ANALYSIS

ECONOMY AND FINANCE

SERBIA'S ECONOMIC GROWTH

It is Real and (Yet Another) Missed Opportunity

Kori Udovički
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Serbia is on a path of strengthening economic growth. As it is economic prosperity that the electorate really cares about, it is important for Serbia's democratic future [that we] to understand why.

After nearly two decades of a slow and tortuous economic transformation, Serbia has grown an economic foundation of vibrant businesses and it is attracting FDI away from China and the Central and Eastern Europe, who have moved to higher steps in the development ladder.

A business environment discriminating against small players and domestic "political outsiders" is preventing Serbia from taking full advantage and spreading the benefits of this (finally!) favorable structural position.

FRIEDRICH EBERT STIFTUNG

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INTRODUCTION

Attaining visible results in the realm of economic growth and prosperity has been by far the most important focus of Aleksandar Vučić's domestic policy effort, absorbing a significant part of his personal as well as the SNS's apparatus time and energy (that is, if we do not consider the informal establishment of repressive control over the country's institutions as "domestic policy"). This is because he understands extremely well that after the tragic implosion of the 1990s and the disappointing overall performance of subsequent years, what the Serbian electorate cares about the most is a stable perspective of economic prosperity.

Mr. Vučić appears to (finally) be succeeding in this regard, and likely better than the statistics suggest at first sight. After nearly a decade of an essentially flat performance following the Global Financial Crisis (GFC), GDP growth accelerated to a 4.2% rate in 2018-2019. While this rate is not particularly remarkable, were it not for the COVID-19 crisis the rate in 2020 would have been higher, and it is likely to accelerate further.

If this is, or is perceived to be, true and to be the result of the SNS's stewardship of the economy, it creates a formidable political problem for the democratic opposition. Mr. Vučić appears to be delivering these results following essentially the same economic model as his democratic predecessors --attraction of FDI and investment in road infrastructure without a plan-- only "better". He was able to establish fiscal sustainability --something that they did not have the strength or skill to maintain after 2005 (and continue not to acknowledge). If indeed this promising economic performance is of such importance to the electorate, why would it give the democratic opposition another chance? Moreover, for two decades whenever Serbia's economic performance was disappointing, the international community argued that the problem was in the weak business environment, that the weak rule of law and institutions discouraged investment and entrepreneurship. Does this improvement in performance now prove that the business environment has become better? Or is it proving that the business environment does not matter?

For all those that care to see Serbia enjoy a truly sustainable improvement in citizen's welfare in a strong, democratic and participatory environment, there is an overarching need to understand in honest and rigorous terms what is happening. I argue that Serbia's growth is indeed accelerating. Although it will not be what it could and needs to be, from the short-term political point of view it is likely to be satisfactory enough, at least for a while.

I argue that this is happening largely because of structural factors whose importance had been neglected in the Washington Consensus-steeped environment of the 2000s. For growth to pick up, Serbia's traditional unrestructured economy needed to "transform enough" and stop weighing down on it. Serbia also needed to build the export base to support sustainable growth. These changes could not happen overnight, and in Serbia's case, in fact, they took a very long time. This long passage of time also "helped" Serbia by increasing its competitiveness in relative terms. This is because know-how and wages grew in competing regions -- the new European Union member states and the Far East-- reducing their competitiveness industries. Serbia is now positioned to attract FDI looking for new destinations out of these countries.

As to the business environment - it has indeed also contributed to attracting FDI, but not by becoming better for everyone, but by becoming better for large foreign investors. This environment discriminates against small (domestic and foreign) as well as against domestic "outsider" investors. I argue that this reduces the sustainability of growth and the contribution economic growth makes to Serbia's citizen's economic welfare. Ultimately, these faulty foundations may lead to the unravelling of the results. Ideally, however, the lessons that can be drawn from the experience so far will help the development of political alternatives with clear, better, alternative policy offerings. Finally, it should be mentioned that the sustainability of the macroeconomic framework and political/geostrategic factors have also played a role. While discussed where relevant, a more thorough discussion of these topics is outside the scope of this note.

1

THE RECENT ACCELERATION IN GROWTH

After many years of stagnation, there is little doubt that Serbia's economic growth performance has been improving in recent years. At this moment it can be characterized as relatively strong and likely to accelerate. In 2020, a year deeply affected by the Covid-19 pandemic, Serbia's GDP decline of only 1.1% (National Bank of Serbia 2021) was a strong performance. Already a while ago the Fiscal Council (2020) attributed this to Serbia's relatively "underdeveloped" production structure. Serbia's output consists of a particularly large share of government services and agriculture, the sectors least affected by the crisis, as well as of a comparably small share of tourism, catering, entertainment and personal services - the industries most affected by the pandemic. What is more, government services happened to record a sharp increase of a purely accounting nature, due to a sharp hike in public administration wages at the end of 2019 (Udovički 2020). The structural explanation is true, but there is also no doubt that Serbia's economy entered 2020 with a growth momentum and that the official growth projections of 6% in 2021 (*Ibid*) are likely to be met and possibly exceeded, as the authorities clearly hope.

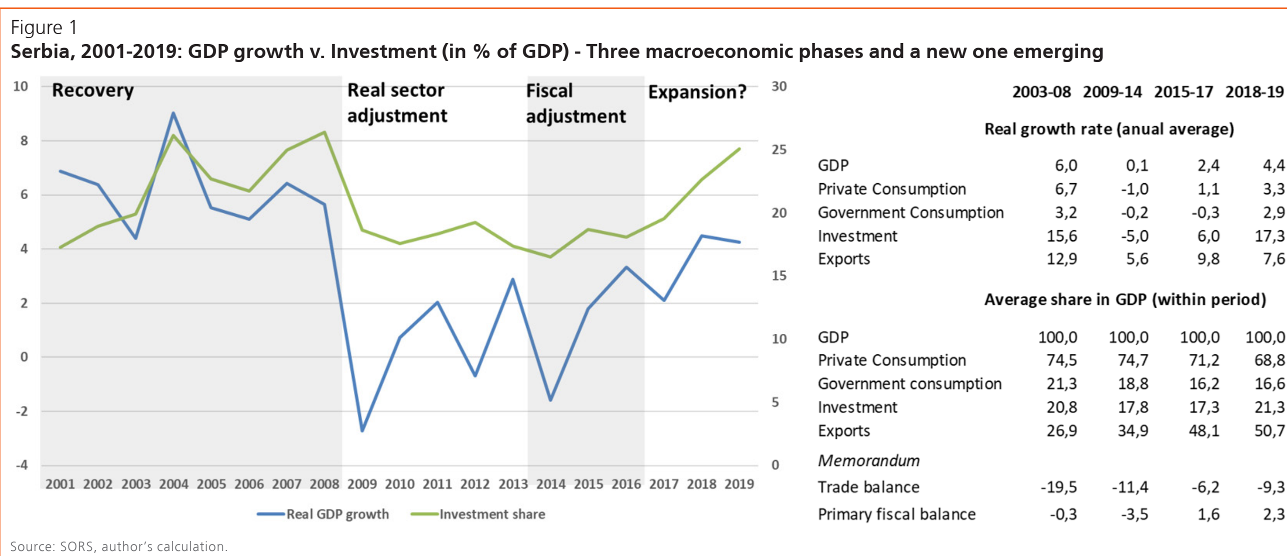
To appreciate the size of the momentum, it needs to be taken into account that the growth performance in 2015 (inclusive)-2017 was dampened by the sharp fiscal consolidation implemented in this period. The primary fiscal deficit was increased by some 6 p.p. of GDP. The multiplier effect of such a contraction would likely have reduced total growth by at least 2 p.p. within the period, and would have continued to have a negative effect on growth subsequently, in 2018 and 2019 (OECD 2012). Yet, during 2015-2017 growth was maintained at an average 2.4% rate and increased to 4.4% subsequently (Figure 1).

The presence of underlying structural processes supporting growth in this period is evident. After touching bottom at around 17% of GDP in 2013-2014, investment grew by 6% annually during the fiscal consolidation years, accelerating further to a 17% rate of increase in 2018-2019. In 2019 investment reached peak levels attained before the GFC. Similarly, exports, which had grown strongly (considering the global environment) already from 2010 continued to grow nearly 10% annually during the consolidation period. The composition of this growth leaves room for concern, with an excessive contribution of construction and manufacturing growing slower than other sectors, but some of this likely reflects continued weaknesses in statistics measurements[1].

It should be emphasized that **the fiscal consolidation itself was a key condition, a *sine qua non*, of the recent improvement in Serbia's growth performance**. Had it not been decisively undertaken in 2015, Serbia would have likely ended in a financial/debt crisis or at least spooked much of the investment that was in the pipeline. This is an extremely important topic that has justifiably been receiving much attention (NCEU Working Group, CEVES 2021, FREN 2020). However, in this paper my focus is on the less-discussed structural longer-term processes and business environment that are currently shaping this growth.

1 CEVES has repeatedly pointed to inconsistencies in Serbia's National Accounts statistics. Most recently, the production of the food and beverage industries are not consistent with the performance of net exports, in 2019 suggesting they are underestimated. The performance of construction, on the other hand, is over-stated in 2019.

Figure 1
Serbia, 2001-2019: GDP growth v. Investment (in % of GDP) - Three macroeconomic phases and a new one emerging



	2003-08	2009-14	2015-17	2018-19
Real growth rate (anual average)				
GDP	6,0	0,1	2,4	4,4
Private Consumption	6,7	-1,0	1,1	3,3
Government Consumption	3,2	-0,2	-0,3	2,9
Investment	15,6	-5,0	6,0	17,3
Exports	12,9	5,6	9,8	7,6
Average share in GDP (within period)				
GDP	100,0	100,0	100,0	100,0
Private Consumption	74,5	74,7	71,2	68,8
Government consumption	21,3	18,8	16,2	16,6
Investment	20,8	17,8	17,3	21,3
Exports	26,9	34,9	48,1	50,7
Memorandum				
Trade balance	-19,5	-11,4	-6,2	-9,3
Primary fiscal balance	-0,3	-3,5	1,6	2,3

Source: SORS, author's calculation.

2

SERBIA'S TIME... FINALLY

Serbia's growth has recently been accelerating because long-drawn change has finally transformed its economic structure and competitiveness to the point where an increase in demand can elicit a commensurate, profitable and hence sustainable, supply response. Clarifying this is important because after having been neglected in the past two decades, structural factors will need to play a role in any truly improved alternative policy package offering. The word "structure" here refers to the structure of production - *what* an economy is able to produce and *how*.

I will refer to the ability of an economy to sustainably produce a set of goods as the economy's "**productive capacity**". An economy's productive capacity encompasses everything that plays a role in ensuring its ability to produce: the resources, know-how and entrepreneurship of its productive organizations as well as the linkages inside them and among them and to market and regulatory institutions that ensure the economy functions. We should understand the concept of productive capacity to include the capacity to produce goods for exports that will earn an economy the foreign exchange it needs to pay for imports. Moreover, if the economy is to grow, it is not enough for it be able to produce, it needs to be able to *increase production*[2] in response to an increase in demand for the goods it produces, and it needs to be able to do so *profitably*, or else its production will not be sustainable.

Furthermore, I will characterize as "competitive" an economy whose productive capacity offers profit opportunities to investors and especially if it is able to profitably increase its exports of goods and services.[3] Competitiveness is often interpreted to be the same as the concept of "business environment". However, I will here make a distinction. While a good environment reassures and encourages investors, it alone does not motivate them to produce and invest[4]. For growth to materialize it is first necessary that its productive capacity -- what it makes or can make and how -- together with the pricing of its resources and outputs entice investors to invest and make profits (Udovički 2020).

In this chapter I discuss the cumulative structural change that was needed to bring Serbia's productive capacity and profit opportunities to the point where it may now be becoming a popular investment destination.

2.1 A GRADUAL STRUCTURAL TRANSFORMATION

Serbia's economy emerged from the 1990s destroyed. While there are no definitive estimates, GDP is likely to have stood at around a half of the end-1980s level. Normally, this would suggest that the actual productive capacity was higher than demonstrated by the GDP. Based on historical experiences from other post-war situations, one might have been justified to expect that double digit growth rates would bring production to pre-1990s levels in 5-7 years. However, Serbia's productive capacity was in many *ways lower* than that indicated by its GDP because much of the economy was not able to increase supply in response to increased demand sustainably. Also, its export capacity was sharply curtailed, with total exports amounting to less than a fifth of the already halved GDP[5]. International market linkages were broken, and a very small share of total output met potential foreign market requirements[6]. Outside the agri-food sector, a company producing tradable goods that was not *de facto* bankrupt was the exception.

To understand the economic restructuring that ensued, it is useful to distinguish between what we will call the "traditional" and "new" economies. By "traditional economy" I denote socialist legacy companies, whether still state- or socially- owned or privatized. At the start of the decade, to become operational this economy (outside the agri-food sector) needed to be massively capitalized and its organization and governance transformed. This is true even of many privatized companies which, having been insider-privatized, were unlikely to have been reorganized and capitalized after privatization. By "new economy" I denote that comprised of companies established as private from the out-

2 In the short run, investment is usually viewed as an autonomous aspect of the demand-side. It is, of course a critical component of increasing supply capacity in the longer-run.

3 Economists like to think of competitiveness as a matter of "price adjustment" – if prices are lowered enough (and so then are wages lowered), an economy will be able to produce sustainably. However, if "price adjustment" means that they need to be changed completely out of normal proportions, then the economy suffers from structural problems.

4 A macro framework that is viewed as sustainable is, in fact, also important for investors and the announcement of the fiscal consolidation was reassuring for investors.

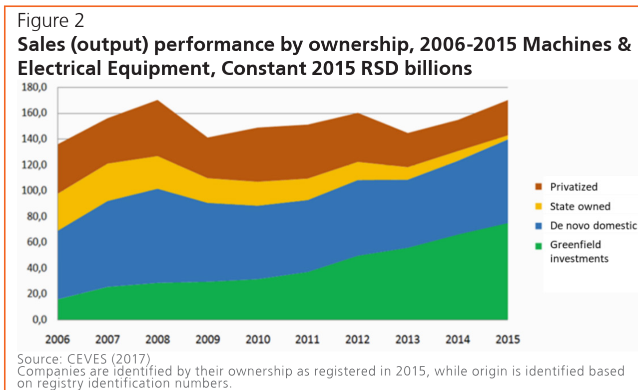
5 Neither the NBS nor the Statistics office of the RS at this moment publish external trade statistics for the period before 2005. This assessment is based on figures published earlier (Udovički 2018) and the fact that BDP figures have been revised upwards since.

6 The list of reasons why this was so is long, and they include not only financial and institutional factors, but also a deeper obsolescence of technology and know-how than is usually assumed (Arsić 2016) .

set - owned by domestic or foreign capital. Companies owned by domestic capital were created indigenously, usually starting as very small SMEs, some of them already in socialist times, but mostly after, and often combining resources built in the traditional economy, of segments spun-off by it. Foreign-owned new companies originally consisted only of greenfield FDI but with time there is an increasing number of indigenous companies sold to foreign owners.

The performance of the overall economy over the past two decades has been the result of the opposite evolution of these two economies. While the new economy grew in earnest, the traditional economy zig-zagged from year to year but ultimately shrunk very substantially over time. It restructured, occasionally generating a (re)privatization success, often spinning-off new entities. With the exception of Serbia's notoriously inefficient national and local utilities and the military and petrochemical complex, what did not restructure by now has effectively died. Some of its equipment and labor was absorbed by the new economy, the rest was dissipated - swallowed by obsolescence and early retirements. All the usable resources have not been put to use, as substantial parts of capital, mostly real estate, remain trapped in endless bankruptcy processes. However, this hardly registers in economic activity statistics. The data do not allow for the reliable measurement of the progress of this transformation, but a carefully prepared case of the machines and electrical equipment sectors illustrates it, in Figure 2 (CEVES 2017). As can be seen, in 2006 only one half of the sectors' output was produced by the new economy (foreign owned shown in green and domestically owned shown in blue), but it doubled in the subsequent ten years. Meanwhile, the traditional economy shrunk, nearly fully offsetting the positive effect the new segment had on the sectors' total growth.

Figure 2
Sales (output) performance by ownership, 2006-2015 Machines & Electrical Equipment, Constant 2015 RSD billions



Source: CEVES (2017).
Companies are identified by their ownership as registered in 2015, while origin is identified based on registry identification numbers.

The **new economy grew steadily and fast** throughout the entire transition period (with the sole exception of 2009-2010) **but for it to lift the growth of the entire economy, it needed to outgrow the traditional one**. We may consider the moment when total formal employment begun to increase, sometime between 2012 and 2014,[7] as a turning point in this transformation. Until then formal employment declined (also very steadily) irrespective of the fluctuations in total economic growth, even in periods when it was strong. An increase in formal employment meant that employment in the new as well as the successfully privatized companies was finally outweighing the shedding of jobs by the traditional ones. Note, however, that due to its higher productivity, the total value added of the new economy had already outstripped that of the traditional one much earlier (other than public utilities, the sectors in Figure 2 were among the last to transform).

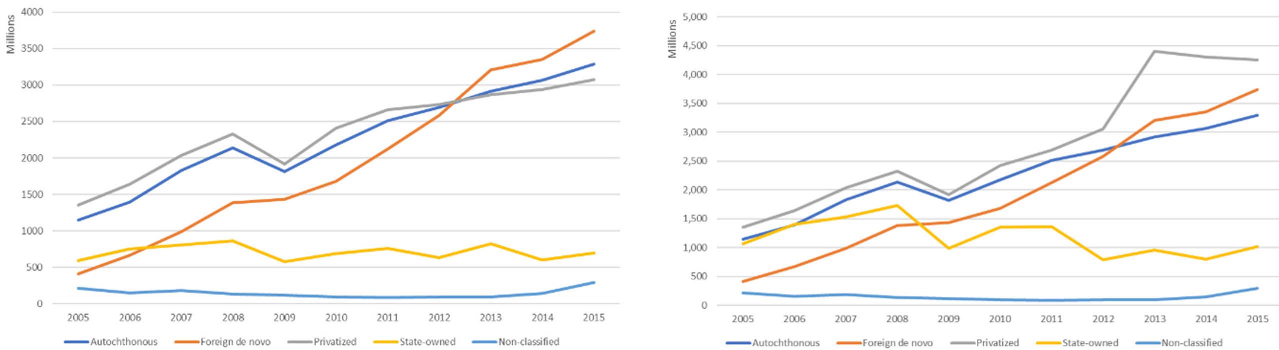
However, the unrestructured traditional economy continued to weigh down on the economy's total performance for longer, until its subsidization was sharply reduced in the fiscal consolidation. Part of these subsidies had been paid explicitly from public funds directly on account of public debt; a part was indirect, through non-payment to public and private sector suppliers. Either way, they had repercussions on the performance of the rest of the economy. Similarly, the deeply inefficient utilities sector -- from the national energy and forest management behemoths to communal utilities -- represents a very substantial obstacle to entrepreneurship and growth in Serbia. However, I do not think their restructuring, possible privatization, and regulation fall quite in the same category as the rest of the corporate sector.

Throughout this transition restructuring the economy also enjoyed a quantum increase in its productive capacity for exports. *It is seldom recognized that the growth rate of Serbia's goods and services exports (in nominal Euro terms) outpaced that of all other European transition economies both before and after the GFC*. By 2015 the export share in GDP had more than doubled compared to the early 2000s and by 2017 it reached 50% of GDP. Although the growth of exports was strikingly steady throughout the entire period the process was not linear. The "roaring" pre-GFC period had everywhere been driven by unsustainable domestic demand. Most European economies needed at least some "structural adjustment" in its aftermath, and so did Serbia's. The period 2009-2015 was a period of a sharp real structural adjustment, in which domestic demand shrunk sharply (despite the large explicit and implicit fiscal deficit) and domestic production shifted towards exports. Despite a contraction in European markets, Serbia's exports picked up in 2010, returning to rates not far behind the pre-crisis period (CEVES 2018).

Note that the performance of exports by ownership of exporter company (Figure 3) also reflects the transition restructuring. Exports by FDI companies grew the fastest. Their rate accelerated after the GFC as the crisis prompted a shift from markets-seeking, service-oriented FDI flows towards efficiency-seeking export-oriented ones (Uvalić et al., 2020). Exports of indigenous and privatized companies also grew quite fast. Meanwhile the exports of companies that in 2015 were still unrestructured shrunk, but did not disappear because they include the military complex as well as public utilities. By the end of the observed period, the traditional economy supplied only a little over a third of all exports.

7 There is a methodological discontinuity, as well as expert controversy, on the reliability of statistical data on employment around this period. However, there is no doubt that formal employment has been increasing at least since 2014.

Figure 3
Serbia's Merchandise Exports, 2005-2015 By ownership of exporting company in 2015; left panel excludes FCA and Železara Smederevo



Source: CEVES (2018)

2.2 COMPETITIVENESS IN A CHANGED GLOBAL ENVIRONMENT

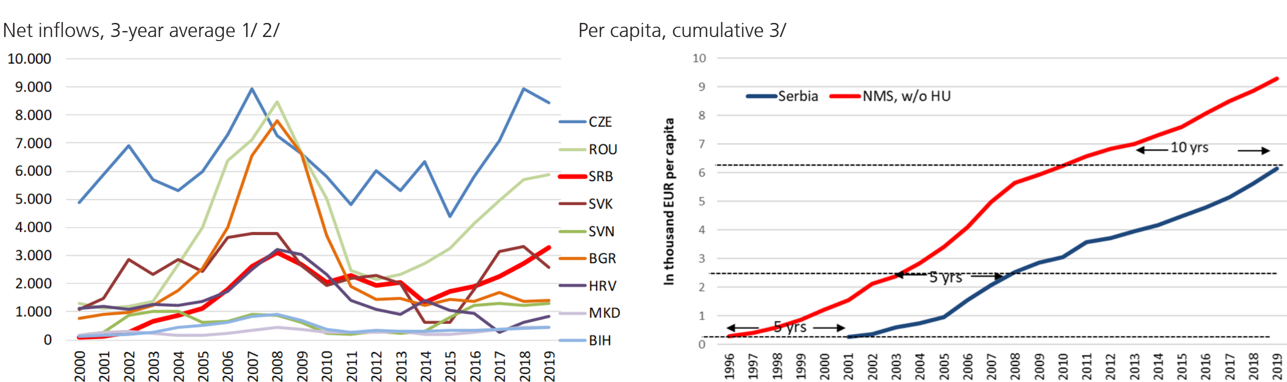
Throughout this slow transformation Serbia's attraction of FDI largely mirrored the dynamics of the total flows into broader transition Europe. However, factors largely outside the control of the authorities appear to have recently additionally contributed to Serbia's increased competitiveness. FDI inflows into Serbia picked up immediately after the change in 2000, increasing thereafter and peaking, as elsewhere, in 2008. They shrunk during the GFC and thereafter, bottoming out in 2014. They have since been recovering (Figure 4. Left panel) with Serbia roughly enjoying a "middling" performance compared to that of other countries.

This has not been enough to secure Serbia's convergence with the NMS to date. To converge in GDP/cap terms, the cumulative investment per capita would need to have grown faster, allowing Serbia to make up for the investment the other countries accumulated before Serbia returned to the fray. Figure 4 right panel shows this comparison. In 2001 the net cumulative per capita FDI inflows (both brown- and green- field) in Serbia stood exactly at the same level as the average for the other Southeast European and Central European transition countries five years earlier, in 1996. For over a decade the flows into Serbia mirrored surprisingly closely the progression of flows into those same countries, maintaining the exact same gap until 2008. Then, as the GFC hit, Serbia fell behind with the gap increasing to 10 years in 2018.

Nevertheless, there are reasons to expect that the gap may now begin to narrow down. Investment into Serbia is accelerating a bit faster in the last three years. More importantly, other than the quality of the business environment strictly speaking, the factors that affect a country's competitiveness are currently working in Serbia's favor. First, the structural transformations described above make a big difference to the likelihood that an investor will find enough synergies with other companies and service providers to make their plans viable. It also means that the size of investment that can be derived from reinvestment has become very considerable.

In particular, both in terms of politics/geostrategy and costs, Serbia now compares well to itself in earlier times and/or competitors. In terms of politics, the 1990s and the assassination of a prime minister are now far in the past. Also, for the time being, Serbia is deriving dividends from its cordial relations with the East. As to costs, although wages in Serbia have inched up recently, in competitor destinations -- East Asia and the NMS countries -- they have increased more. While Serbia's economy stagnated over the past decade, theirs developed. Wages in China overtook those in Serbia in 2013. (Uvalić et al., 2020). Finally, global value chain restructuring processes, especially after the COVID-19 pandemic are likely to further favor the return of European capital to Europe and within Europe, to the Western Balkans.
In the remainder of this chapter, I give a close look to the countries of origin and sectoral destination of FDI into Serbia in 2015-2019 (Table 1) to point out the evidence regarding the above listed factors.

Figure 4
FDI inflows, Serbia v. New Member States and Western Balkans



Source: The World Bank data, author's calculation
1/ Average net inflows in 3-year period ending in year of point; 2/ Absolute level flows into Hungary and Poland are not shown because of their very large size.
3/ Per capita cumulative deflated values; NMS is average of the EU's Višegrad and Southeast European states, except Hungary (due to outlying values).

Table 1
FDI Inflows into Serbia, 2015-2019 (Sector Composition, in EUR mln)

Sector	2015	2016	2017	2018	2019
Mining other than petroleum and basic metals production	12.9	236.7	96.2	633.3	178.8
Food, beverages & tobacco	122.9	145.7	93.9	172.0	168.7
Rubber & plastics	141.9	40.0	97.5	-54.4	274.2
Motor vehicles	140.5	118.7	107.8	148.5	172.6
Other manufacturing	310.0	203.7	248.7	356.1	384.9
Construction	264.5	272.9	406.8	471.5	848.8
Wholesale & retail	208.5	138.2	312.3	323.9	261.0
Telecommunications	77.4	72.9	153.0	-270.0	80.8
Land and pipeline transport, warehousing & logistics	14.2	14.0	16.1	624.9	633.6
Publishing, computer programing and related services	30.2	45.9	36.7	58.5	118.8
Financial services other than insurance	402.6	375.7	229.8	348.4	56.1
Real estate	57.6	124.5	221.7	161.2	195.5
Other 1/	331.1	338.0	527.7	490.5	441.6
Total	2,114.2	2,126.9	2,548.1	3,464.5	3,815.3

Source: NBS
Notes: 1) Methodology of FDI conforms to the Sixth Edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6)
2) Sectors of activity are grouped on the basis of statistical classification of economic sectors of European Union Rev. 2 from 2008 (NACE Rev. 2, 2008)
3) FDIs include investments in money, goods, rights, conversion of debt to capital, intercompany loans and reinvested profits
4) The table is made on the basis of the data that were available until 30th September 2020 and might be susceptible to changes in line with changes in official data sources

I first focus on the big, bulky, figures that may be individually explained, yet could be clouding underlying trends. **These bulky investments (circled in boxes) tend to be driven by discrete policy decisions, including geopolitical choices, although not all are.** Total inflows in the period more than doubled from 2014 to Euros 3.8 billion in 2019 and this increase is only partly explained[8] by the bulky one-off figures. The latter correspond with well-known investments - the purchase by Chinese companies of mining and base metals brownfield companies, by a French company of the Belgrade Airport, into the Balkan gas pipeline, a joint-venture by the Serbian Government and Russian capital building a gas pipeline (as well as railroads) and UAE investments in agriculture and real estate. We have not been able to explain only one very bulky figure - of Euro 849 million into the construction sector in 2019.

The trend exhibited in the above figures leaves little doubt that there is more at work than chance and/or geopolitics. Leaving the bulky one-off investments aside, an increasing trend is evident in the inflows into nearly all the shown sectors (including the residual "other manufacturing" and the residual "other" sectors). Moreover, investments from the EU28 nearly doubled since bottoming out in 2012 (not shown).

There is a "smoothness" in the flows that probably reflects the likely regular re-investment of capital brought in by many large or small investors. This is, again, one more example of the self-reinforcing effect that the passage of time and the gradual accumulation of productive capacity can have on growth. The gradual emergence of a healthy new economy will contribute to investment growth simply because the pool of new companies capable of accumulating (and investing) savings grows. This is also true for FDI as it consists both of new entrants and of reinvestment by existing companies. For reinvestments to keep happening nothing much new or pro-active needs to be done by the recipient country, as long as the global and domestic business environments do not deteriorate sharply. Of course, if and when they do deteriorate, this may cause a sudden reversal, triggering negative flows, i.e. disinvestment through the repatriation of profits.

CEVES' analysis as well as interviews with investors already operating in Serbia (primarily in the manufacturing sectors)[9] strongly confirms the impression that they are very satisfied with their operations - those that can upgrade production mostly plan further investments. Several factors are at play. Serbia's location, with geographic and regulatory access to both the EU and Russian markets, was always an extremely favorable factor. However, now they are moving operations that have become too costly (at relatively low technological levels) both from Asia and from CEE into the Western Balkans or Northern Africa. In the case of transition Europe, the supply of labor for the kind of industries that Serbia is attracting is disappearing, and in the

8 The NBS publishes sectoral data in somewhat greater sectoral disaggregation, and by country of origin. The two perspectives can be matched with information available in the public domain about specific deals. In particular, the 2018 figures in mining and basic metals to inflows shown in the NBS tables as coming from China and Hong Kong, and the inflows into logistics in 2018 correspond to flows from France, while those into land and pipeline transport in 2019 are corroborated by flows registered as originating in Switzerland and Russia. (The company investing in the pipeline is owned by Russian capital but registered in Switzerland; this entry should also include loans from Russia's railroad company for the (re)construction of Serbia's railroads). Spikes in flows originating in the UAE in 2017 and 2018 are associated with (but outstrip) the spikes we show circled in agriculture and could also comprise a part of the increasing flows into real estate. A spike in the inflows from Hungary in 2019 can be partly explained with OTP bank's purchase of Société Générale Bank at the end of 2018, (and there is a corresponding outflow back to France in 2019), but some Euro 200 million of flows from Hungary remain unexplained. Also we have not found an explanation for flows from the Netherlands in 2019 which amount to Euro 800 million. They are likely to be related to at least part of the unexplained flows into construction.

9 CEVES manuscript commissioned by IFC. *COVID-19 and GVC Restructuring: Risks and Opportunities for Mid-tech Manufacturing in the Western Balkans, forthcoming.*

case of the Far East it has become too expensive, as well as risky. In fact, Chinese and other Asian companies are now investors in Southeast Europe, taking advantage of the combination of favorable location and costs at the doorstep of Europe. Second, in recent years a process of global regionalization of formerly global operations has been triggered by geopolitical tensions. This trend has now been further exacerbated by the Covid-19 pandemic that has uncovered the vulnerabilities of overly long or globalized production value chains. European capital is returning from Asia, and Serbia offers the largest and most sophisticated among the low-cost, well-located, Western Balkan labor markets.

3

THE ESSENTIAL BUT ELUSIVE "BUSINESS ENVIRONMENT"

In the previous pages, competitiveness was defined as the effective cost/profitability of producing the goods and services that a country is able to produce. However, there are also indirect or hidden costs as well as risks of doing business in any country, and these are determined by various elements of the business environment, ultimately also affecting competitiveness.

There is no doubt that, with regard to "stability", Serbia is perceived to have improved in recent years. Should a country descend into conflict, or a major financial/currency crisis, the entire investment may be lost. Above all, the stabilization of Serbia's external debt attained with the fiscal consolidation of 2015-2017 has been an essential contribution. However, time and rhetoric have also helped with the perception of political stability. Years of cumulative positive experience by current investors, and the growing distance from the conflict of the 90s, have contributed to Serbia's image as an investment destination. It is more difficult to assess if the effort invested by the government to promote the country as a paragon of political stability is in fact producing positive results or sending mixed messages.

However, in the subsequent pages, I focus on the "ease of doing business" as the core meaning of the term "quality of the business environment". This depends on the quality of governance and regulation – do they impose unnecessary or hidden costs? And even more importantly – how reliably and fairly do the institutions protect/implement policies and regulations? For if they do not, investment may be lost not because of a tsunami or exchange rate devaluation, but by predatory behavior of government officials or well-connected businesses; or they may be lost due to unforeseeable policies. As we will see, in some, more measurable ways, the business environment in Serbia improved in the first years of the regime. In other, harder to measure ways, it has deteriorated.

3.1 THE "EASE OF DOING BUSINESS"

Upon taking the reins of government in 2014, the then PM Vučić invested a considerable and visible effort to send a message of investor friendliness to the world. Over the following few years **international indices measuring the quality of the business environment improved markedly reflecting both real and cosmetic changes**. Real improvements reflected the already mentioned improvement in the macroeconomic performance, as well as some real administrative change. Throughout the past nearly two decades, Serbia has continuously been pursuing regulatory reform finally producing meaningful change in the broad business-friendliness of tax administration, inspections and labor regulation.[10] The indices were particularly affected by the introduction of an electronic tax submission system and the digitalization of construction permit issuance – both meaningful reductions in red tape. A significant share of the improvement, however, simply reflects an effort by the authorities to affect measurement and improve thus the country's image. In particular, about two thirds of the approximately 30-place improvement in the World Bank's "Ease of doing business" ranking can be ascribed to Serbia-specific measurement methodology corrections (The World Bank 2015). Since 2018, however, the indices have stopped improving and in some aspects are deteriorating.

The current regime has also eased the execution and raised the profile of support for large, essentially foreign, investments. For major investments with access to this channel a bee-line has been established to the Office of the President of the Republic, accelerating decision-making by Serbia's indecisive administrative system and trouble-shooting in the always complex relations between the central-local government nexus. Serbia's ministries, the Development Agency and local governments as well as various committees continue to operate formally as regulated. However, a surprisingly large portion of actual investment promotion and individual policy decisions are *de facto* made by the Office with informal lines of command towards the formal institutions. This is a parallel system that has short-circuited real administrative problems. However, it has not solved them. Moreover, the short-circuiting works only for some investors. In doing so, it has necessarily worsened the business environment for the others and it has further weakened the relevant institutions.

This short-circuiting is particularly effective in shortening the period in which construction permits are obtained. **As atte-**

10 This has been painstakingly promoted, documented and measured by a series of USAID's projects (https://saradnja.rs/wp-content/uploads/2020/11/Anketa-1000-preduze%C4%87a-2020..pdf) as well as by other bilateral partners such as GIZ and SDC.

sted to by the growing number of grass-roots protests, this is not a sign of decision-making efficiency but rather of a lack of planning, not to mention insufficient consultation and consensus building around the true public interest. There is not, as one would wish, any evidence of an increased agility of institutions in planning and assuring that the necessary checks and balances in the realization of different interests have been engaged.

3.2 A DISCRIMINATORY BUSINESS ENVIRONMENT IN TWO WAYS

Serbia's business environment discriminates between investors in two ways. One is that the attention lavished on large (foreign) investors inevitably leaves other investors with less support resources. The other comes through the back door and helps domestic political "insiders" in contrast to "outsiders". Ultimately, small "outsiders" end up doubly discriminated against.

Extreme centralization and discretionary central decision-making leave those investors that cannot reach the President's bee-line without adequate service. This discrimination will happen even if it is not the policy intent because the bee-line creates institutional paralysis. A red carpet of administrative procedures can be rolled out from one center only for so many investors. The center will want to focus on the larger ones, to produce maximum effect. But servicing a multitude of investors -- large, medium and small -- requires a multitude of empowered offices and officials, in national institutions and local governments, that can "roll the red carpets out" for each and every one. They should be able to make indiscriminate rules-based decisions and even use well-regulated judgment and discretion (as is necessary in every reasonable system). Instead, in the present system these would-be decentralized authorities do not act. They are too busy attending to the handful of (large) central priorities or worrying if their judgment will meet with political approval.

The administrative discrimination is further exacerbated by the huge difference in policy attention and public resources dedicated to large (mostly foreign) and SME investors. Cash subsidies have been paid primarily to manufacturing and service outsourcing industries, as well as fiscal incentives and land infrastructure improvements whose value is hard to assess. As true policy consultations with incumbent stakeholders are rare, it happens that a foreign large investor may be offered benefits in direct competition with already existing SME operations. And even if such a direct unfair competition may not be frequent, the overall competition for managerial and other skilled talent between local businesses and subsidized entrants is intensifying.

Serbia's business environment presently suffers from an even more pernicious but harder to document discrimination – that between political "insiders" and "outsiders". In any country "good political connections" are useful in doing business. In Serbia, this has tended to go further, amounting in some degree to clientelism. However, it is one thing to be able to use political connections to get contacts, obtain privileged information and even get deals in exchange for kickbacks and quite a different thing if "outsiders" are actively pushed out in favor of "insiders". Currently, there is growing anecdotal evidence that "outside" businesses are hampered if operating independently and even racketeered. Pressure may be applied even by manipulation of the very public institutions that should protect the law – inspections, electricity supply, etc. This clientelist behavior is hard document, as affected businesses will not generally come publicly forward. The anecdotes tend to circulate as hearsay but every so often one comes across first-hand information. Some investigative journalism is also strongly suggestive (Brkić 2017).

The discrimination between insiders and outsiders is closely connected to the rule of law and quality of governance which, most expert observers would agree, are deteriorating. For example, Serbia's standing at the World Bank's Worldwide Governance Index, along with Freedom House's measurement of the quality of rule of law and democratic voice and accountability have been clearly deteriorating since 2017. (World Bank 2019, Freedom House 2017-2020).

In the described business environment, small businesses, domestic or foreign owned, and domestic outsider businesses, large or small, will suffer. Domestic businesses will be hit, or live in the fear of being hit, if they do not play the clientelist game. Foreign businesses, at least, can rely on their embassies for protection against clientelism, but small size is likely to play against them as well. Small domestic businesses are doubly affected - they are not visible to the system and not protected from "insider" extractive interests.

3.3 MISSING THE OPPORTUNITY FOR SUSTAINED DEVELOPMENT

Both these kinds of discrimination will dampen growth and eventually prevent development. Clientelism is clearly the bigger problem, but let us first ask the more complex question – why does it matter whether the investor is large or small, foreign or domestic?

The sustained development of national economies requires a strong role for domestic entrepreneurship and investment, both for strictly economic and for political economic reasons. All else equal, national investors have a stronger commitment to operating (re-investing) in the domestic economy, enhancing stability in times of crises. Also, a developmental policy process needs the engagement of a domestic entrepreneurial class, and Serbia's would certainly benefit from more domestic investment and a stronger entrepreneurial voice.

Importantly, the contribution that domestic capital/small entrepreneurship and foreign capital/large entrepreneurship make to development differ and need to complement one another. On the one hand, large foreign investments can instantly engage large numbers of employees and connect them to the global market and the

newest technologies. On the other, domestic SMEs are much better able to assemble precious bits of the country's legacy of know-how in geographically dispersed locations. For example, a number of such companies in metalworking, machine-building or electronics export high-quality custom-made or niche products (CEVES 2017). Domestic SMEs are also far more likely to be interested and able to access skills or natural resources dispersed across remote, sparsely populated rural communities, creating broad company/farm networks supplying or sourcing from rural markets. Thriving SME networks of this kind are essential to stop the depopulation of rural communities.

An economy may grow for a while by importing foreign capital and investors, but sustained development requires a continuous "movement" of people and capital from less to more productive activities. This, in turn, requires the work of "all hands on deck" — large and small businesses, central government organs and decentralized as well as local institutions. Opportunities need to open to employ the unemployed, and career paths need to open that take those already employed to better and more productive jobs. Take, for example, (typically domestic SME) producers of boiler vessels that tend to operate in small town and rural areas. They may "move" their employees "up" on the productivity ladder by adding components such as thermostats to their products. Such improvements could substantially benefit from rather inexpensive public-private collaboration on small innovations, for example, within regional academic communities. On the other hand, call centers (typically foreign owned) may "move up the development ladder" by developing business process outsourcing operations, on condition that the education system produces sufficiently qualified graduates.

In this "movement" up the development ladder, some activities -- for example very small-scale farming -- will be discontinued. Those who worked in them will need support from institutions such as the employment service to reskill and find better jobs. We should hope that the production of automobile wire harnesses, which pays minimum wages and cannot be upgraded like boilers, will eventually also be discontinued in favor of more productive and better paying jobs. But many of these factories are located in relatively isolated rural locations (CEVES 2019) and a developmental but decentralized state will probably need to help the emergence of new developmental opportunities, at the local and regional level.

Unfortunately, clientelism -- the **discrimination between insiders and outsiders -- will only make sustained development of the kind just described much less likely.** One problem is that it discourages outsider investment, dampening investment overall. And indeed, total investment in Serbia is low by international standards, despite foreign investment being substantial. This suggests that domestic capital investment in Serbia is extremely low (FREN 2018, Fiscal Council 2020). There is anecdotal evidence that that large outsiders from Serbia are taking their capital out of the country, even if they would prefer to invest locally (Brkić 2017).

The other problem, possibly greater, is that clientelism creates a negative incentive spiral even among those that do invest. It is highly unlikely (although not impossible) that a system that discriminates between insiders and outsiders can keep the system of rewards within the insider circle aligned with their contribution to competitiveness and growth. Instead, rewarding political loyalty over merit, it slips into growing corruption. This ultimately redirects economic activity from productive capacity building and growth towards "rent-seeking" (obtaining favors and privileges from the government).

In the longer run a political economy is built that shifts the focus of the policy and political game from enlargement of the "national pie" towards its distribution and grab. What could and should have been a developmental state becomes one supporting an extractive elite. Serbia's cultural legacy is already weighed by the perception that one person's gain is another person's loss. In this environment it becomes expected that income is "received" rather than earned. It may be re-distributed by formal policy (taxes and subsidies) or informally by corrupt and extractive (Acemoglu and Robinson 2012) "insider" practices towards public funds. This is the kind of environment where populism and corruption thrive and development ends.

4

A SUMMING UP

After its implosion in the 1990s, Serbia's economy never "recovered". It needed to be rebuilt, and to this day its performance has stood below what may be described as its "historical potential". First, the strong growth in 2003-2008 was in fact not quite commensurate with an actual recovery from the disaster. Then, although the onset of the GFC dealt it a relatively light blow, subsequently it took a long time for it to recover the pre-crisis activity levels. The far overdue fiscal consolidation while rescuing Serbia from a financial crisis, postponed what appeared as a gathering acceleration of growth by another two years. By the end of 2017, when growth finally begun to systematically pick up, GDP stood only 8 p.p. above the level attained in 2008.

Throughout most of this period the underperformance was largely the consequence of a very slow transitional transformation of Serbia's traditional economy. For the new economy to lift the growth of the entire economy, it needed to outgrow the traditional one, and this happened only around 2014. Without going into the reasons for the slow pace, let it be said that there was no evident effort to tackle the transformation more proactively -- no visioning of the economy's future and needs, capacity-building, or coordination of all those interested in the creation of this future. Throughout, the authorities' focus was on a rather ineffective privatization and a plan-less attraction of FDI. This is important, because the latter remains the essence of the Serbia's current growth model, as well. The life-support system that had kept the unrestructured traditional economy notionally alive was finally unplugged during the fiscal consolidation.

By 2015 the new economy had been built, less accomplished than the potential harbored in the traditional economy of 2001, but competitive and sustainable, with exports soon to reach 50% of GDP. This economy has thus far been able to offer a reasonably rich service and capacity eco-system at very competitive costs to any potential investor, albeit with a seriously tightening skilled labor market.

Throughout the entire described period, Serbia has attracted FDI at per-capita levels exactly commensurate with an average performance for comparator transition countries: less than the highest performing Visegrad countries, but substantially more than the rest of the Western Balkan countries. An analysis of recent FDI inflows suggests they may now be accelerating, not owing to particularly successful policies, but due to global factors. Both Serbia's competitor new EU member states and China are moving up to higher levels in the development ladder, leaving Serbia behind and opening the field for investment in the kind of capacity Serbia has to offer. Other factors, such as Serbia's geopolitical positioning at the doorstep of Europe and Belgrade's central position in the Western Balkans are also helping as the global value chain layouts reconfigure.

Unfortunately, this structural offering is complemented with a very faulty business environment. It helps that Serbia has, over the years, streamlined the administrative burden of doing business. However, while the fast-tracking of procedures and generous incentives designed to attract large foreign investors help attract such investors, they discriminate against others. The single-minded pursuit of large foreign investments, especially as it does not follow any development vision or stakeholder consultations, end up creating a much more difficult environment for small, particularly domestic, investments. The problem is further seriously exacerbated by clientelism, or a discrimination between domestic "insider" and "outsider" stakeholders.

Such a business environment will prevent Serbia from making the most of its (finally!) favorable structural position. Without a level playing field it cannot mobilize all the potentially available domestic capital. All kinds of investors -- small and large, domestic and foreign, regardless of political allegiance -- need to complement one another to both reach all the corners harboring know-how and resources and linking them to global markets. A discriminatory business environment will exacerbate inequalities and foster Serbia's depopulation.

Yet, thanks to the structural moment, even with the current faulty business framework, Serbia's economy can grow at "satisfactory" if suboptimal levels for a while. How long, depends on several factors. First, the authorities need to reign in the populist spending instincts that have been on display during the current crisis. Second, the quality of public infrastructure spending and of the FDI attracted need to be kept at reasonable levels. The effectiveness of both would be greatly increased if there were so much as an effort to plan development and prioritize public investment (including in education) with at least some stakeholder consultation. The most important question, however, is the scope of the clien-

telist state. How many businesses, in how many sectors, does it actually reach? How fast is the rent-seeking game growing? How fast is it replacing entrepreneurship? These questions, unfortunately, are the most difficult to answer.

The promise of less (reckless) clientelism and possibly less investor discrimination is not enough for a meaningful improvement in an opposition policy offering. A truly developmental policy needs not only to level the playing field but also to reach the broad variety of SMEs that make Serbia's economy. This will require the engagement of the very institutions that are currently increasingly being damaged. In this, it should be kept in mind Serbia's governance system was not effective with the previous regime either. The parallel decision-making mechanisms that the current regime relies on short-circuit real shortcomings. They might, in fact, have been justified for a while as a way to buy time to streamline and strengthen institutional operation. Instead, however, they became entrenched and the institutions weakened. A developmental state will require a true improvement in governance and the business environment. This, in turn, will require a true overhaul of the interaction between the political and administrative system, including a fundamental empowerment (and capacity building) of a decentralized administration.

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SERBIA'S ECONOMIC GROWTH

It is Real and (Yet Another) Missed Opportunity

It is the economy that most interests Serbia's electorate and Serbia's economic growth has been accelerating since the end of the fiscal consolidation. To win, a democratic political alternative needs to offer a credible, better, performance. Other than the consolidation itself, growth has been moved by the same old policy model focused on attracting FDI. This time, however, there is not the ballast of the long-drawn restructuring of the traditional economy and Serbia is a more competitive investment destination as Central and Eastern Europe and China have moved up the development ladder. Much can be improved on that by offering active engagement and the rule of law to the domestic business sector.

Short-circuiting of administrative procedures by parallel political decision-making mechanism and generous incentives attract large foreign investors but discriminate against all others. Political "insiders" are then helped out, while small "outsiders" are doubly disadvantaged. Such an environment will exacerbate inequalities and foster Serbia's depopulation. A meaningful improvement on current policies requires not only to level the playing field but also to reach and engage the broad variety of SMEs that make Serbia's economy. This will require the effective operation of the very institutions that were neglected by the previous democratic regime and are actively being damaged by the current one.

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