the credibility of the EU integration process.

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