Regional Integration and Fiscal Harmonization in Southeast Europe

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Abstract

The establishment of free trade area in Southeast Europe on the basis of CEFTA 2006 as an isolated event is not likely to have a substantial positive effect on the economic development of the region. Recent strategic theoretical and empirical studies show that short-term economic implications of regional integration between developing countries in terms of growth and foreign direct investment are ambiguous. Macroeconomic and fiscal stabilization through coordinated efforts with respect to tax and customs harmonization can play more significant role in the economic stabilization in the SEE region than regional trade integration alone. The paper contains an analysis of the changes in trade between the SEE -6 countries and Bulgaria (current EU member state, former member of CEFTA and part of a free trade zone in SEE until the end of 2006) for the period 2006 till 2014.

One of the main conclusions of the paper is that a roadmap of the SEE countries for achieving sustainable growth is needed. The roadmap for sustainable growth can be the next step after the liberalization of trade towards achieving genuine regional economic integration in the Western Balkans in parallel with the process of EU accession.

Key words: SEE, CEFTA 2006, Regional integration, Tax and customs harmonization.

Introduction

On 27 June 2001 seven countries in Southeast Europe: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania and FR Yugoslavia signed in Brussels a Memorandum of Understanding on the establishment of a Free Trade Zone in the region by the end of 2002 on the basis of bilateral free trade agreements. In addition, the Memorandum expressed the intention of the signatory countries to harmonize their legislation with that of the European Union including the harmonization of tax and customs legislation. 14 years have passed after the signing of the Memorandum of Understanding and we have a significantly different situation:

- Bulgaria, Croatia and Romania joined Slovenia and Greece in the European

Union and in 2014 Albania has finally received EU candidate status and lined up with Turkey, Macedonia, Montenegro and Serbia;

- FR Yugoslavia no longer exists and we have now Serbia, Montenegro and UNMIK (hereinafter "Kosovo") separated.
- CEFTA is again completely reshaped as a multilateral trade liberalization vehicle and the current members are Albania, Bosnia and Herzegovina, Macedonia, Moldova, Montenegro, Serbia and Kosovo. The existing network of free trade agreements was cancelled and replaced by CEFTA 2006 agreement.

In 2015 six of the countries in Southeast Europe - Albania, Bosnia and Herzegovina, Macedonia, Montenegro, Serbia and Kosovo (SEE - 6 or Western Balkans) are still rather small and relatively isolated from an economic point of view. At the same time stabilization in general in Southeast Europe is possible only if a more advanced level of economic development and trade integration is achieved. Thus the economic isolation of the countries can be considered one of the main barriers towards sustainable economic growth in the region. On the other hand with the removal of the trade barriers, the differences in the tax and customs legislation are apparent.

What would be the practical impact of trade integration of the countries in Southeast Europe and the economic outcomes in the region? Is there a relationship between regional trade liberalization and direct and indirect taxation? What could be the future of trade liberalization and fiscal harmonization processes in Southeast Europe?

The author of the research paper believes that a roadmap of the SEE countries for achieving sustainable growth is needed. The roadmap for sustainable growth can be the next step after the liberalization of trade towards achieving genuine regional economic integration. The proposed research paper will add value to the current debate on the impact of deeper regional integration in Southeast Europe.

Regional Integration Agreements: A Theoretical Approach

Mr. Masood Ahmed, a Director of the International Economics Department of the World Bank, quite successfully expressed in the foreword of series of World Bank policy research working papers (i.e. 1750, 1782 of 1997) the complexities of regional integration:

> *"As regional trading arrangements (RTAs) have spread, enlarged and deepened over the last decade, they have posed challenges to economists on both intellectual*

and policy levels. On the former, do RTAs stimulate growth and investment, facilitate technology transfer, shift comparative advantage towards high value-added activities, provide credibility to reform programs, or induce political stability and cooperation? Or do they, on the other hand, divert trade in inefficient directions and undermine the multilateral trading system?

The answer is probably "all of these things, in different proportions according to the particular circumstances of each RTA." This then poses the policy challenge of how best to manage RTAs in order to get the best balance of benefits and costs. For example, should technical standards be harmonized and, if so, how; do direct or indirect taxes need to be equalized; how should RTAs manage their international trade policies in an outward-looking fashion?"

For the purposes of the current paper, a brief summary of the research findings both theoretical and empirical of various scholars will be given in outline. This summary will be further used in the analysis of the potential effects of having regional integration in Southeast Europe like CEFTA 2006 and its likely implications on the economies of the six countries and on society's perceptions in the region.

In general, the specialized literature (see Schiff and Winters, 2003, p. 66) identifies three main types of trade integration:

1. "North – North" integration between developed countries (EEC, Canada joining CUSFTA);

2. "North – South" integration between developed and developing countries (Mexico joining NAFTA);
3. "South – South" integration between developing countries (ASEAN, MERCOSUR, CEFTA).

This division is quite important as the economic implications of the various regional integration agreements may vary substantially depending on the type of economic integration perceived. In the subsequent analysis the focus will be mainly on the "North – South" and "South – South" models as obviously CEFTA 2006 or Southeast Europe consists of developing countries.

Regional Integration and Foreign Direct Investment

Undoubtedly there is some correlation between the levels of foreign direct investment (FDI) and the degree of trade integration. However, depending on the economic status of the countries (North or South) involved in the trade integration processes, the impact of trade integration on the inflows or outflows of FDI may differentiate a lot. A number of additional factors such as political, trade protection or administrative developments, geographical location and infrastructure are relevant to FDI allocation as well. At the same time, additional determinants of such processes are the character of the already existing FDI and the time dimension (detailed analysis by Blomstrom and Kokko, 1997).

The most immediate result of a trade integration process is the elimination or reduction of tariff barriers between the countries part of the Regional Integration Agreements (see also Bhagwati, 1988). In its turn, the reduced tariff barriers may lead to a decrease in intra-regional FDI, as a substitute for the increased trade between the countries. Thus, since there is a common market, there is no point of further investments in the region made by local companies – i.e. the comparative benefits of moving or spreading production to the other target country are less since the customs duties were reduced.

At the same time, the outside FDI is likely to be increased and focused on the country having the most attractive locational advantages. This type of concentration is justified by the economies of scale, achieved on a regional basis by the Multinational Companies (MNC). The type of such concentrations will depend to a great extent of the type of structures used for outside investments and already existing in the region – i.e. horizontal or vertical; import-substituting or export-oriented.

As short-term effects of trade integration can be pointed out the effects of trade creation, trade diversion, and trade expansion (more detailed analysis by Molle, 1994). Additional changes may be expected in the utilization of various intangible assets (trademarks, know-how, etc.) usually addressed as technological spillovers, the elimination of the replication of research and development (R&D) in different countries and least but not last the implementation of neutral legislation towards foreign and domestic investors (discussed also by Blomstrom and Kokko, 2003).

One of the most important dynamic effects is the "reallocation of production resources to more closely reflect of regional comparative advantages" (Blomstrom and Kokko, 1997, p.11). This could be illustrated in the following example. Countries "A" and "B" form a RIA, and a single MNC controls enterprises in both countries, which are operating below production limits. Thus, if tariff and non-tariff barriers are reduced, it is likely that the MNC will finally decide to close one of the factories in one of the countries and will shift the production to the other. The benefiting country in this case will be the one having the better locational advantages as a combination between macroeconomic and political stability, transparent legislation and procedures, infrastructure and higher level of public services. This "investment package" will usually include various tax benefits, clear intellectual property rights enforcement rules, high quality and low cost of the labor force.

Such allocation of investment centers may have different directions in the case of various industries. Thus, the "investment package" of country "A" in the vegetable oil industry for example may be better than the one of country "B", and the production of the MNC in the region will be concentrated in country "A". However, country "B" may possess more comparative advantages in the textile sector than country "A", and the textile production will be shifted in the opposite direction.

Thus, although outside FDI is likely to increase, the precise effects for each country within the RIA cannot be easily identified. Various empirical studies were focused on different types of regional integration. A brief summary of the most important findings of Blomstrom and Kokko in their paper "Regional Integration and Foreign Direct Investment" produced in 1997 within the World Bank, with regard to "North – South" and "South – South" type of integrations is given below.

According to the paper, the example of Mexico joining NAFTA is quite positive. The empirical evidence shows that Mexico benefited largely in terms of FDI by joining NAFTA. This could be explained partly by the liberalization of the institutional framework of the country and the strong locational advantages of Mexico compared to the conditions in the Northern partners – USA and Canada. As such locational advantages can be pointed out the increasingly market oriented polices, geographical proximity and cheap labour. In practice, much of the newly attracted FDI in Mexico is due to substantial investments originating outside the NAFTA countries namely: the USA and Canada (see also Echeveri-Carroll, 1995).

MERCOSUR is a typical example of South – South integration between the countries of Argentina, Brazil, Paraguay and Uruguay. The initial empirical studies on the impact of the establishment of MERCOSUR on FDI suggest that macroeconomic stability is a more important determinant of FDI than is regional trade integration itself. As a result the outward FDI has increased substantially. However, it can be noticed that FDI flows are not distributed equally among the MERCOSUR countries. As far as Brazil and Argentina possess more locational advantages than Uruguay and Paraguay, the bulk of FDI is likely to be focused there in the short and medium term[1].

Regional Integration and Growth

Recent studies have explored whether the trade openness of the economies, their market size and the relevant economic development of countries that are close geographically have any positive impact on growth in the home country. In 1998, Athanasios Vamvakidis (Vamvakidis, 1998, p. 251) published a report on the correlation between regional integration and economic growth. Based on the analysis and the empirical evidence gathered, the author concludes that "countries with open, large, and more developed neighboring economies grow faster than those with closed, smaller, and less developed neighboring economies". The study concludes that based on the empirical models, the small countries participating in North – South integration will face faster growth. However, the tests performed with regard to the correlation between growth and regional integration under 4 distinct RIAs shows negative results. Thus, in the case of the following RIAs there is no empirical evidence that during the 1970s and 1980s regional trade integration has led to higher growth:

- Association of South East Asian Nations (ASEAN);
- Andean Common Market (ANCON);
- Central American Common Market (CACM);
- Union Douaniere et Economique de l'Afrique Centrale (UDEAC).

The author explains these results with the fact that the members were "small, highly protected and similar in their economic endowments"[2]. On the other hand, the results of the same test for the European Union are positive for the same period and these results confirm that actually EU regional integration had positive impact on growth.

Regional Integration and Harmonization of Taxes

How does regional trade integration affect corporate tax rates in the partner countries? This is one of the questions that have to be addressed prior to entering in a RIA. In summary, the removal of barriers to movement of goods and services across borders will lead to changes in the allocation of resources (see de Bonis, 1997a). Thus, partner countries will face the necessity of establishment of a certain level of income tax uniformity. Such uniformity could be achieved through tax harmonization or through competition.

[1] Schiff and Winters, argue that South-South RIAs are unlikely to add credibility and may even hinder FDI if not accompanied by liberalization with the rest of the world (Schiff and Winters, 2003, p.17).

However, in the case of competition, the income tax rates are likely to fall below their optimum limits, which will lead in its turn to losses in budget revenues. More recent research on the effects of income tax harmonization in the context of regional integration (see de Bonis, 2002, p.1) suggests that „international tax uniformity does not appear to be the preferable solution".

Harmonization of income taxes is far from being accomplished even in the European Union. The harmonization of income taxes does not simply mean harmonization of tax rates. In order, to achieve considerable level of harmonization, the countries should implement similar if not the same basis for corporate taxation. For various reasons: historical, political, social and economic, this is almost impossible in the near future. On the other hand, competition among the states will lead to constant downsizing of the rates and/or introduction of tax incentives. What can be the solution in such case? One useful suggestion is that some sort of international tax coordination is needed (see also de Bonis, 1997a) in order to limit the undesirable effects of revenue losses in the partner countries.

Another, important issue in this respect is the elimination of double taxation of income by way of Double Tax Treaties (DTT). The differences in the treatment of certain types of income such as dividends, interest and royalties can partly be eliminated between each pair of partner countries in the form of a DTT. Thus, the network of the existing DTT should be considered, prior to entering in the RIA. It can be presumed that DTTs usually encourage cross border trade and investment, and it is advisable that the countries in the RIA enter into DTTs with each other as well.

The correlation between RIA and personal income taxation is not of such importance. This can be partly explained by the fact that additional contributions (social, health, unemployment, etc.) affect the amount of take-in-home money of the employees.

[2] Subsequent research showed mixed results as "the net impact on a country's growth of

trading with relatively less developed countries is an empirical question: it is negative if the relative income effect dominates and positive if the relative growth effect dominates" (Arora and Vamvakidis, 2004, p. 4)

Substantial distortions in the allocation of labor resources among the countries in the region can only be expected if there is a considerable difference in the living standards and real wages of the countries in the region (see also in Bhagwati and Hudec, 1996). Additional restrictions on the movement of people (visas, work permits, etc.) can also prevent such reallocation. A certain degree of harmonization of indirect taxes is important for the success of each RIA (see also de Bonis, 1997b). One of the main concerns is relevant to the level of cross-border shopping. Once, the tariff barriers are removed, the residents of the bordering territories are more likely to shop across the borders. If there are considerable differences in the rates of the indirect taxes applied by countries in the RIA, the residents of the "higher" rate country are more likely to shop in the "lower" rate country. Such problems are still acute in the European Union. The difference is even sharper in the case of exemption from indirect taxes of specific groups of goods. However, harmonization of tax rates only is not the perfect solution. Harmonization of the overall legislation and basis for taxation together with the tax rates may prove far more efficient (Ranchev, 2001). This reallocation of consumption will lead to losses in budget revenues of the "higher" income country. As far as the mechanisms for compensation of such "foregone" budget revenues is practically impossible, harmonization is the only possible solution for avoiding most of the undesirable effects.

Summary

Based on the analysis presented above, we can summarize the following conclusions with regard to the implications of regional integration agreements:

1. RIA between developing countries is likely to have a positive effect on FDI for the region as a whole while the bulk of FDI inflows would be attracted by the countries in the region having the best locational advantages.
2. There is no strong empirical evidence that RIA between developing countries will stimulate growth, as opposed to the benefits in terms of growth rates enjoyed by a developing country integrating with a developed one.
3. Corporate income tax competition between members of a RIA should be avoided, as it could lead to substantial losses of budget revenues. As direct tax harmonization is practically impossible, countries may coordinate appropriate corporate tax levels and conclude DTTs. Harmonization in the field of indirect taxes will lead to limitation of budget revenue losses within the countries forming

a RIA.

Regional integration in Southeast Europe

As of the moment Slovenia, Croatia, Bulgaria, Romania and Greece are members of the European Union. Currently Albania, Macedonia, Montenegro, Serbia and Turkey are officially recognized as candidates for EU membership. Bosnia and Herzegovina and Kosovo are considered "potential candidate countries". Albania, Bosnia and Herzegovina, Macedonia, Montenegro and Serbia have Stabilization and Association Agreements (SAA) in place, while Kosovo whose limited recognition has complicated its relationship with the EU, has only initialled a SAA.

On the 19th of December 2006, Albania, Bosnia and Herzegovina, Croatia, Macedonia, Moldova, Montenegro, Serbia and Kosovo signed an Agreement to amend and enlarge the Central European Free Trade – usually now referred as CEFTA 2006.

CEFTA 2006 agreement actually replaced the network of bilateral free trade agreements based on the Memorandum of Understanding from 2001 and which until then were existing between Albania, Bosnia and Herzegovina, Montenegro, Croatia, Macedonia, Moldova, Serbia and Kosovo. The agreement contains special provisions regarding liberalization of trade in industrial and agricultural products, technical barriers to trade, rules of origin and customs cooperation and the new trade issues such as strengthening cooperation in trade in services, investment, public procurement and intellectual property rights. The main objective of CEFTA 2006 is to facilitate the expansion of trade in goods and services and foster investment by means of fair, stable and predictable rules. An important aim of the agreement is also the elimination of barriers to trade and appropriate protection of intellectual property rights in accordance with international standards. The harmonization of trade policy issues such as competition rules and state aid is also part of the agenda the members agreed to follow. The Agreement is generally in compliance with WTO rules and procedures and the relevant EU regulations. It is expected that the Agreement will provide the necessary conditions for the members of CEFTA 2006 to prepare for EU accession, which was the agenda successfully achieved by the previous and founding members of CEFTA.

Selected SEE-6 country indicators

In order the discuss the potential effects of CEFTA 2006 on the economies of the six Southeast Europe countries namely Albania, Bosnia and Herzegovina, Macedonia, Montenegro, Serbia and Kosovo (referred in this paper as the SEE -6) we need to have a closer look on the basic economic indicators for the SEE-6 countries, which are given in outline below:

Table 1: Selected SEE 6 country indicators

Indicator	**ALB**	**B&H**	**KOS**	**MAC**	**MON**	**SER**	**TOTAL**
Area in sq. km	28,748	51,197	10,877	25,713	13,812	77,474	**207,821**
Population, 1000 pers. (2015)	3,029	3,867	1,871	2,096	647	7,177	**18,687**
GDP at ER, USD billion	13.4	19.6	6.0	10.9	4.7	42.7	**97.3**
GDP/capita (USD at ER)	11,100	9,800	8,000	13,200	15,200	12,500	
GDP, real growth, in %	1.9	1.1	3.0	3.7	2.3	-1.8	
Unemployment rate, in %	18.0	43.6	30.9	28.0	18.5	17.6	
Trade balance, USD billion	-2.8	-5.1	-2.3	-2.3	-1.6	-5.8	-19.9

Source: CIA World Factbook data estimated for 2014/2015 and author’s calculations

Given the above data, SEE -6 has a territory of 207,821 square kilometers and population of more than 18 million people. The economies although having positive growth rates with the exception of Serbia are relatively small in terms of GDP and GDP/capita. The unemployment rates in SEE-6 are very high which could also be a sign for sign for significant grey economy.

The trade balances for all the countries are negative. According to CEFTA statistics for the first half of 2014[3] the share of the countries in imports of CEFTA is around 9%, while the share of countries in export of CEFTA is around 17%. Compared to other South-South RIA’s CEFTA is within the group of relatively strong trade blocks like ASEAN and MERCOSUR (Schiff and Winters, 2003, p. 66).

The structure of the SEE -6 economies is given in Table 2 below:

Table 2: Structure of the SEE -6 Economies for 2014 as % of GDP

Sector	ALB	B&H	KOS	MAC	MON	SER
Agriculture	22.6	8.0	12.9	8.8	8.3	8.2
Industry	15.1	26,3	22.6	21.3	21.2	36.9
Services	62.4	65.7	64.5	69.9	70.5	54.9

Source: CIA World Factbook data estimated for 2014

Looking at the data from all SEE-6 countries only Serbia has a significant share of production in the country GDP – 36.9%. Albania has the largest share of agriculture – 22.6% of GDP compared to the other countries. For all the countries the share of services are the predominant part of the GDP as there is a clear shift from previous years from agriculture to services.

Trade relations of Bulgaria with the CEFTA-6 countries: a case study

The anticipated effects of trade liberalization among the six CEFTA countries representing substantial part of the territory of Southeast Europe can be considered as rather diverse. Trade liberalization means not only changes in the business environment, which leads either to new export opportunities or to increased external competition for a number of industry sectors. It could mean also changes in social and cultural attitudes. Trade liberalization has many faces and by looking at the region as a whole some specifics of trade relations may be omitted or underestimated in the analysis of the anticipated effects.

Back in 2006, Bulgaria was still a member of CEFTA and had bilateral free trade agreements with the SEE-6 countries in place. In this part a detailed analysis of the trade between Bulgaria and six out of seven countries participating in CEFTA is analyzed. Moldova is excluded for the purposes of the present analysis as the main focus of the paper is on Southeast Europe. The case study is based on up-to-date trade information regarding the SEE-6 countries members of CEFTA 2006 – referring the following aspects:

- Analysis of bilateral trade flows for 2006, 2007, 2012,2013 and 2014;
- Major commodities traded and share of total import/export;
- Outlining the tendencies in trade flows.

On the basis of this analysis conclusions are drawn with regard to the specific effects of SEE – 6 countries on the Bulgarian economy. In order to follow the trends, the research is focused on:

- 2006 – the year in which Bulgaria was part of the network of the bilateral free trade agreements with SEE-6;

- 2007 – the year in which Bulgaria joined the EU and left CEFTA and the bilateral free trade agreements with SEE -6 were canceled;
- 2012, 2013 and 2014 – to analyze recent trade information and to identify the trends as compared to the previous periods.
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Trade Relations between Bulgaria and Albania

The trade flows between both countries for the period 2006, 2007 and 2012 until 2014 are shown in Table 3.

Table 3: Bulgarian Trade with Albania in EUR million

	2006	**2007**	**2012**	**2013**	**2014**
Export	82.1	51.2	50.1	62.1	60.8
Import	3.1	8.2	19.0	17.1	18.9
Turnover	85.2	59.4	69.1	79.2	79.7
Balance	79.0	43.0	31.1	45.0	41.9

Source: Ministry of Economy of Bulgaria and author's calculations

The major groups of commodities traded currently between both countries are:

- Foodstuffs;
- Vegetable oils;
- Metal scra
- Medicines;
- Finished goods;

According to the Bulgarian Ministry of Economy, in the past Bulgaria was one of the major foreign trade partners of Albania and at some point back in 2001 ranked fourth in the foreign trade of the country after Italy, Greece and Germany. After the entry of Bulgaria into the European Union, the turnover between Albania and countries like Macedonia, Turkey, Serbia and Kosovo has increased due to the imposed customs duties by Bulgaria (EU) as opposed to the more preferential treatment of the referred above countries.

Although significant fluctuations in the turnover between Bulgaria and Albania have not been observed, the balance of trade was always positive for Bulgaria.

The governments of both countries have set up a number of joint commissions aiming at intensification of the trade relations. The investments of Bulgarian businesses although at very low nominal value exceed significantly Albanian investments in Bulgaria.

It can be anticipated that with the development of railroad transport within transport corridor VIII and the finalization of railroad: Sofia – Skopie - Tirana – Duras, the potential for intensification of trade flows between Bulgaria and Albania will be increased due to reduced transportation costs.

Trade Relations between Bulgaria and Bosnia and Herzegovina

The trade flows between both countries for the period 2006, 2007 and 2012 until 2014 are shown in Table 4.

Table 4: Bulgarian Trade with B&H in EUR Million

	2006	**2007**	**2012**	**2013**	**2014**
Export	101.5	27.1	35.1	39.2	42.2
Import	17.8	23.5	15.9	25.5	42.7
Turnover	119.3	50.6	51.0	64.7	84.9
Balance	83.7	3.6	19.2	13.7	-0.5

Source: Ministry of Economy of Bulgaria and author's calculations

The major groups of commodities traded currently between both countries are:

- Metals and ores;
- Chemical products;
- Finished goods;

Official statistics for the trade flows between Bulgaria and B&H exists since 1996 as the trade with B&H is in compliance with the Dayton agreement. Currently the trade relationships between Bulgaria and B&H are regulated by the Temporary Agreement for trade between B&H and the EU. With the accession of Bulgaria into the European Union the export from Bulgaria to B&H has sharply decreased. Since 2012 the export of B&H to Bulgaria is increasing as in 2014 the trade balance becomes negative for Bulgaria. The structure of import from B&H includes mainly raw materials – i.e. lead and ferrous ores as the total value of import is still rather low. As a major obstacle to further intensification of trade flows between both countries can be pointed out the complex political and economic situation in Bosnia & Herzegovina.

Trade Relations between Bulgaria and Kosovo

Bulgaria has separate statistics for the trade with Kosovo since 2006. The trade flows between both countries for the period 2006, 2007 and 2012 until 2014 are shown in Table 5.

Table 5: Bulgarian Trade with Kosovo in EUR million

	2006	2007	2012	2013	2014
Export	0	34.0	38.9	41.0	47.0
Import	0	2.4	0.4	1.2	4.9
Turnover	0	36.4	39.3	42.2	51.9
Balance	0	31.6	38.5	39.8	42.1

Source: Ministry of Economy of Bulgaria and author's calculation.

The major groups of commodities traded currently between both countries are:

- Mineral oils and oil products;
- Cigars and cigarettes
- Vegetable oil;
- Foodstuffs;

The geographic proximity of Kosovo could presume a higher level of trade between both countries. It should be pointed that the main trade flows pass through the territory of Serbia.

The structure of Bulgarian export to Kosovo remains almost unchanged during the years as significant share of the export is related to oil, oil products and tobacco products. The predominant share of Kosovo's export to Bulgaria is Zink ores and concentrates. The balance of trade was always positive for Bulgaria.

Trade Relations between Bulgaria and Macedonia

The trade flows between both countries for the period 2006, 2007 and 2012 until 2014 are shown in Table 6.

The major groups of commodities traded currently between both countries are:

- Mineral oils and similar products;
- Electricity;
- Vegetable oils;
- Metal ores.

	2006	2007	2012	2013	2014
Export	263.9	284.0	392.7	351.4	358.8
Import	139.2	275.0	252.3	276.0	272.5
Turnover	403.1	559.0	645.0	627.4	631.3
Balance	124.7	9.0	140.4	75.4	86.3

The structure of Bulgarian export to Macedonia is pretty much unchanged for the last couple of years as the share of oil and oil products, electricity and sunflower oil is predominant. The main part of the Macedonian export to Bulgaria is related to metal ores and concentrates.

Table 6: Bulgarian Trade with Macedonia in EUR million

Source: Ministry of Economy of Bulgaria and author's calculations

Trade Relations between Bulgaria and Montenegro

The trade flows between both countries for the period 2007 and 2012 until 2014 are shown in Table 7. Due to the breakup of Montenegro from the FR Yugoslavia in 2006, trade information for this period is not available.

Table 7: Bulgarian Trade with Montenegro in EUR million

	2006	2007	2012	2013	2014
Export	n.a.	4.7	14.3	16.9	13.1
Import	n.a.	0.4	0.6	1.1	2.3
Turnover	n.a.	5.1	14.9	18.0	15.4
Balance	n.a.	4.3	13.7	15.9	10.8

Source: Ministry of Economy of Bulgaria and author's calculations

The major groups of commodities traded currently between both countries are:

- Medicines;
- Foodstuffs;
- Cigars and cigarettes;
- Railway wagons;
- Copper scrap, iron and steel products.

The trade turnover between Bulgaria and Montenegro is very low and the trade relationships are underdeveloped. The trade balance is strongly positive for Bulgaria as there is no significant dynamic observed for the last three years.

Trade Relations between Bulgaria and Serbia

The trade flows between Bulgaria and Serbia are shown in Table 8.

Table 8: Bulgarian Trade with Serbia in EUR million

	2006	2007	2012	2013	2014
Export	454.2	595.8	442.4	373.7	363.7
Import	168.0	174.5	253.0	263.1	301.2
Turnover	622.2	770.2	695.4	636.8	664.9
Balance	286.2	421.3	189.4	110.7	62.5

Source: Ministry of Economy of Bulgaria, National Statistical Institute of Bulgaria for 2006 and author’s calculations

The major groups of commodities traded currently between both countries are:

- Mineral oils, shale oil and similar products
- Electricity;
- Medicines;
- Foodstuffs;
- Metals and metal ores.

Although significant fluctuations of trade turnover between Bulgaria Serbia can be observed within the reviewed period the balance of trade has been always positive for Bulgaria. In the last years there is clear trend that the positive balance for Bulgaria is decreasing due to the decrease in Bulgarian export to Serbia and increase in the import. Serbia is one of the important trade partners of Bulgaria. Serbia ranks 16th in the export partner list countries of Bulgaria for and Serbia are regulated by the Temporary Trade Agreement between the EU and Republic of Serbia from 29.04.2008.

Most important trade partners in CEFTA – 6: a Bulgarian perspective

If the trade partners of Bulgaria within the SEE region are to be ranked on the basis of trade turnover, the following results can be observed for the year 2014:

Table 9: Most important trade partners on the basis of turnover (EUR million) for 2014

Countries	**Balance**	**Turnover**	**Rank**
Serbia	62.5	664.9	**1**
Macedonia	86.3	631.3	**2**
B&H	-0.5	84.9	**3**
Albania	41.9	79.7	**4**
Kosovo	42.1	51.9	**5**
Montenegro	10.8	15.4	**6**
Total	**243.1**	**1528.1**	

Source: Ministry of Economy of Bulgaria and author's analysis

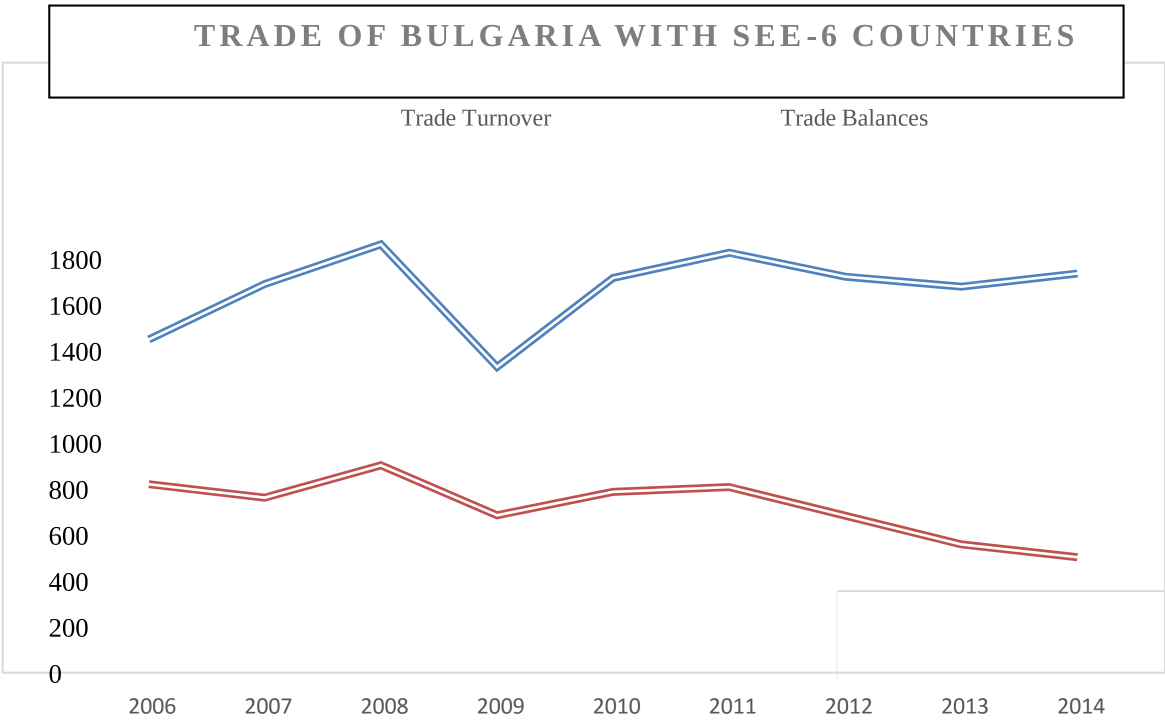
As it can be seen from the data in Table 9, the most important trading partners of Bulgaria within the region are Serbia and Macedonia. Trade turnover with B&H, Albania, Kosovo and Montenegro is still insignificant and trade opportunities are to be further explored.

Looking back to the data analyzed the accession of Bulgaria to the EU had initial negative impact on Bulgarian export only with respect to Albania and B&H for the year 2006 as compared to 2007, while for the other countries of SEE-6 the trend was the opposite.

Summary

Future trade liberalization of the relationship of Bulgaria as member of the EU with Southeast Europe will be largely to the benefit of SEE-6 export to Bulgaria. The trade statistic information for the analyzed period shows a clear trend for increase of the Bulgarian import from SEE -6 countries as the sharp decrease in 2009 is explained by the drop in international trade due to the global financial crisis. In Graph 1 below are shown the trends in trade turnover and trade balances for the period 2006 until 2014 between Bulgaria and the Western Balkan countries.

Graph 1: Bulgarian trade with SEE -6 countries for the period 2006 -2014 (EUR million)



Source: Ministry of Economy of Bulgaria and author's analysis

Although trade balances continue to be negative for SEE–6 countries it is clear that the Bulgarian positive trade balance in nominal value is decreasing. The further reduction or eliminations of trade barriers will provide for more opportunities for SEE-6 companies looking for expansion in the EU.

As remaining obstacles to trade can be pointed out: lack of sufficient infrastructure, low purchasing power of end consumers in the region, general political and economic instability present in some of the SEE partner countries.

The impact of CEFTA 2006 for the countries in Southeast Europe

In this section of the report, the possible economic implications of CEFTA 2006 for the SEE -6 countries on FDI, growth and taxation will be addressed. The following analysis is based to a greatest extent on the conclusions of various theoretical and empirical studies relevant to similar type of regional trade integration discussed in the present paper. It should be noted that some of the implications are contradictory or overlapping based on the fact that two parallel processes of trade integration are taking place in the region: on one hand it is the free trade between the SEE - 6 countries and the process of further trade liberalization and accession to the European Union. Furthermore, the various implications of regional trade integration are intra- related – i.e. as the case of FDI and taxation.

CEFTA 2006: FDI, growth and taxation

On the theoretical level one of the most likely results of the operation of CEFTA 2006 will be the decrease in intra-regional FDI as a substitute for increased regional trade. However, this negative effect will of minor importance, since intra-regional FDI is not substantial by the moment. On the other hand, it could be anticipated that outside FDI will be increased with deepening of the regional integration processes. The countries having the best locational advantages will attract the most of FDI inflows. Recent empirical studies suggest that in the case of South-South integration like CEFTA 2006 for the countries in Southeast Europe, macroeconomic stability will be a more important factor than regional integration itself. As it seems that the political and economic situation in the region will continue to be volatile FDI inflows are not likely to change significantly in the short and medium term.

The above ambiguous effects on FDI take into account the establishment of RIA like CEFTA 2006 as a single factor. However, all the countries in the region have engaged in liberalization of trade with the European Union – their largest trade partner. This type of integration (North-South) leads in general to positive FDI inflows in the Southern economies. In this way, these slightly negative implications on FDI for SEE-6 countries may be partially or fully compensated. However, the presence of macroeconomic stability will be once again an important factor.

The analyzed empirical studies on the correlation between growth and regional integration of the same type as CEFTA 2006 in Southeast Europe show that no such direct correlation can be found based on the empirical evidence or the effects are rather ambiguous. Once again, the process of increasing trade liberalization between the SEE – 6 countries and the European Union as a separate process should lead to more positive effects in terms of economic growth as compared to the process of regional trade integration by itself. In the countries in Southeast Europe, as well as on world scale, there is a common tendency of the decrease of the corporate tax rates.

The corporate tax and VAT rates for 2014 for SEE-6 countries are shown in Table 10.

Table 10: SEE-6 Tax Systems in 2014

	Corporate Tax Rate	Standard VAT Rate
ALB	15	20
B&H	10	17
KOS	10	16
MAC	10	18
MON	9	19
SER	15	20

Source: KPMG Global, 2015.

As it can be seen from the table, the levels of the corporate tax rates for the year 2014 are rather low. This tendency can be explained partly with the growing globalization of the business and implementation of new technologies, the increased exposures, relevant to the investments in the countries of Southeast Europe. As far as the business and the capital are becoming more mobile and the political and economic risk is substantial, the countries in the region are facing a significant pressure to provide competitive corporate tax rates (Ranchev, 2001), which resulted in a minimization of corporate tax rates to historically low levels.

The harmonization or coordination of the tax and customs legislation is of specific importance for the operation of CEFTA 2006. The creation of clear rules, in line with the European requirements in this field is of substantial importance for securing long-term fiscal stability in the region. On the other hand, there is a significant risk for the SEE-6 countries if a compatible tax and customs legislation is not present. With the removal of the trade barriers, the differences between the tax legislation become apparent - especially with regard to the VAT and the excise duties. In this way, if there would be significant discrepancies in the applicable VAT and excise duty rates, an unexpected growth of the cross-border trade could be observed, which under equal conditions would lead to a decrease of the budget revenues in the countries, which apply higher rates of indirect taxes. At the same time bigger differences in the corporate rates might have a substantial impact on the decision of the potential investors to prefer a specific country for investment among all other countries in the region.

Harmonization and FDI in the Region

The problems, related to the re-distribution of the investment flows, from the so-called tax competition perspective, are a painful topic from a long time even for the countries within the European Union[4]. In practice the amount of potential foreign investments from an international perspective and particularly in the SEE region is a rather limited, for the attraction and taxation of which a fierce struggle between the governments of the countries in Southeast Europe is in place. Recent research suggests that "the use of investment incentives focusing on foreign firms, although motivated in some cases from a theoretical point of view, is generally not an efficient way to raise national welfare" (see Blomstrom and Kokko, 2003, p.1). Regarding the relationship between FDI and corporate tax incentives empirical analysis supports the concept that taxes are important factor if the SEE countries become "close substitutes concerning the location of investment" (Blazic and Vlahinic, 2006, p. 23). Further to the above analysis, it is of primary importance that the countries in the region coordinate properly their tax policies and investment tax incentives. Engagement in tax competition and further downsizing of tax rates and/or tax incentives will lead to substantial budget losses.

Roadmap for sustainable growth

One possible solution for the common problems of the SEE-6 countries could be the establishment of a roadmap for sustainable growth. This roadmap for sustainable growth could the next step for achieving deeper regional integration before the countries join the European Union. The roadmap could encompass the following measures for achieving sustainable growth in the region:

- Active support from the international institutions of the aspirations for EU membership of the SEE-6 countries with accession in the next 5 - 10 years;
- Setting up targets and constant monitoring the levels of budget deficits as well as maintaining macroeconomic stability;
- Coordination of the efforts and identifying ways to increase FDI through improved infrastructure and legal environment;
- Coordination of the reforms in the tax and customs legislation oriented at

further harmonization with EU legislation;

- Commitment of the governments to further fiscal consolidation with active measures to limit corruption and bureaucracy;
- Focus of the governments on educational, health and social security reforms focused on integration of minorities and reduction of youth unemployment;
- Strengthening the role of the Regional Cooperation Council and active participations of experts in the working groups monitoring progress and setting the agenda.

Such an ambitious program could be achieved only through the coordinated efforts of the governments of the SEE-6 countries with the support of the EU and international financial institutions[5].

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[3] European Commission, Brussels, 17.6.2015 COM (2015) 302 final, "A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action".

Summary

It seems that the establishment of free trade area in Southeast Europe on the basis of CEFTA 2006 as an isolated event is not likely to have a substantial positive effect on the economic development of the region. Recent strategic theoretical and empirical studies show that the short-term economic implications are ambiguous. It is also clear that the economic effects of macroeconomic and fiscal stabilization through tax and customs harmonization can play more significant role in the economic stabilization in the region than regional trade integration alone. However, it should be noted that the outcome of CEFTA 2006 should not be measured by economic indicators only. There are a number of non-economic implications that are important as well and could not be verified by amounts in foreign currency, shares, ratios and percentages.

Based on the above analysis it can be argued that deeper regional integration in Southeast Europe may have significant non-economic implications, which are positive for the long-term development of the region as a whole (Ranchev, 2002, p.50). It seems that the main argument in favor of the existing RIA between SEE -6 countries will be the increased security through cooperation. The countries in Southeast Europe "will have to prove their readiness to overcome their mutual turbulent past and to leave it to historians" (Kostovska, 2009, p. 95).

While the economic implications of CEFTA 2006 itself may prove ambiguous especially when compared with the effects of trade liberalization with the European Union, it can be anticipated that the RIA will decrease the level of bureaucracy, smuggling and corruption. At the same time trade liberalization in the region could have a positive impact on institution building, environment and health and protection of intellectual property rights. A roadmap for sustainable growth supported by the governments of the SEE-6 countries, the EU and the international financial institutions could be a useful tool for deeper regional economic integration in parallel to the process of accession in the EU.

[4] A good example of such structured approach is the Final Declaration by the Chair of the Vienna Western Balkans Summit 27 August 2015.

Conclusion

This paper argues that deeper regional integration for the countries in the SEE region and relevant tax and customs harmonization can be the considered an appropriate scenario especially for the economies of the Western Balkan countries. In this way the requirements of the European Union in the field of taxation and customs reform can turn out to be a common starting point in the direction of more active economic integration of the region and future accession of the Balkan (SEE) countries in the European Union.

Trade liberalization and fiscal stability through harmonization of tax and customs legislation should go hand in hand for the six countries in Southeast Europe, in order to secure a long-term vision for the undergoing processes of transformation. The common goal of achieving European Union membership for the countries in the region makes the transformation processes rather unique. It can be argued that harmonization of tax and customs legislation in combination with regional trade liberalization is a phenomenon that can be observed currently only in Europe. The European Union in its turn should provide more clear messages regarding the timing of accession of each of the SEE-6 countries as to accelerate the processes of transformation and modernization in the region via the Regional Cooperation Council.

The objective of the present research has been to identify some of the most significant implications of deeper regional integration of the economies of the six SEE countries. The findings of this research show that although short-term economic effects would be ambiguous for the region as a whole, the process of trade liberalization will bring more security, which in its turn will assist the economic reforms and will probably lead to a greater degree of harmony and stability in these countries in the long run.

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