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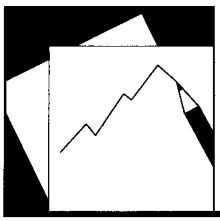

IMF Working Paper

Boosting Job Growth in the Western Balkans

Dmitriy Kovtun, Alexis Meyer Cirkel, Zuzana Murgasova, Dustin Smith, and Suchanan Tambunlertchai

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Prepared by Dmitriy Kovtun, Alexis Meyer Cirkel, Zuzana Murgasova, Dustin Smith, and Suchanan Tambunlertchai[1]

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Abstract

Labor markets in the Western Balkan countries (Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, and Serbia) are characterized by some of the highest unemployment and low employment rates in Europe. We analyze the poor labor market outcomes in these countries by comparison with the New Member States of the European Union and advanced European economies. Our findings suggest that long-lasting labor market weaknesses in the Western Balkans have structural roots: the institutional setup of the labor markets, labor cost factors, and especially the unfinished transition process. Finally, we offer policy recommendations for boosting job creation.

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I. INTRODUCTION

Much has been written about labor market problems and policy challenges in advanced Western Europe, including in the euro area periphery countries. The group of economies considered in this paper—South-Eastern Europe's Western Balkan region—offers an important, though less extensively discussed, case study for the potential of structural reforms to overcome bottlenecks, including especially those in the labor market.

Labor markets in a number of South Eastern European countries are characterized by high levels of unemployment and low rates of job creation. Many of these economies face a unique set of challenges: labor market problems are especially severe among the emerging market economies which are not members of the European Union, namely, Albania, Bosnia and Herzegovina, Kosovo, the former Yugoslav Republic (FYR) of Macedonia, Montenegro, and Serbia. Given their many similarities and challenges, this set of countries, henceforth referred to as the "Balkan countries," is the focus of this paper.

In particular, this paper aims to (1) bring to light the relatively weak performance of the Balkan labor markets in a cross-country context; (2) analyze the factors that may have contributed to this longstanding problem−the unfinished transition process, the institutional setup of labor markets, including possible market rigidities, and labor cost factors; and (3) present a range of policy recommendations for tackling these problems while keeping in mind that the labor market challenges differ across countries, and reforms to address these challenges must be carefully tailored to specific country circumstances.

II. HOW DO BALKAN LABOR MARKETS COMPARE WITH OTHERS IN EUROPE?

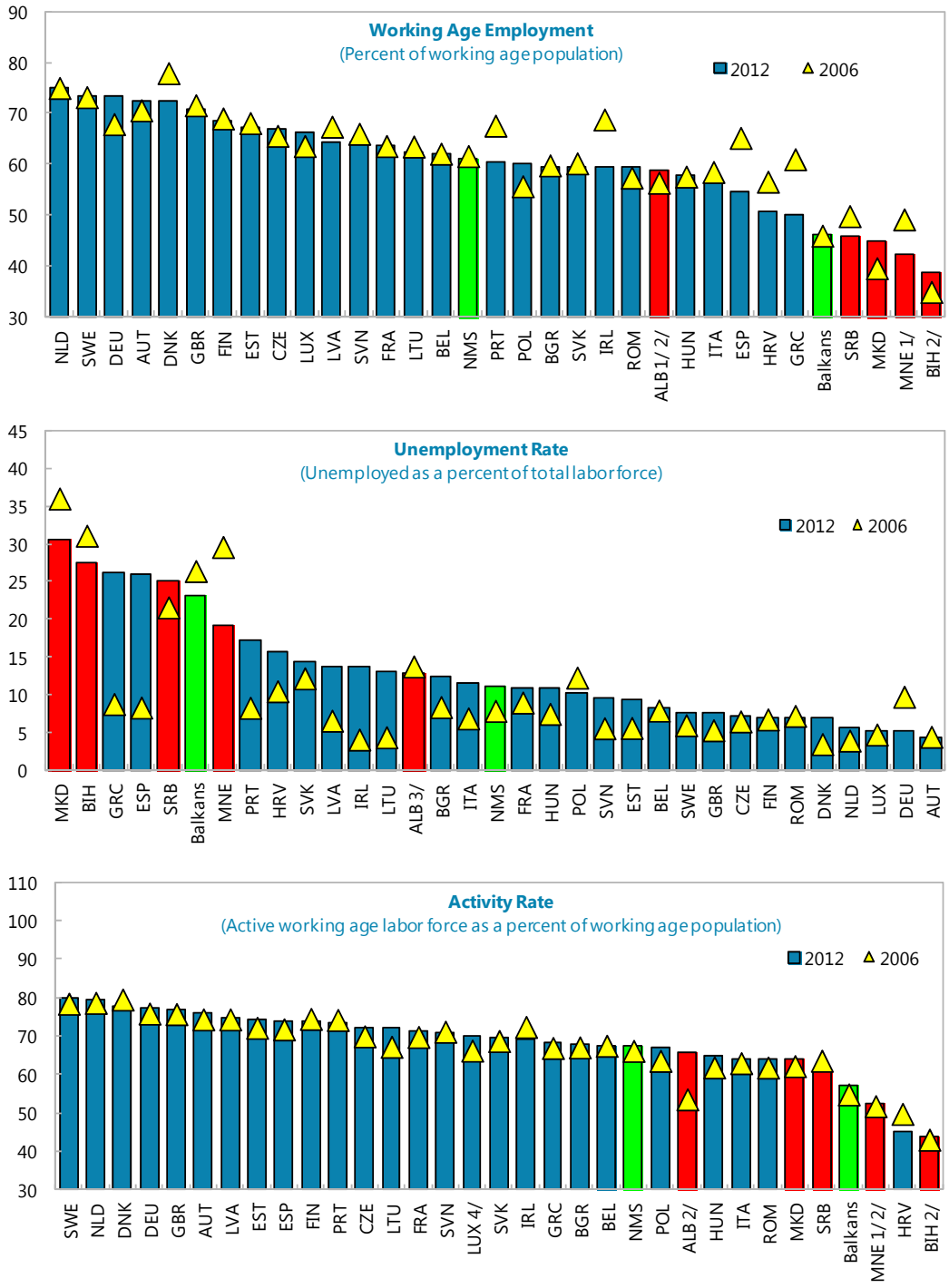
Labor market conditions and developments in the six Balkan countries share a number of similarities among them, and on the whole they are considerably worse than in most other European countries. One striking factor is the very low employment rates—the average ratio of employed persons to the working-age population in these countries was 46 percent in 2012, compared with 64 percent in the euro area and 63 percent among the new member states of the European Union (NMS) (Figure 1).[2] These rates reflect low activity rates,[3] and high unemployment rates. The Balkan countries also have some of the highest youth and long-term unemployment rates in Europe (Figure 2).[4]

[2] The NMS comprise Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Slovenia. The list of countries referenced in this paper and their abbreviations are shown in Appendix I.

[3] The activity rate is defined as those employed or seeking employment as a share of the working-age population.

[4] Long-term unemployment is defined as unemployment spells of 12 months or more.

Figure 1. Selected Labor Market Indicators, 2006-2012



Sources: Country authorities; OECD; Haver; Eurostat; CEA: and IMF staff calculations.
1/ 2007 data used in place of 2006 data.
2/ 2011 data used in place of 2012 data.
3/ Registered unemployment used in place of labor force data.
4/ 2007Q2 data used in place of 2006.

The weak labor market performance in the Balkan countries is a key social concern—it undermines medium- and long-term economic growth and poses major challenges for policymaking. The low rates of employment mean forgone production and the unemployed risk losing their skills and thus making it harder for them to find employment in the future. This cycle may, in turn, increase the natural rate of unemployment (thereby creating the "hysteresis" effect). The very low employment rate of young people can impede the process of acquiring human capital and increase dependency on support systems, diminishing the countries' long-term growth potential. Finally, the high rates of unemployment create a burden on public finances in the form of higher social benefits for the jobless, and could undermine social cohesion.

High rates of unemployment in the Balkan countries have persisted through the boom years of the 2000s. For example, between 2004 and 2008, when real annual GDP growth in the Balkan countries averaged 5½ percent, unemployment rates remained high. The degree of responsiveness of unemployment to economic cycles can be gauged from Okun's coefficient, which measures the correlation between contemporaneous changes in GDP and the unemployment rate (Okun, 1962). Figure 3 confirms that the Balkan countries have a lower Okun's coefficient than the NMS and the euro area periphery countries, and the nature of unemployment is more long lasting.[5]

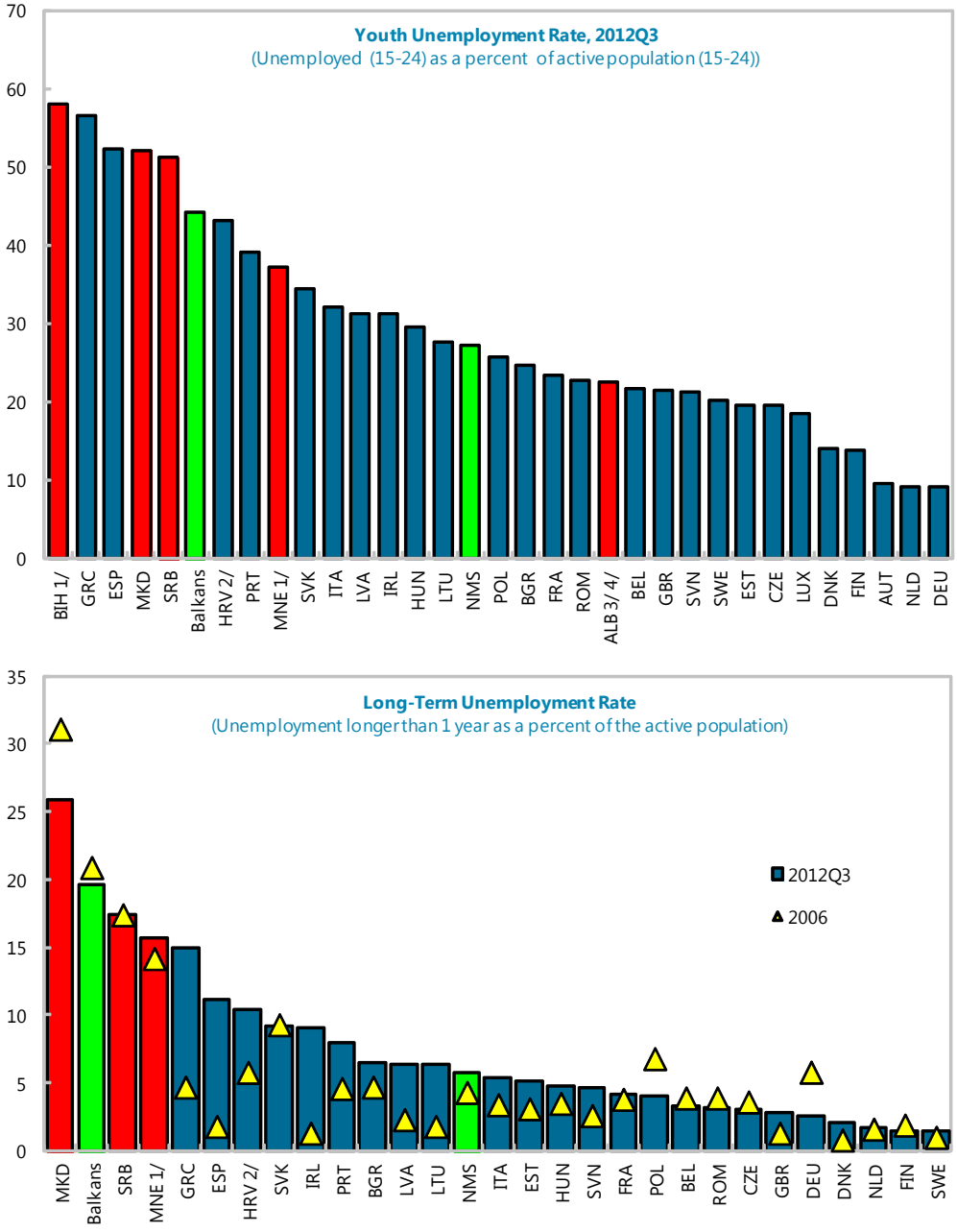
III. Diagnostics: Causes of Poor Labor Market Performance

Various factors can explain labor market outcomes.[6] For the Balkan countries, these factors are organized into three groups: (1) the more standard "labor market institutional factors," which influence the ease with which the unemployed can be matched to available job vacancies, and also with which firms can adjust employment; (2) the "cost factors," which tend to raise wages despite excess supply in the labor market, and which are, to some extent, a reflection of the rigidities summarized under (1); and (3) the more unique "structural factors," capturing the Balkan countries' processes of transition and European integration, which appear to correspond to the persistent nature of their labor market problems.

[5] For more detailed estimates of Okun's coefficients in individual countries, see Ball et al. (2013).

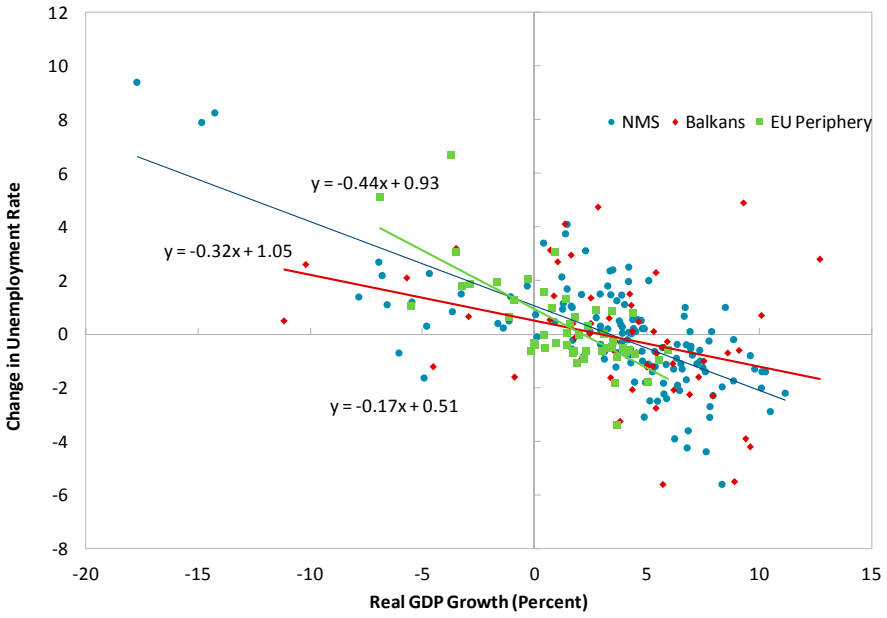
[6] See the survey study by Layard, Nickell, and Jackman (2005) for a summary of many of these factors.

Figure 2. Youth and Long-Term Unemployment, 2006–2012:Q3



Sources: Eurostat; country authorities; and IMF staff calculations.
1/ 2011 data used in place of 2012Q3 data.
2/ 2012 data used in place of 2012Q3 data.
2/ 2010 data used in place of 2012Q3 data.
3/ Youth unemployment rate ages 15-29.
4/ 2007 data used in place of 2006 data; 2011 data used in place of 2012Q3 data.

Figure 3. GDP Growth and Changes in Unemployment, 1993–2011



Sources: WEO; and IMF staff calculations.

A. Institutional Rigidities in Labor Markets

Strong employment and social protection systems were important features of centrally planned economies. Although these systems have largely been dismantled, their legacy remains in some aspects of the Balkan countries' labor markets—if not in legislations, then in workers' attitude.

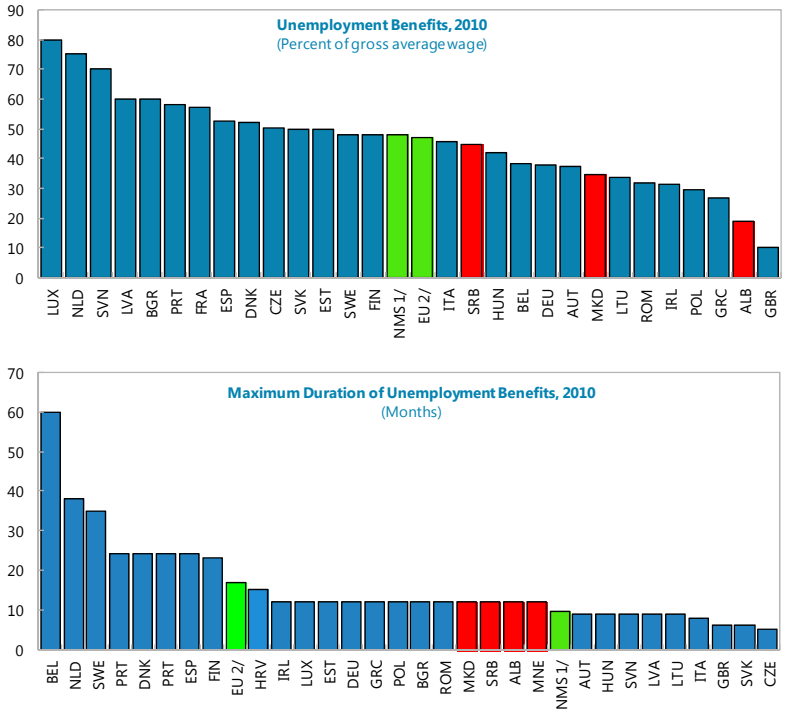
Unemployment and unemployment benefits

When properly designed, social assistance and unemployment benefit programs reduce poverty and hardship for the most vulnerable segments of the population. However, such programs can also induce moral hazard by allowing program recipients to substitute benefits for productive work, possibly at large social costs (Hansen and Imrohoroglu, 1992). Similar to remittances, social and unemployment benefits relax household budget constraints and alter labor-leisure decisions, and thus affect the job search behavior of the unemployed, duration of their unemployment, and labor force participation (Katz and Meyer, 1990; Meyer, 1990; Cullen and Gruber, 1997; Lalive, 2008). Moreover, fiscal resources tied up in benefits cannot be used for productivity-enhancing investments, such as in infrastructure or human capital development.

For the Balkan economies, unemployment benefits in relation to wages fall at or below the average level in a cross-country comparison (Figure 4). Benefit duration follows the standard 12-month limit in most countries. Given the prevalence of long-term unemployment in the region, benefit coverage is likely to have expired for a large portion of the unemployed. The

role of unemployment benefits in explaining the high rates of unemployment in the Balkan countries is thus likely to be limited. However, although the benefits themselves may not contribute to the high unemployment rates, their administration can affect unemployment spells. Unemployment benefits in the Balkan countries are not typically accompanied by active labor market policies, though such policies have been shown to matter in helping workers return to employment (Blanchard, Jaumotte and Loungani, 2013).

Figure 4. Size and Duration of Unemployment Benefits



Sources: OECD; country authorities; and IMF staff calculations.
1/ Average of the New Member States excluding Croatia.
2/ Average of EU countries.

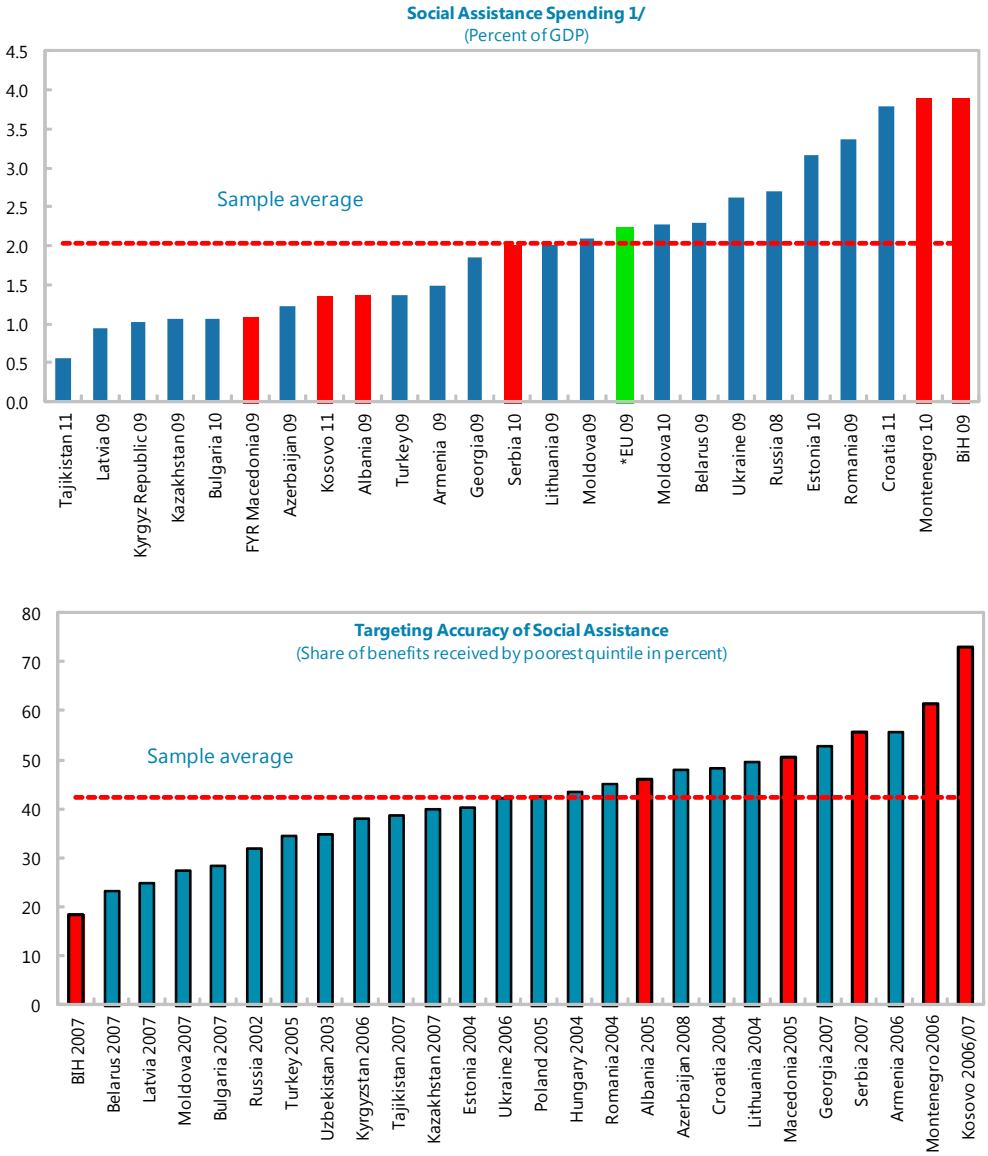
Differences in social benefits emerge across the Balkan countries. Benefits are particularly high in Bosnia and Herzegovina and Montenegro (Figure 5), but are in line with or below the sample average in other Balkan countries. Lack of benefit targeting also appears to be a problem for Bosnia and Herzegovina, where less than a quarter of the benefits are received by the poorest quintile (Mitra, Selowsky, and Zalduendo 2010). This poor targeting occurs because many benefits are "rights based" rather than "needs based." In other Balkan countries, however, targeting accuracy is quite high, with more than 50 percent of benefits going to the poorest quintiles in Serbia, Montenegro, and Kosovo (Mitra, Selowsky, and Zalduendo, 2010). Therefore, with the exception of Bosnia and Herzegovina, social benefits do not appear to have contributed significantly to the high unemployment outcomes in the Balkan countries.

Employment protection legislation

Labor market institutions in most countries feature elements of employment protection legislation (EPL) to provide a degree of protection to workers and to encourage investment in workers' firm-specific skills. However, protective measures can go too far and create

inefficiencies (Blanchard, Jaumotte and Loungani, 2013). In addition to restricting hiring and firing, Bassanini, Nunziata, and Venn (2009) find that overly strict EPL depresses productivity growth

Figure 5. Social Assistance Spending and Targeting



Sources: Europe and Central Asia Social Protection Database; World Bank; Mitra et al., 2010; "Turmoil at Twenty: Recession, Recovery, and Reform in Central and Eastern Europe and the Former Soviet Union"; and IMF staff calculations.
1/ For comparability purposes, the chart only includes social assistance provided in cash. Source: Staff calculations based on ESSPROS data.

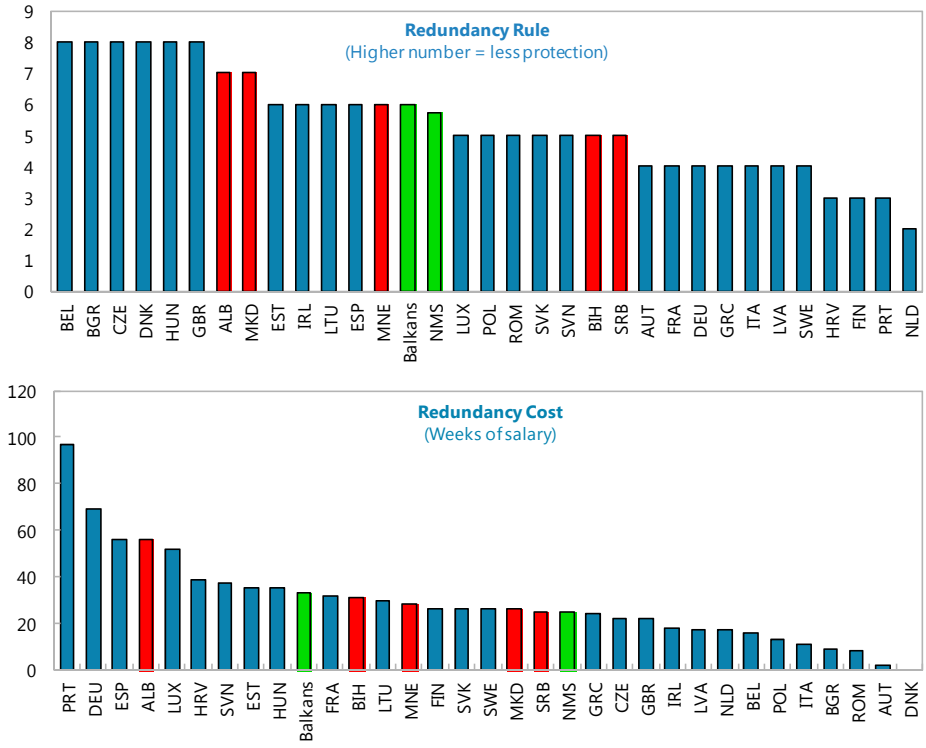
because firms are less able to adjust to technology and market changes that require labor reallocation. In such conditions of lower turnover, workers themselves face greater challenges to switching jobs, and the unemployed face greater obstacles to enter the labor market, which prolongs their unemployment spells. Evidence from the literature confirms that there is a clear positive relationship between EPL and long-term unemployment (Layard, Nickell, and Jackman, 2005). Findings from a panel study of 97 countries for 1985–2008 by Bernal-Verdugo, Furceri, and Guillaume (2012) suggest that in addition to reducing long-

term unemployment, greater labor market flexibility may also reduce overall and youth unemployment, with hiring and firing regulations and costs having the strongest effects.

Labor market practices in the Balkan countries have traditionally been rigid and afforded workers high degree of protection. In the socialism era, workers "owned" factors of production and exercised self management: the system was strong on workers' rights and weak on efficient allocation of risks (Annex in OECD, 2008). Since the disintegration of the socialist economies, substantial labor market reforms have been undertaken, with the reform momentum having picked up since mid-2000s. Current redundancy costs in most of the Balkan economies appear to be in line with those in the more advanced emerging market economies, with the possible exception of Albania, whereas redundancy rules appear to be tight in Bosnia and Herzegovina and Serbia (Figure 6). However, anecdotal evidence suggests that reforms remain incomplete and differences between legislated and actual practices continue to persist. In Serbia, for example, redundancy costs are not necessarily high per se, but total severance payments are based on the length of lifetime employment rather than tenure at the most recent workplace, creating a strong disincentive to hire workers with many years of experience.

The apparent effort to increase labor market flexibility in most Balkan countries is an encouraging sign, but judicial enforcement will need to accompany the legislative changes. Because increased labor market flexibility in the Balkan economies is a recent phenomenon, it may be some time before its effects take hold and the current high unemployment rates are reduced.

Figure 6. Employment Protection



Sources: World Bank: Doing Business Database (2012) and Global Competitiveness Report (2011).

Wage bargaining sructure

Theory suggests that the degree of centralization of wage bargaining can affect unemployment, and fully centralized or fully decentralized bargaining systems offer the best results (Scarpetta, 1996). Under the centrally planned systems in the Balkan countries, all workers were effectively unionized and wage bargaining was completely centralized. Since the start of the transition process, union coverage has declined and become more fragmented. Nevertheless, union coverage in the Balkan countries remains extensive compared with the NMS and other EU countries (European Commission Report, 2008). Furthermore, the fragmented nature of the unions may lead to inefficient bargaining, contributing to the high unemployment rates. One such example is Serbia, in which wage agreements negotiated with trade unions are imposed on all firms in the sector, regardless of union membership.

B. Are Labor Costs Too High?

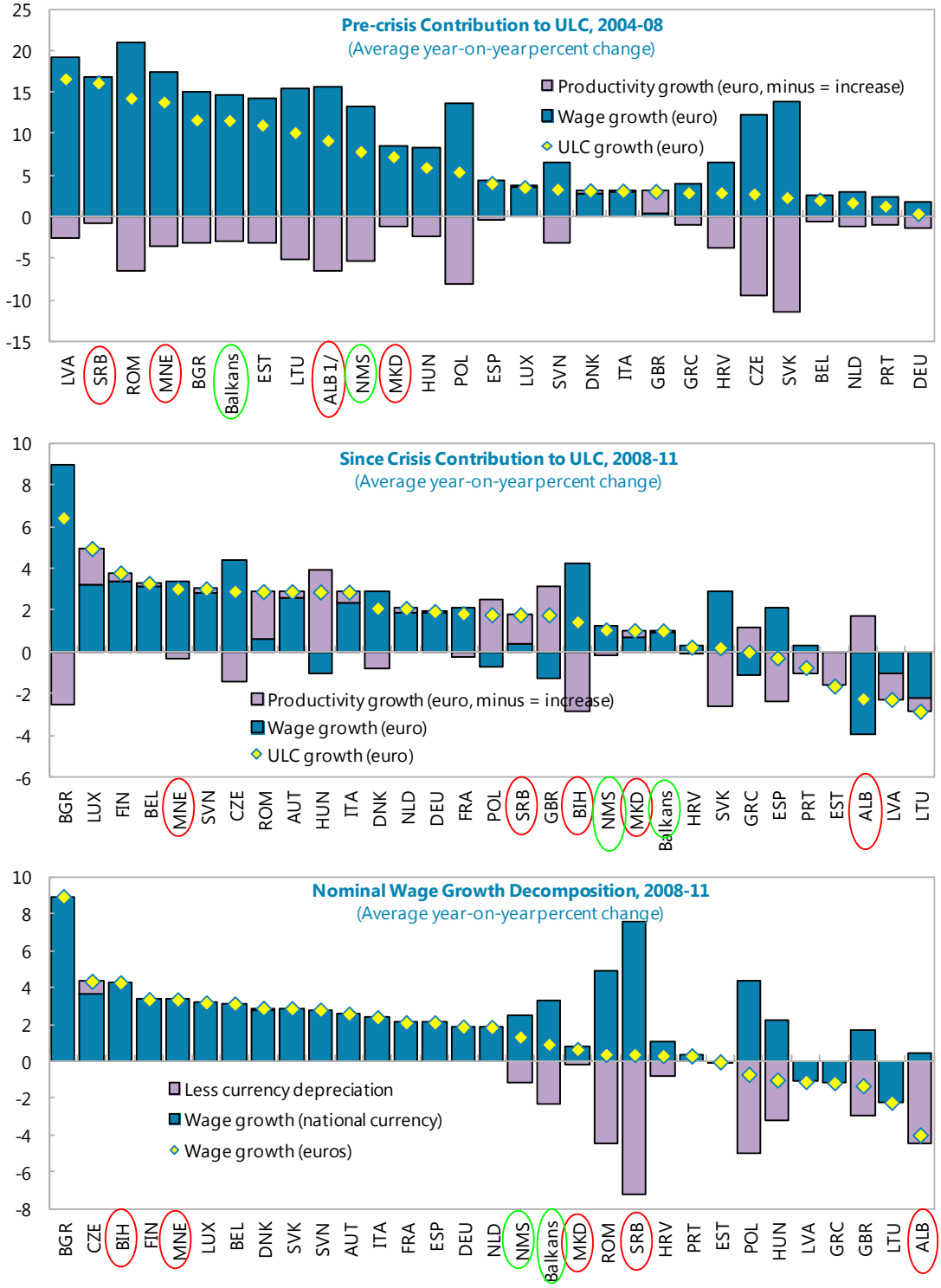
Unit labor costs

Labor costs, which include workers' wages and benefits as well as social contributions and taxes paid by employers and employees, affect hiring decisions and can contribute to unemployment if they are out of line with labor productivity. In the same vein, rising labor costs are not necessarily a problem if accompanied by commensurate increases in labor productivity—a natural part of the income convergence process. A key measure of labor competitiveness that captures movements in costs and productivity is the unit labor cost (ULC), calculated as the ratio of labor costs to real GDP. Changes in ULCs affect firms' profitability and, therefore, their demand for labor.

The boom years leading up to the global financial crisis were characterized by significant capital inflows from advanced to emerging European economies, including the Balkan countries. These capital inflows drove up wages across all countries. However, productivity gains in many countries did not keep up with wage increases, resulting in very rapid ULC growth (Figure 7). Since the onset of the global economic crisis in 2008, ULC growth moderated throughout Europe and declined in the Baltic countries (Estonia, Latvia, Lithuania) as a result of flexible labor markets and a significant downward wage adjustment. By comparison, among the Balkan countries, only Albania experienced a reduction in ULCs. In Bosnia and Herzegovina, the ULC deceleration was driven by continued productivity growth rather than wage moderation, and in Serbia by a euro-denominated wage decline. In Montenegro, wages continued to outpace productivity significantly.

Exchange rate regimes played an important role in relative wage competitiveness across countries. Despite continued increases in local currency wages, Albania improved and Serbia contained the deterioration of its wage competitiveness through currency depreciations. Other Balkan countries (Bosnia and Herzegovina, FYR Macedonia, and Montenegro) did not benefit from such exchange rate adjustments given that the currencies of these countries are either pegged to the euro or use the euro as their currency.

Figure 7. Unit Labor Costs and Nominal Wages, 2004–2011

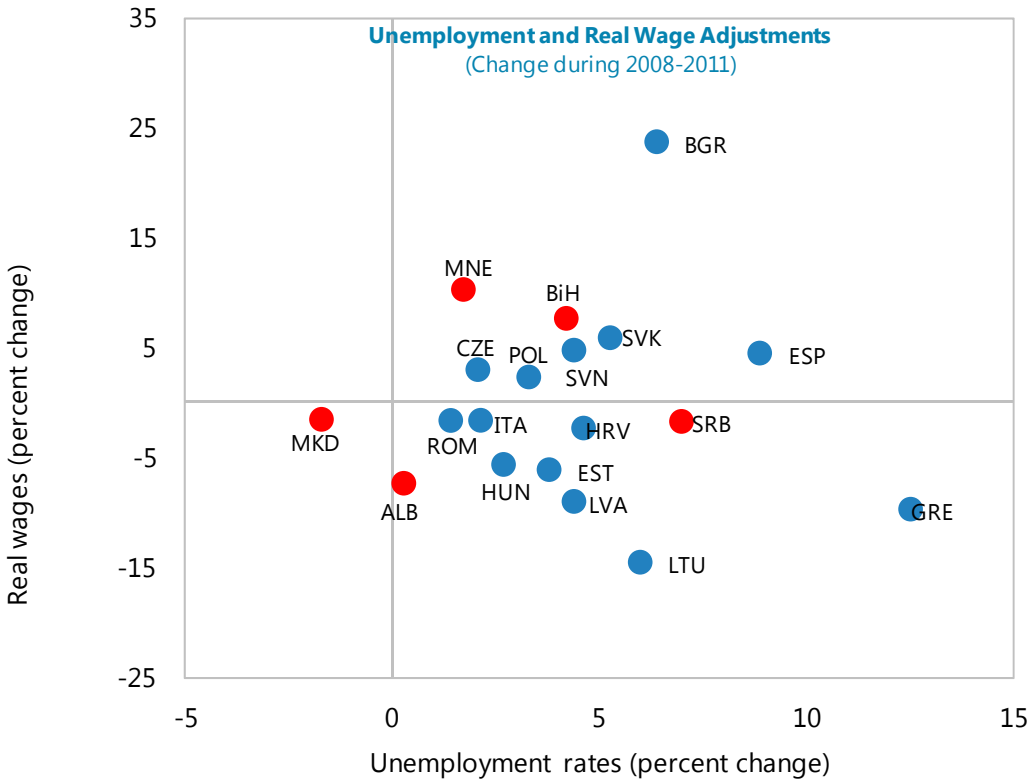


Sources: Haver; WEO; IMF staff calculations.

Wage rigidities

Real wage rigidities can limit downward wage adjustments and aggravate unemployment problems, particularly during economic downturns. In the years following the financial crisis, countries such as Montenegro and Bosnia and Herzegovina continued to see growth in real wages despite rising unemployment (Figure 8). Such impairment in the wage adjustment mechanism can be an outcome of institutional rigidities including high employment protection and inflexible wage bargaining structures.

Figure 8. Unemployment and Wages



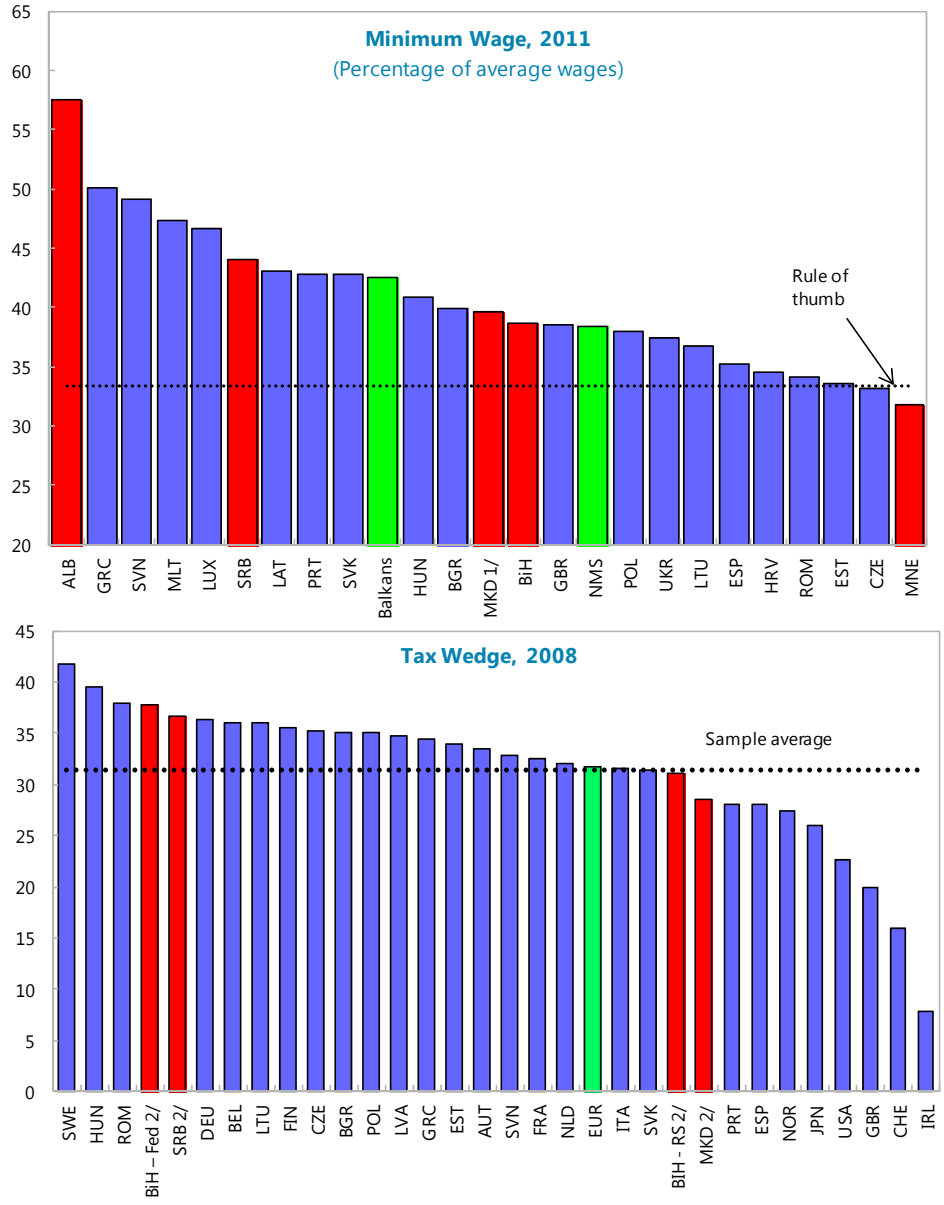
Sources: Haver; OECD; and IMF staff calculations.

Minimum wages

The purpose of minimum wages is distributional—to ensure that low-skilled workers receive pay that is sufficient to live on (Blanchard, Jaumotte and Loungani, 2013). However, minimum wages distort labor market outcomes by reducing the scope for downward wage adjustments and compressing the wage distribution (Tonin, 2004). In general, wider wage ranges are thought to support employment growth because firms can hire profitably across the skills spectrum (OECD, 1993). By forcing a compression in the wage distribution, minimum wages create disincentives to hire low-skilled workers, thereby increasing unemployment among the very population they are intended to support.

The restrictiveness of minimum wages can be proxied by the ratio of minimum to average wage. Rutkowski (2003) suggests that for countries with high unemployment concentrated among young and low-skilled workers, this ratio should not exceed one-third. According to this rule of thumb, all Balkan economies, except for Montenegro, have excessively high minimum wages (Figure 9).

Figure 9. Minimum Wage and Tax Wedge



Sources: Eurostat, World Bank (2011c); Koettl (2012); and national authorities.
1/ Value for Macedonia refers to 2012. Minimum wage in Macedonia is not binding for several sectors with low wages.
2/ Values refer to 2009.
Notes: The tax wedge is defined as the share of income tax and social security contributions by employers and employees over total labor costs. The numbers presented in this table refer to a single earner with no children who receives average wage and works part-time or full-time.

Tax wedges

Social security contributions and labor taxes are nonwage labor costs that create a wedge between the employer's cost of hiring a worker and the wage that the worker receives (OECD Jobs Study, 1993). If costs cannot be passed on to workers, employers adjust by decreasing their demand for labor, resulting in higher unemployment. Evidence in the literature confirms this relationship (Alesina and Perotti (1997); Nickell and Layard (1999); Daveri and Tabellini (2000); Blanchard and Wolfers (2000)), albeit with varying estimated sizes of the coefficients (Castellino and Fornero, 2003). In a similar vein, if workers do not fully internalize the expected benefits from taxes on their labor, the decreased net wages are a disincentive to work (Summers, 1989). Workers thus reduce their supply of labor, while those at the margin may withdraw from the labor force altogether.

Although labor taxes in the Balkan countries have recently fallen because of competition to attract foreign investors, social insurance contributions remain high in many countries. Serbia, for example, has a high tax wedge largely as a result of such contributions (Figure 9). These large tax wedges likely contribute to the problems of high unemployment and low participation, and possibly explain the large informal economies observed in some Balkan countries.

C. Structural Hurdles from Unfinished Transition to Market Economies

A range of labor market rigidities is something that the Balkan countries have in common with many other economies, both advanced and emerging. More unique to the region are the structural hurdles from an unfinished transition to market economies. Despite geographic proximity to the EU, the Balkan countries are latecomers to the European integration. In the process of transition, standard growth theory predicts that lower-income economies converge toward higher incomes via several distinct channels. First, capital flows from advanced economies to ones with lower capital-to-labor ratios can increase labor productivity and facilitate for a transfer of knowledge and technology (e.g., through foreign direct investment (FDI) flows). Abiad, Leigh, and Mody (2009) find that in Europe—including in NMS—capital flows from relatively rich to relatively poor countries, and that these flows are associated with accelerated income convergence. The second channel involves labor flows, as workers move across borders in search of higher wages. Finally, fiscal transfers reduce differences in incomes among countries, but can also lead to more persistent differences in labor market outcomes.[7]

What distinguished the convergence of Balkan economies from that in the NMS was the relative strength of these channels. In particular, FDI inflows in the Balkan countries have been smaller and labor outflows significantly larger than in the peer countries. Fiscal transfers channel has been limited for the Balkan countries because they are not members of the EU.

[7] For example, Spilimbergo (1999) shows in a theoretical framework how wage and unemployment differences between a more and a less developed region in an integrated labor market can persist because of large fiscal transfers from the former to the latter region.

Capital and labor flows

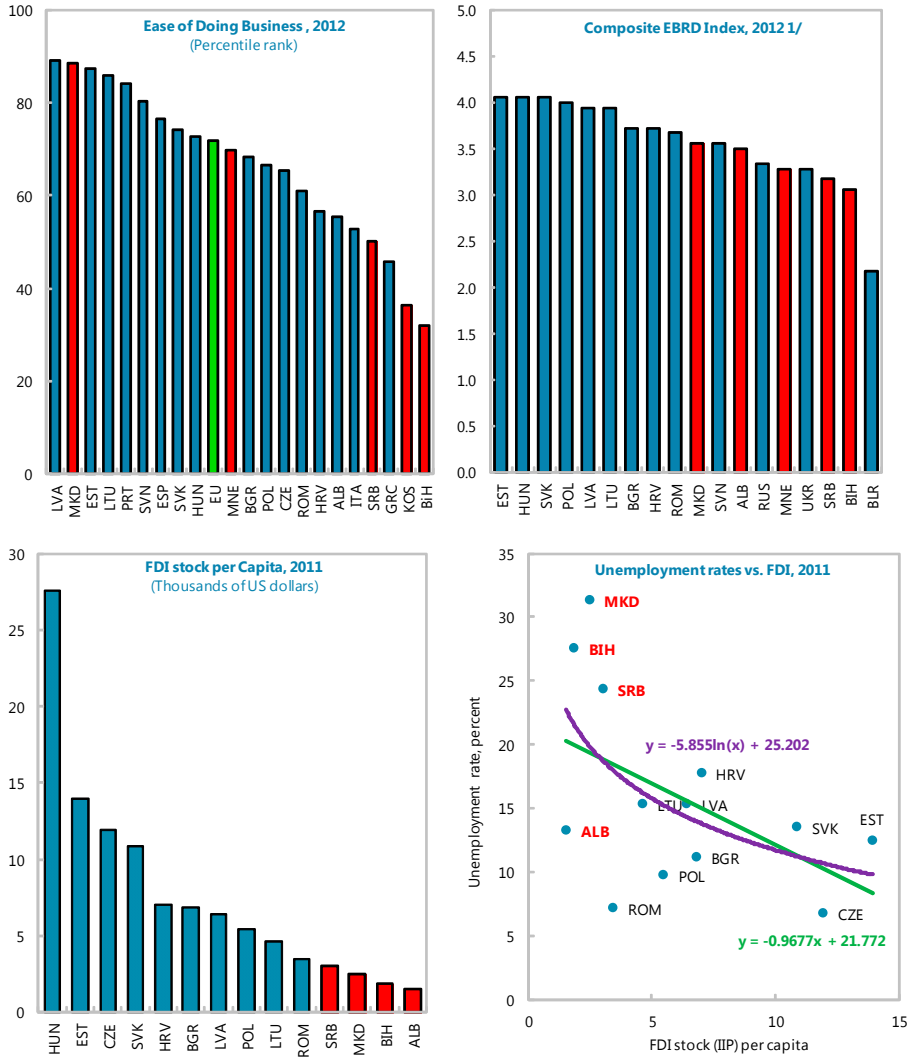
Successful transitions during the 1990s in Central European NMS were generally associated with comprehensive structural reforms that attracted significant inflows of FDI and promoted job creation. Despite unemployment having possibly increased in the short term (Burda, Bean, and Švejnar, 1993), the reforms allowed development of the private sector that eventually provided conditions for reducing unemployment rates. The infusion of capital from abroad—especially via greenfield FDI—played a key role in developing new businesses or even entire new sectors of the economy and provided a chance for workers dismissed from the declining areas to be reabsorbed by new economic activities. Although other types of capital, such as equity flows, have also shown positive relationships with growth under specific circumstances, only FDI inflows proved to be a robust and significant driver of output growth (Aizenman, Jinjarak, and Park, 2011) because they provide a more stable long-term foundation for transfers of technology, know-how, managerial skills, and international marketing networks. Broader changes in the economy can in turn reduce the natural rate of unemployment (Ball and Mankiw, 2002).

The literature on economic development suggests that convergence to higher income levels involves structural change. This change includes flows of both capital and labor from lower-productivity sectors, such as those involved with primary products, to sectors with higher potential productivity gains, such as manufacturing and services (Rodrik and McMillan, 2011). Agriculture also experiences productivity gains, but at a slower rate than other sectors. Recent research on the Middle East and North Africa has also emphasized the importance of appropriate structural change to boost growth and absorb the supply of labor (World Bank, 2011a).

Unlike the NMS, the Balkan countries were delayed in their transition to market-based economies by the conflicts of the 1990s and the need for post-conflict rebuilding. Significant reforms largely began only after 2000, nearly a full decade after the NMS. Although the Balkan countries made significant progress in the transition, many critical reforms—such as privatization, enterprise restructuring, and promoting a competitive business environment—were still incomplete when the global financial crisis erupted. These delays have stifled FDI and reduced opportunities for job creation (Figure 10).

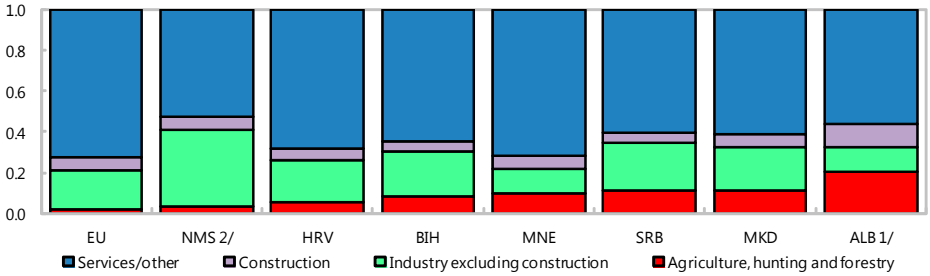
The delayed transition and low FDI put the Balkan economies at a disadvantage in diversifying away from traditional sectors. They have a higher share of agriculture than the EU or the NMS on average, and a smaller share of industry than the NMS (Figure 11). Thus, sectors that provided a source of employment in successful transitions in other countries—such as export-oriented industries—have been lagging behind in the Balkan countries. Furthermore, in some countries (e.g., Serbia and Montenegro), unemployment has been aggravated by continued labor shedding from the declining sectors, while new sectors have not developed fast enough to absorb the dismissed workers.

Figure 10. Business Environment, FDI and Unemployment



Sources: IMF IIP Database; LFS from national authorities; Doing Business 2012; 2012 EBRD transition report; and IMF staff calculations.
1/ Average of six EBRD transition indicators (large scale privatization; small scale privatization; governance and enterprise restructuring; price liberalization; trade and forex system; and competition policy).

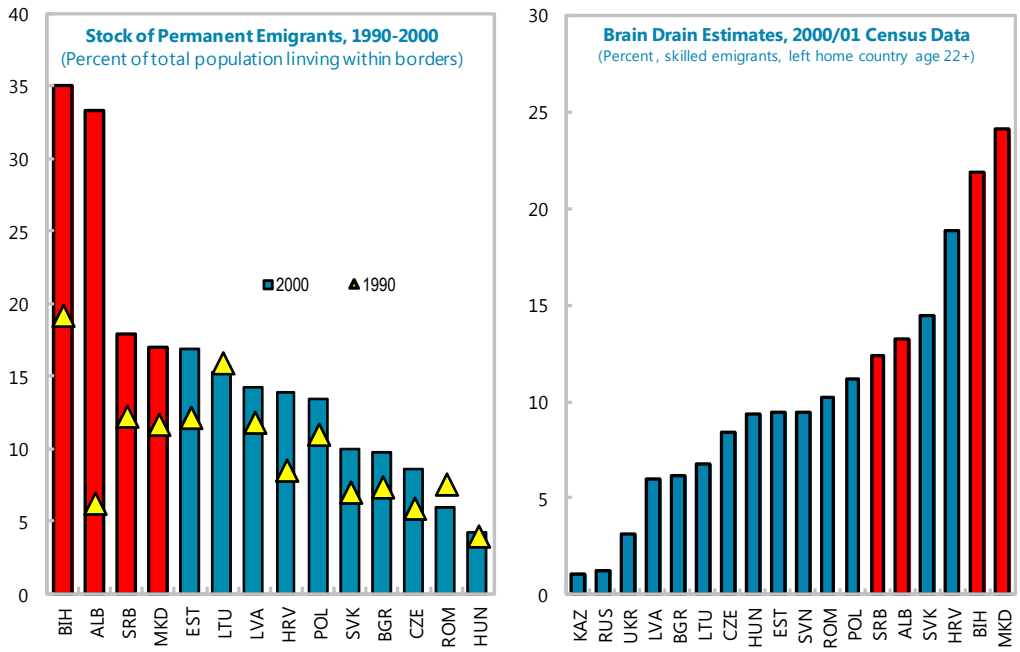
Figure 11. Gross Value Added by Sector, 2011
(Share of total)



Sources: SORS; Haver; BIH LFS; and IMF staff calculations.
1/ Data from 2010.
2/ Calculated using each new member countries GDP weight.

Although the inflow of FDI was weaker in the Balkan countries than in their peers, the outflow of labor has been much stronger. The rates of emigration from the Balkan countries increased significantly during the 1990s, in some cases to dramatic levels. The migration motives were unique in many respects for the Balkan countries, particularly related to the social and institutional instability surrounding the breakup of the former Yugoslavia. Although not all of the emigrants were in the labor force, the unique impetus behind emigration in the Balkan countries led to a major "brain drain" effect, which further diminished aggregate human capital (Beine, Docquier and Rapoport, 2001, 2006) and growth potential (Figure 12).[8]

Figure 12. Labor Migration and Brain Drain



Sources: World Bank; United Nations; and Beine, Docquier, and Rapoport (2006).
Note: Brain drain is measured as a percent of skilled emigrants out of total skilled workforce.

Remittances

Balkan countries have strikingly high remittance inflows, among the highest in the world. To put things in perspective, while Latin America for example, with its long history of migrant workers to the US, has had remittance levels as a ratio to GDP in low single digits, Kosovo and Bosnia & Herzegovina received the equivalent of 18 and 13 percent of GDP respectively

[8] Beine Docquier and Rapoport (2006) quantify the loss of skilled labor based on census and registered data from 12 OECD countries, using the immigrants' age of entry as proxy for the level of education.

in 2011. As can be seen from Figure 13, the group of Balkan countries as a whole stands out compared to the NMS in regards to their reliance on workers abroad.[9]

Remittances can affect labor market outcomes. The theoretical literature typically suggests that households' efforts to engage in the labor market depend on several factors, including non-work-related income supporting their budgets. In particular, any type of steady household income relaxes budget restrictions and affects labor-leisure decisions (Cahuc and Zylberberg, 2004). As set forth in Blanchard, Jaumotte and Loungani (2013), nonwork-related income such as unemployment insurance affects reservation wages and increases unemployment duration. One strand of the literature looking at the impact of remittances on labor market dynamics focuses on the insurance aspect of this flow of individual transfers (Amuedo-Dorantes and Pozo, 2006b). Family-provided insurance and self-insurance mechanism can play a role similar to that of unemployment insurance, and hence can impact individuals' incentives to search for and take up paid work. Because the length of the unemployment period depends on the job seeker's ability to wait for a job that meets the individuals' expectations, unemployment insurance as well as remittances could increase long-term unemployment.

The estimated empirical effects of remittances on employment in emerging market economies are not clear-cut. Micro-level data from Armenia show that remittances reduce job seeking efforts (Grigorian and Melkonyan, 2011). On the other hand, Amuedo-Dorantes and Pozo (2006b) find ambiguous effects, based on a study of remittances sent by Latin American migrants in the US to their home countries: the overall female labor supply declines because of remittance income, although only in the rural areas. Diverse effects are noticeable for men, depending on type and location of work. An increase in remittances seems to have a negative impact on formal employment for men in rural and urban areas, but a positive impact on informal work, rendering the overall effect ambiguous.

The migration motives in the Balkans differ from many other regions and hence the reasons behind the high levels of remittances are unique in many respects to the region. This is particularly due to the social and institutional instability surrounding the breakup of the former Yugoslavia.[10] To a certain extent, this breakup with all its socio-economic consequences is a "natural experiment" setting for testing causal relationships. Since it was mainly the breakup that led to high emigration rates, which then resulted in large remittance inflows, the reverse causality of unemployment leading to immigration can be at least partially excluded.

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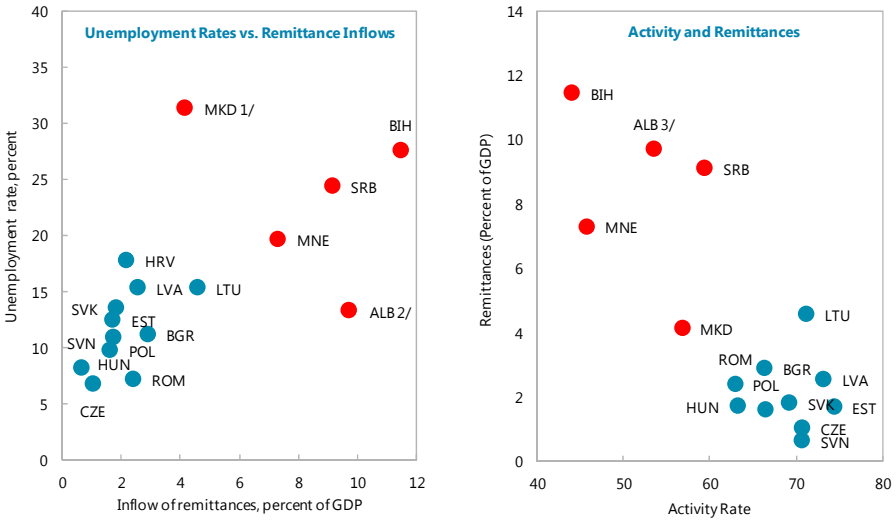
[9] For comparability reasons, remittance definition and data are from World Bank (2011b). For some countries, using private transfers from the balance of payments statistics could be more precise and indicate a much higher level of potential remittances—particularly for FYR Macedonia. Nonetheless, to ensure comparability, the narrower World Bank definition is used in this paper.

[10] The extent of forced migration in many of the Balkan countries is portrayed in Bonifazi and Mamolo (2004), based on data from the UN High Commissioner for Refugees (UNHCR). They report the number of internally displaced persons at the end of 2002 to total 367,000 in Bosnia, 262,000 in Serbia and Montenegro, and about 85,000 people under protection of the UNHCR in Kosovo.

The strikingly high level of remittance inflows to the Balkans relative to NMS undoubtedly affected the local labor market dynamics. Those private transfers should have allowed their recipients extended periods of job search, which could also have exacerbated the skill decline. In addition, remittances may have increased reservation wages and thus reduced domestic workers' willingness to accept lower-paid jobs.[11] This helps explain the high proportion of long-term unemployment in the region. Figure 13 indicates a strong relationship between remittances and unemployment or activity rates for the Balkan countries and the NMS, supporting the view that high remittances reduce the effort of the active population to engage in paid work. Finally, remittances may have indirectly supported social stability in the Balkan countries because their role as a safety net for households helped mitigate the negative social impact of high unemployment.

Figure 13. Remittances and Labor Market Performance, 2011



Source: Country authorities and labor force surveys; World Bank; and Eurostat.
1/ Official remittances data for Macedonia most likely underreport the true remittance inflows given that private transfers stood at about 19 percent of GDP in 2011, according to IMF statistics.
2/ Registered unemployment.
3/ 2010 Activity data the latest available.

IV. Summary and Policy Implications

How can employment levels and the longer-term growth potential of the Balkan countries be raised? The analysis so far has examined a wide range of hypotheses about factors that may have contributed to labor market outcomes, and it is important to understand which of these factors are most relevant, and which are the ones where the Balkan economies fall short of best practices. To provide a broader comparative perspective, this section assesses the relative relevance of each factor in contributing to the labor market outcomes in the Balkan economies, as well as in the NMS.

The cross-country "heat map" (Figure 14) summarizes the degrees to which different factors discussed in previous sections contribute to labor market problems. For the most part, the rankings were constructed by dividing the minimum-to-maximum range of each indicator into three equal parts. The significance of each *individual* indicator is reflected with one of three rankings: 1 (red or the least favorable for job creation), 2 (yellow), and 3 (green or the most favorable for job creation), with grey indicating values that are not available. In special cases, outliers were excluded. *Average* indictors are displayed as follows: values 1 to 1.5 (red), 1.5 to 2.5 (orange), and 2.5 and above (green). The heat map serves only to provide an overview of where problems are most likely to emerge; this methodology was adopted because of its simplicity and tractability (Annex II provides more details on the methodology).

Grouping indicators into the three main categories of factors—structural, labor market-related institutional, and cost—provides a summary of the impact of that factor category on each country's labor market outcome.[12] Averaging across all factors produces an overall country average (last row of the table). Similarly, averaging the rankings of a particular indicator across countries summarizes the overall prevalence of that problem in the region.

A distinct pattern emerges from the heat map. Most of the Balkan countries suffer from deep-rooted structural problems related to the delayed transition, the poor investment climate, and the resulting low FDI inflows. Only FYR Macedonia fares better, mainly because it has recently improved its business environment. By contrast, the NMS, particularly the countries that entered the European Union in 2004, appear well advanced in this area, The labor-market institutional factors in the Balkan region as a whole appear not to be out of line with the NMS; therefore, they are unlikely to be the driving force behind the relatively worse labor market outcomes in the Balkan countries. Nevertheless, some divergence across countries is evident: FYR Macedonia and Albania, which have undertaken a series of reform efforts, do not seem to be in danger of significant future problems. In other Balkan economies, rigid labor market institutions add to the structural problems and further worsen labor market outcomes. The cost factors seem broadly similar on aggregate in the Balkan countries and the NMS, and appear to pose issues for Montenegro, Serbia, and Bosnia and Herzegovina. During the boom period these problems were masked by the large capital inflows that fueled the Balkan economies, but were revealed by the crisis and have become more binding.

[12] The groupings indicators are calculated as an arithmetic average of the indicators' rankings under each factor.

Figure 14. Cross-Country Heat Map

Possible factors	MKD	ALB	MNE	SRB	BiH	KOS	AVG	POL	CZE	SVK	EST	HUN	LVA	LTU	SVN	HRV	ROM	BGR	AVG
Structural factors	*2.3*	*1.5*	*1.7*	*1.0*	*1.0*	*1.0*	*1.4*	*2.5*	*2.8*	*3.0*	*3.0*	*3.0*	*2.8*	*2.5*	*2.7*	*2.3*	*2.0*	*2.3*	*2.6*
Progress in structural reforms	2	2	1	1	1	1	*1.3*	3	3	3	3	3	3	3	2	2	2	2	*2.6*
Business environment	3	2	2	1	1	1	*1.7*	2	2	3	3	3	3	3	3	2	2	2	*2.5*
FDI per capita	1	1	...	1	1	...	*1.0*	2	3	3	3	3	2	2	...	2	1	2	*2.3*
Remittances	3	1	2	1	1	1	*1.5*	3	3	3	3	3	3	2	3	3	3	3	*2.9*
Labor market institutional factors	*2.6*	*2.6*	*2.0*	*1.8*	*1.7*	*2.5*	*2.2*	*2.8*	*2.8*	*2.4*	*2.4*	*2.4*	*2.2*	*2.2*	*2.0*	*1.8*	*2.4*	*2.6*	*2.4*
Redundancy rules	3	3	2	1	2	2	*2.2*	2	3	2	2	3	1	2	2	1	2	3	*2.1*
Redundancy cost (weeks of salary)	2	1	2	1	2	...	*1.6*	3	3	3	2	2	3	2	2	2	3	3	*2.5*
Social benefits 1/	3	3	1	2	1	3	*2.2*	3	...	2	3	2	3	2	2	1	1	3	*2.2*
Unempl. benefits (share of wage) 1/	2	3	...	2	...	...	*2.3*	3	2	2	2	2	1	2	1	...	3	1	*1.9*
Unempl. benefits (duration)	3	3	3	3	...	...	*3.0*	3	3	3	3	3	3	3	3	3	3	3	*3.0*
Labor costs	*2.0*	*2.3*	*1.8*	*1.8*	*1.5*	...	*1.8*	*2.4*	*2.4*	*2.2*	*2.0*	*2.0*	*1.6*	*2.0*	*1.8*	*2.5*	*2.0*	*1.4*	*2.0*
Euro-denom. ULC growth (Pre-2008)	2	2	1	1	...	...	*1.5*	3	3	3	2	2	1	2	3	3	1	1	*2.2*
Euro-denom. ULC growth (Post-2008	2	3	2	2	2	...	*2.2*	2	2	3	3	2	3	3	2	3	2	1	*2.4*
Exchange rate flexibility (ER regime)	1	3	1	3	1	...	*1.8*	3	3	1	1	3	1	1	1	1	3	1	*1.7*
Minimum wage	3	1	3	2	2	...	*2.2*	3	3	2	3	2	2	3	1	3	3	3	*2.5*
Labor taxes	2	...	...	1	1	...	*1.3*	1	1	2	1	1	1	1	2	...	1	1	*1.2*
Average	*2.3*	*2.1*	*1.8*	*1.5*	*1.4*	...	*1.8*	*2.6*	*2.6*	*2.5*	*2.5*	*2.5*	*2.2*	*2.2*	*2.2*	*2.2*	*2.1*	*2.1*	*2.3*

Rankings of average values:
1 ≤1.5
2 >1.5 and ≤2.5
3 >2.5

Source: Fund staff estimates.

1/ In this heat map, higher scores were assigned for lower unemployment benefits (UB) and social assistance (SA) levels. In principle, very low (or zero) levels of UB and SA are not optimal, either. In the heat map sample, UB varied from 18 percent of average wage in the Albania to 70 percent in Slovenia, and SA varied from about 1 percent of GDP in Latvia to close to 4 percent of GDP in Bosnia and Herzegovina.

Structural factors are likely to have the predominant effect on the poor labor market outcomes in the Balkan countries because they shape the underlying nature and viability of the economies. Therefore, to alleviate labor market problems, priority should be given to reforms that foster structural change, help attract FDI, and reduce the natural rate of unemployment and thus promote job creation. These reforms include, for example, strengthening macroeconomic stability and improving the numerous aspects of the business environment. Without addressing these issues, any improvement in the institutional setup of labor markets or cost factors would likely have a limited impact on job creation. Nevertheless, institutional rigidities should be addressed because they compound the impact of structural problems in the labor markets. In this regard, there is scope to ease redundancy costs and revamp redundancy rules in Albania, change the severance payment formula in Serbia; and pursue social welfare reforms with the aim of better targeting benefits in Bosnia and Herzegovina and Serbia. The need to reduce labor market rigidities and improve cost competitiveness indicates that wage bargaining should be moved closer to the company level in Bosnia and Herzegovina, Montenegro and Serbia; minimum wages should be reduced in Albania and Serbia; and the tax wedge should be reduced in Serbia. In addition, implementing policies that enhance the skills of the labor force would boost labor productivity.

Most important, the broad-based nature of labor market problems will require equally broad-based policy solutions. Focusing on any single area would be unlikely to result in significant success. This conclusion is broadly consistent with those of Chapter 5 regarding the importance of comprehensive structural reforms. Finally, the policy reform effort must be sustained in order to deliver a tangible improvement in labor market outcomes.

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Appendix I. Countries Referenced in the Paper and their Abbreviations

Abbreviation	Country Grouping and Country
Balkans	**Balkan countries**
ALB	Albania
BIH	Bosnia and Herzegovina
KOS	Kosovo
MKD	Former Yugoslav Republic of Macedonia
MNE	Montenegro
SRB	Serbia
NMS	**New Member States**
BGR	Bulgaria
HRV	Croatia
CZE	Czech Republic
EST	Estonia
HUN	Hungary
LVA	Latvia
LTU	Lithuania
POL	Poland
ROM	Romania
SVK	Slovak Republic
SVN	Slovenia
	Other European economies
AUT	Austria
BLR	Belarus
BEL	Belgium
DEU	Germany
DNK	Denmark
ESP	Spain
FIN	Finland
FRA	France
GBR	United Kingdom
GRC	Greece
IRL	Ireland
ITA	Italy
LUX	Luxembourg
MDA	Moldova
NLD	Netherlands
PRT	Portugal
RUS	Russia
SWE	Sweden

TUR	Turkey
UKR	Ukraine
	Non-European countries
ARM	Armenia
AZE	Azerbaijan
GEO	Georgia
KAZ	Kazakhstan
KGZ	Kyrgyz Republic
TJK	Tajikistan
UZB	Uzbekistan

Appendix II. Underlying Data and Ranking Methodology Used in the Heat Map

Indicator	Underlying Data	Underlying Sample	Rankings[1]		
			Red ("1")	Orange ("2")	Green ("3")
Structural Indicators					
Progress in structural reforms	The European Bank for Reconstruction and Development's 2012 Transition Report: the average of six transition indicators (large- and small-scale privatization; governance and enterprise restructuring; price liberalization; trade and foreign exchange system; and competition policy).	15 countries shown on the upper-right panel in Figure 10.	<3.4	≥3.4 but <3.7	≥3.7
Business environment	Percentile ranking in "Ease of Doing Business, 2012" database of the World Bank.	Sample of 31 European economies[2]	<53.8	≥53.8 but <75.8	≥75.8
Foreign direct investment (FDI)	FDI stock per capita in thousands of U.S. dollars.	14 countries shown on the bottom-left panel in Figure 10.	<5.7	≥5.7 but <9.8	≥9.8
Remittances	Inflow of remittances as a percentage of GDP.	16 countries shown on Figure 13.	≥7.9	≥4.3 but <7.9	<4.3
Institutional Factors					
Employment protection laws	World Bank (2012): Cumulative score based on responses to eight questions related to redundancy rules.	31 countries shown on the upper panel in Figure 6.	2-4	5-6	7-8
Firing costs (weeks of salary)	World Economic Forum (2011): Redundancy costs in weeks of salary.	31 countries shown on the bottom panel in Figure 6.	≥46	≥23 but <46	<23
Social benefits	Social assistance spending in percent of GDP.	26 countries shown on the upper panel in Figure 5.	≥2.8	≥1.7 but <2.8	<1.7

Size of unemployment benefits	Unemployment benefits as percentage of gross average wage (for a single person without children).	28 countries shown on the upper panel in Figure 4.	≥56.6	≥33.3 but <56.6	<33.3
Duration of unemployment benefits	Maximum duration of unemployment benefits in months	29 countries shown on the bottom panel in Figure 4.	≥27	≥16 but <27	<16
Labor Costs					
Euro-denominated ULC growth (Pre-2008)	Average annual rate of ULC growth during 2005–08 period.	25 countries shown on the upper panel in Figure 7.	≥11.2	≥5.8 but <11.2	<5.8
Euro-denominated ULC growth (Post-2008)	Average annual rate of ULC growth during 2005–08 period.	29 countries shown on the middle panel in Figure 7.	≥3.4	≥0.4 but <3.4	<0.4
Exchange rate flexibility (exchange rate regime)	Exchange rate regimes.	Countries in the heat map	Fixed	…	Flexible
Minimum wage	Minimum wage as a percentage of average wage.	23 countries shown on the upper panel in Figure 9.	≥46.3	≥35.1 but <46.3	<40.4
Labor taxes	Tax wedge defined as the share of income tax and social security contributions by employers and employees over total labor costs.	30 countries shown on the bottom panel in Figure 9.	≥49	≥40.4 but <49	<27.2

1/ The rankings were constructed by dividing the minimum-to-maximum range of each indicator into three equal parts. The following outliers were disregarded when constructing minimum-to-maximum ranges: Hungary in the FDI category, Belgium in the unemployment benefits category, Portugal in the firing costs category and Ireland in the labor taxes category.

2/ The sample includes ALB, AUT, BGR, BiH, CZE, DEU, DNK, ESP, EST,FIN, FRA, GBR, GRC, HRV, HUN, IRL, ITA, KOS, LTU, LUX, LVA, MKD, MNE, NLD, POL, PRT, ROM, SRB, SVK, SVN, SWE.