# ALIGNMENT WITH EU REGULATIONS FOR ENHANCED DEVELOPMENT EFFECTIVENESS OF STATE AID

BELGRADE, 2019

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CENTAR ZA VISOKE EKONOMSKE STUDIJE



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# LIST OF FREQUENTLY USED ABBREVIATIONS

| | |
|---|---|
| **CESEE** | Central, Eastern and Southeastern Europe |
| **CEVES** | Center for Advanced Economic Studies |
| **CSAC** | Commission for State Aid Control |
| **EBRD** | European Bank for Reconstruction and Development |
| **EEC** | European Economic Community |
| **EU** | European Union |
| **FDI** | Foreign Direct Investments |
| **NMS** | New Member States |
| **R&D** | Research and Development |
| **SA** | State Aid |
| **SBRA** | Serbian Business Registers Agency |
| **SEZ** | Special Economic Zone |
| **SORS** | Statistical Office of Republic of Serbia |

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# FOREWORD

The goal of the present policy paper is to support Serbia's EU accession process by pointedly showing how harmonization with the acquis in the area of state aid is in Serbia's own interest. All too often the need to reform systems and harmonize regulation are presented as a sacrifice, or, at best, a chore — an item on a list to be crossed out — on the way to EU membership. In particular, the public and even some policy-makers have become aware of the EU's state aid policies in the context of support for Serbia's Smederevo steel mill, or lack thereof, and a few other big systems under restructuring. There is a misconception that this would somehow reduce the development policy space available to the authorities, and hence little interest and support for alignment in this regard. The paper aims both to counter the populist understanding that unending support for failed systems is somehow desirable from the societal point of view, and to show that the better alternatives are supported by EU policies. It aims also to show how necessary are these better alternatives for Serbia's own welfare.

This topic cannot easily be kept thus confined. It opens questions regarding the effect of current state aid policies, as well as regarding the shortcomings of the development policy system currently in place. If anything, we have erred on the side of delving too far into those questions rather than not answering enough within the limited resources available. We do hope, however, that the paper will whet the appetite, both spark more interest and attract more support for, research and evidence gathering about Serbia's development policies.

# EXECUTIVE SUMMARY

**The key message of this policy paper is that a better alignment with the EU acquis and regulations would ensure greater development effectiveness of Serbia's state aid and not, as it is often misconceived, reduce its development policy space.** It has been developed in the context of a broader effort to support Serbia's EU accession by showing that EU membership conditionality is, in general, in Serbia's own interest regardless of accession. A more comprehensive assessment of the effects of FDI in Serbia, and attendant policy recommendations, remain outside its scope.

**A single, integrated and fair market lies at the very foundation of the European idea.** Therefore, practices that fragment it– such as monopolistic or state interventions — in general, are not allowed.

**However, the EU does allow state aid in circumstances when it is justified from the point of view of a country like Serbia.** Specific circumstances (market failures) under which state aid is allowed are those in which unfettered markets are, in principle, not likely to give optimal results, and when interventions are required. These are: to support industrial

restructuring, accelerate the development of less developed regions (by attracting investments), to support development of the SME sector, to advance goals related to environmental protection, and to support EU cultural and social policies.

**Total amount of state aid in EU-28 has been steadily rising from 0.48% of GDP in 2000 to 0.65% of GDP in 2016.** Most of it was initially directed into sectoral aid and industrial restructuring (30% of total aid in EU core countries, almost 50% in its southern periphery, and 60% in the New Member States, on average from 2000 to 2006) and regional development (cca. 15%-20% across all country groups). The New Member States relied particularly heavily on state aid in the period before and immediately after their accession in 2004 when their coal, shipbuilding and steel industries were restructured. Thereafter, primacy is taken by aid for regional development and for environmental protection. Indeed, the latter began a steady increase already after 2006, and accelerated significantly after simplifications in aid regulation in 2014. It is currently the dominant form of aid in EU core countries (65% in 2016) and NMS (36%), and much less significant in EU southern periphery (6%).

**To yield development results, state aid needs to be used as one of the instruments aligned behind a clear development vision. This is illustrated by the cases of the Metropolitan Area of Bilbao in Spain, Ireland, and, to a lesser extent, by more successful NMS.** Bilbao, heavily affected by the failure of Europe's shipbuilding industry, was transformed into a tourist and logistics urban service center through combined use of state aid, investments in infrastructure and cultural institutions. Ireland became Celtic tiger when its development policy based on FDI attraction through heavy fiscal support was enriched by, among others, education and institutional improvements.

**For transition economies, initially, the vision was less important as the focus was largely on restructuring, or attracting investments into rebuilding of viable parts of their industrial legacy.** However, they have increasingly been building more complex development policies, especially as access to regional development funding was opened with membership in the EU. We present the case of the Polish special economic zones, that proved successful due in good part to intermunicipal character of their governance and consequent elements of regional specialization.

**Serbia's experience resembles in many ways that of the NMS, with an approximately seven-to-ten-year lag.** FDI inflows began 7-10 years later and picked up gradually. Although FDI inflows have been accelerating lately, their cumulative per capita level has overall kept pace with them, essentially remaining permanently lower than in any of the NMS. Today, employment in foreign companies stands at approximately 9% of total employment (250,000), two to three times lower than in most NMS. For well over a decade, state aid was primarily directed towards maintaining the large traditional industrial systems in function, awaiting restructuring and privatization that never came. Ultimately, much of labor in them was dissipated.

**This protracted transformation resulted in a substantially less favorable economic structure than in any of the NMS.** Well over a half of the working age population is either not in employment, or is in vulnerable, low-productivity employment. While the quality of the labor force is cited by employers as one of Serbia's greatest assets, the lack of skilled labor is also cited as the greatest constraint in employer's efforts to expand. Skilled labor tends to be scattered in relatively small pockets, drawing a leopard's skin of capacity throughout the country.

**To analyze the structure of FDI attracted by state aid and trends, we look at their employment and classify them in four types.** The key characteristic is the average wage level, but also typical size and value chain lengths, technology and complexity. Type 1 companies, with average wages typically about 30% above the minimum, tend to produce automobile wire sets and simple textile products (29,400 employees in 2016). Type 2 companies typically produce automotive parts, home appliances or other components, employ the largest number (35,800) of people and display a tendency to add complexity and expand their range of activities. Type 3 companies have labor force of which a half is in higher qualified jobs, also with the ability to add complexity. The smallest number of people (14,400) are employed in Type 4 companies producing R&D, high-technology, creative or management invisibles. They tend to be smaller and keep short value chains, but have the potential to generate great knowledge spillovers.

**The observed trends in the structure of attracted FDI give cause for concern.** Type 1 companies have accounted for the largest increase in employment after 2009 (19,500). While they may generate very significant

short-term impacts on depressed local economies, in the longer run there is a risk of cementing a mono-industrial-type situation without offering opportunities for development. On the other hand, the number of employees generated in Type 3 and Type 4 companies after 2009 (respectively less than a third and a quarter of the total) is very limited, when a positive loop of mutually reinforcing entries and spillovers should have been attained.

**In order to put in motion a positive spiral of human capital building, spillovers and development, state aid policy needs to become much more strategic, engaging domestic businesses as active counterparts.** It is evident that the level of integration of FDI with the local economy is very low, and that simple extension of state aid is too heavily relied on. More needs to be done to match the foreign companies with the needs and potential of the environments to which they are being attracted and avoid crowding out local SMEs. Also, local environments need to be strategically built and adapted with complex policies involving education, infrastructure and SME support to enhance the developmental potential of both local and foreign entrants. Finally, to reach out-of-decent-employment people and develop capacities distributed in a "leopard skin"-like fashion, a greater share of employment growth must come from domestic SMEs and smaller-size FDI projects.

**Above all, state aid cannot be a replacement for a substantially more supportive business environment.** Developing shared visions requires a comprehensive and continuous public-private dialogue which, in turn, requires an environment of trust and much shared information. This, in turn, requires a stronger and continuously improving rule of law - a sense that all players are treated equally, according to the same principles. Instead, the quality of Serbia's business environment - consisting primarily of the rule of law, governance of public enterprises and red tape - today stands below that attained in most CEE countries and Croatia at the time of their respective accession to the EU.

**Unless a conducive environment is developed, state aid for investment promotion may be harmful.** As the authorities endeavor pointedly to shield foreign investors from business environment shortcomings, an unequal environment is being created that places domestic investors at a disadvantage. This

is not only counterproductive with respect to the mobilization of domestic resources, but it ultimately also lowers the effectiveness of the measures in support of FDI.

**Serbia's state aid system, although enhanced in recent years and broadly aligned with the European Union (EU) framework, requires some key changes to become duly aligned.** Regarding aspects of longer-term relevance, it needs: (a) more transparency; (b) institutions, state aid grantors and those in charge of monitoring compliance with EU principles, principally the Commission for State Aid Control (CSAC), need to be much more capacitated to play their respective roles; and (c) the CSAC needs to become independent. The capacitation of a truly independent CSAC to truly monitor state aid alignment with EU regulations could be an excellent first step in the broader capacitation of government agencies to advance development policies and accelerate Serbia's development.

**In particular, the enhanced capacity to plan and assess development impacts for the sake of state aid policy alignment would also build the capacity for the application of more substantive, i.e. less mechanical, criteria in the determination of amounts of granted state aid (assuming it is coupled with greater societal trust).** This would be an important step for the better targeting of FDI projects to be attracted. It would also have a demonstration effect on the entire public administration, currently trapped in formulaic policy criteria.

# I. STATE AID POLICY - A PILLAR OF THE EU'S SINGLE MARKET

## A. STATE AID AND COMPETITION POLICY

**The understanding that a single, integrated, market — unobstructed by any single country's desire to promote its own industry — would, in fact, greatly benefit the whole of Europe, as well as every single one of its national economies, lies at the very foundation of the European idea.** The single market offers a large market and integral territory to all European firms to operate on and derive economies of scale. However, it also pressures them to compete — keep pace with the progress and competitiveness of all their peers. These two effects work together to spawn larger, more dynamic, more innovative and more efficient firms. Ultimately, this creates a more competitive and resilient European economy, capable of facing on the global stage the competition of firms similarly

spawned by the large and integrated US, and now Chinese, markets. Hence, common competition policies restrict monopolies, as well as any national policies that distort competitive market conditions and/or fragment the single market, and have been a key element of the acquis since the Treaty establishing the European Economic Community in 1957.

**Under general circumstances, the prohibition of state aid is one of the EU's key policies ensuring the integrity of the single market.** State aid is defined as any transfer of public funding that provides advantage to specific recipients beyond that which would have been granted by the market, and which affects national or international trade. Clearly, if specific actors, usually "national champions" are selectively provided with support, this will distort competition on the single market. It will benefit those selected actors in the short run, but in the long run they will not be as competitive as their competitors on the global market, and they will drain fiscal resources that could have been used to promote the competitiveness of all. Moreover, if every EU member state incentivizes its champions, the effects of these policies will cancel out, resulting solely in waste and a less efficient economy.

**The EU recognizes, however, the existence of market failures — circumstances in which unfettered markets do not deliver optimal or even desirable long-term results.** When state aid is the solution to such circumstances, state aid is allowed. These can be roughly grouped in five kinds of circumstances. One is the need to address large (potential) pockets of long-term unemployment due to the failure of large companies or the loss of competitiveness of entire industries (hereinafter referred to as 'industrial restructuring'). The second situation is the need to accelerate the development of less developed regions. In both these cases a number of different market failures conspire to keep the population long-term unemployed or in low-productivity employment and an array of policies is needed to overcome such problems. These packages of policies usually include, and sometimes rely mainly on, state aid, be it to companies in need of restructuring, or to attract investors to the troubled regions. A third kind of circumstances concerns SMEs. Their operation, in competition with large companies for funding and entry and access to markets, as well as under regulations often developed to regulate large companies, is also beset by market failures and requires special considerations and support.

A fourth kind of circumstance arises when an economic activity has benefits (externalities) to society beyond those recognized and awarded by the market. This is most often the case with activities that impact the environment, or knowledge — both of which are largely shared by society. In those cases, state aid is allowed (and encouraged!) to support environmentally friendly (as opposed to destructive) technologies, or to encourage companies' research and development. Finally, state aid is allowed to promote specific social, cultural and other political goals, providing advantage to specific groups in line with European policy goals.

**State aid can take many forms and its identification, as well as justification, can be complex.** Its most obvious form is grants (subsidies) and they also tend to comprise the largest share (about two thirds) of all state aid granted in the EU. However, it can also take the form of tax exemptions, tax deferrals, soft loans or guarantees, and public fund participation in the equity of a firm. Public fund participation in private business undertaking need not represent a form of state aid if it does not provide the business with an advantage.

**The EU today prescribes a set of requirements that, if met, would ensure not only that the EU's interests are protected, but that the use of state aid have optimal effects from the standpoint of the country's development policy goals.** In addition to requiring that state aid be used in response to market failure, it is also expected that it be used only if it will change the behavior of the organization that receives it. Third, there should be a clear case that state aid is the best way to address the market failure at issue. And the final condition is that the benefits of its use ought to outweigh any negative effects on competition.

**In practice, however, the regulations ensure that these conditions are tested only in cases where large industries with a Europe-wide market effect are at issue.** However, where it is almost a priori clear that the aid is unlikely to affect Europe-wide markets, as is the case in small countries with small industries like Serbia, the appropriateness of state aid as a tool itself, or even the question of whether it changes the behavior of the organization that receives it, are seldom tested. In the case of industrial restructuring, usually it will suffice that a company receive the assistance once in no less than ten years. In the case of a less

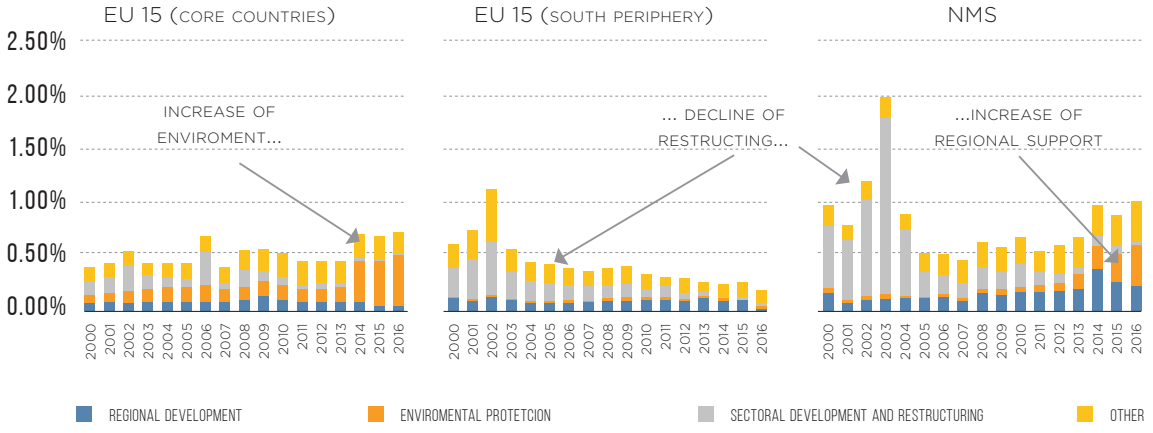
developed region the country need only show that State aid (SA) was given for investment in a less developed region. It also needs to be able to show, if contested, that indeed the investor would not have gone to the said region without this incentive.

**As the regulation of state aid became increasingly complex, a complex system of monitoring compliance, in large part decentralized, developed as well.** The common framework regulating competition policy was embedded already in the Treaty of Rome in 1957, but it took several decades to adopt a fully-fledged legally binding package of rules. After adopting soft measures (notices, guidelines, communications and frameworks) during the 1970s, a ''hard'' acquis was adopted in 1998, with certain groups of exemptions from the total ban of state aid declared. The Commission began exerting increasingly more influence on Member States' national aid and economic policies, including the obligation of Member States to notify the Commission on its state-aid-related disbursements. Of particular importance in the further development of the system were reforms in the 2010s, when the so-called General Block Exemption Regulation (GBER) was introduced with block exemptions concerning the environment and sustainable development. Also, de minimis aid, or aid of small amounts (currently, below 200,000 Euros) was exempted from compulsory notification by Member States to the Commission.

# B. EVOLUTION OF PERMISSIBLE STATE AID

**Total amount of State Aid in the EU reached in average EUR 66bn over the years 2000-2016, and until 2006 was mostly allocated in support of industrial restructuring, sectoral and regional development.** Total amount of state aid in EU-28 has been steadily rising from 0.48% of GDP (EUR 46bn) in 2000 to 0.65% of GDP (almost EUR 100bn) in 2016, Graph 1. Most of it until 2006 was directed to industrial restructuring, and sectoral and regional development, a trend especially strong in Central, Eastern and Southeastern Europe (CESEE). After that, and in line with EU enlargement and environment related GBER modernization, environmental aid has been steadily increasing and it is now the most dominant form of aid, which is especially driven by EU-15 core countries (excluding Portugal, Italy, Spain and Greece). The CESEE trends are more thoroughly discussed in a separate section of this document.

*Graph 1. State aid per type of objective in % of GDP*




Source: State Aid Scoreboard

**The use of state aid is most tempting, and it has been most often used in the past, as support to ailing enterprises.** As state aid regulations were tightened in the 1990s, the gradual decrease and elimination of sectoral aid (e.g., coal and mining or shipbuilding) resulted in widespread and healthy restructuring of these industries. State aid was then used to alleviate the enormous social effect on workers active in these industries, but it became conditional on actual restructuring measures and of limited time duration (once in ten years per company). For example, the coal industry in Poland collapsed during the 1990s, cutting cca. 250,000 jobs (International Institute for Sustainable Development, 2018).

**State aid is also often part of complex policy packages directed at ensuring the accelerated development of less developed regions.** Certain regions may be locked in less productive activities and emigration, even when they make a part of mature European economies with conducive business environments. Market forces alone may not accelerate the development and help the convergence of less developed regions. They may even exacerbate further regional disparities — drawing populations and resources away from the less developed ones and into the more developed ones. Aid in these cases aims to decrease unemployment, but also to help increase local productivity through creation of supply linkages and technological networks with local firms. State aid mechanisms in this context include various investment incentive schemes or providing favorable investment climate and adequate labor pool. Regional state aid can take many forms, ranging from investment aid, through SME support, to research infrastructures.

**State aid to small and medium enterprises (SMEs) is granted for a variety of reasons and goals, including as one of the key policies to generate employment in troubled regions.** SMEs are often beset by market failure such as asymmetric or imperfect information, resulting in high transaction costs. Given their potential for employment and output growth, their operation requires special considerations and support. However, SME-support-related aid's share in total aid dropped by more than half to 5%, of which 5-6% is attained in EU-15 and only cca. 1% in the CESEE.

**More recently, however, state aid to advance goals related to environmental protection has become the dominant form of state aid**

**in Europe.** At the level of EU-28, 60% of total state aid spending in 2016 was allocated to support in environmental and energy saving measures, against only 12% in 2000. This mirrors the idea that setting up environmentally clean activities or abandoning technologies with a negative footprint may generate a positive externality for the economy, but can be too costly for market players alone. Indeed, there has been a surge in approval of numerous renewable energy initiatives in many Member States, especially those in EU-15 core. These initiatives, such as wind farms, tidal energy plants or solar power installations, may be costly to set up, and need state aid to be organized, but provide sustainable alternatives to fossil fuel consumption.

**The transition in the countries of Central, Eastern and Southeastern Europe (CESEE) triggered massive economic restructuring and deep institutional changes, unparalleled in economic history.** At first, it heavily affected most state-owned companies, causing unemployment to soar and provoking transition countries to rely massively on restructuring aid. The comparative data in Graph 1 are available only for 2000 and after, when these expenditures became lower than in the 1990s.

**Restructuring and sectoral aid were main forms of state aid in the CESEE countries in the initial phase of transition. Their amount peaked right before EU enlargement and plummeted in the following years.** Rescue and restructuring, as well as sectoral aid were dominant forms of aid from the early 1990s, and its size peaked in the years just before the 2004 enlargement in many of the CESEE countries. For instance, Poland's rescue, restructuring and sectoral aid topped at least 1.3% of GDP (cca. 85% of total aid) in 1997, soared to cca. 2.5% in 2003, before stabilizing at level of 0.1-0.2% of GDP (cca. 20% of total aid in average) in the following years; while similar albeit less striking trends are seen across CESEE.

**The CESEE ensured to be able to quit restructuring programs, and after enlargement focused on investment attraction.** Restructuring efforts were temporally limited, so the focus of the CESEE gradually turned towards stimulation of economic activity instead of supporting (the remaining) ailing companies. The investment attraction schemes have been largely disbursing via regional development aid. For instance, the CESEE disbursed 0.14% of GDP in 2003 at measures of regional development, while it almost doubled by 2016.

# II. STATE AID IN THE CONTEXT OF INDUSTRIAL RESTRUCTURING AND REGIONAL DEVELOPMENT

In this section we focus on the experience with state aid in support of industrial restructuring and enhancement of regional development through investment promotion. State aid is an "easy" tool to use, but industrial restructuring and regional development are complex situations that require complex policy interventions. Alone, state aid may not work, and it may even be counterproductive. By testing for the presence of a market failure, the EU's restrictions do reduce the scope for wasteful and counterproductive action, but they are not designed to protect a country from wasting its resources. Ultimately, the factors that determine success depend on the context, and each case is a different one. This is why, after some general considerations, we showcase two well-known successful examples — restructuring the wider metropolitan area of Bilbao, and the accelerated development of Ireland, the so-called Celtic Tiger — as well as the case of the Polish Industrial Zones.

# A. HOW LIKELY IS STATE AID TO WORK?

It is clear how the support to a failing industry may be easily wasted. An unsustainable, uncompetitive, industry needs to be truly restructured to become sustainable. A fundamental change needs to happen in the way business is organized, and most likely some capital and labor become superfluous. Take the example of shipbuilding, a highly labor-intensive industry. Once the far Eastern countries conquered the necessary technology and inputs, while engaging much cheaper labor, European shipbuilders became increasingly unable to compete. Most of Europe's shipyards had to close down or focus on niche products – such as the Italian luxury cruiser production, or high-tech components – generating large surpluses of employment. Ensuring a successful restructuring required much more complex interventions than simply granting state aid to companies in hardship: re-training the labor force, adjusting infrastructure, adapting regulation to different needs, attracting new investment. Had it just been paid to companies in distress, state aid would have served just to postpone unemployment, but also to keep capital and employment from moving to more productive uses.

The potential pitfalls with investment promotion may seem less obvious. While the positive short-term effects are evident, it is the longer-term effects that become complex, and can even be counterproductive. In fact, the economic profession is divided over the justification of policy interventions to attract specific investments (Haucap, Schwalbe 2011). Moreover, there is some evidence that FDI does not necessarily promote development, regardless of whether it was attracted through state aid or flowed out of its own accord (Li, Liu 2005; Hertzer, 2012).

FDI is expected to generate positive longer-term developmental effects — the so-called spillovers — on other players in the market (Gordonchenko et.al 2014). Knowledge, both of technologies and skills will spread to other players in the economy, mainly when employees trained by the foreign company are hired by other domestic companies.

Spillovers, however, may be negative. Empirical economic studies show that negative effects often happen in the case of FDI in primary industries, such as mining mineral resources

(Tabak et al. 2016; Leanaerts, Merlevede, 2015). Such investments often cause the so-called Dutch disease effect — raising domestic wages overall, and drawing resources into the extractive industry, therefore preventing other domestic industries from developing.

Moreover, state aid may cause the wrong FDI — if by distorting incentives it attracts an industry in which the recipient country does not have a competitive advantage. In that case, the country will face the need to continue paying state aid or suffer consequences of the company's failure. The risk of attracting the wrong investor increases with the size of the incentive compared to the fixed costs of setting up the operation. If the incentive covers the costs of the move and start of operation, the investor has little to lose from trying. In fact, where there is very little upfront investment to run an operation, these are called footloose industries (James, 2013). They easily move from country to country

When spillovers are taken into account then state aid may be doubly counterproductive — not only by ending in unemployment if unsustainable, but also by initially driving up wages and preventing alternative industries from developing in the meantime. In particular, resources that were used to attract the FDI may have been used to support the development of local SMEs instead, typically, in different industries. Hence, employment may have been generated that is not sustainable, while preventing more sustainable employment from developing.

It is important to bear in mind that whether the FDI will generate significant development effects or not, depends on both the characteristics of the industry being attracted and the characteristics of the economy in the recipient country. The investment industry should provide a certain amount of "stretch" relative to the capacities existing in the country, so that implementation will require that the investor build skills through training and learning by-doing. At the same time, the economic structure of the recipient country/region plays an equally important role (Batten, Vo 2009). Clearly, the kinds of investments that can be attracted will depend on the sort of profiles that the education system prepares — for example, R&D activities cannot be attracted without there being a strong technical higher education in the relevant areas. Also, much engineering, for example, or technical skills, can only be learnt on the job and this is also the case with worker discipline and effective organization.

# B. STATE AID IN INVESTMENT PROMOTION: SIGNAL V. SHADOW PRICE OF WEAK INSTITUTIONS

Economists rightly ask: if all the above conditions for a successful, developmental investment are in place — there are adequate complementarities among the characteristics of the investing firm and the recipient economy, with good development prospects — then that means the investor stands to earn long-term profits; why would there be a need to incentivize their investment? Is this not a compensation, then, for something that is missing? Indeed, in many ways it is (Arsić, 2010).

When the business environment is not supportive, payment of state-aid incentives may be viewed as partial compensation for that. Every investment involves numerous one-time, initial, costs as well as risks. Those associate with the fact that an investment is flowing across national borders can be particularly high — political risk of expropriation, exchange rate risk, bringing the new establishment up to speed. There are also entry-costs related to the investor's learning about, and implementing, the recipient country's administrative requirements and mode of operation.

However, state-aid incentives are also often considered by investors to be less important as a compensation of cost, and more important as a sign of the government's commitment to providing a welcoming business environment. Foreign investors into Serbia also confirmed this view.

A particular justification may happen when a country simply has difficulties making the advantages of its environment known. State aid then may help attract an investor, "test the waters", and show that the business environment is better than understood and viewed from outside. In that case, the investment may be initially small, but serve to attract much larger follow-up in subsequent stages.

Finally, an unhealthy practice has been developing on the global stage, in which incentives are being offered by countries and regions in a competitive fashion. Such competition, notably, happens between countries/regions of otherwise similar business environment/ economic structure characteristics (Haucap,

Schwalbe 2011). It is happening, for example, between the countries of southeast Europe, with Serbia competing particularly strongly with North Macedonia, Bulgaria and Romania. And we were recently able to witness it in the competition among large cities of the United States, as they vie to attract behemoth companies such as Amazon.

## C. FACTORS OF SUCCESS: TWO EXAMPLES

**State aid yields the highest development results when accompanied by complementary instruments aligned behind a clear development vision. Strategy and vision may improve effects of restructuring-related support and investment attraction mechanisms, as is illustrated by cases from Bilbao and Ireland.** The case of Bilbao is an example where a strategic, visionary and participative approach yielded high development results via improvements in infrastructure; and help the city recover from collapse of its traditional industries. The Irish case shows that FDI attraction based on hefty fiscal support to foreign investors yielded disappointing results, in terms of employment and spillovers of knowledge to indigenous companies. However, it also shows that its development effects dramatically improved after having been enriched by, among others, education and institutional improvements.

BOX 1:
CASE OF URBAN REDEVELOPMENT OF BILBAO, SPAIN

**In the 1980s Bilbao's traditional industries collapsed, which produced extremely negative economic and demographic effects, with the half of manufacturing jobs being wiped out, and population dropping by almost 15% in only 5 years. Instead of directly or indirectly supporting ailing industries, multiple tiers of government created a participative and multifaceted strategy with a development vision, consisting of, among others, investments in infrastructure. This resulted in deep restructuring of regional economy, increase of share of (sophisticated) services in labor market, surge in tourism and investment inflows and, in recent period, mild population increase.**

**Bilbao's economy collapsed in the 1980s, inciting major demographic challenges, while the city was additionally challenged by major natural disasters.** A traditional port and industrial city of Bilbao had seen its traditional sectors, such as shipbuilding and steel, collapse during the 1980s, in line with Spain's political transition and opening to foreign markets. Between 1975 and 1995, almost a half of industrial jobs were lost – or a total of 60,000 persons. Severe loss of population ensued, with the city's population dropping to 380,000 at the peak of the crisis in 1985, down from 440,000 only five years before. Finally, the city also suffered from natural disasters, i.e. the 1983 floods, which had damaged Bilbao's historic core.

**Spanish approach to economic crisis of 1980s consisted of its retrenchment from public sector and refraining from supporting ailing companies; while its regions became more autonomous and eligible for increasing regional development aid.** Spanish approach to this and similar issues within post-Franco environment, consisted of state's widespread retrenchment from declining traditional industries such as shipbuilding, steel or textiles. According to Campa (1997), the contribution of public companies under the INI, a major public holding, fell from 6.9% of GDP in 1983 to 3.7% in 1990, while employment dropped by more than 22%. On the other hand, the country had just joined the EEC in 1986, and Spanish regions soon became eligible for massive European structural and regional aid. Also, Spain's political transition implied an especially wide autonomy for Bilbao's Basque region, including wide fiscal prerogatives and autonomy in setting local development strategies. Moreover, the 1983 flooding may have been a catalyst for change and institutionalized and systematic approach. All in, with typical forms of aid consisting of support to ailing industries being automatically ruled out, an alternative approach, aligned behind a clear vision for urban renewal, needed to be created.

**Bilbao responded to crisis by a systematic and collaborative action of various tiers of government, whose effectiveness was amplified by Spain's 1986 admission in the EEC and increasing decentralization during political transition in Spain in the 1980s.** The country had recently joined the EEC in 1986, and the region soon became eligible for massive European structural and regional aid. Also, Spain's political transition implied wide autonomy for Bilbao's Basque region,

including wide fiscal prerogatives and autonomy in setting local development strategies. Moreover, it is widely believed that the 1983 flooding may have been a catalyst for change and institutionalized and systematic approach. Strong political leadership aligned behind a clear vision for urban renewal, allowing for Bilbao's redevelopment into a modern city. (Cerna et al, 2018).

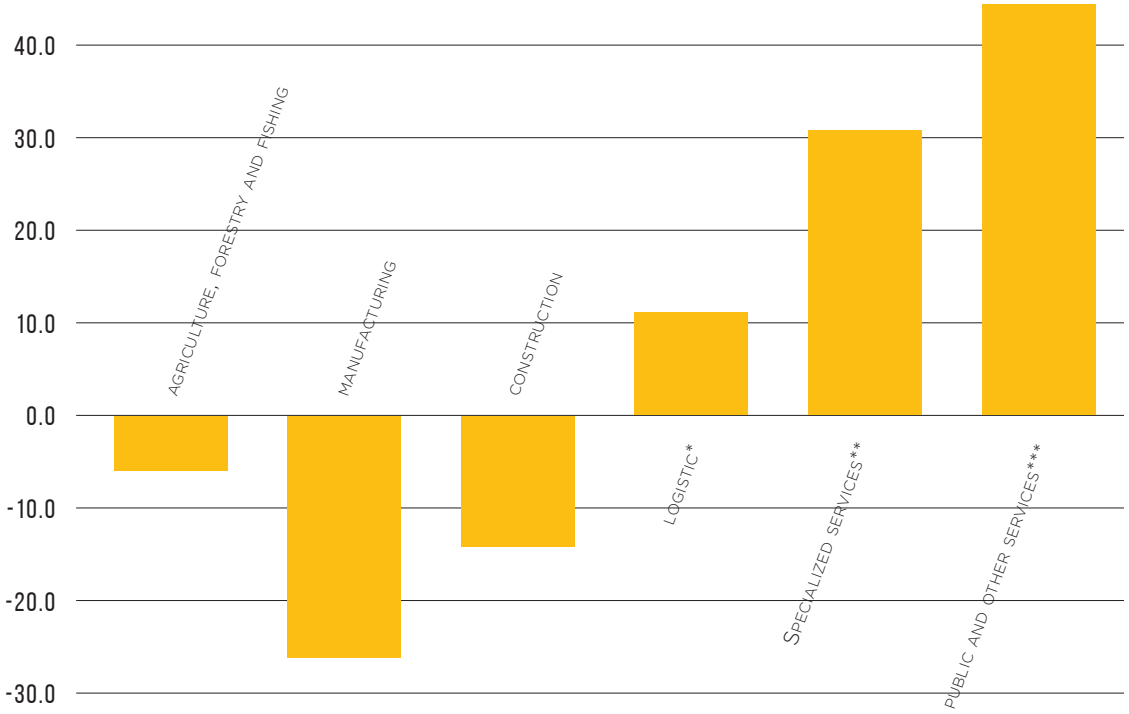
**Various tiers of government, private sector and wider public collaboratively created a set of strategies and new development institutions, which shaped the form and content of anti-crisis measures.** The City council first launched wide public discussions in mid-1980s on how to best reshape the city. Then the local, regional and national leaders engaged in development of a clear strategy, which culminated in adoption of the "Strategic plan for the Revitalization of Metropolitan Bilbao" in 1991. The objectives of the Strategic Plan included intercity urban renewal, environmental intervention, strengthening of cultural identity, and development of a knowledge-based, high-tech sector; with the Basque government being given overall responsibility. Two agencies were established, Bilbao Metropoli 30 – in charge of strategic planning, and Bilbao Ria 2000 – managing large-scale revitalization of abandoned (mainly industrial) land. Both agencies are controlled by various tiers of government and in some cases private sector and wider public.

**Policy-mix was multifaceted, and fostered deep structural changes of economy, rather than helping ailing companies keep afloat.** Firstly, the strategy promoted redevelopment of areas formerly occupied by manufacturing. Secondly, it had a strong focus on environmental goals, such as cleaning up of the city's river Nervion. Thirdly, the strategy favored retraining and re-skilling of the unemployed persons – with as many as 70,000 persons undergoing these programs (Power, 2016). Fourthly, there were new measures of support available to local SMEs, aiming innovation and development of special enterprise centers to house startups. Fifthly, there was more support for university-led technological research, international exchanges, and startups. These goals also implied massive investments in infrastructure - a subway system and a tramway network were constructed in the 1990s, international airport and a waste water treatment facility in the 2000s, and railway and port network were overhauled during this period. Construction of a high-speed railway network is in plan.

**Bilbao also opted for massive urban projects, such as construction of the Guggenheim Museum in 1997, to further diversify economy and spur related economic activity.** Bilbao followed the example of some other Spanish cities which based economic development around large projects or events – such as Barcelona's 1992 summer Olympic games or Sevilla's 1992 World Exposition. Bilbao has invested, mostly from public sources, cca. EUR 144 mln. into construction of the now iconic Guggenheim Museum in 1997, turning the city into a tourist hub attracting over a million visitors in its first year alone. Indeed, this has revived the regional tourism as well – the entire Basque region hosted some 220 thousand foreign tourist arrivals in 1990, which rose to 500 thousand by 2000 and almost 1.5 million in 2017. In the same time, Bilbao has also invested in environmental clean-up, with projects such as the new water sanitation system.

**These measures resulted in reshuffle of local economy towards a service-led one, modernization of remaining manufacturing and intense FDI inflows to the city and region.** Although the population still stands somewhat below pre-1970s levels, the unemployment rate is low for Spanish standards (i.e. at cca. 10%). The economic structure is increasingly dominated by high value-added activities, such as financial intermediation or manufacturing of higher technological level. Also, despite its small population, it is just below Madrid and Catalonia regions in terms of FDI attraction – according to Hierro et al (2016), it was attracting cca. EUR 800 mln in inward FDIs between 1997 and 2013, vs merely EUR 14 mln and EUR 66 mln and EUR 55 mln in neighboring provinces of Cantabria, Castilla y Leon and Navarra. All of the aforementioned has helped turn Bilbao turn away from the old manufacturing-dominated economy towards a logistics and service led one.

*Graph 2 Change in 000 jobs between 2000 and 2016*




Source: Eurostat

*Wholesale and retail trade; transport; accommodation and food service activities; information and communication,

**Financial and insurance activities; real estate activities; professional, scientific and technical activities; administrative and support service activities,

***Public administration and defense; compulsory social security; education; human health and social work activities; arts, entertainment and recreation, repair of household goods and other services

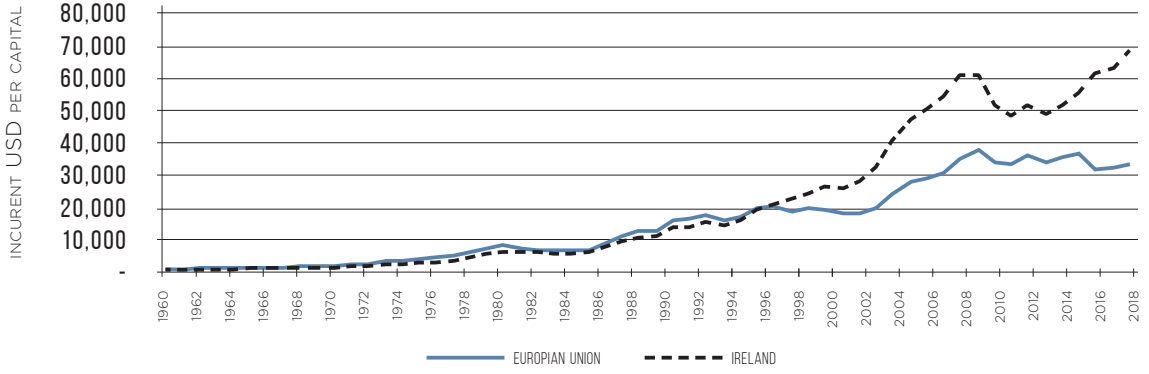
BOX 2: CASE OF FDI ATTRACTION SYSTEM IN IRELAND

**In the 1970s and 1980s, Ireland's unemployment rate stood at 10-20% - much above its West European peers, while GDP growth was insufficient for a meaningful convergence. In order to close the gap, it turned to FDI attraction. Ireland was the first country to take such an aggressive tack to attracting FDI – it succeeded in attracting almost 300 foreign companies only between 1965 and 1973 (vs. 110 between 1955 and 1964, according to Barry, 2006). However, several years later it became clear that the approach required certain adjustment, as it attracted mostly low-tech companies.**

**Then IDA recommended a more concerted and systematic approach, with emphasis on education policies.**

**Ireland's economy exploded in the 1990s, after having quasi-stagnated for decades.** Ireland has experienced a spectacular economic growth during the late 1980s and 1990s, following decades of modest convergence, very high unemployment and unfavorable demographics. Its GDP/capita converged to European Union by merely 10pp to 90% between 1960 and 1985. However, by 1996 it had surpassed it, and by 2017 it is twice higher. The unemployment rate tumbled from almost 20% in mid-1980s – double the EU average – to less than 5% in late 1990s – half the EU average.

Graph 3 GDP per capita in Ireland and European union




Source: World Bank database

**Ireland was a global pioneer in adopting an FDI-driven model of development, which at first relied on hefty and unselective fiscal incentives. However, it provided only limited development effects as it attracted mostly low-tech companies.** As one of the first countries to adopt an FDI-focused development strategy in 1950s, it had first created a fiscally and financially welcoming atmosphere[1]. The backbone of the tax strategy was the Export sales relief introduced in 1956, consisting of a zero tax on manufactured exports[2]. Also, FDI benefited from very generous investment grants from the beginning: for instance, according to OECD (1994), in the 1980s almost 80% of foreign firms have been granted, while Ireland has been one of the most intensive givers of grants to industry in the EEC, surpassed only by Greece. This tack favored inflows of low-tech manufacturing, which had extremely weak linkages with indigenous industries (McAleese, 1970). By 1973, manufacturing FDIs employed some 80,000 persons (against twice that in domestic manufacturing companies), of which almost two-thirds of jobs were in low-tech sectors, such as textile or foodstuffs (Barry, 2005). In the same year, there was less than 5% of workforce with a third-level educational qualification in manufacturing.

**Key reforms were made in 1970s which tackled education, institutions and commerce, but results kicked in only a decade later.** Responding to disappointing results, Ireland fine-tuned its strategy. Indeed, seeds for subsequent spectacular growth were largely sown in late 1960s and during 1970s. The literature points out three major policy changes which were set in this period. Firstly, the country thoroughly reformed its education system. Secondly, it has increased institutional and analytical capacities of its investment-attraction institutions. Thirdly, it had joined the Anglo-Irish free trade agreement in 1965 and the EEC in 1973. However, it took another decade for the results to

1 Ireland still retains a low-corporation tax environment. As of 2017, Ireland's effective average tax rate amounts to 11.8%, against 33% in France, 27.3% in Germany, and even much lower than many CESEE, such as 21.8% in Slovakia or 20.6% in Czech republic, according to OECD (https://www1.compareyourcountry.org/corporate-tax-statistics)

2 Looking from an evolutive perspective, the ESR could not survive in this form the entry into EEC. However, it was prolonged in various forms until early 1990s – first expanded to all corporations – and not only exporters, and then increased to 10% in the 1980s and 12.5% in 1990s. It should be noted that in the same time regular corporate tax in other developed economies amounted to as much as 50% (EY, 2014)

kick in, largely due to political and macro-economic instabilities, and the lapse of time which was needed before education reforms made any impact.

**Education system overhaul was the key element of success, as it allowed a widespread secondary and tertiary education attainment with focus on technical and science degrees. In matter of one decade, Ireland has built a world-class layer of technical and engineering specialists from scratch.** The educational system was widely believed to be the bottleneck for a more rapid industrialization. For instance, by mid-1960s a half of children left education before the age of 13 (Barry, 2008), while tertiary education, with merely a thousand students enrolled in technical colleges annually (White, 2001), could not support a stronger growth of the high-tech industry. In response, Ireland introduced free second-level education and setting up a transport network for all pupils. It had also reinforced a technical-vocational education system, whose cornerstone were the Regional Technical Colleges, providing at first largely continuing education, adult education and retraining courses (White, 2001) before turning to short-cycle third-level degrees in science and technology. This has helped create a spectrum of occupations ranging from craft to professional level, notably in engineering and science, but also in commercial, linguistic and other specialties (Clancy, 1993). As result, between 1965 and 2005, number of students in higher education rose sevenfold to almost 140,000 students (Browne, 2012). Ireland today has one of the highest proportions of population age 25-34 in OECD with third-level educational qualification, including a very high percentage of science and engineering degrees (at least 40%).

**Ireland pioneered a selective investment attraction approach through a set of professionalized and autonomous institutions, of which IDA Ireland was in forefront.** Although IDA – Ireland's investment attraction institution – was created in 1949, it was granted wider autonomy in late 1960s in order to allow greater flexibility, more rapid decision making, and a more important role within the government system. The agency oversaw identification and promotion of FDI from specific industries and provided incentives and grants to prospective investors. The increased autonomy has allowed for taking a more strategic approach and a more selective attraction of FDIs, towards encouraging

a pattern of investments in high-tech sectors. Buckley and Ruane (2006) stipulate that selectivity was achieved by proactively seeking out investors in high-tech sectors, first in electronics and chemicals/pharmaceuticals, then in software and computer hardware, and by providing higher assistance to enterprises in the promoted sectors. IDA strived to attract renowned global leaders in promoted sectors, in order to stimulate attraction of a layer of smaller companies in these sectors. For instance, Microsoft opened a support and customer support center in 1985, before expanding into a European research and development hub. Intel located its chip plant in early 1990s, and by now has expanded into research and more sophisticated manufacturing. This has turned Ireland into an electronics hub, and the spokes were quickly populated by dozens of smaller electronics and software enterprises, all of which wanted to interconnect with these key industrial leaders (Buckley and Ruane, 2006).

**Both education and institutional changes were concerted and driven with vision of attracting high-tech FDIs.** A shift towards high-tech manufacturing was allowed by aforementioned improvements in the education system, and by improved coordination between businesses' needs and the education system. In 1978, IDA initiated establishment of the Manpower Consultative Committee as a platform of its dialogue with the education system, leading to massive increase in output of graduates of computer sciences (share in total enrolments doubled between 1971 and 2003), and business (+50%). The previous trends led to an improved technology mix in foreign firms, with high-tech employment soaring from 10% in 1974 to almost 50% by 2000, and share of third-cycle educated workers in manufacturing soared from cca. 3-4% in 1971 to almost 30% in 2001 (Barry, 2005). As number of graduates in technical sciences soared, IDA had an additional ''selling'' point to international investors. On the other hand, given the apparition of clusters of high-tech and sophisticated services and manufacturing, Ireland could afford a gradual decrease in intensity of its state aid investment incentives, which in some aspects remain above EU -15 levels.

*Graph 4 Difference Ireland vs EU-15 in state aid intensity in % of GDP (+ Irish state aid higher than EU-15 average, - Irish state aid lower than the EU-15 average)*


Source: EC Scoreboard

# D. REGIONAL DEVELOPMENT AND FDI ATTRACTION: EXAMPLES FROM CESEE

**At first the CESEE did not have a strategic long-term approach in providing restructuring aid, but gradually increased sophistication in the following years.** Institutionally, the restructuring process in CESEE at first was often not connected to any long-term development policy but to saving as many enterprises as possible (Hashi, 2004). However, many of the more successful CESEE soon set up distinct institutional units facilitating the process. For instance, Poland introduced a system of decentralized conciliation between banks and debtors, where each bank negotiated a specific restructuring plan. This led to rescheduling and write-offs of debt payments against specific restructuring measures, such as reorganization, downsizing, or closing down unprofitable parts, with state providing funds for recapitalization of banks. Hungary's development bank (HIDB) was engaged in acquiring stakes in distressed industrial flagship companies, and directly oversaw their restructuring. According to Hashi (2004), Czech Republic first wrote off a significant chunk of debts in early 1990s (USD 1.7 bn), and then set up a "bad bank" which collected distressed loans from commercial banks at discount rate (USD 4 bn). This put the state in a position to oversee the restructuring process and to reduce bad debt portfolio of commercial banks. Finally, it introduced an inter-company debt clearing scheme, relieving distressed companies of another USD 0.5 bn in debt.

**At the beginning of transition, investment attraction approach was not strategically targeted, but at a later stage it became increasingly regarded as a development instrument.** Many of the successful CESEE started at first to attract investments by non-selectively providing generous fiscal and financial aid primarily to foreign companies, aiming mostly to tame unemployment. Over time, as these countries established an investor base, they would gradually move towards investment allowance subject to some specific conditions (Jirasavetakul and Rahman, 2018), implying a more analytically and institutionally sophisticated approach. Hungary, for instance, in early years of transition, had a particular goal

to attract a few large blue-chip companies, and to this end, individual bargains with FDIs were frequent (Sass, 2004), while subsidy intensity was higher relative to other CESEE. In later periods, however, it aspired to provide more benefits of FDIs for local economy. As means of achieving development and macroeconomic policy objectives, incentives targeted export-oriented, large investments in a specific set of manufacturing sectors and aimed at increasing backward linkages with local companies. At the same time, subsidies became less generous and more transparent, and some of the popular instruments, such as special economic zones, were abandoned.

**Although used in many countries, the Special Economic Zones (SEZs) of Poland are distinguished as particularly well-designed instrument of regional development largely due to their size and intermunicipal character.** These packages of policies usually include, and sometimes rely mainly on, state aid, be it to companies in need of restructuring, or to attract investors into the troubled regions. A more effective approach would aim to help increase productivity through creation of supply linkages and technological networks with local firms. This point is well illustrated by Poland's core investment attraction strategy, consisting of organization of large scale, institutionally well-developed special economic zones, which, apart from positive employment effects, also provide favorable spillover effects on indigenous companies.

BOX 3:
CASE OF SPECIAL ECONOMIC ZONES IN POLAND

**After collapse of much of its traditional industry in early 1990s, wiping 1.7 mln jobs out, many of Poland's regions faced significant economic and social challenges. In order to alleviate these challenges, Poland relied heavily on its special economic zones, a part of the country's territory where business activity may be conducted under preferential conditions, to spur FDI inflows. Although there were similar zones in other CESEE, Polish ones were relatively more efficient due to its very large size and the intermunicipal character of its governance. Apart from hosting 300,000 jobs, they also provided exceptionally favorable spillover effects on indigenous companies.**

**Poland's transition was marked by collapse of many companies from the traditional sectors, causing mass unemployment across the country.** Following the start of transition, much of the Polish traditional industry, such as shipbuilding, coal and iron mining and steel milling, has significantly shrunk, in line with increasingly stringent ecological standards and sharp international competition. As an illustration, the number of the unemployed in Poland reached 2.8 mln in 1994 (16% unemployment rate), against 1.1 mln (6.5%) in 1990.

**In order to contain unemployment and to spur economic development by attracting FDIs**, Poland relied heavily on special economic zones. In Poland, a special economic zone (SEZ) is a separate, uninhabited part of the country's territory where business activity may be conducted under preferential conditions, with aim to accelerate development, manage post-industrial property and infrastructure, create jobs and attract FDIs. Introduction of large scale Special economic zones, scattered across the country, facilitated inflows of FDIs and allowed for a shift of workers to new industries and has been a pillar of Polish investment attraction strategy since mid-1990s.

**From onset in mid-1990s, the SEZs positively contributed to economic rebound and development.** The first Polish SEZ was opened in 1995, and there are currently 14 scattered across the country, with an ever-growing area in usage. As of end 2016, SEZs employed more than 300 thousand persons, with a total of more than EUR 20

bln in investments. Unlike most similar zones, Polish SEZs are occupied by unusually high level of indigenous companies – more than 20% - ensuring spillovers of know-how and skills from international to local companies. Each SEZ has a particular focus. For example, Legnica and Katowice SEZs have a prevailing component from the automotive industry, the Mielec SEZ houses the Aviation Valley, and the Pomeranian SEZ hosts an ICT cluster. In turn, the Wałbrzych SEZ is a preferred choice for producers of household appliances whereas the furniture sector is growing in the Warmia-Mazury Special Economic Zone.

**Polish SEZs are also specific due to their inter-municipal character and very large size.** Polish SEZs occupy very large territory while the geographical borders are not permanent - when necessary, new plots are incorporated whereas those which have low appeal for investors are excluded. At the end of 2004, the total designated area of all SEZs amounted to about 6,500 ha, 16,200 ha in 2013, and 25,000 ha currently. Plots of 14 SEZs are scattered across more than 200 communes, which allows for a better planning of usage of land resources and improves coordination between various tiers of government.

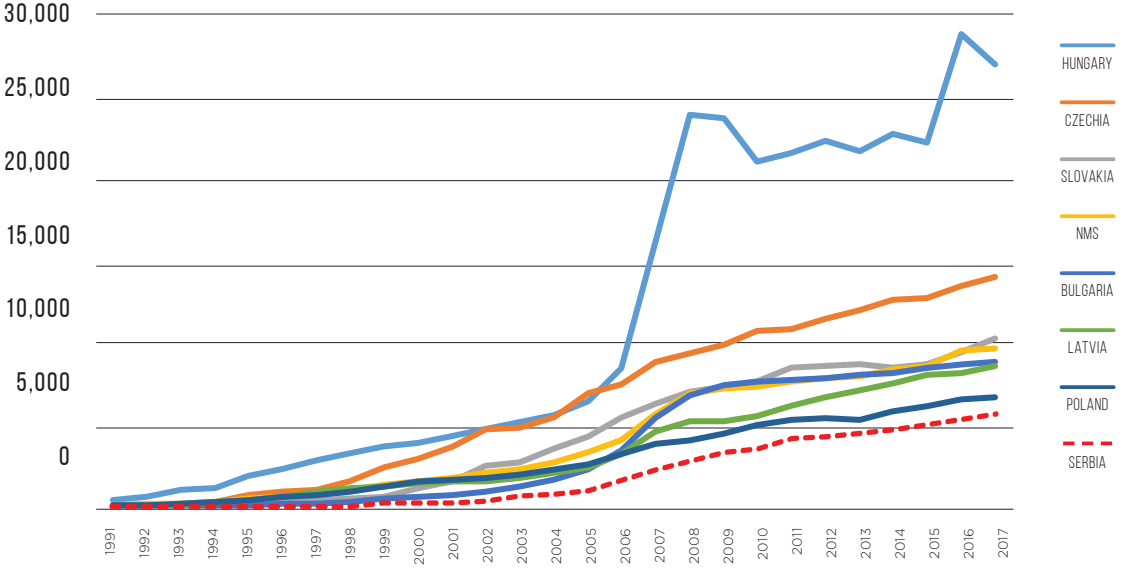
# III. FDI INTO SERBIA—STYLIZED FACTS

Serbia's experience in many ways resembles that of the CESEE states, with an approximately 7-10-year lag. We focus on FDI attraction as it is likely to remain at the heart of Serbia's development policies for the foreseeable future. We argue that the lag in the takeoff of transition and FDI inflows has created a peculiar economic structure. We further develop a typology of foreign companies that allows as to distinguish between different likely types of development impact and spillovers. We argue that the structure of FDI currently attracted into Serbia needs to be improved if a positive spiral of human capital building, spillovers and development is to be put in motion.

# A. SLOW TRANSFORMATION

**Foreign-owned companies play an important part in Serbia's economy today, and inward FDI has been increasing in recent years.** However, FDI inflows began with a 7-10-year lag (Graph 5) compared to the CESEE (about a year after the adoption of a new privatization program in 2002), and they flowed gradually, picking up a relatively smaller share of those employed in large traditional industrial systems. These systems, heavily supported by state aid, were for a long time held in a limbo, awaiting restructuring and privatization, that never came. Ultimately, the labor in them was dissipated through increasing technological obsolescence, lack of experience and old age.

*Graph 5: Cumulative FDI per capita, (net inflows) constant 2015 USD*[3]




3 Author's calculations based on UNCTAD data.

**Ultimately, FDI currently plays a smaller role in Serbia's economy than it does in other CESEE.** In 2006, the first year for which we have relatively reliable figures, employment in FDIs had reached somewhat above 180.000 people with less than a third of this figure employed in greenfield investments. As of 2016, total employment in foreign-owned companies increased to some 250,000 people with greenfield investments employing as many as 160.000. Overall, this amounts to somewhat over 9% of total employment, a significant share compared to Serbia's' relatively small corporate sector, but significantly smaller than in CESEE today (accounting for around 20% of total employment on average)[4].

As a consequence of the very protracted transition described above, **Serbia's economy today has a peculiar structure in which the quality of the labor force is cited by employers as one of Serbia's greatest assets, but the lack of new quality labor is also cited as the greatest constraint in their efforts to expand.** Yet, well over half of the working age population is either not in employment or is in very vulnerable, low-productivity, employment. To be sure, not all the skilled labor has been absorbed, and there are many with the potential to become more productive. But their geographic and industrial distribution is scattered, and their mobility is low. Small companies do emerge engaging such labor and creating a leopard's skin of capacity throughout the country.

While over the entire period the number of foreign companies, including those privatized, increased significantly, total employment increased little because of the restructuring and consolidation of privatized companies. Much of the increase in employment (about 50,000) has been contributed to by greenfields that were attracted through a change in policies that sought to strengthen incentives for investors in 2009. FDIs established before 2009 were also incentivized to increase employment, and they did, contributing some 25-28,000 new jobs.

4 Author's calculations based on Eurostat data.

BOX 4: STATE AID FOR INDUSTRIAL RESTRUCTURING: AWAITING PRIVATIZATION OR SLOW DEATH

Throughout much of the 1990s the economy had operated at around half of its previous power. After a hyperinflation and international sanctions, much of the economy was de facto bankrupt and both massive financial and technical assistance would have been needed to restructure and reorganize the segments that may had had a chance of becoming competitive. Instead, the focus was on privatization which was unsuccessful, and state aid served as a subsidy compensating for a lack of productivity.

The large enterprise systems that had not been attractive or viable enough for insider privatization during the 1990s and early 2000s were put under a special regime that shielded them from bankruptcy"under restructuring"). However, many of these companies benefited from protracted restructuring support. Enterprises under restructuring were initially comprised of some 70 enterprise systems and, subsequently, more enterprises were added to the list. As illustration, in 2002 there were 220,000 persons were employed in enterprises in portfolio of Serbia's agency for privatization. Few of the enterprises were successfully privatized, nor was their fundamental restructuring tackled. They operated largely based on explicit and implicit subsidies, and occasional half-measures, most of them dying a slow death from the outset.

After the global financial crisis, however, the costs of this complacency began to soar, ultimately threatening to create a public debt spiral. Finally, in 2015, with the adoption of a new Law on Privatization and changes to the bankruptcy law, their resolution began to be more decisively tackled. According to the IMF and the Fiscal Council of Serbia (IMF, 2015; Fiscal Council of Serbia 2014), fiscal costs of support to companies in the portfolio of Agency for Privatization and public enterprises amounted to 2-3% GDP on average in 2010-2015, while official data show that state for companies in restructuring amounted to 0.2% of GDP in the same period.

It is a pity that the opportunity was missed since the resolution of these enterprises began to create a more transparent system that could reassure Serbia's citizens. There are good reasons to believe that this is all the state aid these enterprises are receiving today, but there is no way for the outside observer to ascertain it nor to ensure that no hidden costs will begin to be incurred in the future.

## B. COMPANIES IN FOCUS

**We focus[5] on greenfield investments in tradable goods and services industries** — mostly comprised of manufactured goods, but also including tradable invisibles such as IT programming, pharmaceuticals, customer service and other professional services (hereinafter referred to as "analyzed FDI") - as these have been the primary target of state aid in the context of export promotion[6]. These comprise some 63% (80% in 2009 and later) of employment in foreign companies (excluding privatized ones).

**We have been able to verify for companies employing about three quarters of the employees of companies established after 2009 that they are recipients of state aid.** These are comprised of nearly all those with more than 500 employees, and somewhat over 50% of those larger than 100 employees. As companies become smaller, it both becomes more difficult to verify it and the likelihood that they are indeed recipients declines somewhat, especially when they fall under 100 employees. In the area of tradable services, we gauge that at least 80% of employment is in companies that are the recipients of state aid. For companies established before 2009, both the likelihood that they were recipients of more than land and possibly some tax exemptions is substantially lower, and hard to verify.

5 We are not able to distinguish with precision between all of the FDIs that have and have not been recipients of state aid, nor the total magnitude of state aid granted before 2015 [see Appendix].

6 The regulation of state aid in investment promotion is discussed in the next chapter.

## C. TYPOLOGY OF FOREIGN COMPANIES

**Unless an investment is directly drawing away employees from local companies, the short-term effects of FDI on employment, production and income generation will generally be positive.** This is especially true if directed to depressed regions where the income generated locally through increased salaries of those employed as well as by suppliers of locally sourced inputs, will have a multiplicative effect on economic activity in the region. Overall, these effects will be proportional to the wage bill of the new company and the value of local sourcing.

**The likely medium- to longer- term developmental effects may vary widely,** however, as mentioned in Chapter "State Aid in the Context of Industrial Restructuring and Regional Development" and we build four "idealized" company types based on how their characteristics[7] determine three different channels of effect. The first is the amount of human capital they build. The second may come if the company itself develops and adds complexity and human capital to the initial operation. The third may come through spillovers of knowledge and technology that Serbia's companies can use.

**Type 1 companies –** Exemplified by the production of car cable sets, knitted apparel or automobile seat upholstery, they employ typically more than 70% or even 80% of staff with low or no qualifications. As they have very short and relatively simple value chains, they have few intermediate or higher technical positions to which the labor force with basic skills could look forward to progress, and they are not very likely to branch out to more advanced production. They are also unlikely to develop local suppliers of core inputs, as these tend to be linked to industries of a very different nature from those available locally and produced in massive global series.

**Type 2 companies** resemble Type 1 in that they employ large numbers of less qualified people, but they also have 15-30% of

7 Based on key informant interviews and the analysis of publicly available data.

employees with mid-high to high technical or engineering skills, because their products are more complex and/or have longer value chains. This type is exemplified by the production of automotive components such as plastic interior parts, seating mechanisms, fluid mechanisms, as well as more complex electrical engines, home appliances, and electrical and electronic equipment. They engage more qualified labor and, consequently, are also likely to have to add more sophisticated human capital through training for specific jobs; their less qualified employees will have some chance of individual development and progression. Most importantly, these companies are able to start with simpler and less risky segments of the value chain — often product assembly — and then develop and branch out into more demanding segments. Thus, Gorenje for example, a home appliances producer, started off with only assembling products in Serbia, and today has moved its entire operation, including R&D, into the country. Another example is Johnson Electric, that also started from basic assembly of automotive industry parts, but has been adding the production of increasingly sophisticated product parts. However, the bigger ones, producing large or massive product series, are not very likely to develop local core part suppliers, because in such production components tend to be purchased off the shelf on the global market.

**Type 3 companies** are characterized by their predominant reliance on educated workforce, with typically more than one half of staff consisting of employees with higher-education degrees or advanced technical skills. They produce a wide variety of products and services, exemplified by pharmaceutical products, wind generators, customized sophisticated metal components, water pumps, web design, digital marketing and customer service companies. The share of domestic value-added in their product values is typically much higher than with Type 1 or 2, be it because their more complex value chain incorporates high-value R&D components or because the entire output consists of services. These companies, especially those producing intangibles, are likely to generate more knowledge and technology, and hence have more knowledge spillovers. Their high-skilled labor input is often linked to the production of customized products, in which each needs to be adapted to the needs of a known buyer. However, because of that, they tend to produce smaller series, and employ fewer employees which limits their employment impact, and may limit their overall income impact as well.

**Type 4 companies** are characterized by a predominance of a highly qualified staff, producing high-technology products or, more likely, knowledge, creative or managerial invisibles — products and services. Exemplified by global IT company or pharmaceutical research centers (Microsoft, Merck or Quintiles), aircraft services (SR Technics) or 3D design solutions, and the regional logistics centers for companies such as Bosch, or Coca Cola, these are Serbia's superstars. These companies engage highly qualified labor and further build skills that are highly valuable and often in short supply in Serbia. Their developmental effect comes largely from skill spillovers, and much less likely through the lengthening or branching out of the value chain itself.

## D. KEY STYLIZED FACTS

In order to gauge the relevance of these four company types to Serbia, we build a correspondence between each company type and a segment of the universe of analyzed foreign companies, focusing on the employment they generate. A key characteristic of the four idealized types is the sophistication of their average work force: the average wage in Type 1 is lower than that of Type 2 and so on. We build, hence, the correspondence by grouping companies in the universe by observed average wage levels in 2016. We find that all greenfield foreign companies in tradable industries whose average wage in 2016 was lower than 280 euros (75% of the average official wage in the economy and 36% above the prescribed minimal wage) are well represented by Type 1, those with average wages between 280 and 460 euros (75-125% of the average official wage) are represented by Type 2, those with average wages between 460 and 750 euros (125% and 200% of the average wage) by Type 3 and those with average wages higher than 750 euros by Type 4.

Although there are, of course, many companies that do not fully fit in any of the descriptions, these four company types represent

the universe of analyzed foreign companies grouped by wage level surprisingly well. The basic statistics about these four groups of companies, distinguished by year of entry and by size are shown in Tables 1. And 2. The largest number of people today work in Type 2 companies (around 35,800) but this is closely followed by Type 1 companies, which comprise the largest share of employment after 2009 (29,400, of which 19,500 after 2009). The analysis of trends not shown in the table, suggest that, as would be expected, some of the Type 2 companies begun seeming as Type 1 companies before 2009. The smallest number of people is employed in Type 4, they are mostly employed in smaller companies (56% in 10-250 employees) and there are considerably fewer employees in companies established since 2009 (3,000 thousand v. 11,300 thousand).

*Table 1: Employment in tradable FDIs in 2016*

| GREENFIELDS FDIs | # OF TOTAL COMPANIES | TOTAL | '09 OR AFTER |
|---|---|---|---|
| Type 1 | 131 | 29 390 | 19 500 |
| Type 2 | 194 | 35 728 | 10 358 |
| Type 3 | 140 | 18 535 | 5 612 |
| Type 4 | 162 | 14 419 | 3 080 |
| **TOTAL** | **627** | **98 072** | **38 550** |

*Table 2: Shares of employment by a company size*

| EMPLYMENT SHARES | 1 000+ | 251-999 | 10-250 |
|---|---|---|---|
| Type 1 | 51% | 25% | 24% |
| Type 2 | 42% | 29% | 29% |
| Type 3 | 32% | 30% | 38% |
| Type 4 | 0% | 44% | 56% |
| **TOTAL** | **36%** | **30%** | **33%** |

**The Type's developmental effects are not necessarily proportional to the average level of qualification in it,** despite the fact that the company typology has been defined and ranked essentially by this criterion. Investors can only be attracted where there is a foundation on which they can build the skills they need, and if this foundation is very weak, then Type 1 employment may be all that a region can sustain at first. The large numbers in Type 1 companies certainly reflects the fact that many people were ready to work for nearly minimal salaries when the opportunity arose. Similarly, Type 4 companies engage a high level of knowledge and skills, but they are typically small. If the necessary interaction has not been established through which knowledge can spill over to the rest of the economy, they can conceivably remain isolated islands of capacity.

**To have a developmental effect, the attracted companies need to provide an optimal match to the local opportunities and constraints.** Type 1 companies may be welcome in very depressed areas where their immediate employment and income effect may make a very important impact on the local economy. For example, the construction and establishment of Leoni Wiring Systems in Prokuplje, a Type 1 factory today employing 5.5 thousand[8], provided an important developmental impetus in 2009-2011. It led to the development of a domestic company that today exports factory construction and support services. Key informants from large Type 2 companies established in Niš explain that they considered establishing in Leskovac but did not believe they would be able to find enough of the more qualified technical staff needed to operate their business.

**However, questions with regard to the complementarity and integration with the local or national economy do exist.** With all the types of companies excepting possibly some subtypes of Type 3, the level of integration with the local economy is visibly very low. And while this observation holds true for transition Europe more generally, in the case of Serbia it may be particularly problematic as it is to be expected that a greater share of employment will have to come from domestic SMEs, owing to the delayed transformation. Beyond the emergence of the occasional local supplier such as in the Leoni-Prokuplje example, what spillovers does a Type 1 or even Type 2 company have on local SMEs, when

8 As of 2017, according to SBRS.

the latter are likely to operate in commerce food production, and tourism?

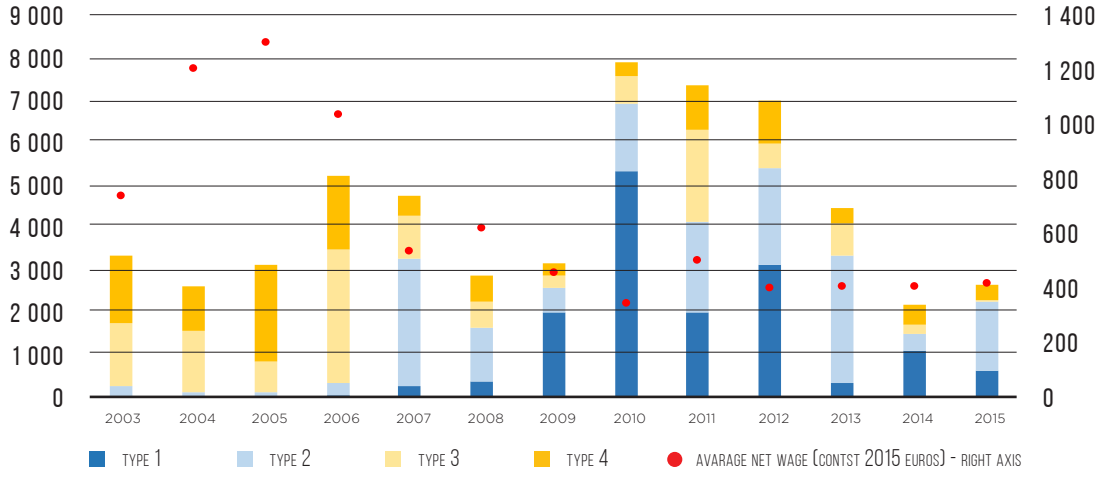
**The problems with local spillovers and integration are exacerbated by the size of companies in question relative to the thin demographic spread.** More than 46% of employees in Type 1 and 2 companies are employed in companies with more than 1000 employees, and as many as 27% in those between 250 and 999. Mid- to higher- qualified labor can be found throughout Serbia, including depressed regions, but owing to the peculiar "leopard skin" of capacities structure, they come in small dispersed pockets. A number of relatively small companies employing low- but also mid- to higher- qualified staff can be found in depressed regions, and it is possible that more could be attracted if the policy and broader environment were more receptive to small-scale Type 2 FDIs. Smaller employers may be more likely to work in small-scale, likely customized, series. This would increase the likelihood of integration with national SMEs as they, too, tend to operate in customized production. Of course, it is more difficult to employ 1000 people attracting 10 companies than attracting one. Nevertheless, now that pockets of unemployment are not so large anymore, this may end up being a necessity.

**Also of great importance is that the environment provide paths that can conceivably lead to the local economy's further development.** There need to be answers, if tentative, to the question– where is the "next stage" of development going to come from in this local environment? The scenario in, say, a Chinese city is that domestic and foreign companies agglomerate while people move from the countryside. More advanced companies are able to take away staff from those offering fewer opportunities, raise salaries and move to the next stage of development. In Serbia, in the case of Type 1 employers in relatively dense urban settings, one can imagine, say, a Type 2 employer setting up a company and taking away employees to somewhat better paid jobs. However, salaries are still far from levels that would attract internal moves and agglomeration. It is hard to imagine such competition developing in less populated and depressed regions and the risk is therefore high that large Type 1 companies are cementing a mono-industrial type situation, without themselves offering the likelihood of development.

**The evolution of employment in foreign companies by company type lends further support to the concern that FDI movements at present in Serbia are not producing the**

**desired spillovers and virtuous cycle of development.** Trends after 2009 show significant shares of Type 1 FDIs (50% of the employment generated from 2009-15), and significantly less FDIs of the types 3 and 4 than in years prior to 2009. The increase in Type 1 employment may simply reflect a belated concern with doing something for the largely underdeveloped regions of south-eastern Serbia. However, it is hard to think of a hopeful explain for the slowdown in Type 3 and 4 employment. This inevitably tells there is no positive spiral. This situation is illustrated in Graph 6, that shows employment broken down by type and average wage, by the year of the FDIs' establishment. The graph stops at 2015 because of comparable data availability. Based on some more recent evidence, for example Continental and Essex have signed contracts with the Ministry of Economy (1.500 EUR and 900 EUR average agreed net salary respectively), it could be that the trend is changing for better.

*Graph 6: FDI employment by type, recorded three years after the entrance*[9]




9 Author's calculations based on SBPA and SORS data.

Values for employment and wage are taken three years after entrance (with a three-years lag), meaning that we wanted to show status of the firm once the initial investment phase was finished.

* denotes years with less than three-years lag – 2014 and 2015, since we have the reliable data only up to 2016.

# IV. SERBIA: FROM INVESTMENT PROMOTION TO EFFECTIVE DEVELOPMENT

The previous pages have shown the complexity of a truly effective use of state aid, and apparent risks in the structure of FDI inflows that Serbia is currently able to attract. To get to the accelerated development and growth it needs, Serbia needs a comprehensive and participatory development policy, embedded in a predictable and fair institutional environment ruled by law.

Based on the premise that the interest in faster development is a strong motivator, we argue that **alignment of the state aid system with the EU regulatory framework could be an excellent starting point** in building such a comprehensive framework.

# A. TIME TO TURN THE PAGE

**Now that the bulk of the transitional transformation of Serbia's economy is finished, the lack of a strategic approach to investment promotion (or regional development) is a serious shortcoming.** In the first transition decade or even two, the attraction of FDI, be it through privatization or state aid, was not particularly systematic or strategic in any of the CESEE economies — nor did it need to be so. Essentially, the sectors of focus, the industrial strategy so to say, were determined by legacy. Investments flowed to pick up and advance resources that were already there and needed the "stretch" of, above all, better management and access to markets. However, Serbia's industrial legacy has by now been either rebuilt or lost. The accelerated growth of quality employment cannot be secured by attracting relatively large employers, even if policy were focused mainly on attracting Type 2 and 3, with further reliance on Type 1 employers downright posing serious development risks.

**A strategic approach is needed — one that will, first, set a vision both for foreign and domestic companies, test for each specific locality that no crowding out is being caused, and guide not only the types of FDI being targeted, but also the preparation of the environment into which they are brought.** Only thus can mutually reinforcing interaction between the local domestic economy and the new companies develop. As shown by the examples of Bilbao and Ireland, foreign investment promotion needs to be complemented with support to domestic entrepreneurs. Such an approach can only be built based on an intensive public-private dialogue that will set clear, feasible and mutually reinforcing goals.

**Building the necessary public-private dialogue and strategic approach requires that key elements of the broader institutional and business environment also be fundamentally strengthened.** On one hand, broad and inclusive dialogue can only be carried out in an environment of trust and needs to be based on well processed and publicized information. This, in turn, requires a stronger and continuously improving rule of law — a sense that all players are treated equally, under the same principles. In fact, the quality of Serbia's business environment — consisting primarily of the rule of law, governance of public enterprises

and red tape — today stands well below that attained in most CEE countries at the time of their respective accessions to the EU (in 2004, as well as Croatia in 2013). As measured by EBRD, after normalization[10], of indicators for comparative purposes, Serbia's score for Governance quality stands at 0.49 (EBRD, 2019), while it ranged between 0.61 and 0.71 for accession countries in 2004.

**Moreover, as the authorities endeavor pointedly to shield foreign investors from the business environment shortcomings, an unequal environment has been created. T**he Development Agency of Serbia, as well as local government officials in charge of foreign investment, engage much of their resources in ensuring that myriad administrative obstacles are removed from the path of foreign investments. They follow these investments from beginning to end. This dedication has been observed and praised by foreign investors. However, domestic interlocutors feel put at a disadvantage, and this is even recognized by some foreign ones. It is not only counterproductive with respect to the mobilization of domestic resources, but it ultimately also lowers the effectiveness of the measures in support of FDI, as they too need a thriving local economy to derive maximal benefits from their investment.

## B. STRONGER STATE AID SYSTEM

**Fundamental improvements to the institutional environment need to be in progress, even if they are hard to make and take time.** All investors, domestic and foreign alike, need to see this and count on it. As the motivation to deliver better development results can be strong, and the state aid system is viewed as the central development tool in Serbia's policy making, it is logical that improvements in the state aid system be used to motivate and enhance the improvement of the overall business environment.

10 Normalization of data perfomed in line with standard methodology, with all Transition scores for the "Well governed" pillar of the new' EBRD' Transition quality (ATQ) scores, oscillating between 0 and 1.

$$X_{new} = \frac{X - X_{min}}{X_{max} - X_{min}}$$

**Serbia's current investment promotion system (framed by the 2016 Law on Investment, with subsequent update in 2018) represents an improvement over the arbitrary system of previous years.** It puts in one place, transparently, the logic and criteria used in investment promotion. The criteria it sets in principle to determine the magnitude of support to investments are economically reasonable. Criteria is tied to developmental effects of the project, and criteria for assessment of the importance of investments, in addition to the number of new jobs and the amount of investments, also include criteria such as the type of investment, impact on the total foreign trade balance of the Republic of Serbia, long-term nature of investments etc., as well as the references and credibility of investors. Further, it includes an elaborated implementing regulation that indeed turns the policy into a well-defined system that gives a measure of comparability of treatment among the players and can be monitored.

**The implementing regulation, however, defines a set of easily implementable rules whereby the assistance amount can be set, and it does not clearly reflect economic criteria set in the Law.** While one would expect a well-defined methodology testing for the criteria established in the Law, the rules described in greater detail in Box below, reflect the concerns and priorities of policy-makers such as that the support be granted in proportion to the wage bill, that less developed regions be given an advantage, and emphasizing the number of employees. Regulation determines the amount of incentive on the basis of just a few verifiable criteria (the main one is the amount of reasonable wages costs), which precisely indicate the amount of the incentive. Thus, the Law mostly encourages an increase in the number of jobs and there is nothing that points to the measurement of developmental effects, nor is there a reference to the measurement of contribution to goals of strategic documents. It considerably narrows down the choice of logic in decision making by unambiguous, directive provisions based on firm quantitative frameworks according to which the amounts of incentives are tied only to jobs, development of the region which is being invested in, as well as the amount of investment. This would be an extremely rigid system where it not for two "escape clauses" that could, in principle, entirely invalidate the rest of the regulation. In practice, they do not appear to be used as arbitrarily as could be the case.

BOX 5:
REGULATION ON INVESTMENT PROMOTION:

The Regulation sets the maximal amount of granted aid at 50% of up to 50 million EUR of justified costs* for large companies, 60% for mid-sized and 70% for small ones. If investment is larger than 50 mil EUR, amount between 50 million EUR and 100 million EUR will be eligible for maximal threshold of granted aid amounting to 25%, and part of the investment above 100 million EUR for additional 17%. For example, investment project of 180 million EUR, carried out by large company, will be eligible for up to: 50mil * 50% + 50mil * 25% + 80mil * 17% = 51.1 mil EUR of aid.

Final amount of state aid depends on development level of the host region, with the highest incentives directed towards investments in least developed regions.

| REGIONAL DEVELOPMENT | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| % of labor costs | 20 | 25 | 30 | 35 | 40 |
| % of investment | 10 | 15 | 20 | 25 | 30 |

Mechanism illustrated in the table above sets a starting point for determining the magnitude of aid, under the constraint of 50, 60, and 70% of costs justified, for large, medium and small enterprises, respectively. Flexibility of the mechanism is achieved through several instruments:

1. Part of the aid related to % **of the investment** is defined as ***up to***, meaning that actual amount should be determined in respect to qualitative criteria (type and presumed effect of investment).

2. **For large employment projects (200+ jobs),** % of aid for labor costs can be increased. Intensity of additional aid for such projects is determined as follows – additional 10% for 200-500 jobs, 15% for 500-1000 jobs and 20% for 1000+ jobs.

3. **The regulation pays special attention to projects that create up to 100 jobs.** Depending on technological level of the investment, aid as % of investment can be doubled for high-tech industries. Additional 10% can be awarded based on fulfilling multiple criteria related to the quality of the investment project (experience, estimated ROI, share of high-skilled workforce...).

4. **Investments of special economic interest** for Republic of Serbia, defined as those that positively impact economic development through improving competitiveness and even regional development **can be evaluated separately.** Condition that has to be fulfilled for an investment to qualify as the investment of special economic interest is investing at least 5 mil EUR and employing at least 500 workers for the region type 1 and 2, and 2 mil EUR and at least 100 workers for types 3, 4 and 5. According to the Regulation, these projects require experts' analysis before the aid is granted.

* Broadly, justified costs include costs of two-year gross wages (true labor costs) and investments in material and intangible assets (investments).

**The investment promotion system needs to be enhanced** as a part of an overall enhancement of the development policy system. This could start with a more strategic approach to investment promotion by enhancing participation, transparency and the use of more in-house analytical know-how (a capacity that needs to be built) in the design of interventions. Much that is required for the full alignment of the state aid system with the acquis (see Box [6]) is a necessary condition for this list.

BOX 6:
ALIGNMENT OF STATE AID LAW WITH EU RULES AND MONITORING CAPACITY

The law on regulation of State Aid in Serbia was adopted in 2009, as a part of the EU pre-accession process. Largely based on Slovenian (and many other CEE countries) model, CSAC (Commission for State Aid Control) was established in 2010 as the institution responsible for the implementation of the law, and for control of state aid in Serbia. CSAC consists of five members nominated by the granting institutions (line ministries), while the Secretariat of the Commission is located in the Ministry of Finance. Every form of state aid, except for de minimis aid, should be reported to CSAC for ex-ante evaluation before it is granted. Additionally, CSAC can start the ex-post control if available information suggests that State Aid has been granted or/and violates the Law. If CSAC finds the aid not eligible, it shall order the recovery of the aid that was granted, with interest. However, by 2017, CSAC had no negative conclusions, either ex-ante or ex-post. Also, courts in Serbia did not have any case of action brought against illegal use of state aid so far.

The Law in Serbia is generally in line with the EU acquis, defining the same concepts (legal, illegal and potentially legal) and types (regional, horizontal, sectoral and de minimis) of state aid. However, there are several significant deviations from the EU acquis:

1. Enterprises in the process of privatization are exempted from the Law. These enterprises were large beneficiaries of state aid, primarily through guarantees issued by the state government. Situation changed for better from 2015 on, largely resulting from IMF's demands to significantly reduce spending on state-owned enterprises (SOEs). New Law on state debt, adopted in 2015, prohibits issuing guarantees for liquidity purposes for state-owned enterprises, and allows only guarantees for investing purposes.

2. Absence of General Block Exemption Rule (GBER) mechanism – a channel through which state aid is granted without time-consuming ex-ante control of CSAC, if it sufficiently meets required criteria. "GBER approach" has not been adopted yet in order to raise awareness

of State aid rules among aid grantors and ensure their effective implementation.

3. Additionally, Screening report on Chapter 8 contains a list of legislative deviations concerning particular fiscal schemes, enhancing transparency, some new guidelines in restructuring aid, culture aid etc... For example, the report suggests that operating aid to uncompetitive coal mines should be granted only under certain conditions, including their closure by the end of 2018.

4. In the screening report, it is also concluded that the capacity and enforcement record of the CSAC and its Department are largely insufficient. The CSAC urgently needs more qualified staff, in order to establish a good enforcement record. The CSAC cannot be considered as an operationally independent authority since most of its members are nominated by aid granting ministries, and since the Department for State Aid Control, which assists the CSAC in investigating State aid and preparing decisions, is part of the Ministry of Finance. Ensuring operational independence of CSAC with appropriate capacity is one of six benchmarks set in Negotiating Chapter 8. To our knowledge, European Commission has not confirmed its fulfilment yet.

**True alignment of the State Aid monitoring framework with the EU requirements would require several elements that would directly contribute to the needs of a better investment promotion system, and ultimately a greater capacity to conduct effective development policies.** First, there is a need for much greater transparency, providing accurate and up-to-date individual award data on value and type of subsidies and expected effects in machine-readable format. Also, alignment requires considerable strengthening of the capacity of CSAC (Commission for State Aid Control, further described in text box above) to analyze ex ante, as well as conduct ex post controls of state aid. The strengthening of the CSAC's capacity would have to start from training of a number of civil servants in the application of the EU's evaluation methodologies. This would be a novel and possibly eye-opening approach for many Serbian civil servants. Moreover, CSAC needs to be made independent from granting institutions, which means that the CSAC's counterparts in the granting institutions would also need to be trained and made aware of the developmental and other criteria applied in the EU regulations. Finally, alignment is also needed with respect to the adoption of the GBER approach, which concerns a number of sectors. Through this, civil servants in all these sectors will learn about state aid rules, and how they are linked with development. Other important requirements are not necessarily connected with the capacity to improve the investment promotion system. Most important among them is the abolishment of the exemption of enterprises under privatization from implementing the Law on State Aid.

# V. APPENDIX

Ministry of Economy is acting as a key provider of state aid to private sector of Serbia's economy, using it as a tool to enhance economic development and employment. Ministry provides state aid either directly, when it comes to support for implementation of investment projects, or through Development Agency of Serbia (DAS) or Development fund (DF), when it comes to support for SME sector.

Ministry of Economy heavily relies on state aid as a key instrument of FDI attraction. Based on data and documents available on Ministry's web pages, it can be observed that Ministry spends at least 50-60 mil EUR annually on FDI attraction programs. In the period of 2015-2019, according to Ministry's data, contracts with 72 FDIs have been signed, mostly with firms from automotive and textile industry, with total value of

subsidies reaching 242 mil EUR. Supported FDIs have committed to invest more than 650 mil EUR and to employ 37,000 workers. Average net salary, agreed in those 72 contracts, was around 420 EUR. It should be mentioned that average agreed salary remains relatively the same throughout the observed period, with an exception in 2018, when Continental (1.500 EUR average agreed net salary) and Essex (900 EUR) have signed the contracts with Ministry.

However, although it is evident that some efforts have been made in terms of data availability and transparency, especially after the adoption of the new Law on investments in 2015, there is still no comprehensive set of systematically available data on total value and structure of annual state aid provided, and therefore, it is still difficult to reliably track and analyze Ministry's decisions. CSAC's annual report on state aid indicates that total expenses for regional development aid, that include support to FDIs, have been around 250 mil EUR annually, in the period 2010-2017, totaling almost 2 bn EUR. Hence, regional aid is multiple times higher than publicly available data about support to FDIs. It is clear that only a small part of the residual can probably be explained by subsidies of local communities in land and its development, which is usually granted to FDIs. Such incompatibility between Ministry's data and CSAC's report indicates that there are support schemes (either for FDIs or domestic firms) that are not fully presented to public nor available in documents and files. In addition, some publicly and anecdotally well-known state-aid beneficiaries, such as Yura Corporation or Geox, also could not be found among the formal beneficiaries, either in the Ministry's files, or in CSAC's. In order to conduct reliable and in-depth monitoring and evaluation of effectiveness of state aid used to support investments, fully transparent, timely and reliable data is required.

As regards support to SMEs, the Ministry usually provides between 15-20 mil EUR on annual basis, through DAS and DF. Those funds are provided to SMEs in different forms, depending on the year observed and active programs. The most important recent schemes include support to SMEs for purchasing new equipment (around 8.5 mil EUR planned for 2019, while around 5 mil EUR has been spent during 2018) and for entering value chains of large multinational companies (around 4 mil EUR planned

for 2019 – new program), that are provided through DAS as de minimis. In addition, DAS also provides mentoring and promotion services, but their value is relatively low (below 1 mil EUR in total). The Ministry also provides support to SME sector through subsidized loans, serviced by DF and intended for development of start-up and entrepreneurship (total grants around 6 mil EUR).

Although support programs cover the largest number of activities necessary for improving competitiveness, a deeper review of the amount and allocation of funds indicates that support to SMEs tends to be largely fragmented and split, therefore often unable to produce tangible effects. For example, in 2018 the support for purchasing new equipment was directed at 250 companies, with average support provided to a single company of only EUR 20,000 – probably insufficient to substantially upgrade firm-level technological competitiveness of a beneficiary.

In addition to Ministry's state aid granted to SMEs, National Employment Service (NES) provides additional 10-15 mil EUR on annual basis, in form of de minimis, intended for trainings of employees or subsidies for new employment and self-employment. In 2018, there were around 8,000 recipients of that form of state aid, mostly SMEs. Therefore, average aid per company was around 2,000 EUR.

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