

**The Effects of Institutions on the Transition  
of the Western Balkans**

Az intézményrendszerek hatása a Nyugat-Balkán gazdasági  
átmenetére

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**Abstract:** The Western Balkan countries have been lagging behind in their transition process, which started more than 30 years ago. While some justification can be made in the fact that the countries went through wars in the 1990s, the real problem is that they have not been able to create efficient institutions. Inefficient institutions hamper economic growth, as the countries do not attract foreign direct investment (FDI) to the extent they could and should. A lack of FDI affects three aspects of the transition process in the region: developing a functioning market economy, competitiveness, and convergence. Improvements in these areas can only be done by building efficient institutions.

**Keywords:** institutions, transition, Western Balkans, Foreign Direct Investment, convergence.

**Összefoglalás:** A Nyugat-Balkán lemaradt a több mint harminc éve indult gazdasági átalakulás folyamatában. Noha ezen országokat az 1990-es években fegyveres konfliktusok terhelték, az igazi probléma forrása a hatékony intézményrendszerek létrehozásának hiányában keresendő. A nem megfelelő intézményi működés hátráltatja a gazdasági növekedést, mivel az országok nem vonzzák a közvetlen külföldi befektetéseket (FDI) olyan mértékben, mint ahogy azt a lehetőségekhez mérten megtehetnék. Az FDI hiánya a térség átalakulási folyamatának három aspektusát érinti: a működő piaccgazdaság fejlesztését, a versenyképességet és a konvergenciát. Kizárólag hatékony intézmények kialakításával érhető el valódi fejlődés.

**Kulcsszavak:** *intézmények, gazdasági átmenet, Nyugat-Balkán, közvetlen külföldi befektetések (FDI), konvergencia.*

## INTRODUCTION

The Western Balkan states, namely Albania, Bosnia and Herzegovina (BiH), Kosovo, Montenegro, North Macedonia, and Serbia, are small, open, and diverse economies that have been going through the transition process for almost three decades. The states are candidates and potential candidates for European Union (EU) membership. Given their proximity to the EU, which is the main trade partner of the region, the Western Balkan states should be attracting more foreign direct investment (FDI) and going through the transition process faster. Central and Eastern European (CEE) countries, which share a similar socialist economic history with the Western Balkans, went through the same process in less than 15 years. Then why have the Western Balkans lagged behind in their transition process? Most of the Western Balkan economies went through armed conflicts

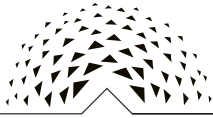
in the 1990s, which had negative effects on their economies. These wars are still an excuse for the delayed transition, even though they ended more than twenty years ago. The only reason for the insufficient progress of these countries lies in [inefficient institutions](#), which “arise from the desire of political elites to protect their political power and they may oppose changes in economic institutions that would stimulate economic growth”. The transition process is a process of [institutional change](#), a process of building new institutions required by a capitalist economy. Institutions are defined as “[the humanly devised constraints](#) that structure political, economic, and social interaction”. [Efficient institutions](#) involve the establishment of private property, a strong and uncorrupt legal system, efficient markets, and macroeconomic stability, with a small and supporting state.

All the countries of the region, except Albania, were part of the Socialist Federal Republic of Yugoslavia, a country known for its special, soft type of socialism, and the socialist past of the Western Balkan economies still has an impact on how institutions function. In general, institutions are analysed through proxies: the Corruption Perception Index, the Government Integrity Index, the Property Rights Index, and the Judicial Effectiveness Index. Inefficient institutions affect three aspects of the Western Balkan economy: a functioning market economy, competitiveness, and convergence.

## A FUNCTIONING MARKET ECONOMY AND PROPERTY RIGHTS PROTECTION

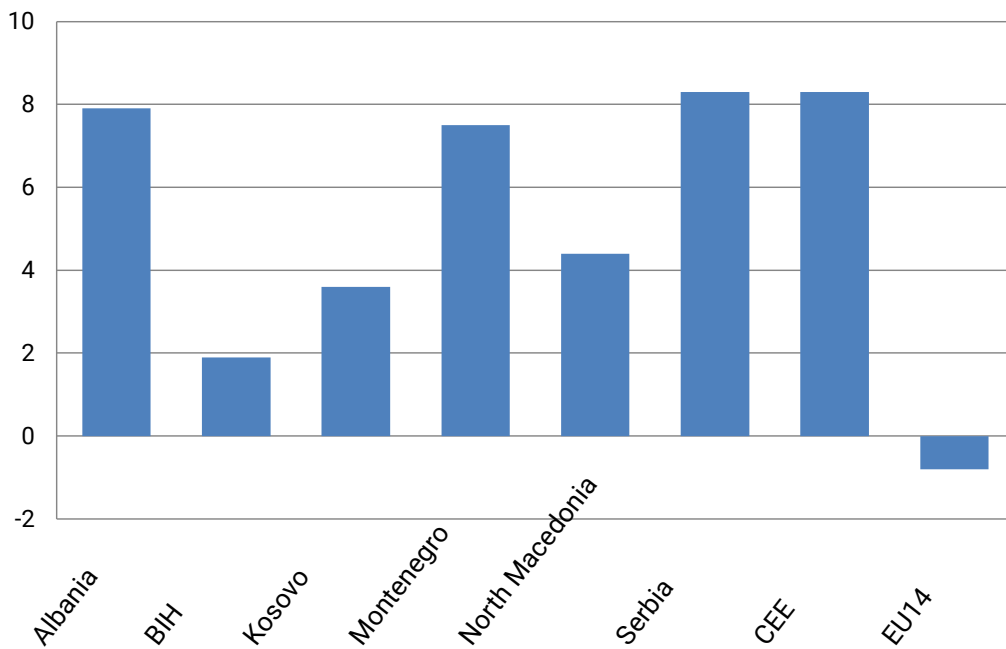
Developing a functioning market economy is the key goal that each country has to achieve if it wants to join the EU, as it is one of the Copenhagen criteria. The existence of a [functioning market economy](#) requires that all prices, as well as trade, should be liberalized and that an enforceable legal system, including property rights, is in place.

The Western Balkan economies have made the most substantial progress in developing functioning market economies among the above-mentioned requirements. However, they are still at the [early stage](#) or [moderately](#) prepared for establishing it. The countries have liberalized trade and prices, and they have started the privatization process, but it has not been completed yet. One of the reasons is that the countries do not attract foreign direct investment (FDI) to the extent they could and should. This is a vicious circle: the countries do not attract FDI due to the lack of a well-functioning market economy, and there is a lack of a well-functioning market economy because there is no FDI. The Western Balkan economies must rely on FDI in the transformation process as foreign investors bring new technology and know-how, and they create jobs and open the economy to new markets. However, inefficient institutions, together with political instability, discourage investors from coming to the region. [The countries are also listed as the least](#) politically stable countries in Europe (the only countries that are less stable are Belarus, Russia, Ukraine, and Turkey).



The countries offer many [advantages to foreign investors](#): they are diverse economies that enjoy a high degree of macroeconomic stability, they have favourable taxes, low labour cost, and an educated population, and they are located close to the EU. However, the ratio of FDI to GDP in the region is lower than in the CEE countries (Figure 1).

Figure 1:  
FDI rates in 2019 (% of GDP)



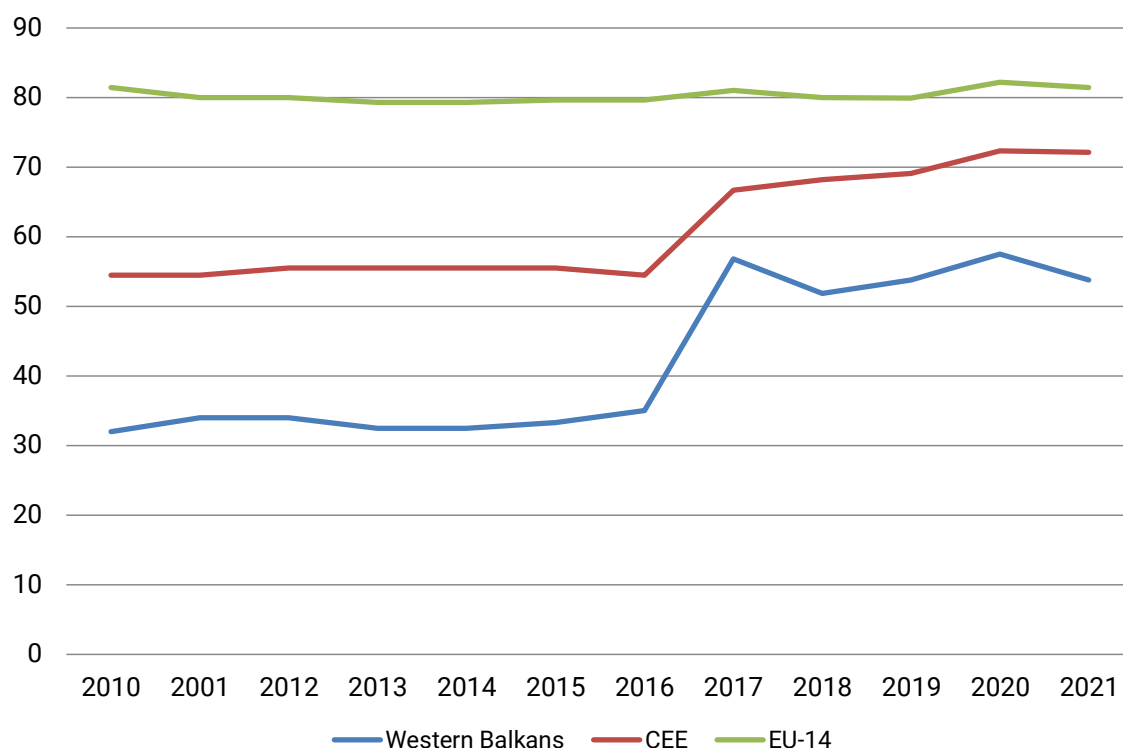
Source: World Bank data, 2021.

[A transparent legal system](#) where parties can enjoy impartiality in the settlement of disputes and fairness in judicial processes is an important factor in assessing the business climate of a country. Of particular importance for businesses is the protection of property rights, especially intellectual property rights. [Efficient institutions](#) should provide protections of property rights because it is a factor that contributes to a better economic performance.

On average, the Western Balkan economies have had lower Property Rights Index values compared to the EU member states (Figure 2), and large differences can be observed between this region and the CEE countries. Even in the period before joining the EU, CEE countries had a better protection of property rights than the Western Balkans have today. Between 2010 and 2021, the Property Right Index values increased in CEE (from 54.5 in 2010 to 72.1 in 2021) and remained stable in the EU-14 (81.4 in both 2010 and 2021), therefore the gap between these two groups decreased. However, although the Western Balkans also experienced

an increase in the Index values during this period (from 32 to 53.8), the region is not catching up with either group at the rate it should. In 2021, Bosnia and Herzegovina had the lowest Index value in Europe (44.1), and the value of the Index in other Western Balkan countries (ranging between 46.1 in Albania and 62.6 in North Macedonia) was lower than the lowest Index in the EU (Bulgaria: 66.2).

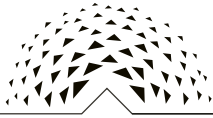
Figure 2:  
Property Rights Index, 2010-2021



Source: Author's calculations based on Heritage Foundation data, 2021.

The Western Balkan countries were part of the Ottoman Empire, where property rights were poorly defined and unstable. When most countries became independent (Bosnia and Herzegovina and Croatia became part of the Austro-Hungarian Empire), they set up new legal institutions. [The adopted legislation](#) was mostly in line with other European countries, but its implementation was weak. In 1945, the Communist Party came to power in Yugoslavia and made all decisions. It put the judiciary under its control and mostly negated [private property rights](#) though forced collectivization and property redistribution.

Both the CEE and the Western Balkan countries were socialist, so why is it that one group has been more successful in protecting property rights than the other? The answer may be that the CEE countries were more willing to change. While socialism was softer in Yugoslavia, the CEE countries experienced more



authoritarian socialism imported from the Union of Soviet Socialist Republics (USSR). Therefore, when they started their transition process, they wanted it to be successful. Most CEE countries passed a law on lustration; in the Western Balkans only Albania did so.

In the Western Balkans, the same people, political parties, and ideologies have been in power for decades, and they do not have an incentive to change. Therefore, bad institutions keep arising because the political elites benefit from bad institutions to protect their political power. [Acemoglu, Johnson, and Robinson \(2005\)](#) give a theoretical explanation for what has been happening in the Western Balkans. Those with political power cannot commit to not using their political power ex post, which creates a set of economic institutions that do not provide secure property rights to groups without political power. If a change in economic institutions leads to increased economic growth, it could also enrich groups that could potentially contest political power in the future, which could lead to greater threats against the power of the elites. Fearing these potential threats to their political power, the elites may oppose changes in economic institutions that would stimulate economic growth.

The Western Balkan economies are moderately prepared or have a good level of preparation in the area of intellectual property law. [Bosnia and Herzegovina](#) is the only country that did not make any progress in this field between 2020 and 2021, and it is the country with the lowest FDI inflow in the region (1.93% of GDP). Other countries have made limited or some progress, and only Serbia's FDI inflow is at the level of the CEE average (8.3%).

The Western Balkan countries have many economic advantages in attracting FDI, but a lack of institutional efficiency affects the competitiveness of the region.

## COMPETITIVENESS AND CORRUPTION

The World Economic Forum defines [competitiveness](#) as “the set of institutions, policies and factors that determine the level of productivity of a country”. In the CEE countries, [improvement in competitiveness](#) to a great extent was due to FDI and high globalization. On the other hand, the Western Balkan countries are not competitive economies. According to [the 2019 Global Competitiveness Index](#), the countries are ranked between the 72<sup>nd</sup> (Serbia) and the 92<sup>nd</sup> position (Bosnia and Herzegovina, making it the least competitive country in Europe). In the EU, the positions range between 4<sup>th</sup> (the Netherlands) and 63<sup>rd</sup> (Croatia). The Western Balkan countries are among the least globalized countries in Europe. They are ranked between the 37<sup>th</sup> (Serbia) and the 77<sup>th</sup> position (Albania, which is the least globalized country in Europe). Serbia is one position above Malta, the EU's least globalized economy, while the most globalized economy is the Netherlands (1<sup>st</sup> position in the world). In 2019,

the [labour productivity](#) of the region was only 42% of the EU average, while the growth rate of labour productivity was negative in Albania, BiH, and North Macedonia.

The lack of competitiveness in the Western Balkan region can again be explained through inefficient institutions. Even though the countries have low taxes, provide incentives for investors, and have relatively simple processes of starting a company (except BiH), a high level of corruption discourages FDI and hinders economic growth.

As for corruption, [it is defined](#) as “the abuse of entrusted power for private gain and it erodes trust, weakens democracy, hampers economic development and further exacerbates inequality, poverty, social division and environmental crisis”. According to [the Economist Intelligence Unit](#) (EIU), the countries are categorized as either [flawed democracies](#)<sup>1</sup> (Serbia and Albania) or [hybrid regimes](#)<sup>2</sup> (BiH, Montenegro, and North Macedonia), with BiH positioned last in the region.

The Western Balkan countries are among the countries with the highest level of corruption in Europe. In 2021, Montenegro had the highest Government Integrity Index value in the region (51), and it was the only country that had an index value higher than an EU member state (Bulgaria – 46.8). According to [the Heritage Foundation data](#), BiH is the most corrupt country, with the average value of the Index at 34.7 in the period 2010-2021. The highest average value was recorded in North Macedonia (42.6). In 2021, the Government Integrity Index in the Western Balkans was 44.6; much lower than the average EU value of 70.7 (Finland is the least corrupt country in the EU with a Government Integrity Index value of 97.2 out of 100). In the period 2010-2021, Kosovo and Montenegro made the most progress, while North Macedonia made the least progress.

The average Corruption Perception Index (CPI) of the Transparency International score in the Western Balkans decreased from 38.7 in 2012 to 37.5 in 2020. The countries that improved their scores and ranks during this period are Albania, Kosovo, and Montenegro. Bosnia and Herzegovina and North Macedonia decreased their CPI scores by 7 and 8, respectively, and their ranks dropped from 72<sup>nd</sup> and 69<sup>th</sup> position to 111<sup>th</sup> position. Serbia’s score decreased by 1, and its ranking decreased from 80<sup>th</sup> to 94<sup>th</sup> position between 2012 and 2020. Overall,

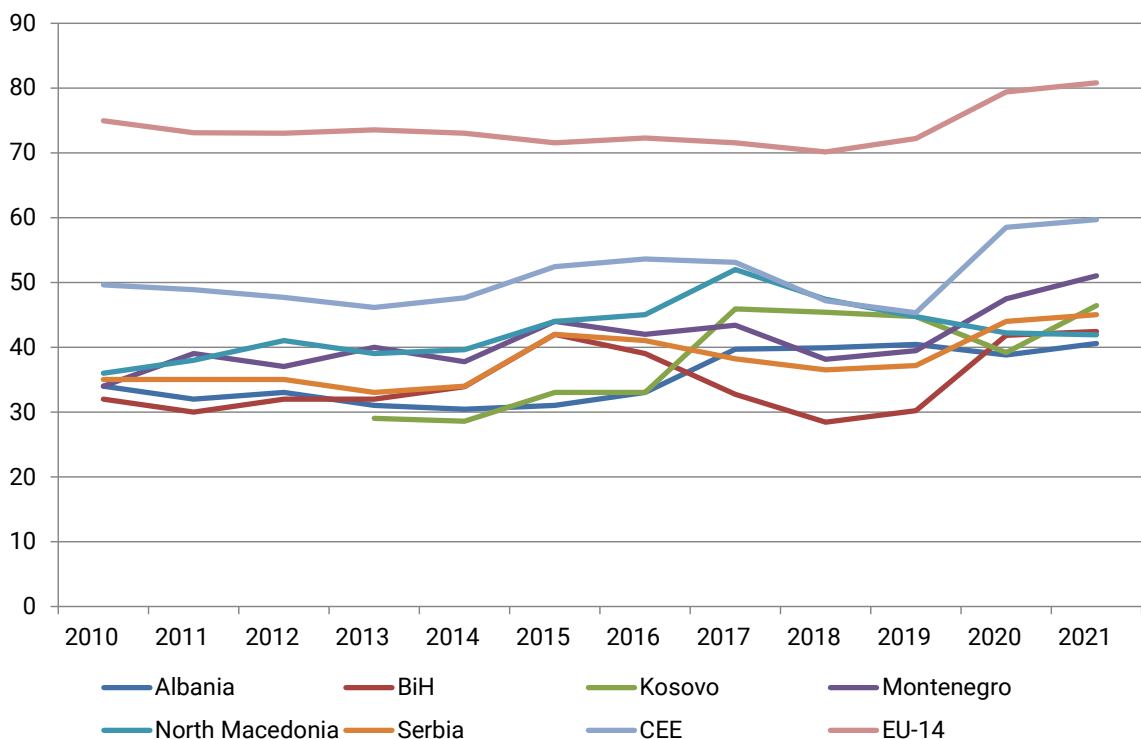
- 1 These countries also have free and fair elections, and even if there are problems (such as infringements on media freedom), basic civil liberties are respected. However, there are significant weaknesses in other aspects of democracy, including problems in governance, an underdeveloped political culture, and low levels of political participation.
- 2 Elections have substantial irregularities that often prevent them from being both free and fair. Government pressure on opposition parties and candidates may be common. Serious weaknesses are more prevalent than in flawed democracies—in political culture, the functioning of the government, and political participation. Corruption tends to be widespread, and the rule of law is weak. Civil society is weak. Typically, there is harassment of and pressure on journalists, and the judiciary is not independent.





corruption in the Western Balkans is widespread, and it is not unusual for it to be happening at the state level. According to the [European Commission reports](#), the countries have some level of preparation for the fight against corruption, with limited progress being made, and only North Macedonia is moderately prepared. In theory, the countries are dedicated to their fight against corruption. They have anti-corruption agencies and laws on corruption prevention. However, reality is different, as [the countries show](#) clear elements of state capture, including links to organised crime and corruption at all levels of government and administration, as well as a strong entanglement of public and private interests.

Figure 3:  
Government Integrity Index, 2010-2021



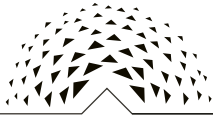
Source: Heritage Foundation data, 2021.

Serbia was on Transparency International's 2020 ["Countries to Watch"](#) list. During the pandemic, the country suspended Parliament, implemented extensive curfews, and incited violence against protesters. In addition, the police arrested and detained an investigative journalist, while the government restricted access to information on the procurement of medical equipment. [When asked about ventilator procurement](#) during the Covid-19 pandemic, President of Serbia Aleksandar Vučić said not to ask him where they came from and that it was a state secret. The reaction was the same when he was asked about vaccine procurement.

Not all cases of corruption are related to the pandemic, however. In 2019, Aleksandar Obradović was arrested because he had leaked files to journalists that uncovered abuse of weapon exports involving state-owned company Krušik, where he worked. According to the files, a private company owned by Branko Stefanović, father of former Serbian Minister of Internal Affairs and Minister of Defence Nebojša Stefanović (who was also accused of plagiarizing his PhD dissertation), purchased millions of dollars' worth of weapons from Krušik at [surprisingly low prices and resold them to foreign buyers](#). The Serbian office for the fight against organized crime [started an investigation into alleged](#) corrupt deals at the Serbian arms factory in June 2021, only after Stefanović had resigned from the Serbian Progressive Party (Srpska napredna stranka, SNS) in May 2021. The Krušik case was mentioned in the [2021 European Commission report](#) because it had not been investigated in accordance with the law.

On the other hand, Bosnia and Herzegovina is among the twenty-two countries that have decreased their [CPI score since 2016](#). The country has had one of the most talked-about corruption cases in public procurement during the Covid-19 pandemic in the region. In April 2020, Prime Minister of the Federation of BiH, Fadil Novalić announced that 100 ventilators had been purchased. Similarly to many countries, the Law on public procurement was suspended during the pandemic. In late April, it was revealed that the ventilators had been purchased by the company "Srebrena malina", which was registered for the purposes of fruit production. The question that instantly arose was how a company that was not registered for the procurement of medical equipment had been able to buy ventilators, as they could not even provide maintenance for the equipment. The Agency for Medications and Medical Equipment confirmed that the company had a licence to import the ventilators.

According to the [contract](#), "Srebrena malina" was obliged to purchase 100 ventilators from Chinese producers, paying EUR 5.37 million for them. The ventilators were overpriced, considering that ventilators produced by Western companies, which were of a much better quality, [cost EUR 35,000-40,000](#). In late April 2020, the district attorney's office started investigating the procurement. The subject of the investigation was why a company that produces fruit bought the ventilators and why the ventilators were overpriced. Apparently, it was the only offer that promised to deliver the ventilators by the end of April. [Experts confirmed](#) that the chosen ventilators could not be used in the intensive care unit (ICU), for which purpose they had been bought. It was estimated that the real [price per ventilator was between approximately EUR 1,500 and 15,000](#), while the lowest price of a ventilator that could be used in ICU was approx. [EUR 20,000](#). Another inconsistency was that, according to the receipts, the price for 100 ventilators was approximately EUR 4,750,000. The question is what happened to the more than [EUR 620,000 difference](#).

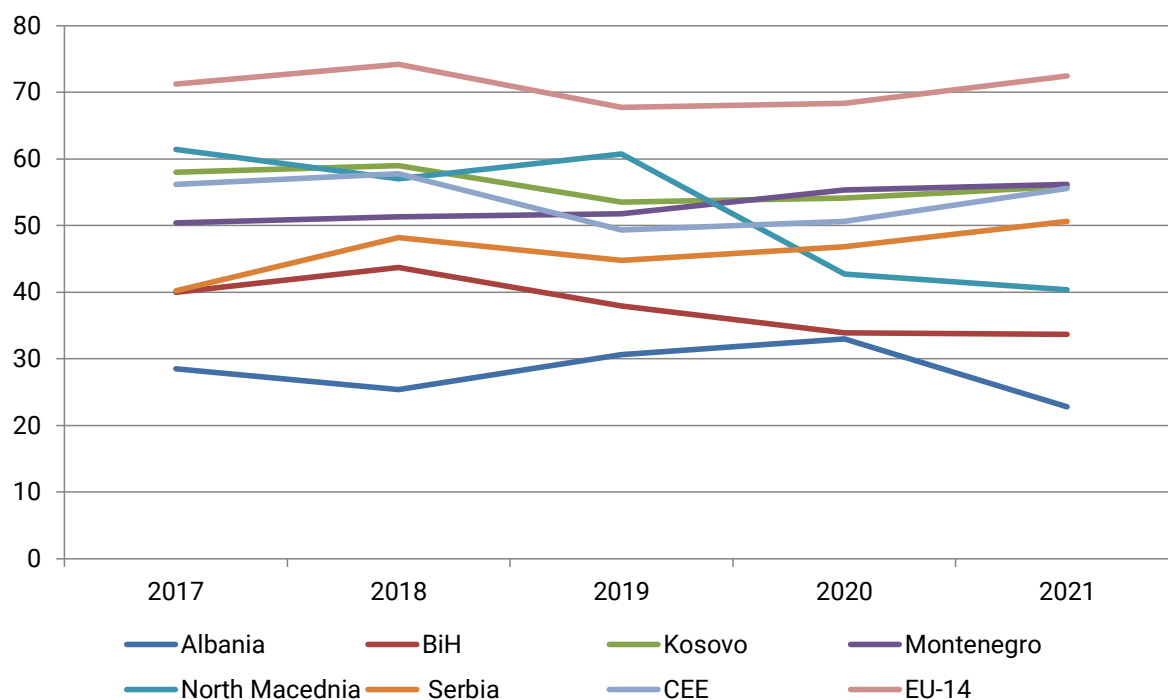


Considering that there were inconsistencies in the contract, that the ventilators could not be used and could even harm people, the DA's office indicted the prime minister, the owner of the company, and the head of the crisis headquarters, which played a crucial role in the ventilator procurement, in June 2020. [The charges include money laundering and abuse of position](#). It is an ongoing process.

[Corruption is prevalent](#) in many areas of public and business life and remains an issue of serious concern in Albania. However, [the country](#) has been in the middle of large-scale institutional changes for the past few years when it comes to fighting corruption and reforming the judiciary. The vetting process or the temporary re-evaluation of all judges and prosecutors has advanced steadily, and [62 % of the vetting files processed so far have resulted in dismissal](#) and termination, largely due to resignations by the assessees. However, the vetting process currently has a significant negative side, too: many judges and prosecutors have been dismissed for alleged corruption and illegally acquiring property and money, and the state cannot train new judges fast enough. Therefore, there are years of delays in legal proceedings, especially in cases related to corruption. On 13 December, 2021, it was announced that former [chief prosecutor of Albania Adriatik Llalla had been arrested in Italy](#). He had been convicted in May 2021 and sentenced by an Albanian court that handles top officials' corruption cases while he was on the run from the authorities because he had failed to justify how he had financed land and real estate purchases and his family's expenses in the United States and Germany. Llalla was the first high-ranking person to be sentenced by the newly formed judicial institutions that were established to address the issue. However, Albania is still the country with the lowest judicial effectiveness in the region, and the situation even deteriorated in 2021, with the Judicial Effectiveness Index increasing from 28.5 in 2017 to 33 in 2020, then dropping to only 22.8 in 2021. BiH's, Kosovo's, and North Macedonia's indices also decreased, although they increased in Serbia and Montenegro. Between 2017 and 2021, the average Index values in the region (45.6) were lower than the CEE (53.9) and EU-14 average (70.8) (Figure 4).

Other Western Balkan countries are not immune to politicians being involved in corruption cases, either, but they are not as high profile as the above-mentioned cases. Montenegrin President Milo Đukanović has been in power since 1989, as Prime Minister or President. [In 2005](#), Đukanović's sister, Ana Kolarević, was linked to corruption during the privatization of the state-owned company Telekom in 2005, which [he denied](#) several years later. [In November 2021](#), the Balkan Investigative Reporting Network (BIRN) published wiretapped conversations in which Albanian oil businessman Rezart Taçi said he had involved Đukanović in money transfers to Montenegro's Prva Bank. Both the bank, which was privatized in 2006 and bought by Đukanović's family, and Đukanović himself denied the accusations. Even though a European Parliament resolution urged Montenegro to investigate and prosecute the "high-level cases including alleged money laundering by [Prva Banka](#)" in 2016, the bank has never been investigated by the Montenegrin authorities.

Figure 4:  
Judicial Effectiveness Index, 2017-2021



[Kosovo is still at an early stage in developing](#) a well-functioning judicial system and fighting against corruption, but it has made progress. Kosovo is the only Western Balkan country that does not have a visa-free regime with the EU. In order to achieve visa liberalization, the EU created a list of 95 criteria, most of which focused on corruption and organized crime. Kosovo has fulfilled all 95 of them, [more than the criteria met by Albania, North Macedonia, or Serbia](#). The country has been prosecuting state officials, but the number of cases has been dropping. The problem is that there are only [a few guilty verdicts](#), and the charges are usually dropped. In 2020, former Prime Minister Avdullah Hoti from the Democratic League of Kosovo (LDK) abolished the [anti-corruption police task force](#). Later it became known that the task force was investigating three tenders signed by LDK's Minister of Interior, Agim Veliu.

Corruption in North Macedonia is omnipresent. The country has made progress in the fight against corruption, as it has established the State Commission for Prevention of Corruption, and the [government launched a nationwide campaign](#) to raise awareness and support the fight against corruption in September 2021. Like in other countries of the Western Balkans, the state administration and state-owned companies are [politically appointed](#), regardless of their experience. Even [lower-level appointments](#) in education and healthcare systems have to pass the filters of the ruling parties.



## CONVERGENCE

Creating efficient institutions will have a positive impact on the Western Balkan economies, [as it was the case with CEEs](#). Eventually, it will lead to a faster convergence process. [Convergence](#) is a tendency of poor countries to grow faster than rich countries, and it is a [condition for and indication of efficient and successful integration](#). Throughout its history, the EU has helped its member states develop faster; since its foundation more than 60 years ago, the EU has become the greatest [“convergence machine”](#) of the modern world, propelling poorer and newer member states to become high-income economies, and delivering to its citizens some of the highest living standards and lowest levels of income inequality in the world. Fulfilling the Copenhagen criteria is a way for potential member states to converge with the EU.

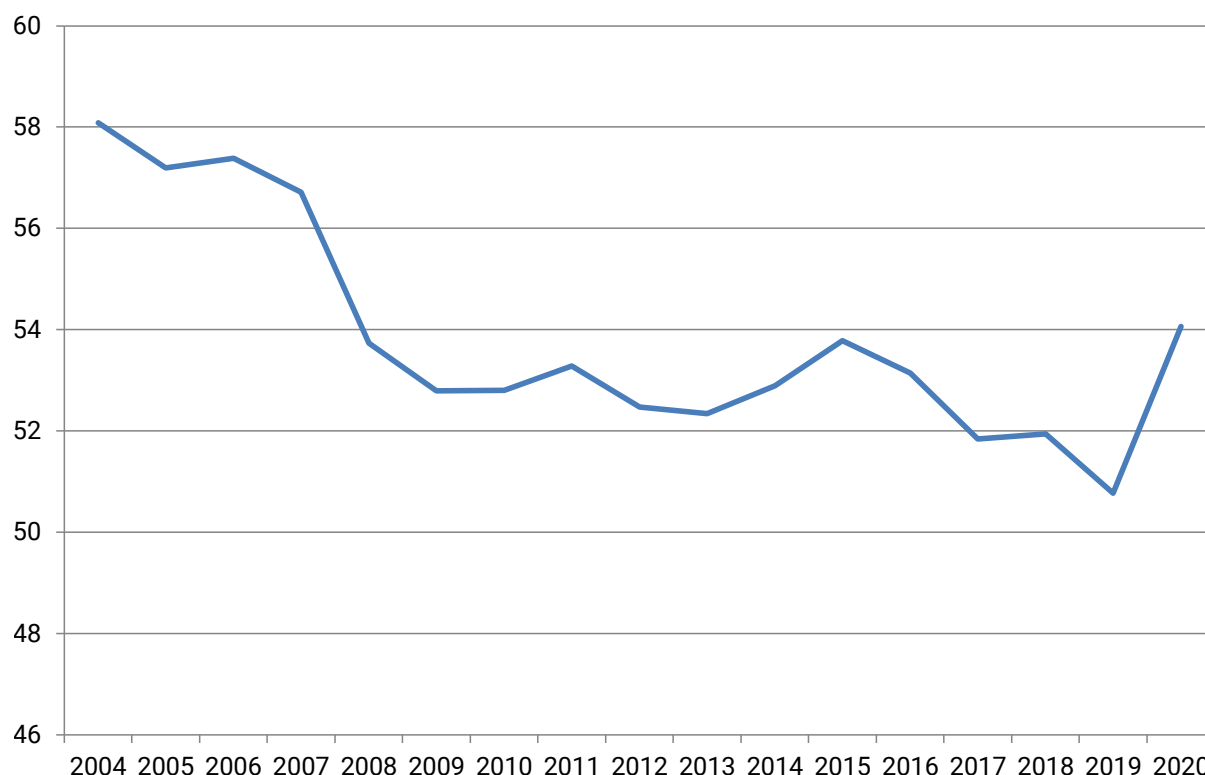
Sigma convergence is used to analyse whether the Western Balkan region is catching up with the EU, using the coefficient of variation of per capita GDP in the period 2004-2020 (Figure 4). The region has been mostly converging with the EU, with a few periods of slight divergence (2006, 2011, 2014, 2015, and 2018). The Covid-19 crisis has had a negative impact on all economies, as GDPs fell and dispersion increased to the highest level since 2008. GDP per capita of the Western Balkans increased from 28.2% of the EU average in 2004 to 35.5% in 2019, and it increased by 0.4 percentage points in 2020. In 2019, the Western Balkan countries grew at an average rate of 3.7%, while the average EU rate was 2.2%. However, the former socialist countries of the EU grew at the average rate of 3.5%, and the countries' per capita GDP was only 48.6% of their average.<sup>3</sup>

According to the economic growth theory, the Western Balkan countries should converge towards the EU faster. However, the structure of their economies is one of the reasons why they are lagging behind. Transition economies lie between developed and developing countries; they were industrialized during socialism, but today their technology is obsolete, and they have to modernize it in order to be competitive. In this process, FDI plays a crucial role.

The socialist system was characterized by import substitution industrialization (ISI). The administration of [ISI](#) created opportunities for rent seeking and other corrupt practices. Those who engaged in these activities had a vested interest in the continuation of the system. Even though a consequence of the transition process should be less involvement on the part of the state in the economy, a state presence is still pervasive in key industries. [A major restructuring and privatization agenda](#) remains in BiH, Kosovo, and Serbia, while important assets also remain to be restructured and/or sold in Albania, North Macedonia, and Montenegro. State involvement should be limited to creating a stable business environment that attracts investment, which was the case in East Asian countries, one of the fastest-growing groups of economies.

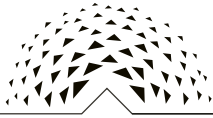
3 2020 is excluded from the analysis because the Covid-19 pandemic was an exogenous shock.

Figure 5:  
Western Balkans' convergence process with the EU average, 2004-2020



Source: Author's calculations based on World Bank data, 2021.

The Western Balkan economies, even though they are diversified, mostly rely on the production of services (around 60% of GDP). If the countries do not have technology, they cannot produce products, there will be no supply and no demand, and the GDP cannot grow. Economic history teaches us that developed countries reached the highest growth rates during the industrialization period. However, it seems that the region is skipping this step, as it has attracted a large part of FDI primarily in non-tradable services. [FDI has not contributed much](#) to promoting exports or to industrial diversification and upgrading, and FDI currently does not have an impact on economic growth. Relying on services during a transition process is not sustainable, which has been shown during the Covid-19 pandemic. Therefore, in order to grow faster and converge, the countries have to improve technology, which is something that [Robert Solow](#) showed in the 1950s. They have to build their industries, become competitive and open to more trade and investment, which will have a [positive impact](#) on the convergence process. The only way this can be achieved is by attracting FDI, which is not possible without making institutions efficient.



## CONCLUSION

The Western Balkan countries, with all the potential that they have, are lagging behind in the transition process. The process has lasted for thirty years, twice as much as for CEE countries. The Western Balkan countries are not functioning, competitive market economies, and their convergence process is slower than it should be. The reason for this is that they do not have efficient institutions.

One reason for a lack of institutional efficiency in the region is its socialist past, where all decisions were made by the central government. The Western Balkan countries have among the lowest scores of Property Rights in Europe, and they are among the most corrupt countries. In combination with political instability in the region, it is no wonder that the countries cannot attract foreign investors.

Developing efficient institutions that will decrease corruption and improve the rule of law and democracy will help the countries attract FDI. The role of FDI has proven to be crucial in the transition process of the CEE countries. With FDI, the privatization process would be more successful; the countries could become competitive, develop market economies, and converge faster with the EU. The improvements in the area would lead to eventual EU membership, something that the countries do not have an alternative for.

The CEE countries have the same economic and political background, but their transition process was much faster, and they are full members of the EU now. The Western Balkan countries are in a much better position because they have to follow the path of former socialist economies, which were pioneers in the transition process. All it takes is a little bit of political willingness to start the change.