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# Political Sources of Growth and Competitiveness Contemporary Serbia in Comparative Perspective

BY

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## Abstract

The present paper explores the levels of growth and competitiveness in Serbia with regard to the institutional, political and economic environment of the country, providing a detailed report. The paper explains: 1) the significance of economic growth in general in order to inform the reader about the importance and necessity for an environment reinforcing economic growth within a country, 2) the link between economic growth and the levels of competitiveness in the country, as well as on the institutional, political and economic determinants that can positively or negatively affect growth, 3) the political, institutional and economic background of the Balkan region and Serbia in particular, in order to assist the reader in understanding how the current institutional and economic environment of the Balkan region and Serbia were formed during the period of post-communist transition, 4) the level and trends of the competitiveness of Serbia's institutional, economic and business environment, in a longitudinal and comparative examination, in order to detect specific inefficiencies in its growth performance.

The analysis concluded that the country has many weaknesses, but the most important ones are inefficient institutions and a weak rule of law, which have allowed corruption to spread to every sector. To further analyze the issue, a regression and two correlation models were created in order to detect the factors that have the strongest impact on Serbia's economic competitiveness, using quantitative methods. The results confirmed that economic growth in Serbia mostly depends on efficient institutions and a solid rule of law, and not on FDIs, which are not sufficient by themselves to guarantee growth.

Based on the findings of this comprehensive analysis, the paper makes specific recommendations about improving the most problematic aspects of Serbia's competitiveness performance. In addition, the qualitative and quantitative studies led to a number of conclusions regarding growth and competitiveness in Serbia, and the country's future prospects. It seems that major reforms are needed, in the direction of Serbian EU accession, for the country to enter a stable path towards development. Those reforms need to be complementary, taking place in all required sectors simultaneously, to have a strong impact.

## Table of Contents

Abstract	
1.1 Introduction.....	5
2.1 Importance of growth.....	7
2.2 Interconnection between competitiveness and growth .....	10
2.3 Political, institutional and economic determinants of growth .....	12
3.1 Political, institutional and economic background of the Balkan region .....	34
3.2 Political, institutional and economic background of the Republic of Serbia.....	40
3.3Comparative analysis of the competitiveness performance of the Republic of Serbia .....	47
3.4 Empirical results .....	72
4.1 Recommendations regarding the improvement of the competitiveness and growth performance of the Republic of Serbia .....	82
5.1 Conclusions - Prospects for the future .....	126
Bibliography: .....	129
Appendix I: .....	152

## Introduction

Country competitiveness and economic growth has become a leading issue for both developing and developed nations. Especially in a period where the negative effects of the global economic crisis continue to persist in a great extent in many countries, the need for a better and more developed growth environment is extremely crucial for any state (Prochniak, 2011). In an open and integrated world economy, the countries strive for competitiveness, investment and human capital that are critical to their economic growth. As a result, one of the main questions for political researchers and policy makers at the present time is how to significantly increase the levels of economic growth and competitiveness in their countries (Barro, 1989).

Competitiveness refers to the ability of a country to create the best social, economic and environmental conditions for economic growth. In other words, “ competitiveness reflects a country’s ability to attract investments, raise per capita GDP, create jobs and wealth for itself, and ultimately raise the standard of living for its own people”(World Economic Forum, 2014). Especially, an appropriate educational system will improve institutions which in turn can increase the democratic levels and economic growth within the country (Barro, 2001).

Nevertheless, institutional and political determinants of growth affect the competitiveness levels of any country in a very significant extent, and these are considered as being the most crucial on growth development by many researchers (Acemoglu and Robinson, 2008). Especially for countries that are still experiencing transition periods, like Serbia and many other SE Europe countries after the fall of the communist regimes, factors such as democratization, marketization, state-institution and civic nation-building play a catalytic role on their development and growth (Kuzio, 2001).

Increased regional cooperation could promote political stability, reduce corruption, enhance economic recovery and attract FDIs in the most needed sectors of the Serbian economy (Uvalic, 2000).The role of the EU is also becoming of great importance regarding political issues in Serbia and SEE in general, such as the issue of the status of Kosovo, which can be resolved only with its political and economic guidance and assistance (Uvalic, 2002).

On the report that is about to follow regarding Serbia’s comparative competitiveness performance, many determinants of growth will prove to be decisively significant.

Nonetheless, the country's inefficient institutional and political environment, as well as its high corruption levels and its weak rule of law seem to be the most crucial for its current poor performance. Therefore, recommendations will be proposed mainly towards the direction of addressing these issues (Acemoglu, 2006a).

## Importance of Growth

Economic growth is often seen as the most important achievement of a successful political and economic policy within a country. The previous thought is mainly based on the positive outcomes that accompany economic growth and improve the social welfare of the citizens to a great extent (Templet, 1996). The key challenge for policy makers is to understand why growth outcomes differ so much across different countries in order to be able to provide recommendations on improving the growth performance of countries lagging behind (Barro and Lee, 1994).

Regarding growth importance Roberts J. Barro, at the second edition of his book named: “Economic Growth”, mentions that the apparently small differentials in growth rates, even at only 1% of GDP, when compounded over long periods of time, can transform a country like USA from a leading world economy to possess similar economic performance to Mexico or Poland. With the previous example, Barro wanted to stress the crucial importance of government policy options in influencing growth rates to the direction of economic growth, poverty reduction and social welfare (Barro and Sala-i-Martin, 2003).

In order to understand the crucial importance of growth for every country in greater depth, some of the most important effects of economic growth in a state will be mentioned, such as:

- Reduction of unemployment

A strong economy that possesses great rates of economic growth is capable of reducing the negative outcomes of unemployment because of the working opportunities that are created within it. With the expansion of economic growth, new working placements are being created continuously, keeping the working force in a productive and non-static rate (Cuaresma, Doppelhofer, and Feldkircher, 2014).

- Reduction of poverty

Even though a significant number of countries that show great levels of economic growth keep a fragment of their citizens to certain levels of poverty (Acemoglu and Robinson, 2012), still economic growth is one of the most efficient ways that can lead to the long-term reduction of poverty within a country. Economic growth counters back poverty because it is one of the most effective ways to create the necessary capital to combat poverty. This is especially

important in developing economies where the sources of finance are usually limited (Roemer and Gugerty, 1997).

Regarding the significance of economic growth for social welfare, Sala-i-Martin, in his book: “The World Distribution of Income 1970–2000”, notes that poverty reduction has been most efficient in the regions where growth has been the largest. For the poorest countries the fertility rate may also rise with per capita GDP, leading to even greater growth perspectives in the future (Sala-i-Martin, 2003).

- Combating budget deficits

Economic growth is essential to improve a government’s budget deficit. Deficits may occur for a variety of reasons, but one of the main reasons that can lead to a budget deficit is the negative phenomenon of recession within a country’s economy (Roubini and Sachs, 1989). Recession happens when a significant decline in activity across the economy takes place, lasting longer than a few months. The technical indicator of a recession is two consecutive quarters of negative economic growth. Budget deficits have a negative result on industrial production, employment, real income and wholesale-retail trade (Galbraith, 2010).

- Quality of living - Protection of environment

Economic growth can lead to greater levels of economic and social prosperity. First of all, higher income can allow consumers to buy and use a greater number of goods and services that will increase their standards of living. Money can also be spent on protecting the environment. With higher real GDP a society can devote more resources to promoting recycling and the use of renewable resources (IMF, 2014). If managed wisely, economic growth can create significant amounts of capital that, in turn, can be spent to the direction of the improvement of the health and education sectors. In addition, it is extremely important that these developments of social welfare can occur through the rise of economic growth without a necessary increase in social spending or an increase in tax rates inside the country (European Commission, 2005).

- Attraction of investments

Investments and especially foreign direct investments (FDIs) are extremely important for the development and overall competitiveness of a country. FDIs are related to economic growth, transfer of technology and know-how, and enhancing employment and productivity inside a country’s market. Especially for developing

economies, economic growth encourages investment and therefore encourages a virtuous cycle of future economic growth, preconditioned on the degree of complementarity and substitution between FDI and domestic investments (Mello, 1999).

Recent global trends in per capita GDP show that the world average per capita GDP has significantly risen and that most countries also increased the per capita GDP of their citizens (World Bank, 2014a). Nevertheless, in some countries income inequality rose but still this inequality was not enough not to cancel out the trend of decrease in the world poverty levels, which fell from 20 percent in 1970, to only 7 percent in 2000. At this point it is very crucial to stress that despite aggregate growth, the increased income inequality can prove to be extremely negative on the effort of reducing world's poverty levels. As can be understood, government policy options are again significantly important in controlling and trying to reduce the world's income inequality (Barro and Sala-i-Martin, 2003).

## **Interconnection Between Competitiveness and Economic Growth**

High competitiveness ratings in a country mean that the country's economy is highly competitive, a condition which leads to higher levels of productivity, which in turn leads to economic growth and poverty reduction. As Alan Greenspan supports in an article of his regarding competitiveness: "History tells us that it is those societies that have the most competitive and advanced cutting-edge technologies that have the highest standards of living" (The Globalist, 2011). A country with high competitiveness provides its firms with the ability to compete effectively in export markets or against imports in its home market. The more competitive a country is the more it can support the welfare of its citizens. As Josef Stiglitz argues "a free and competitive market is highly beneficial to society at large, but it needs government regulation and oversight to remain functional" (Stiglitz, 2013).

A lack of competitiveness usually exists in poor or developing countries. A low level of competitiveness in a country's domestic market is associated with lower productivity that leads to higher unemployment and higher levels of corruption as well. The level of competitiveness in a country depends on many factors that are going to be examined in this report, factors such the effectiveness of the financial system or the state of infrastructure (OECD, 2008a).

Policy makers continuously try to understand the interconnection between the determinants of competitiveness that can influence economic growth, in order to be able to provide recommendations on improving the growth performance of their countries (Barro and Lee, 1994). An efficient and competitive performance within the institutional and political background of a country is considered to be extremely crucial for the improvement of the country's growth rate as well (Acemoglu and Robinson, 2008).

The most economically advanced countries give special attention to increasing their level of competitiveness even more. For example, the International Economic Development Council (IEDC) in Washington, D.C. published the "Innovation Agenda: A Policy Statement on American Competitiveness". This provides policy recommendations to ensure that America remains globally competitive (IEDC, 2012). The promotion of competitiveness is among the primary objectives of the European Union as well. Through the "Competitiveness and Innovation Framework

Programme” the European Commission aims to support SMEs with a budget of 1.1 billion EUR (European Investment Fund, 2013).

On the other hand, well-known economists like Paul Krugman argue that, in the context of countries, productivity is what matters and "the world's leading nations are not, to any important degree, in economic competition with each other." Krugman supports that an emphasis on country competitiveness could lead to protectionism and even trade wars (Krugman, 1994). Nevertheless, in terms of economics, countries constantly compete with each other and are always looking to improve their competitiveness level or gain a competitive advantage. The crucial point is to compete in compliance and respect to the international rules that are set to prevent possible disputes between countries (Dunn, 1994).

## **Political, Institutional and Economic Determinants of Growth**

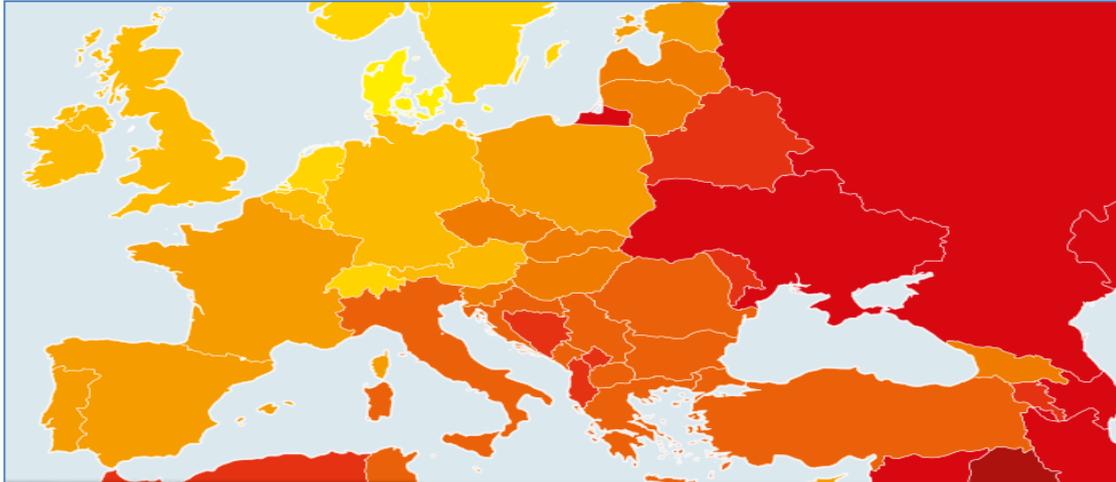
The determinants of growth are the main topic of discussion among many economists, political scientists and academics that continuously try to identify and explore the main factors that can lead a country's economy to economic and also social welfare.

There are many political, economic and institutional factors known at the present time that, according to the structure, number and complexity of their regulatory bodies, can affect the level of growth within a country's economy (Henisz, 2000). It is considered very interesting to study each one of them in order to create a more complete image of the effect that they can have on growth. A more thorough analysis of the institutional and political determinants of growth will be conducted, because according to this and various other reports as well, these factors are considered to be the most crucial for growth development (Acemoglu and Robinson, 2008). Nevertheless, specific economic determinants will be mentioned as well. The most basic of them are listed below:

### 1) Level of corruption

Empirical analysis shows that the degree of non-transparency is an important factor in a country's level of economic growth. In the majority of countries, corruption takes the first or second place in their most problematic factors for doing business and as a result puts an important obstacle to the promotion of a healthy and competitive business environment (World Economic Forum, 2014). High levels of non-transparency can also make a country's business environment extremely unattractive to foreign investors. On average, only a one point increase in the transparency ranking in a country can result to a 40 percent increase in FDIs in that country, as it becomes a much more attractive target for serious foreign investment (Payne, 2001).

Map 1



Source: Transparency international (2014)

Map 1 above illustrates with dark red the highly corrupt countries and with light yellow colors the less corrupt in Europe and the Black Sea region. It is extremely interesting to notice, especially in the European region, that countries with greater levels of economic performance, such as the countries of Northwestern Europe also perform significantly better on the prevention of corruption, something that strengthens the original assumption regarding the negative correlation between corruption and economic growth (Acemoglu and Verdier, 1998).

At this point someone may claim that countries that possess great levels of corruption can still have an upward trend on their economic growth. The following observations provide an answer to this assertion.

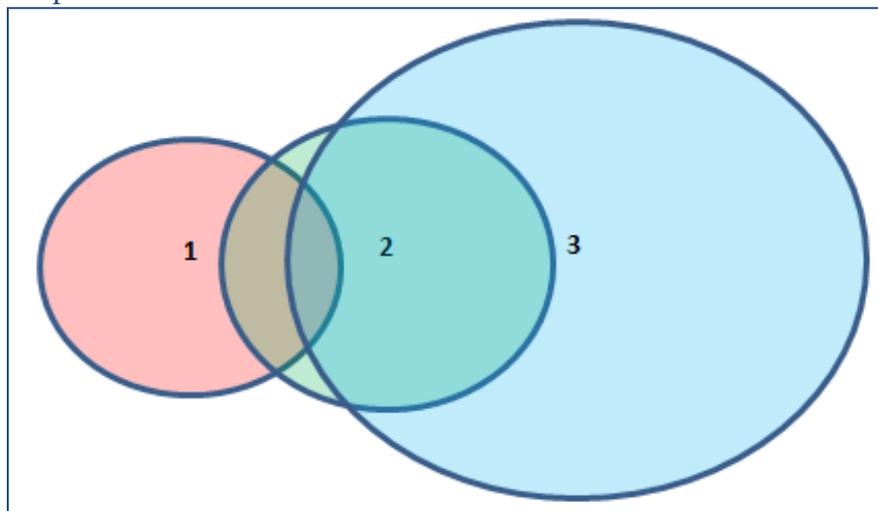
Firstly, growth on these instances is not as stable through time as it is in countries that continuously try to prevent corruption. Secondly, with the absence of corruption, those countries would probably have created even greater growth rates than the ones that were created within a corrupt market (Transparency International, 2014). Thirdly, countries that exhibit great levels of corruption and positive growth rates at the same time usually base their growth development on rich reserves of natural resources that will eventually run out, instead of a deeper and more consistent pattern of economic development targeted on the improvement of their competitiveness and business environment. Lastly, the positive outcome of their economic growth is usually exploited by very few people that possess economic or political power, instead of going on the direction of the public good and the general social welfare of the country (Acemoglu, Naidu, Restrepo, and Robinson, 2014).

## 2) Veto players

According to George Tsebelis, veto players are individual or collective decision makers whose agreement is required for the change of the status quo. As the ideological distance between veto players increases (graph 1), policy stability increases and the win share of the status quo shrinks. In addition, as the number of veto players increases, then policy stability increases as well. The same argument can be used to demonstrate that if 1 and 3 are the veto players, including 2 with veto powers does not affect the set of possible outcomes. As it can be concluded, countries with many veto players are less flexible and are able to engage only in incremental policy changes, including policies regarding growth (Tsebelis, 2000).

A third determinant of policy stability concerning veto players is the size of the “yolk” of the veto players. More specifically, policy stability decreases when the size of the yolk of each veto player increases because cohesive political actors have smaller yolks (Tsebelis, 1995).

Graph 1



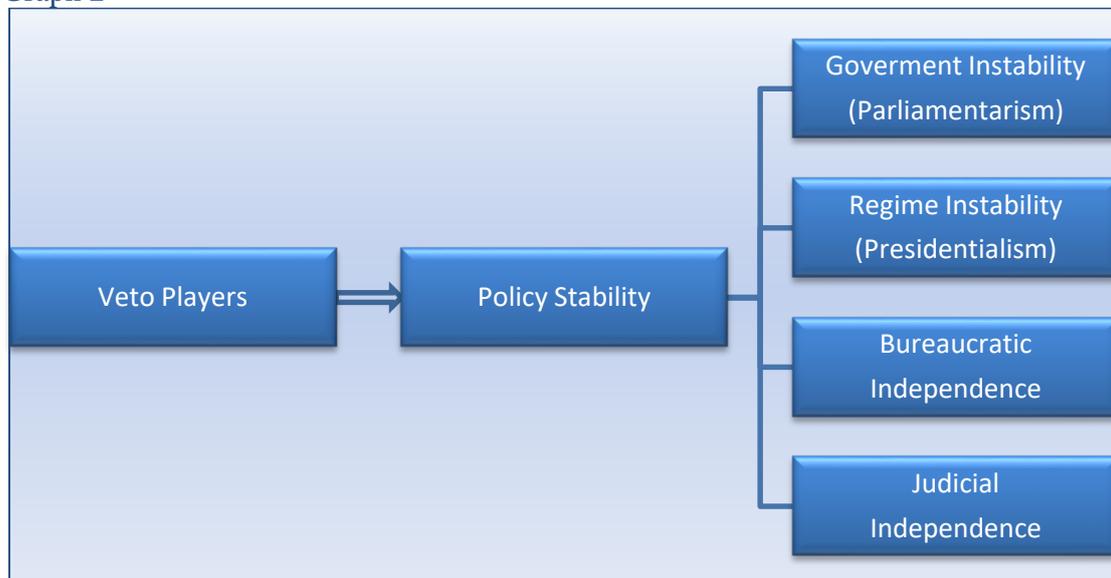
Source: Tsebelis (2000)

To understand the importance of the number of veto players regarding policy stability more clearly, Tsebelis provides an example from the EU. Tsebelis mentions that the legislative decisions of the EU at the past required unanimity from the country members, and as a result the political system was unable to take important decisions and European integration was pushed through by the European Court of Justice. In addition, when many veto players exist increased freedom can be given to bureaucrats concerning the interpretation of law (Tsebelis, 2000).

Also, in another interesting article by Tsebelis and Chang titled: “Veto Players and the Structure of Budgets in Advanced Industrialized Countries”, Tsebelis and Chang, instead of focusing on macroeconomic indicators concerning growth, such as budget deficit or budget spending, claim through their empirical results that the budgetary structure in those countries has the tendency to “lock itself”. This effect takes place in political systems that contain veto players with significant ideological differences between them, while it is minimal when ideologically similar veto players exist accompanied with insignificant changes in government composition through time (Tsebelis and Chang, 2004).

Other important effects of the number of veto players can be seen in graph 2, where it is demonstrated why policy stability is so extremely important in policies concerning growth as well. Policy stability may lead to a series of important negative implications such as: “inability to adapt in exogenous shocks, creation of coalition governments with many veto players, and parliaments with many anti-system parties. Because the regime cannot adapt to sudden changes of the status quo it may fall and give rise to political instability that deters growth. Nevertheless, political systems have a relative stability in their veto players’ structure in order to avoid political failure” (Tsebelis, 2000).

Graph 2



Source: Tsebelis (2000)

On the other hand, in countries that possess a decisive political system it is possible that at certain circumstances it is considered more desirable to add more veto players

in order to increase policy stability, for example in matters concerning wages bargaining (Tsebelis, 1995).

A question that can arise from the previous analysis of Tsebelis, is what can be the solution regarding the number of veto players in order for policy efficiency to be achieved in growth development. According to George Tsebelis the “compartmentalization of institutions can provide one solution to the previous question asked. More specifically, the institutional design can be structured in a way where the overall political system will depend on many veto players, but in areas where decisiveness is required the institutional design may require only one veto player” (Tsebelis, 2000).

### 3) Level of institutional and legal framework

The institutional framework plays a tremendous role in the attraction of FDI inflows, especially for less-developed countries. Unhealthy institutions allow corruption to take root and this means that the trust of the potential investors in the institutional mechanisms of the country is diminished (Walsh and Yu, 2010).

The level of institutional and legal framework can be rated according to its efficiency and its lack of corruption. Corruption can penetrate the governmental elites or the government’s decentralized units such as: public officials, the public roads and transit authorities, the army, the police, the primary schools and healthcare system, which use public funds and provide public services (Transparency international, 2013a).

Since well-established institutions seem to be so crucial for a country’s socioeconomic welfare it would be very interesting to detect the basic elements that can create and maintain a healthy institutional environment. According to many researchers, the answer to the previous question depends on the human capital stock of the country, which through the proper education will lead to improved institutional functioning. A well-functioning educational system will improve institutions which in the longer run will lead to greater democratic freedom and economic growth within the country (Barro, 2001).

Also trade may positively affect institutions, which in turn affect growth (Mamoon and Murshed, 2009). The essential need of every country to create and develop efficient and productive trade mechanisms in order to create profit and social welfare for its citizens plays a drastic role in the establishment of the proper institutions that

will promote and strengthen the country's trade transactions, which in turn will positively affect growth (Le, 2009). However, it has to be mentioned that institutional development is a long-term phenomenon and not an objective policy concept for short-term economic growth strategies (Mamoon and Murshed, 2009).

At the present time many researchers using empirical techniques claim that a higher level of GDP per capita is associated with a larger informal economy size when the level of institutional quality is low and a smaller informal economy size when the level of institutional quality is high. As a result, it can be concluded that without improvement in institutions, economic development alone does not lead to the phasing out of the informal economy (Elgin and Oztunali, 2014).

Finally, regarding the performance of institutions on growth, according to Witold Henisz, the number and complexity of regulatory bodies that form those institutions can be conceived as additional veto points that can alter the direct and efficient faction of the institutional environment of a country on the direction of its economic growth. Because of this, the political elites should work towards simplifying the structure and complexity of the institutions in order that the capture of decisions and activation of reforms will take place in a more effective and direct way (Henisz, 2000).

Unfortunately, the political elites usually do not support drastic institutional reforms in order to simplify the complicated institutional structure in their countries, mainly because of the following three reasons:

- Political elites are unwilling to accept the economic cost of such a procedure, because of their political coalition's economic interests.
- Political elites are unwilling to accept the political cost of such a procedure, because of their coalition's political interests.
- Inefficient institutions persist because the different social, economic and political groups that are able to reform them do not agree on who (increased complexity that promotes veto power) should bear the cost of the reform (Acemoglu and Robinson, 2008).

#### 4) Degree of economic freedom

The level of economic freedom plays a significant role in the promotion of economic growth within a country. In general, state action or government control that interferes with individual autonomy limits economic freedom (Heritage, 2014a). A comprehensive view of economic freedom encompasses all liberties and rights of

production, distribution, or consumption of goods and services. Reports show that the greater the level of economic freedom of a country the greater the attraction of FDIs (OECD, 2007a).

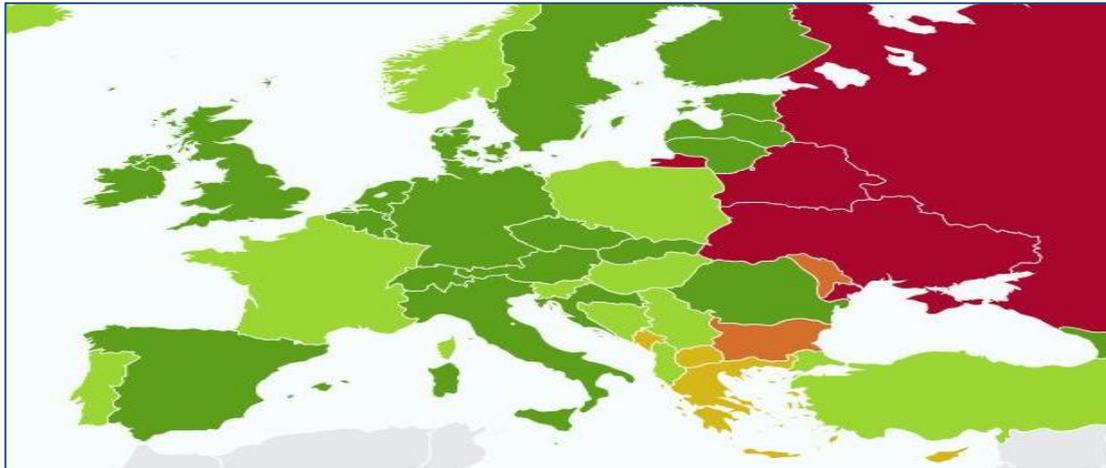
Economic freedom includes secure property rights, the freedom to enter into agreements with other domestic and foreign entities, the lack of state intervention in the conditions of voluntary agreements, and freedom from confiscation of property through excessive taxation or unexpected inflation (Hanke and Walters 1997).

Regardless of the selection of countries and the time of analysis used, political and economic researchers agree that, in general, economic freedom has a significant and positive impact on the pace of economic growth. More precisely, increases in economic freedom are robustly related to growth, while the overall level of economic freedom is not strongly related to growth (Sturm and Haan, 2001). In addition even if unexpected political freedom does not have a significant effect on growth, changes in the level of political freedom are influenced by economic growth (Piatek, Szarzec, and Pilc, 2013). Democracy may enhance growth but this happens mainly when low levels of political freedom exist (Barro, 1994).

Empirical studies reveal that the level of per capita real income is an increasing function of the different aspects of economic freedom. More specifically, business freedom, freedom from corruption, investment freedom, monetary freedom, government size freedom, trade freedom and property rights freedom seem to occupy the first places among determinants that can positively influence growth (Cebula, 2013).

As it can be easily understood, the role of the government of a state is of great importance, because if it fails to create the necessary institutional arrangements to protect and increase the level of the economic freedom of the country, this will have serious negative consequences for the economic and social welfare of its citizens (Sturm and Haan, 2001).

Map 2



Source: Heritage Foundation (2014b)

Map 2 above, illustrates with dark red colors the highly repressed economies and with dark green colors the freest economies in Europe and the Black Sea region, according to the measurements used by the Heritage Foundation for 2014. It is extremely interesting to notice, especially in Europe, that countries with greater levels of economic freedom, such as the countries of North, Central or Western Europe, perform also significantly better on their growth rates in comparison with the countries of South Eastern Europe or the Black Sea area, something that strengthens the original assumption regarding the positive correlation between economic freedom and growth (Heritage, 2014b).

##### 5) Political stability

The term political stability can be defined as the state of peace that is achieved in a country thanks to the activities of the government. The government in this case makes decisions keeping in mind the best interests of the people (EBRD, 2014).

Economic growth is undoubtedly strongly interconnected with political stability for a number of reasons. Probably the most crucial of those is that political stability strengthens the confidence of internal and external investors that social unrest that can lead to government collapse and possible investment failure will not occur within the country (Ozler, Roubini, and Swagel, 1996).

In addition, political stability is usually interconnected with higher institutional efficiency regarding the protection of property rights of the potential investors and as a result contributes to the increase of economic growth rates (Barro, 1989).

Nevertheless, the interaction between political stability and growth may take different forms at different levels of development. For example, during periods of

exceptionally high growth in middle income countries growth may be associated with rapid social transformation and political unrest (Huntington, 1968).

#### 6) The starting level of per capita GDP in the country

According to the empirical findings of Robert J. Barro in his book: “Economic Growth in a Cross Section of Countries”, it was detected among 98 countries that the lower the starting levels of per capita GDP the faster the growth rate. As a result, the findings showed that poor countries eventually tend to catch up with rich countries, although this is based on the assumption that poorer countries have high human capital<sup>1</sup> per person, which may not always be the case in practice (Barro, 1991).

The previous conclusion, which is also known as the effect of “convergence”, can also be extracted from the assumption of diminishing returns to capital, which supports the belief that economies with less capital per worker have higher rates of return and higher growth rates. Nevertheless, it has to be mentioned that the previous phenomenon of growth convergence refers mainly and can be taken into account between countries that belong to more homogeneous groups, for example the EU countries or the U.S.A, where the institutional framework is in a great extent similar among them (Barro and Sala-i-Martin, 2003).

#### 7) Macroeconomic stability

The term “Macroeconomic Stability” describes a national economy that has minimized vulnerability to external shocks, which in turn increases its prospects for sustained growth (OECD, 2012a). Factors such as low and stable inflation, low long term interest rates, low national debt relative to GDP, low deficits and currency stability are used to measure the stability of a country’s economy (Montiel and Servén, 2004).

A useful framework regarding macroeconomic stability, from an economic point of view, is the public sector solvency condition, which requires the present value (PV) of primary surpluses ( $T - G$ ) and seignior age revenue ( $dM$ ) to be at least as large as the government’s outstanding stock of net debt:  $PV (T - G + dM) \geq B$  (World Bank, 2004).

In addition, the level of tax-rates is extremely decisive because it’s the amount of money that the investor has to give away from his profits to the government of the

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<sup>1</sup> Human capital: Refers in the efficient level of knowledge, skills, experience and training within a population.

country that he is about to make an investment in. For example, if the corporate tax rates of Greece in 2014, that was 26%, are compared to those of Montenegro, that was 9%, the importance of that difference on the investor's actual profit is quickly understandable (OECD, 2014).

Another decisive factor regarding tax rates as determinant of growth that requires government stability and efficiency is the stability of the tax system of the country. More specifically, the main concern of many potential investors regarding the fulfillment of an investment activity in a country, despite the magnitude of taxes, is the power of predictability of the level of tax rates for the following years to come (Barro, 1981). That way the investors will be in a position to create stable future business plans regarding the operations and obligations of their entrepreneur activity in a depth of time. This is why the role of the government of every country concerning policies of macroeconomic stability is of crucial importance for the promotion of growth within it (Galbraith, 2011).

Nevertheless, the relation between macroeconomic stability and growth cannot be explained so easily due to a variety of factors that can mutually affect them. Firstly, the institutional framework that a country has established should provide a feeling of safety to potential investors that the healthy macroeconomic environment (if it existed) will also continue to be so, in other words providing stable macroeconomic level not just for the present but for the future as well (Acemoglu, Johnson, Robinson, and Thaicharoen, 2003). Secondly, stable macroeconomic outcomes must be vulnerable to the smallest possible degree on possible external shocks that might have negative effects on the stabilization of the economy (Montiel and Servén, 2004).

#### 8) Level of education

Education is another important determinant of economic growth. The level of education across countries is responsible for great differences in their levels of freedom and democracy. Education promotes democracy by embodying democratic values and beliefs to citizens through educational procedures that on their turn result to greater social welfare and prosperity. Accordingly, the level of prosperity achieved leads to greater political development and institutional efficiency within the country (Acemoglu, Johnson, Robinson, and Yared, 2005).

Through quality educational mechanisms and procedures a country also provides its citizens with the necessary knowledge and technical skills that a competitive market

desires in order to develop innovative knowledge that will boost economic growth and social welfare (McGrath, 2010).

The importance of education can be proven by empirical results. As explained by Hanushek and Woessmann in their article: “Education and Economic Growth”, each year of schooling is associated with a long-run growth that is 0.58 percentage points higher (Hanushek and Woessmann, 2010).

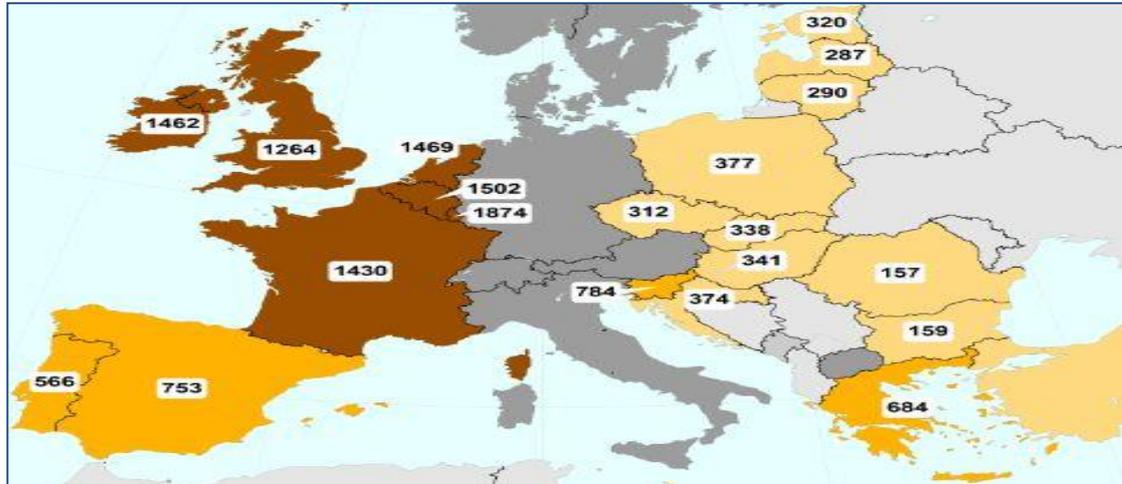
Furthermore, Robert J. Barro at his article: “Education and Economic Growth”, analyses the determinants of economic growth and investment in a selection of around 100 countries observed from 1960 to 1995. Regarding the importance of education in economic growth according to the empirical findings of Barro, it was concluded that:

- Growth is positively related to the starting level of average years of school attainment of adult males at the secondary and higher levels.
- Growth is insignificantly related to years of school attainment of females at the secondary and higher levels. That means that educated women are not well utilized in the labor markets of many countries.
- Growth is insignificantly related to male schooling at the primary level. However, this level of schooling is obviously a prerequisite for secondary schooling (Barro, 2001).

#### 9) Labor and capital cost

From an economic point of view, the level of labor and capital cost is very important because it indicates the amount of money that the investor has to invest in order to finance a business and to pay his workers every month (Bernal-Verdugo, Furceri, and Guillaume, 2012). For example, if the minimum labor cost in Slovakia, that is 338 euros / month, is compared to the one in France that is 1,430 euros / month (map 3) it is quickly understandable that the investor has to pay much higher salaries every month in the second case, something that he takes in great consideration (Eurostat, 2014).

Map 3



Source: Eurostat (2014)

Of course, there are many other factors, that can affect the attraction of investments within a country to a serious extent and that can constitute the main reason that many of the countries that possess low labor or capital costs still do not manage to attract investors. These are factors such as: extremely worrying levels of corruption, unattractive tax-rates, inefficient institutional or legal framework and minimum protection of property rights, among others (Acemoglu, 2010).

#### 10) Access and availability of resources

Another important factor to create growth and attract FDI inflows in a country, especially in a transition economy, is the availability of natural resources such as minerals, raw materials and agricultural products (Walsh and Yu, 2010). Resources can provide a great boost to a country's economy since their existence can create a more alluring geostrategic profile to the country that possess them. As a result, the country will attract investments, reduce the levels of unemployment within it by creating new working positions for its citizens and increase in a great extent the amount of exports (IMF, 2014).

In every commodity inside a country's economy, there are five important procedures that describe its life cycle, which are: resources, manufacture, distribution, retail and consumption. Resources are the natural inputs to the industrial system, including minerals, energy and water. As it is easily understood by the description of this production chain, resources initially play the most significant part on the production procedure since without them the life chain of a product cannot even start (Walker, 2006).

Nevertheless, history has undoubtedly proven that only the existence of natural resources within a country is not sufficient enough in order to create and increase the economic growth levels of the country. Moreover, it is a frequent phenomenon for democracy levels within a country to fall because of greater reliance on natural resources. If the necessary institutional framework on which the country functions is problematic then natural resources can not necessarily lead to efficient, stable and long term growth (Barro, 1999). Arguably countries like Australia or Norway have gained enormously over long periods from their natural resources, while in some countries, such as Bolivia, Venezuela, Congo, Angola and Sierra Leone natural resources have even been the cause of conflicts (Boschini, Pettersson, and Roine, 2007).

#### 11) Productivity

Productivity is commonly defined as a ratio between the output volume and the volume of inputs. It measures how efficiently production inputs, such as labor and capital, are being used in an economy to produce a given level of output (OECD, 2011). In order to measure productivity the MFP (Multifactor Productivity) and the labor productivity indicators can prove very useful.

Measuring labor productivity per hour worked provides a better picture of productivity developments in the economy than labor productivity per person employed, as it eliminates differences in the full time/part time composition of the workforce across countries and years (Eurostat, 2013). In many occasions labor productivity can be increased, but the decomposition of productivity can show different causes of that increase, such as an increase due to the capital stock per hour worked, which actually hid a decline in the MFP (Castro, 2012).

Even when all countries have equal access to new technologies, differences in the skills that each country's workers possess, through the training procedures that they had received, can create important differences on the outcome of labor productivity per hour worked (Acemoglu and Zilibotti, 2001).

Among many researchers and policy analysts prevails the idea that lagging-behind regions concerning technological progress on production would benefit from other more developed regions taking place in the common market. Empirical evidence show that backward regions show increases in the number of patents and quality of human capital faster compared with advanced regions (Filippetti and Peyrache, 2015).

## 12) Participation in political-economic groups and trade organizations

Every country must attempt to boost its economic growth levels through the establishment of proper institutions, mechanisms and procedures that should exist within it. The participation of every country in political or economic groups and trade organizations can also foster growth to significant levels because of the institutional and economic interaction that will be developed among country members (WTO, 1996).

Political or economic groups and trade organizations strengthen the inflows of FDI and the trade-openness of a country. Through the participation in those groups and organizations a number of positive outcomes can be earned, such as:

- Further development of the country's institutional level.
- Lifting living standards around the world.
- Encouraging innovation and the use of new technologies.
- Benefiting all businesses sizes.
- Boosting incomes.
- Creating new employment positions.
- Solving bilateral issues of political or economic content more efficiently.
- Accomplishing cheaper imports and larger export markets (McCubbrey, 2015).

Especially when a country becomes a new member in economic groups and trade organizations, it automatically receives valuable knowledge and technology transferred from countries that are more experienced and possess greater levels of technological development, through their trading and economic interaction (Fagerberg, Verspagen, and Caniels, 1997). Moreover, as the number of trading partners increases, the market in which producers can sell their products expands both in size and diversity, supporting even more growth and development (Kali, Mendez, and Reyes, 2007).

At the final stage of the positive interaction between less and more developed countries within the economic groups and trade organizations that they participate, there is the possibility for the less developed countries to be able to gradually develop innovative power in certain economic or trade sectors that will eventually place them at internationally competitive levels (Grossman and Helpman, 1991).

To provide an example of this, all the European Union countries belong to the European market which allows for a number of economic and trade benefits that come with membership. The European Union acting within the WTO and bilaterally in order to secure better market access for EU countries puts forward three mutually reinforcing goals for 2020:

- Smart growth: developing an economy based on knowledge and innovation.
- Sustainable growth: promoting a more resource efficient, greener and more competitive economy.
- Inclusive growth: fostering a high-employment economy delivering social and territorial cohesion (European Commission, 2010).

### 13) Size of the market

The market size of a country can play an important role on the development and increase of its economic growth levels. Of course, many researchers will argue that there are many cases of countries that despite their large market size they do not manage to create efficient growth (Jaumotte, 2004). The answer to the previous argument lies on the fact that indeed market size by its own cannot guarantee economic growth if other crucial factors like: proper institutional and legal framework, political stability and low levels of corruption do not exist in the country. Only if the previous factors mentioned exist in sufficient and competitive levels, then the market size can certainly boost growth in higher levels, due to a number of reasons mentioned below (Alesina, 2003):

- First of all, because of economies of scale in the production of public goods, the cost of many public goods is lower in larger countries, considering that more taxpayers pay for them (Anan, Mishraand, and Spatafora, 2012).
- Secondly, a large country in population or its national product, receives fewer threats from other, smaller countries, because of its size and influence. On the other hand, smaller countries often receive greater amounts of threats and consequently have to spend a significant amount of their limited budget on defense, where economies of scale again are not in their favor (Alesina, Spolaore, and Wacziarg, 2005).
- Thirdly, smaller countries are not in the position to provide the same amount of insurance and stability in specific regions of theirs that are affected enormously by a potential external shock, as bigger countries usually can

(Anan, Mishraand, and Spatafora, 2012). For instance, the USA consists of 50 states that if one of them will be affected by an external shock, like a natural disaster for example, the rest of them will provide fiscal or technological help to the affected state in order to recover.

- Fourthly, larger countries can build redistributive schemes from richer to poorer regions, therefore achieving distributions of after tax income which would not be available to individual regions acting independently (Alesina, Spolaore, and Wacziarg, 2005).
- Finally, empirical studies show that the greater the size of the market the greater the attraction of FDI inflows in a country, mainly because of a reflecting labor supply effect rather than a market size effect (Jaumotte, 2004).

#### 14) Level of development-infrastructure-Innovative power

The level of development infrastructure is another crucial factor determining economic growth and the attraction of FDI inflows in a country. Empirical studies show that the coefficient of the infrastructure variable is one of the biggest concerning FDI attraction (IMF, 2013a). Also, it is proven by the flows of FDI in the past that more developed countries tends to attract much greater FDI's than non-developed ones.

Factors such as innovative technology systems, reducing distances through effective modes of transport, electricity supplies free from interruptions and a solid and extensive telecommunications network play a significant role in this (Filippetti and Peyrache, 2015). Furthermore, empirical analysis concerning the determinants of economic growth suggests that human capital measured by the education level of the labor force and the development of information technology and communications are among the most important factors that can positively influence economic growth within a country (Prochniak, 2011).

Even when the European Union faced the negative effects of the financial crisis in 2010 and negative growth rates appeared in nearly a quarter of European countries, with Greece and Ireland showing the most significant decreasing trends on growth, the economy remained in positive figures in Europe, thanks to the fact that other more developed and innovative countries like Germany, Finland and Sweden continued growing above three and a half percentage points (Sanchez, 2013).

Lagging-behind regions will adopt the knowledge of current technologies of the most advanced regions and consequently will be able to possess the technological level that will boost labor productivity and will strengthen the growth performance of their markets (Filippetti and Peyrache, 2015).

Finally, the development of innovation techniques through research and development projects is able to deteriorate monopoly power and as a result strengthen competitiveness and growth rates within a country even more (Rodriguez-Pose and Crescenzi, 2008). Nevertheless, distortions related to the creation of the new goods and methods of production signify that in the long run, governmental actions are the most critical on maintaining growth through policies concerning: regulations on trade, protection of property rights, judicial independence from corruption and financial market development (Barro and Sala-i-Martin, 2003).

#### 15) Geographical position

The geographical position of a country can also play a role on the growth that it may experience. There are many factors regarding geographical position that can affect growth, the most significant of them probably are: the sum of bilateral distances between markets, the market potential and the cost regarding market access (Boulhol, Serres, and Molnar, 2008).

Market potential which is often strongly correlated with geographical position is another important factor that affects growth. For example, countries that are geographically placed near a warm seacoast, like Greece, Spain, Italy or Portugal can attract greater number of tourists during summer periods than countries that are placed in the European North. In addition, if a country is geographically placed between significant trade and energy paths this can also have a great effect on the increase of its economic growth (Stern, 2006).

Moreover, countries that are placed in regions where solar energy or wind power is more accessible, due to their climate conditions, may have an advantage on their economic growth by producing solar or wind power respectively. Especially at a time that other energy resources like oil or gas are gradually phased out, ecofriendly energy resources like wind or solar energy will be in an increasing demand in the near future (Biroi, 2007).

Finally, the cost regarding market access is another influential factor that can determine the effect of geographical position of a country on its growth levels. More

specifically, trading costs between European member states are lower, because of the common trade market that exists between them, in contrast with trading costs between a European member state and another country that is placed far away from the European Union's geographical territory and is not a member of the EU (Young and Peterson, 2006).

#### 16) Unemployment rates

Despite the fact that unemployment has a negative effect in the performance of economic growth within a country, the opposite effect does not always take place. More specifically, it has been shown in some cases that despite experiencing growth across many sectors within a country, an economy may still suffer from great unemployment levels. The role of the government is again of crucial importance. This negative phenomenon provides evidence that growth in specific sectors is, in many cases, not sufficient to combat general unemployment within a country, when the country lacks a proper and efficient socioeconomic policy (Mandal.B and Mandal.A, 2015).

Another worrying result of unemployment at the recent time is the negative effect this has on the effort of reducing the growth levels gap between countries that possess low and high GDP per capita across the world. An illustrative example of this negative effect can be provided by the differences in GDP per capita among European Union's member states (North Europe in comparison with South Europe) that put an important obstacle on the efforts of the EU to create policy cohesion and stability between the European economies (Fagerberg, Verspagen, and Caniels, 1997).

Furthermore, as it was mentioned before, labor productivity measures the amount of real GDP produced by an hour of labor and consists of three main factors regarding its increase, which are human capital, physical capital and new technology. As a result, unemployment is negatively correlated with labor productivity growth because it reduces the human capital size to a significant extent (Muscatelli and Tirelli, 2001).

Except for the economic aspects of unemployment, the social effects are also very concerning because of the depressing feelings that are being created, especially in the younger generation that seems incapable to integrate into the mainstream society and in the production process (Artner, 2013).

Many researchers believe that growth and employment recovered after past depressions and this is also going to happen after recent or future economic crises, but

still this theory does not provide any guarantee that many of the recent economic problems will be solved by such a revival in the following years to come, if drastic policies leading to the decrease of unemployment will not take effect (Williams, 1982).

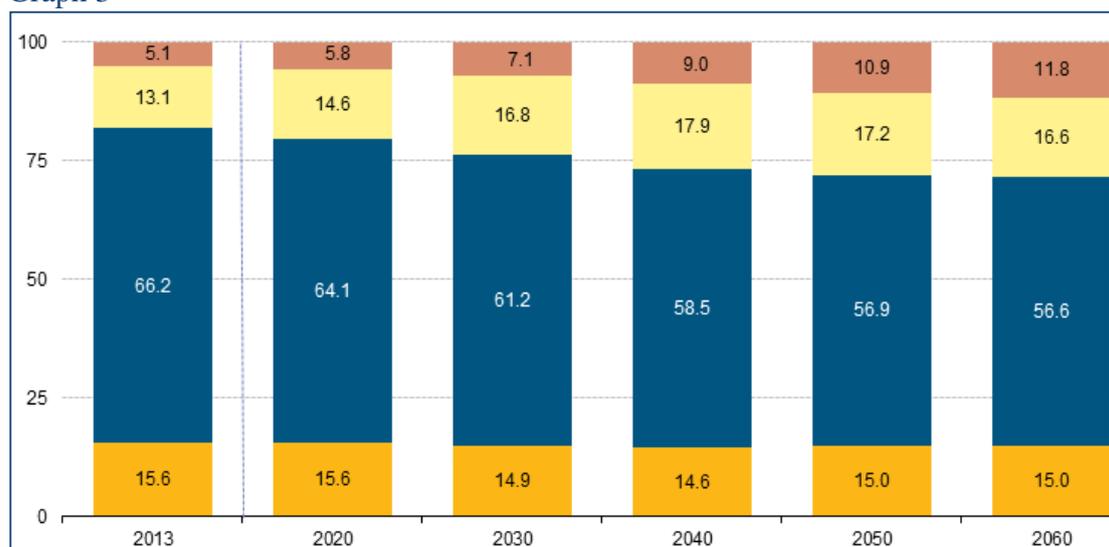
#### 17) Population structure (share of working-age population)

Another significant factor that can play a vital role regarding the growth rates of a country is the structure of its population, more specifically the proportion of people that are in an age that enables them to work in comparison with those who aren't (Fuentes-Castro, 2012).

For example, the proportion of people of working age in the EU-28 is decreasing while the relative number of those retired is increasing. It is also very worrying that the share of persons able to work in the total population will decrease significantly in the coming decades. If policies towards the confrontation of the previous problem won't take place, it can threaten the growth levels of the EU and lead to an increased burden to provide for the social expenditure required by the ageing population placed on those of working age (Bloom, Canning, and Fink, 2010).

In 2013, young people (0 to 14 years old, deep yellow color) made up 15.6 % of the EU-28's population (graph 3), while persons considered as being of working age (15 to 64 years old, blue color) accounted for 66.2 % of the population. Older persons (aged 65 to 79 years old, light yellow color) had a 13.1 % share and finally older persons (aged 80 to 80 plus year's old, light yellow color) had a 5.1 % share. The most worrying part of graph 3 is that in the decades to come according to Eurostat models, the percentage of people considered being of working age (15 to 64 years old, blue color) will have a downward trend and will reach a 56.6 % share of the total population, almost half of the whole population (Eurostat, 2015).

Graph 3



Source: Eurostat (2015)

Policies regarding the increase of the fertility rates are of crucial importance in order to counterbalance the increasing trends of the ageing population. Those policies may concern: tax breaks, cheap childcare centers, and years of paid maternity leave among others. Once again the strong effect that the political and institutional framework can have on factors that can boost economic growth is evident (European Parliament, 2013).

#### 18) Health and life expectancy

Health is of crucial importance regarding the social welfare of every country's citizens. When the citizens of a country are healthy and free from diseases, productivity and competitiveness inside the country is strengthened to a greater extent than would otherwise be possible simply because healthier people can promote greater levels of production. The promotion of efficient health services is on the top priorities of the EU as well. The European Commission proposed an allocation of 396 million € for the period 2014-2020 expenditures in the area of health (European Commission, 2011).

Nevertheless, the empirical results of Daron Acemoglu and Simon Johnson, in their article: "Disease and Development: The effect of Life Expectancy on Economic Growth", indicate that "the increase in life expectancy leads to a significant increase in population. We observe a small positive effect of life expectancy on total GDP over the first 40 years, and this effect grows somewhat over the next 20 years" showing

that health improvement has only a small direct positive effect on growth (Acemoglu and Johnson, 2007).

Moreover, Acemoglu and Johnson in their article: “Disease and Development in Historical Perspective”, mentioned that “when previously isolated populations came into contact during the period of European colonial expansion, differences in disease environments had a major impact on the path of institutional development and consequently on results for economic growth” supporting clearly the idea that it was not the health levels directly but the institutions that were formed because of different health environments of the past, that affected to a greater extent the outcome of growth. Once again it is observed that the importance of institutions cannot be ignored (Acemoglu and Johnson, 2003).

#### 19) Financial markets

Last, but extremely crucial for investments is the level of the financial markets in a country. Financial markets are critical to a country’s overall development. When functioning properly, financial systems allocate risks appropriately and contribute to making economies more resistant to economic shocks. Banking systems and stock markets enhance growth, which is the main factor in poverty reduction. Strong financial systems provide reliable and accessible information that lowers transaction costs, which in turn bolsters resource allocation and economic growth (World Bank, 2013a).

Financial markets facilitate the transfer of resources from savers to investors which can create wealth and opportunities within the society of a country. Of course financial markets must function properly in order to create all those positive effects mentioned within a country, otherwise extremely negative consequences can occur that may exceed the benefits to developing and transitional economies in the future (Nickerson, 1995). Financial market inefficiencies can lead to very negative results, such as: financial crises, rise of poverty levels, social unrest and even political instability (Laeven and Valencia, 2012).

In order to achieve proper functioning and avoid negative outcomes such as the ones mentioned before, financial markets need institutional mechanisms for lowering enforcement costs, sustaining financial stability, making corporate reforms, controlling risk reduction, and increasing the levels of security and transparency (Chami, Fullenkamp, and Sharma, 2010). Also, trusted and transparent institutions

must control in the strongest possible degree the profitable nature of the banks. More specifically, the issue is that, firstly, the banks often do not control the creditability of the borrowers in their greediness to make more profit. Secondly, governmental loans must focus on real growth procedures that would increase the productivity and competitiveness of the country (Woolley, 2010).

A very critical point regarding the positive effects on growth that efficient financial markets can achieve is the level of stability and development that each country possesses at that time (Aisen and Veiga, 2013). To be more specific, countries that are institutionally underdeveloped or in a serious transition period in their political or economic level, often experience slower economic growth in the long run despite the initial financial and stock market development. The reason that the previous phenomenon takes effect in those countries (East Europe, Central Asia, Latin America and Caribbean regions) is mainly because of the vulnerable and inefficient legal systems and the political instability that exists during their transition period (Yu, Kabir, and Sanchez, 2012).

To sum up regarding the nature of the determinants of economic growth within a country, it is extremely crucial to mention that none of the previous factors is capable of creating increased growth rates by its own. Only the combination of all the previous factors mentioned into a significant level can lead to a significant increase of the growth levels of a country (Walsh and Yu, 2010). Finally and most importantly, regardless of whether the previous determinants that can affect growth are of economic or political nature, it was observed and emphasized that institutional and governmental efficiency is always required in order to boost economic growth (Acemoglu and Robinson, 2008). This is the reason that the solutions that will follow on a later section of this report will be focused mainly on an institutional and political basis in order to examine what can the governmental elites of a country do in order to promote growth within it.

## Political, Institutional and Economic Background of the Balkan Region

According to the categorization of countries in transition by Taras Kuzio in his article “Transition in Post-Communist States: Triple or Quadruple”, that was published in 2001, transition in post-communist states can be specified in three broad categories according to the level of institutional, political and national background of the state examined (Kuzio, 2001). More specifically, Kuzio separates the transition of post-communist states in the following main categories seen in table 1.

Table 1

<b>'Double (democracy/market)'</b>	<b>'Triple (democracy/market/ stateness)'</b>	<b>'Quadruple (democracy/market/ state/nation)'</b>
Latin America and southern Europe, Poland, Hungary and the Czech Republic	Remainder of central-eastern Europe	Former Yugoslavia and USSR, Slovakia

Source: Kuzio (2001)

At first it was assumed that successful transitions were a matter of efficient democratization and marketization. Later on, because of the fact that the post-communist countries inherited weak states and institutions, the third factor of “stateness” was added. Nevertheless, because still the transition process of some post-communist states could not be explained, a fourth factor regarding the nationality question was introduced (Brubaker, 1996). According to the previous conclusions mentioned, transitions in post-Yugoslav states that inherited both weak states and nations should therefore be defined as quadruple. This quadruple transition includes democratization, marketization, state-institution and civic nation-building (Kuzio, 2001). The previous additional factor of civic nation-building makes the transition of the western Balkan states much more complicated, because of the large size of ethnic minorities that exist among those states, as the recent Yugoslav wars had tragically proven (Baboona, 2000).

Regime crises can be external (for example a war) or internal (for example the death of an authoritarian leader, or the inability of the authoritarian regime to provide goods and services) and according to many political researchers can be decisive

regarding the democratization process of a country (Grzymala-Busse and Luong, 2008).

The concept of nation and nationhood unfortunately had extremely negative results for the cohesion of the Yugoslav states. The creation of several Balkan self-identities and the stigmatization of the rest as the “oriental” others (from a geographic neighbor to different religious groups within Yugoslavia) was one of the crucial factors that led to the beginning of the tragic Yugoslav wars and the disintegration of Yugoslavia. The previously described perception still exists to a significant extent among the population of the Balkan countries (Bakic, 1995). As a result of the constant war between the post-Yugoslav states the words Balkan and Balkanization had become a synonym for a reversion to the backward and violent, leading to the perception of the Balkans in the West as the “other” of Europe (Todorova, 1997).

Another extremely crucial factor that must be kept in mind when analyzing the post-communist transition path of the Balkan states, especially of the Western Balkan region, is the fact that during the Yugoslav wars’ new economic elites emerged through the black market, the wartime criminality and the organized thieving that had created strong relations with the political elites of the period (Uvalic, 2001). Finally, after the end of the wars those newly established economic elites continued in a great extent to flourish and to gain power, becoming that way a determinant on the levels of corruption and the institutional inefficiencies in the political environment of the newly emerged democratic Balkan states (Macek, 2009).

Moreover, structural prerequisites can play a decisive role on a country’s successful democratization path. More specifically, the level of literacy, economic development and urbanization developed over centuries are able to act as a significant constrain on elite behavior within countries (Grzymala-Busse and Luong, 2008).

Many economic researchers or policy makers often aim on promoting economic efficiency within a country without understanding the political implications that may occur. In many occasions, especially in post-communist states like Serbia that are still in their transition period, accomplishing well intentioned economic reforms to increase economic growth can unfortunately lead to the empowerment of only certain, already powerful, groups, instead of the improvement of the general social welfare, creating in that way adverse consequences for the political stability of the transition country in the near future (Acemoglu, 2010).

An interesting question that can arise at this point is how the transition to democracy and in particular the post transitional constitution affected the business and financial environment of the Balkan countries after the fall of communism and the ceasefire of the Yugoslav wars. The answer to the previous question can be provided through the following two observations:

- Market liberalization did not lead to stable economic development and social welfare improvements because of the political and institutional incapability of the new formed democratic states to prevent private enterprise (domestic or foreign) from taking advantage the devaluation of capital and the decreasing labor costs (Uvalic, 2000). Rather, it created a crucial decline in disposable incomes that lead to a huge decrease on demand, discouraging new investments and new firm formation (Monastiriotis and Petrakos, 2010).

In order to successfully combine capitalism and democracy in the Balkan states the rich must be convinced that the costs of repression or the threat of revolution by the poor class would be too high, in other words, as Torben Iversen explains at his article: “Capitalism and Democracy”, a “Class compromise” should be established. In the Balkan region the concept of complementarity is also very important, which maintains that the effectiveness of one institution depends on the design of another. In order to create a successful transition the Balkan states should create capitalist institutions that are complementary to each other in terms of training, industrial relations, financial governance and innovation mechanisms (Iversen, 2006).

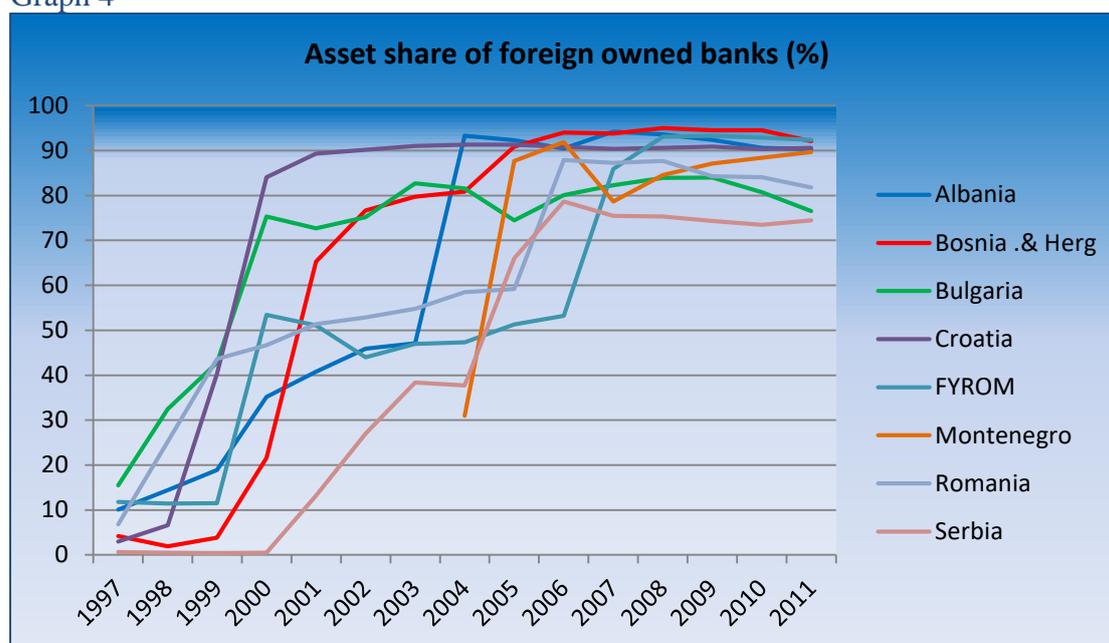
- The failure of incapable policy makers in identifying the complexity of modern market-based economies led the Balkan states to a wild form of uncontrolled capitalistic behavior (Kostovicova, 2006). The complexity of modern markets is strongly interconnected with the social, cultural, historical and institutional background of the countries where they were formed. As a result, their direct transmission from the developed West to the Balkan states didn't lead to the desired growth outcomes (Monastiriotis and Petrakos, 2010).

Usually countries in transition are facing the problem of financial liquidity and the absence of technology that foreign investors can successfully supply through investment actions. Nevertheless, the absence of a concrete and efficient policy plan of attracting foreign investors over time in the Western Balkan region and the reliance

on borrowing capital led those countries in serious debt problems that were further increased by the recent global economic crisis (Skuflic, 2010).

Graph 4 provides an extensive outlook of the asset share of foreign owned banks in SEE, showing the significant degree of interaction between Western European banks and the banking system in the SEE.

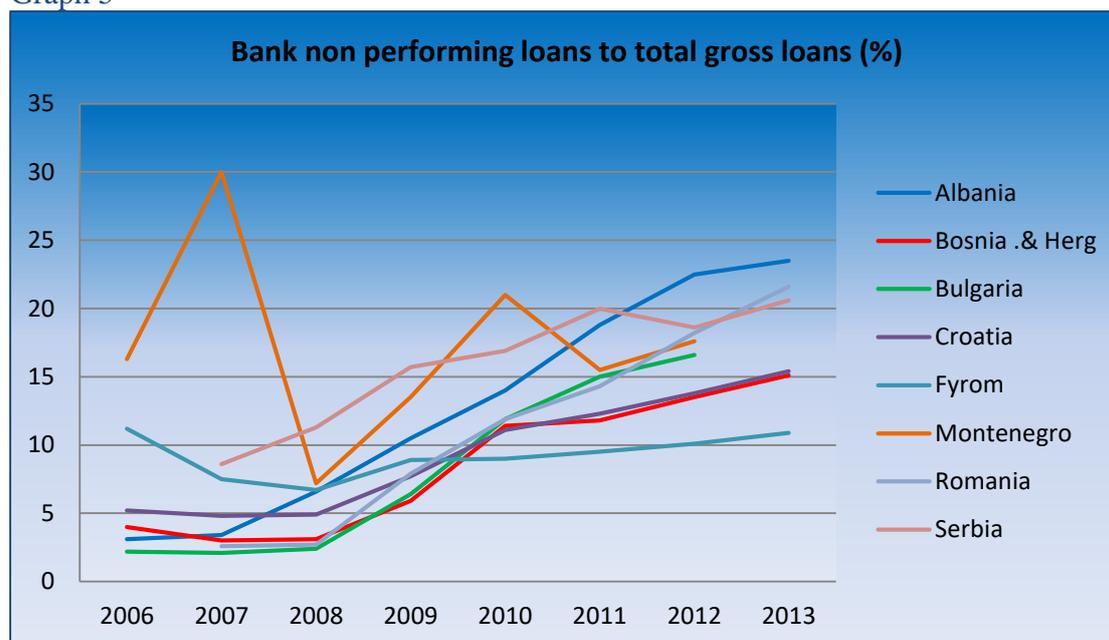
Graph 4



Source: Authors' calculation and elaboration based on data provided by the IMF document on the evolving role of the banking systems in CESEE

Graph 5 shows the percentage of bank non-performing loans to total gross loans in SEE countries which is a very crucial factor in indicating the extent of economic inefficiencies and the need for financial liquidity for the region. As the graph demonstrates, until 2008, these percentages were significantly low under 5%, in all countries except Montenegro and FYROM. But, as soon as the repercussions of the economic crisis started from 2008 until 2013, the previous percentages went extremely higher for all the countries, reaching sometimes 3 or 4 times greater percentages than of those in 2008 (IMF, 2013b).

Graph 5



Source: Authors' calculation and elaboration based on data provided by the IMF document on the evolving role of the banking systems in CESEE

In recent years the EU helped the countries of the Balkan region to a great extent, helping to strengthen their rule of law and judiciary and also to more efficiently face the worrying levels of corruption across the region (European Commission, 2010). Nevertheless, as conditions of EU accession become harder to meet and financial assistance remains limited, this leads to greater economic and political divides within Europe and in turn to worrying signs of anti-EU sentiments in the poorer countries (Monastiriotis and Petrakos, 2010).

In addition, democratic consolidation cannot depend only on the previous actions mentioned. Civil mobilization towards defending democratic values is proven to be an extremely crucial determinant of future democratic welfare in the region (Uvalic, 2002). More specifically, the citizens of the Balkan countries should put more pressure on their political elites through active civic organizations in order to defend free press, improved levels of education, greater transparency in government and parliamentary activities and increased monitoring of financial governmental actions (Subotic, 2010). As Rosa Balfour and Corina Stratulat mention in their article: The democratic transformation of the Balkans: “civil society needs to be seen as a subject of politics, not as an object of policies” (Balfour and Stratulat, 2011).

Finally, providing EU accession status, and thus also full access to pre-accession EU funds, in a combination with a concrete formation of a Balkan development and

cooperation plan aiming at institutional and political reforms in the Balkan countries (Anastasakis and Bojicic, 2002), will maybe make it more possible in the near future for the whole Western Balkans region to enter the EU simultaneously (Monastiriotis and Petrakos, 2010).

## Political, Institutional and Economic Background of the Republic of Serbia

Before proceeding to the evaluation of the competitiveness performance of Serbia, it will be very useful to briefly study the political, institutional and economic background of the country in order to be able to understand in greater depth the political and institutional forces that led to the creation of its current socioeconomic environment.

As it can be seen (in table 2) the country is located in Southeastern Europe and includes a total area of 77.474 sq. Serbia shares borders with Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Kosovo, Macedonia, Montenegro and Romania. Serbia is landlocked, with Belgrade being its capital. The country is governed through parliamentary democracy and possesses a civil law legal system. In 2014 the population of the country was near 7.2 million (CIA World Factbook, 2014).

Table 2

<b>Country</b>	Serbia
<b>Capital city</b>	Belgrade
<b>Location</b>	Southeastern Europe
<b>Population 2014 (Millions)</b>	7.2
<b>Total Area</b>	77.474 sq.
<b>Border Countries</b>	Bosnia and Herzegovina 302 km, Bulgaria 318 km, Croatia 241 km, Hungary 151 km, Kosovo 352 km, Macedonia 62 km, Montenegro 124 km, Romania 476 km
<b>Coastline</b>	0 km (landlocked)
<b>Natural resources</b>	Oil, gas, coal, iron ore, copper, zinc, antimony, chromite, gold, silver, magnesium, pyrite, limestone, marble, salt, arable land
<b>Government Type</b>	Republic
<b>Legal System</b>	Civil law system

Source: CIA World Factbook

Some basic economic characteristics are mentioned in table 3. As it can be observed, the country possesses a large public debt close to 60% of GDP and a worrying public deficit of -4.4% of GDP. The FDI inflows in the country were 650.4 million \$ in 2014 and the inflation rate (in consumer prices) 2.1%. Serbia's composition of GDP is

based mainly on services and industry while the composition of the labor force is based on services and agriculture (World Bank, 2015). Serbia recorded a trade deficit of 405.90 million USD in June of 2015. Balance of trade in Serbia unfortunately averaged -575.67 million USD from 2001 until 2015, reaching an all-time high of -161 million USD in August of 2001 and a record low of -1,364 million USD in July of 2008 (Trade in economics, 2015).

Table 3

<b>GDP (current US\$) 2014</b>	43.87 billion \$
<b>GDP (current US\$) 2014 per capita</b>	6.152 \$
<b>GDP per capita, PPP (current international \$) 2014</b>	12.150 \$
<b>GDP real Growth Rate 2014 (%)</b>	-1.8 %
<b>FDI Inflows 2014 (US\$)</b>	650.4 million \$
<b>Public debt (2014)</b>	60.2% of GDP
<b>Public deficit (2014)</b>	-4.4% of GDP
<b>Inflation rate (consumer prices) (2014)</b>	2.1%
<b>GDP - composition, by sector of origin (2014)</b>	Agriculture: 8.2% industry: 36.9% services: 54.9%
<b>Labor force - by occupation(2014)</b>	Agriculture: 23.9% industry: 16.5% services: 59.6%

Source: Data provided by the CIA World Factbook, Heritage and World Bank database

Serbia also belongs to a number of international organizations, including BIS, BSEC, EBRD, EU (candidate country), FAO, G-9, IBRD, ICC (national committees), IMF, Interpol, ITUC (NGOs), NAM (observer), OAS (observer), OIF (observer), UN, UNCTAD, UNESCO, UNFICYP, UNHCR, UNIDO, UNIFIL, UNWTO, UPU, WCO, WHO, WIPO, WMO,(observer)in WTO (CIA World Factbook, 2014).

After the tragic Yugoslav wars and the disintegration of Yugoslavia, the fall of Milosevic and the end of his nationalistic and authoritarian policies in 2000 ended Yugoslavia's international isolation. Revolutionary moments often arise in the life of the vast majority of autocracies, as their corruption and inefficient economic ways assure it (Bueno de Mesquita and Smith, 2011). Nevertheless, valuable time was lost regarding institutional reforms during the Milosevic's regime, because "The more

transition leaders can accomplish in the first few months of the transition, the more successful the transition will be in the end” (Begovic, 2013).

In 2003, the Federal Republic of Yugoslavia was renamed Serbia and Montenegro, and the EU opened negotiations with the country for the Stabilization and Association Agreement. Serbia's political climate has remained tense and in 2003 the Prime Minister Zoran Djindjic was assassinated as result of a plot originating from circles of organized crime (Freedom House, 2015).

On 21 May 2006, Montenegro ended its union with Serbia. The results of the referendum showed that the majority of voters were in favor of independence. Also, the province of Kosovo unilaterally declared independence from Serbia on 17 February 2008. Serbia, along with 5 other Western Balkans countries, was identified as a potential candidate for EU membership during the Thessaloniki European Council summit in 2003 (European Commission, 2014a).

In 2008, a European partnership for Serbia was adopted, setting out priorities for the country's membership application. Moreover, in September 2013 a Stabilization and Association Agreement between the EU and Serbia entered into force. Finally, on 21 January 2014, the 1st Intergovernmental Conference took place, signaling the formal start of Serbia's accession negotiations, an accession that unfortunately seems distant because of the political, institutional and economic inefficiencies that still exist in the country (European Commission, 2014b).

Because of the previous flow of events mentioned concerning Serbia, deeper research concerning institutional and political factors that led the country to its current fragile situation must be pursued. The critical question of which specific factors can lead a state to failure is addressed by Acemoglu and Robinson in their book: “Why Nations Fail”. According to them, political institutions that are sufficiently centralized to provide basic public services including justice, the enforcement of contracts, and education are essential to enable innovative energies that lead to continuing growth and lead to a state's economic success (Acemoglu and Robinson, 2012).

A very interesting theory is that if centrists take control after the fall of the authoritarian regime, the democratic transition is likely to have a successful path. In contrast if extreme hardliners take or maintain power (like Slobodan Milosevic in Serbia in the 1990s) the transition path is most likely going to develop many institutional malfunctions (Grzymala-Busse and Luong, 2008).

The article of Denisa Kostovicova, “Civil Society and Post-Communist Democratization: Facing a Double Challenge in Post-Milosevic Serbia”, supports the interesting belief that the post-communist civil society in Serbia was also weakened by democratization itself. More specifically, the nationalist regime under Milosevic’s leadership used to repress autonomous liberal and anti-nationalist groups and associations. Autocracies want to keep the people poor, isolated, ignorant, with no free press, by having strong-loyal core supporters. That is why “successful” autocracies make rebellion truly unattractive (Bueno de Mesquita and Smith, 2011). As a result, the liberal segments of society were unable to promote and strengthen good governance and the illiberal segments prevailed, leading the country to its enduring institutional, political and economic inefficiency (Kostovicova, 2006).

Acemoglu and Robinson divide the political institutions, in two types: “extractive” where a small group of individuals do their best to exploit the rest (like the criminal groups and specific exploitative business circles that still exist and flourish in Serbia) and “inclusive”, where many people are included in governing and as a result exploitation is limited. Only the inclusive institutions are in a position to deliver continuing growth because of the innovation mechanisms that they can enable (Acemoglu and Robinson, 2012).

Nevertheless, the institutional and political background of Serbia after the fall of the communist regime was incapable to establish and promote efficient growth mechanisms in the 1990s. As a result, privatization (mostly towards criminal groups and specific exploitative business circles) of some 40% of all former socially owned enterprises occurred (Bolcic, 2003). The incredibly low levels of public sector participation in the economy proved the inability of the Milosevic’s regime to design and implement a successful economic policy (Monastiriotis and Petrakos, 2010).

Unfortunately, it is a common phenomenon after the establishment of the democratic institutions in a country in transition that because of the legacies of the past, the elites (often survival actors of the authoritarian past) manage to exploit legal loopholes (like Milosevic in the case of Serbia) in order to serve their private political or economic interests. The real purpose of these new formal institutions may be to serve informal ends in order to preserve the distribution of power of the participating elites as it was formed before the authoritarian regime collapsed (Grzymala-Busse and Luong, 2008).

As a result, the business circles that were exploiting the Serbian market before the Yugoslav wars under the communist regime supported the other end, nationalism,

during the Milosevic regime, in order to preserve their privileges after the end of the war. Subsequently, after the fall of Milosevic, once again they changed front and started pretending to be liberals and pro Europeans in order to further extend their economic parasitic activity in the country by posing as intermediaries between the Serbian local market and big Western capital (Mladenovic, 2014).

Consequently, during its post-communist transition, Serbia dramatically transformed from an industrial based economy to an unproductive fragile economy that was totally dependent on foreign direct investments that were not directed to the needed sectors of the Serbian economy because of its nonexistent productivity (Uvalic, 2001). As the Nobelist Joseph E. Stiglitz argues, FDIs can significantly promote the growth of an economy, but if they are not driven in certain economic sectors they may produce the exact reverse effects (Stiglitz, 2000).

The curse of easy money as it is described by Boris Begovic in his article: “The Serbian Experience in Transition”, is that the Milosevic regime created no strong incentives to the next governments to create radical reforms on institutional and economic bases in order to achieve concrete and long term growth mechanisms in the country. Transparency and predictability continued to be absent from market regulation after 2000. In addition, the rule of law in Serbia is characterized by great inefficiencies in matters regarding protection of property rights, competitive market regulation and specialization of judicial officials (Begovic, 2013).

The exploitation of the market by criminal leaders and incumbent firms did not only restrict competition by preventing the needed and healthy foreign direct investments to flourish, but also reduced the per capita purchasing power of consumers through greedy exploitative mechanisms, eliminating in that way any future healthy kind of investment (internal or external) in the country because of the inefficient and non-attractive market structure that they had created (Kostovicova, 2006). The governments that followed after the Milosevic regime provided bigger salaries only to specific portions of public officials in order to win their support in the next elections. As it was expected after the previous facts mentioned, the inefficient market that was created led to extremely high rates of unemployment especially among the youth: 48.9% in 2013 (World Bank, 2013b).

Moreover, the EU hard-line stance on Serbia regarding political and economic decisions contributed to the formation of a two-level game of the political elites of Serbia, involving in one side the EU negotiations on the international level and on the

other side the domestic audience of the country with its powerful veto players (such as political parties of different ideological bases, business elites that want to avoid and eliminate competition in the Serbian market, organized crime that still possesses influence on politicians and policy makers) able to change policy outcomes (Tsebelis, 2000). As a result, reforms imposed by the EU are being fulfilled at a very slow pace while at the same time they are being promoted in the domestic audience of Serbia as greatly beneficial, creating in that way vicious circles of domestic elites that manipulate international norms and use them for their personal advantage (Subotic, 2010).

Regarding Serbia's veto players that were mentioned before and specifically the political ones, it has to be noted that the parliamentary system that Serbia possesses at the present time is based on proportional representation, something which creates many additional actors that can acquire veto power and as a result alter policy change. Consequently, future policy changes will be difficult to achieve if political red lines between political parties will not be overthrown (Pavlovic, 2013).

Another political factor that must be considered when analyzing Serbia's transition path is that the country, instead of focusing on its political aim in a concrete and efficient transition path, lost a huge amount of its "political energy" because of political issues that emerged during the separation of Montenegro and the proclaimed independence of Kosovo in 2008 (Begovic, 2013). The political problem of Kosovo independence still remains unresolved and puts a significant obstacle in Serbia's path for EU accession (European Commission, 2014a). Moreover, Serbia's political energy was spent concerning the demands of the international community for facing the past regarding war crimes committed by Serbian authorities during the Yugoslav wars. Finally, political energy was reduced by the critical debate of how the business circles that exploited the country's market during and after the Yugoslav wars during the Milosevic regimes should be tolerated. Unfortunately, the Serbian government, instead of taking away the power of the previous business circles mentioned, has actually legitimized them through a special one-off taxation of the "extra profit" earned, contributing with that way to their future establishment and development (Begovic, 2013).

To sum up regarding Serbia's transition, it can be concluded that inefficient market liberalization, the political unwillingness for institutional and political development in combination with the strong influence of internal veto players

(Pavlovic, 2013), the inefficiency in fighting the worrying levels of corruption (Transparency International, 2013b), the uncontrolled exploitation of the market by parasitic business circles, the almost total dependence on uncontrolled foreign direct investments, the decrease of the industrial facilities in the country that led to great imbalances between imports and exports (Uvalic, 2012), the low income per capita and high unemployment that reduced purchasing power of the citizens of the country, the political insolvency between Serbia and Kosovo regarding Kosovo's declaration of independence and the high degree of conditionality imposed by the EU, led Serbia to a rather unstable and unpredictable political, institutional and economic future (Monastiriotis and Petrakos, 2010).

## Comparative Analysis of the Competitiveness Performance of the Republic of Serbia

At this stage of this report a comparative analysis of the competitiveness performance of Serbia in relation to the other countries of Southeastern Europe will be conducted. Competitiveness is defined as the set of institutions, policies, and factors that determine the level of productivity of a country. The productivity level also determines the rates of return obtained by investments in an economy (World Economic forum, 2014).

The purpose of this report is not to conduct a macroeconomic analysis through an economic comparison of different SEE countries, but rather to identify the institutional and political reasons that cause Serbia's negative performance through the detection of the country's weak points and problem issues. In others words, the comparison that is about to follow will be based on the assumption that countries that perform poor in macroeconomic aspects (like Serbia) possess inefficient institutions that do not prevent corruption among political elites, who are allowed to prioritize their own private (political or economic) interests (Acemoglu, Johnson, Robinson, and Thaicharoen, 2003).

Since Serbia is geographically located in the Balkan region and very close to some of the EU (28) and Black Sea countries, it will be extremely useful to conduct certain comparisons among them regarding their competitiveness performance. The 12 Balkan and 10 Black Sea countries that are included in this comparison are shown in table 4 below.

Table 4

Balkan (12)	Black Sea (10)
Slovenia - Greece – Croatia	Armenia – Azerbaijan - Bulgaria
Bulgaria - Turkey – Romania	Georgia – Greece - Moldova
Albania - Bosnia – FYROM	Romania - Russia
Moldova - Montenegro – Serbia	Turkey - Ukraine

Map 4bellow illustrates with dark green the highly competitive countries and with dark orange the less competitive in Europe and the Black Sea region. As it can be clearly seen, the countries of Northwestern Europe perform significantly better on

competitiveness compared to Southeastern Europe, where the competitiveness performance is rather poor (World Economic Forum, 2014).

Map 4



Source: World Economic Forum (2014)

As it was shown by map 4, the most uncompetitive region in Europe by far seems to be the Southeast. In addition, as this report already explained, the corruption levels seem to be the highest countries and the levels of economic freedom the lowest in Southeastern Europe (see p.12 and p.18 respectively). These results indicate that except for the strong negative correlation noticed between competitiveness and repressed economies with high levels of corruption, there are also probable political and institutional factors that shaped the transition process of some post-communist states of SE Europe, and seem to have led to the inefficiency of their current competitive performance (Acemoglu and Robinson, 2010).

At this point it will be quite fruitful to examine the performance of Serbia regarding its low competitiveness levels in various sectors of its institutional and economic framework in order to try to identify the political forces that shaped the institutional factors that cause its poor performance in competitiveness. The sectors that are going to be studied are: Institutions, infrastructure, macroeconomic environment, health system, higher education and training, goods market efficiency, labor market efficiency, financial development, market size, business sophistication, innovation and finally the bureaucratic restrictions imposed by the state in entrepreneurial activity. In addition a comparative analysis will follow among Serbia and the other post-Yugoslav states in crucial political, institutional and economic

sectors accompanied by their relative levels of freedom, such as: Corruption, political rights and civil liberties, government stability and rule of law.

### Institutions

The main concern of investors is the institutional efficiency of a country, reflected in conditions such as: low levels of bureaucracy and corruption, efficient legal system to enforce contracts and the prevalence of law and order in general (Barro, 2013). Strong political institutions are also important because they assure investors that none of the democratic forces that govern the country will be overthrown by an authoritarian leader. Finally, political stability that derives from a satisfied society with no intentions of revolting and leading the country to a possible economic downfall are the investors' main concern (Acemoglu and Robinson, 2012).

Concerning the efficiency of its institutions, Serbia has problems in a variety of issues such as: poor protection of property rights, low judicial independence, high favoritism in decisions of government officials (Begovic, 2013), wastefulness of government spending, a big burden of government regulation, low transparency of government policymaking, inefficiency in facing organized crime, and poor protection of minority shareholders' interests (World Economic Forum, 2014). Also, the number and complexity of regulatory bodies that form those institutions provide them with veto powers that can alter the direct and efficient function of institutions (Henisz, 2000).

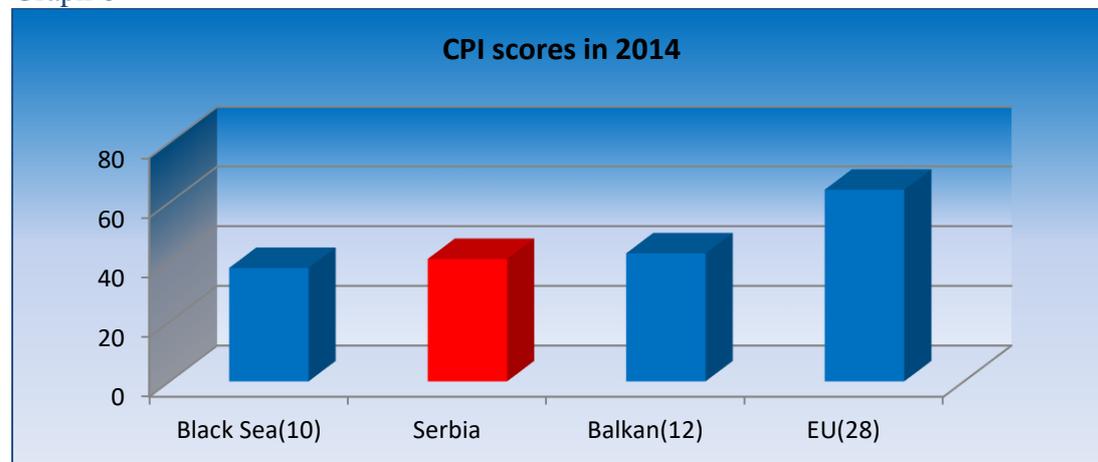
The causes that lead to the formation of these inefficient institutions are strictly political. More specifically, the main three factors that led to Serbia's present institutional structure can be traced to the beginning of the 1990s and these are: a) The new oligarchs that in the absence of a proper market regulation took control of the Serbian market after the fall of the communist regime and were greatly strengthened by Milosevic's policies during the 90s (Kostovicova, 2006), b) The organized crime that in the absence of an efficient legal system developed to an extreme degree and includes various form of criminality such as robbery, drug trafficking, kidnapping, murders and the black market, c) Corrupt politicians that cooperated with the new class of oligarchs and even the rising criminal groups in order to achieve personal political success (Uvalic, 2007).

Consequently, corruption has spread to almost every sector of the political institutional and economic activity of the country. Corruption levels in Serbia at the

present time are extremely high. Graph 4 illustrates the average CPI scores of different regions compared to Serbia according to Transparency International. A higher score reflects a better performance on facing corruption<sup>2</sup> (Transparency International, 2014). Unfortunately, the existence of problematic institutions allows corruption to take effect in Serbia (Walsh and Yu, 2010).

As it is shown in graph 6, Serbia's score is by far lower than the EU (28) average, slightly lower than the Balkan (12) average and just above the Black Sea (10) average.

Graph 6



Source: Authors' calculation and elaboration based on data provided by the Transparency International Organization (2014)

### Infrastructure

An efficient infrastructure network within a country can improve the educational system, attract and facilitate private investment in greater extent, increase the working opportunities within society, raise the efficiency and productivity levels of enterprises and finally contribute to the establishment of innovation techniques capable to boost a country's economy (Estache and Garsous, 2012). According to the empirical models of Barro and Sala-i-Martin, investment in infrastructure along with capital and labor, affects output positively throughout the production process (Barro and Sala-i-Martin, 1992).

Regarding the efficiency of its infrastructure, Serbia lacks a competitive performance in a variety of sectors such as: Quality of road infrastructure, quality of railroad infrastructure, quality of energy infrastructure and finally quality of air transport infrastructure (World Economic Forum, 2014).

<sup>2</sup>The CPI index ranges from 0 (highly corrupt) to 100 (highly transparent).

The main causes that led to the inefficiency of Serbian infrastructure may be traced to the: a) Significant slowdown caused by UN economic sanctions and excessive damage to infrastructure and industry caused by the NATO bombing in 1999 b) Lack of market competition and exploitation of European funds by parasitic internal Serbian business circles with political connections (Uvalic, 2001) c) Lack of investment expenditures by the Serbian governments because of inefficient fiscal policies and corruption d) Lack of adequate maintenance (Zeljko, 2010).

The causes of infrastructural inefficiency once again indicate that, except for the exogenous factors of the NATO bombing and the UN economic sanctions, it was mainly the institutional environment of Serbia that allowed corruption to flourish in that sector as well. Local institutions affect investments in infrastructure by influencing the incentives of government officials to provide public goods (Acemoglu and Dell, 2010), and unfortunately in the case of Serbia these institutions are controlled by exploitative private businesses interests (Monastiriotis and Petrakos, 2010).

#### Macroeconomic Environment

Macroeconomic stability refers to the levels of stability of a country's economy concerning specific variables, such as: low and stable consumer price inflation, low unemployment and generally efficient fiscal and monetary policies that can lead the economic environment of a country to stable long-term growth (Dhonte and Kapur, 1997). Macroeconomic stability is necessary in order for a country to achieve sustainable economic growth because "it increases national saving and private investment, it also improves exports and the balance of payments by improving competitiveness" (Hausman and Gavin, 1996).

Serbia unfortunately possesses an extremely unstable and unattractive macroeconomic environment. More specifically, the inflation rate in Serbia averaged 7.27 percent from 2007 until 2015 (indicating a non-stable performance), interest rates averaged 11.08 percent from 2006 until 2015, the government debt to GDP in 2015 is 70.90 percent and the government budget deficit was equal to 4.55 percent of the country's GDP in 2014. Unemployment rates in Serbia increased to 19.20 percent in the first quarter of 2015 with youth unemployment reaching almost 50% (World Bank, 2015).

Based on this, extremely negative macroeconomic performance, many would claim that the inefficient macroeconomic policies that Serbia has adopted led to the creation of its current macroeconomic instability. Nevertheless, in the case of Serbia, as in many countries lagging behind economically, macroeconomic policies are not the ones to blame. The main problem is that weak institutions did not constrain corruption as they do in more advanced economies (Acemoglu, Johnson, Robinson, and Thaicharoen, 2003).

More specifically, the new class of oligarchs that emerged under the Milosevic regime and continued to control the business and economic environment of Serbia and after 2001, created an extensive mechanism of corruption in the judicial, financial, political and institutional framework of the country, effectively eliminating the country's growth prospects for the sake of their own private interests (Pesic, 2007).

The fact that Serbia does not possess a healthy macroeconomic environment has serious consequences on its overall competitiveness performance since an unhealthy macroeconomic environment is one of the main causes of poor growth performance. Negative results on this sector can seriously affect other important sectors of competitiveness and growth as well, such as political stability, financial market development and attraction of investments (Montiel and Serven, 2004).

### Health System

Health plays a vital role in order for any country to be able to strengthen and promote its competitiveness and growth environment. Health plays such an extremely important role on growth that according to World Bank reports, 50% of economic growth differentials between developed and developing nations are attributed to ill health and low life expectancy (World Bank, 2014a).

That's the main reason that developed countries spend a significant share of their GDP on health, while countries that lag significantly behind in growth and competitiveness, usually possess disappointing performance on providing health services. When a country works towards the improvement of its health sector, positive outcomes on development and social welfare are immediately shown in its growth performance (Ogobine, 2012). There is also a positive empirical relation between life expectancy, which can be strengthened through an efficient health system, and the growth outcomes within a country (Barro and Lee, 1994).

Serbia possesses a relative good performance on Malaria cases per 100,000 people, Tuberculosis cases/100,000 people and HIV prevalence in the percentage of adult population (World Economic Forum, 2014). On the other hand, the limited budget of the government towards needed infrastructural projects and modern technological equipment, unethical relations between pharmaceutical companies and doctors, doctors getting money directly from patients in order to serve them more efficiently, conflicts of economical-political interests even inside the hospitals hierarchy and, finally, additional work of doctors once more indicate high levels of corruption (Dickov V, Dickov A, and Milicevic, 2010).

### Higher education & training

Many researchers that conduct research on macroeconomic theory provide strong empirical evidence that education, and mainly higher education, is strongly correlated with greater production output that eventually leads to an increase in GDP and the creation of more working opportunities (Blankenau and Simpson, 2004).

Unfortunately, the educational system in Serbia has many problems in sectors such as the extent of internet access in schools, the availability of research and training services and the extent of staff training and technological readiness (World Economic Forum, 2014).

Some causes of the previous problems in Serbian performance concerning education may also be traced to the Yugoslav tradition that universities, including major universities such as the Belgrade University, are groupings of semiautonomous faculties rather than fully integrated institutions. As a result reforms are much more difficult to take place under the lack of a common institutional framework (OECD, 2012a). In addition, because of proliferation purposes, at the current time in Serbia there are 13 accredited universities, making the creation of a coherent institutional planning even more difficult, while before the disintegration of Yugoslavia there were only 6 in the same provinces for a greater number of students. Finally, academic corruption exists, aided by the inefficient institutional framework, and it resulted in legal repercussions and resignations of faculty deans in 2007 (Trumbic, 2012).

### Goods market efficiency

Market efficiency is the main objective of any market that targets the promotion of economic growth and social welfare. According to many economic theories, when a market is running efficiently, it will not be possible for investors to exploit it and

make above average profits. Serious abnormalities in the markets reduce market efficiency and are responsible for unsafe market exploitation (Gilson and Kraakman, 1984). Of course, there can never be a “perfect” market efficiency, nevertheless the less the extent of abnormalities the smaller the possibility of market exploitation (Grossman and Stiglitz, 1980).

Unfortunately, the goods market in Serbia lacks competitiveness in sectors such as: The intensity of local competition, the extent of market dominance, the effectiveness of anti-monopoly policy, the effect of taxation on incentives to invest, the business impact of rules on FDI, the structure of customs procedures, the degree of customer orientation and finally the buyer sophistication possess (World Economic Forum, 2014). In addition, the value of Serbia’s imports has regularly been almost double that of its exports, leading to a rising trade deficit (Uvalic, 2012).

The attraction of FDIs that could promote greater market competition and provide more efficient customer oriented products in the Serbian market is facing many obstacles. More specifically, business representatives who consider selected issues major obstacles for doing business in the country, identify the following problems: a) Complicated tax laws b) Frequent changes in law and regulations c) Political instability d) Corruption e) High taxes f) Limited access to financing g) Labor regulation h) and finally trade barriers as the greatest obstacles within the country (United Nations, 2013).

As it can be concluded from the above, the Serbian goods market needs the necessary operational and institutional reforms in order to become more efficient and competitive. Those reforms are sadly blocked by the internal exploitative business circles, known also as the emerging “Tycoons”, who promote only their own private interests through the corruption mechanisms that they have established (Begovic, 2013).

#### Labor market efficiency:

Labor market efficiency is essential for a country that aims on improving its competitiveness and growth levels (Fuentes-Castro, 2012). The labor market in Serbia lacks competitiveness in sectors such as: Cooperation on labor and employer relations, hiring and firing practices, effects of taxation on incentives to work, pay and productivity, reliance on professional management, country capacity to retain talent, country capacity to attract talent perform extremely low. Only the labor cost has a

high score on its competitive performance since a cheap working force is easy to find in the country (World Economic Forum, 2014).

As it can be detected from the above an efficient labor regulation based on a strong institutional basis is absent from Serbia. As a result the labor market is shrinking and high skilled workers are fleeing the country. The unemployment rate in Serbia increased to 19.20 percent in the first quarter of 2015 from 16.80 percent in the fourth quarter of 2014 with youth unemployment (ages: 15-24 years old) reaching almost 50%. The previous results indicate the extremely worrying levels of unemployment across the country and especially among the young population (World Bank, 2015).

The Minister of labor Aleksandar Vulin noted in March that for 2015, the National Employment Service envisaged employment measures that should result in 120,000 jobs, for 50 percent of which young people (under 30 years old) should be hired. In addition, an increase in the number of foreign private enterprises that operate within the country will be attempted (Inews, 2015). Nonetheless, improvement in labor market efficiency is likely to require reforms in more than one area of policy in Serbia. If a country lacks overall market efficiency, then the level of competitiveness and productivity within the country will be limited and inadequate (Bernal, Furceri, and Guillaume, 2012).

#### Financial market development:

The level of the financial markets in any country is extremely crucial concerning competitiveness. Financial markets are critical to a country's overall development. Banking systems and stock markets enhance growth, the main factor in poverty reduction. Strong financial systems provide reliable and accessible information that lowers transaction costs, which in turn bolsters resource allocation and economic growth (World Bank, 2013a).

Sadly in Serbia limited availability of financial services, limited affordability of financial services, inefficient financing through local equity market, limited access to loans, the low extent of venture capital availability, limited soundness of banks and the inefficient regulation of securities exchanges mean that the financial market development of the country suffers from great problems (World Economic Forum, 2014).

In addition, the financial sector of Serbia has not yet emerged from the most recent global recession. The deeper reasons that caused the banking crisis in SE Europe can be traced to the following 3 factors mentioned below:

- 1) Profitability of the Banks. More specifically the Banks in Serbia and in SEE in general, did not control the creditability of the borrowers in their greediness to make more profit (Friedman and Kuttner, 2010).
- 2) The first loans that Serbia took had not been invested in real growth procedures that would increase the productivity and competitiveness of the country but in unproductive procedures and actions targeted to personal interest only (Uvalic, 2012).
- 3) Lack of control (because of the inefficient institutional and financial framework) by the respective governments to the loans given by the banks to the borrowers, regarding of where that money has been invested: in growth or in personal unproductive interests only (Laeven and Valencia, 2012).

Moreover, the asset share of foreign owned banks as well as the number of foreign owned banks in Serbia is very high and as a result the degree of interaction between European banks and the Serbian banking system is extremely strong (IMF, 2013b). Confidence in the banking sector, but also the entire financial system is not fully restored, because certain banks are concerned about facing a high risk of litigation. Commercial banks adopted a restrictive credit policy by setting high interest rates in order to face the recent EU crisis, which constricts credit growth as well as increasing levels of capital and maintenance of liquidity planning. Another problem for Serbia is the lack of depth of domestic financial markets. European banks are much more significant in financing local borrowers in the region than in other countries in transition (Mehmed Ganic, 2013).

Additionally, one of the most significant risks to the economy of Serbia and the overall region of SE Europe is the high level of NPLs<sup>3</sup> that are still growing, and the exposure to sectors that have been particularly affected by the crisis, such as: the decline in trade volumes, manufacturing export activities, and construction (IMF, 2013b). The EU is trying to develop the necessary policies in order to effectively promote financial reforms and to face the negative effects of the recent banking crisis in Serbia. Only through consistent institutional and financial reforms financial

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<sup>3</sup> NPLs: Non Performing Loans.

investments will be attracted within the country. It is increasingly recognized that Serbia will have to rely more on its own resources and an enhanced institutional and financial reform agenda if it is to move to a sustainable growth path that will create greater financial independence from foreign ownership in the future (Pavlovic, 2013).

#### Market Size:

Empirical studies show that: “The greater the size of the market the greater the attraction of FDI inflows in the country. Domestic population size also appeared to matter, possibly reflecting a labor supply effect rather than a market size effect” (Jaumotte, 2004).

Unfortunately, the population of Serbia, which at the present time is near 7.2 million, is one of the oldest populations in Europe (Eurostat, 2015), mainly because of the recent wars that took place during the disintegration of Yugoslavia. Also, the inefficient economic environment that followed after the Yugoslav wars continues to have serious miss-functions until the present time, something that leads to even lower birth rates within the country and the creation of large emigration rates towards more advanced countries (The Economist, 2009).

As a result, the domestic market size of the country is very limited and the GDP in purchasing power parity very low. In addition the value of exports of goods and services is very low, especially in comparison with the number of imports, as it was mentioned before, the value of Serbia’s imports has regularly been almost double that of its exports, determining a rising trade deficit (Uvalic, 2012). Finally, exports as percentage of GDP disclose again a limited performance mainly because Serbia is not a big country regarding population or geographical size and its production infrastructure lacks of the proper sophisticated methods and technological readiness (World Economic Forum, 2014).

#### Business sophistication:

Business sophistication is based in the interconnection of producers and suppliers in business clusters<sup>4</sup> in order to achieve greater market efficiency and allow greater entry for new firms through branding, marketing, distribution, advanced production processes, and the production of unique and sophisticated products (World Economic Forum, 2014).

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<sup>4</sup>Clusters: When companies and suppliers from a particular sector are interconnected in geographically proximate groups, called clusters, in order to create more efficient and innovative products.

Countries with markets that have business sophistication possess greater and more efficient production levels. As a result of the increased productivity the country becomes more competitive. Business sophistication is crucial not only for developing countries that must have a certain production plan and structure in order to achieve efficiency, but also for more advanced countries that aim in the achievement of greater competitive performance and the adoption of innovation techniques capable of boosting the country's growth levels to the greatest possible degree (Doing Business, 2014).

Moreover, the level of productive efficiency within a country is based on the quality of its institutions, which allow and promote innovation techniques within its firms. In countries that possess institutions that do not provide healthy firm competition, protection of innovations, free entry without market barriers and efficient training, it is almost impossible to develop firms with innovative power within them (Acemoglu and Dell, 2010).

Nonetheless, cluster development between Serbian firms is unsuccessful, with very little progress being made. In addition, the competitive advantage of the country is based mainly in low-cost labor or in access to natural resources instead of unique products and processes (National Employment service of Serbia, 2014). Moreover, companies have a narrow presence in the value chain involving mainly resource extraction or production instead of including production, marketing, distribution, and design. Finally, an inefficient extent of marketing and low willingness to delegate authority to subordinates of firms and businesses downgrade even more the levels of business sophistication in the country (World Economic Forum, 2014).

The causes that lead to the low business sophistication levels in Serbia are mainly traced to the establishment of the new Serbian oligarchs during the 1990s, that in the absence of a proper market regulation took control and exploited the Serbian market by eliminating competition (Kostovicova, 2006), and in corrupt politicians that cooperated with them in order to achieve personal political success instead of public welfare (Uvalic, 2007).

### Innovation:

Innovation is one of the most critical components of development for a country, especially at the present time where states compete against each other in order to produce the most efficient products in the markets. Through innovation techniques the productivity of a country increases, because the same or better result on production can be achieved by using less amount of human, capital or natural resources (OECD, 2007b).

The adoption and promotion of innovative techniques can also help smaller companies promote a country's economy and to support the companies in competing with larger companies. More specifically, innovation capacity can provide smaller companies with the advantage of high quality patents that lead to greater production efficiency. As a result, innovation increases the competitiveness levels within a country's business environment to a certain degree (Acemoglu and Ufuk, 2012).

The answer to the question of how can innovative power be created within a country is simply by inventions. Inventions that can be transformed into innovations are, according to many empirical studies, the most powerful and dynamic growth tool that can boost development and economic growth. This is why the role of research and development (R&D) is of unique and crucial importance in every country's growth policies agenda (Rodriguez-Pose and Crescenzi, 2008).

Unfortunately, Serbia lacks of the proper institutional and economic environment it needs in order to promote efficient and stable innovation policies across its firms and industries. More specifically, capacity for innovation, company spending on R&D, university-industry collaboration in R&D, government procurement of advanced tech products and availability of scientists and engineers are almost absent in the country (World Economic Forum, 2014).

### Bureaucratic levels in entrepreneurial activity

Entrepreneurship plays more and more a critical role on the increase of economic growth within a country because of the significant rise in the development of information and communication technologies that create new needs for producing efficient methods of effective allocation of resources. At the same time the institutional framework that should be established in order to support the healthy development of entrepreneurial activity is becoming of increasing significance (Wennekers and Thurik, 1999).

A lot of studies have been made recently regarding the interconnection between the business environment and economic growth. Famous economists that were awarded with a Nobel Prize in economics like Joseph E. Stiglitz or Paul Krugman support the idea that growth within a country can be truly achieved by establishing efficient mechanisms that will successfully facilitate growth from inside out (Washington monthly, 2014). More specifically, the government of a country must first create and sustain public policies that will create and develop a healthy business environment instead of trying to initiate growth methods from outside upon an inefficient public policy basis that cannot truly sustain stable and decisive growth (Uvalic, 2007).

Crucial factors can determine how a state can create efficient and competitive conditions in order to provide assistance and strengthen entrepreneurial activity to the largest possible extent. Factors such as procedures or time needed in order to start operating and even closing a business play significant role on the decision of an entrepreneur to start business in a certain country, since they include the bureaucratic procedures that should be decreased by any state to the highest possible degree (Mata and Portugal, 1996).

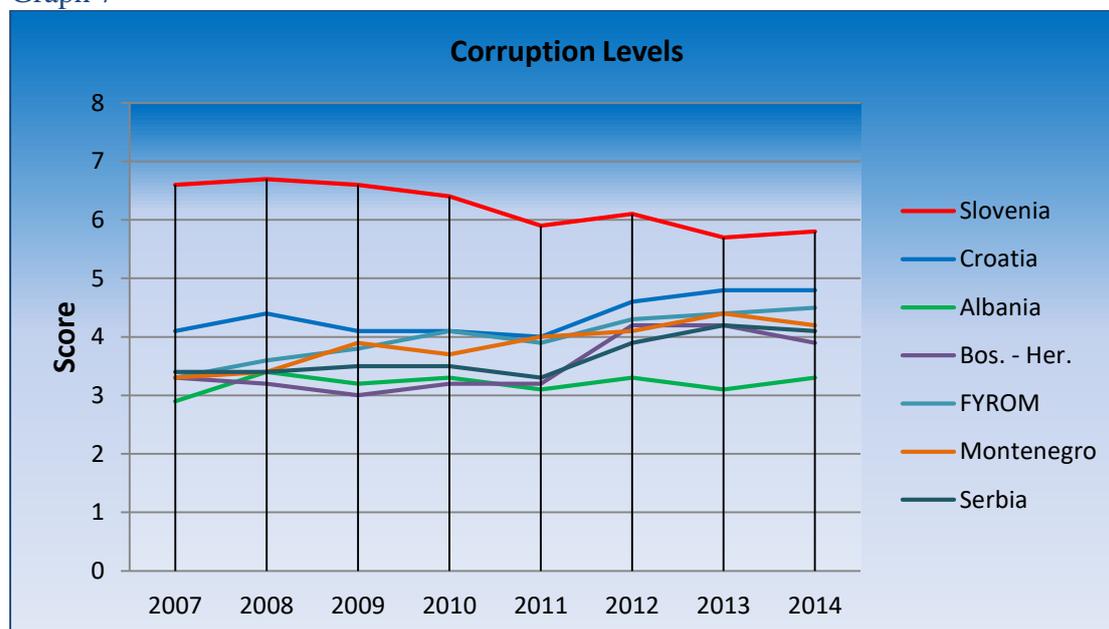
The most problematic sectors regarding Serbia's performance on its business environment are the time and procedures needed in order to: resolve insolvency of a business, pay the business's taxes, take credit, enforce contracts, deal with construction permits, trade across borders, protect investors' property rights and get electricity (Doing Business, 2014). Serbia's business environment unfortunately possesses high levels of bureaucracy because of the political and institutional incapability of all the Serbian governments after the Milosevic regime to establish and guarantee law harmonization, protection of property rights and competitive market regulation based on the specialization of judicial officials (Begovic, 2013). As a result, unattractive bureaucratic procedures that contribute to the rise of corruption and to the fragmentation of growth in the country were maintained (Monastiriotis and Petrakos, 2010).

Since Serbia is geographically located in the Balkan region and belongs to the post Yugoslav states of SE Europe, it will be extremely useful to perform certain comparisons among them in order to study in a comparative framework the performance of Serbia in basic political and institutional factors such as: the level of corruption, political rights and civil liberties, political stability and the efficiency of rule of law.

## Corruption

Corruption is one of the main reasons that impeded the democratic consolidation in Serbia. The exploitative business circles and criminal groups before and after the Milosevic regime managed to curb the state's efficiency in matters concerning the rule of law and institutional efficiency of the country (Kostovicova, 2006). Consequently, they promoted their own private interests and prevented a successful democratic transition period. That caused a massive citizens' mistrust in the states institutions (Uvalic, 2010).

Graph 7



Source: Authors' calculation and elaboration based on data provided by the Transparency International Organization

As it is shown by graph<sup>5</sup> 7, there is a similarity in the patterns of corruption from 2007 to 2014 in almost all the post Yugoslav states, which ranges from 3 to 4.5 points, except Croatia that since 2012 showed a slight increase and Slovenia that is the least corrupt country of them all, with its rating ranging from 5.5 to 6.5 points (Transparency International, 2014). Unfortunately, in the absence of proper institutions and efficient rule of law the corrupt groups (business and crime circles)

<sup>5</sup>The CPI scores and ranks countries based on how corrupt/transparent a country's public sector is perceived to be. Until 2011, the CPI ranged from 0 (highly corrupt) to 10 (highly transparent). Since 2012 the CPI index ranges from 0 (highly corrupt) to 100 (highly transparent). Nevertheless, in order to provide more consistent results the author of this report recalculated the score rating from 0 (highly corrupt) to 10 (highly transparent) for all the years that are included.

that acted during and after the recent Yugoslav wars in Serbia and the other post-Yugoslav states continue their corrupt and exploitative behavior until the present time (Bolcic, 2003).

In order to examine in more detail the problem of corruption in the country, it is very interesting to study the impact of corruption in certain sectors so that specific recommendations can be given later for every one of them. Concerning this effort, data from the Global corruption Barometer (GCB) by Transparency International can prove extremely helpful<sup>6</sup>.

As graph 8 of the GCB shows, corruption affects a variety of sectors in Serbia through time. Those sectors are mainly the political parties within the parliament, the police, the health system, the parliament, the media, the judiciary, the educational system and the public servants (Transparency International, 2013b).

Graph 8



Source: Authors' calculation and elaboration based on data provided by the Transparency International Organization

Sadly, high levels of corruption in combination with weak institutions and inefficient rule of law seem like a never ending story for Serbia. That's the main reason that extended recommendations on facing corruption will be provided in the next sector of this report.

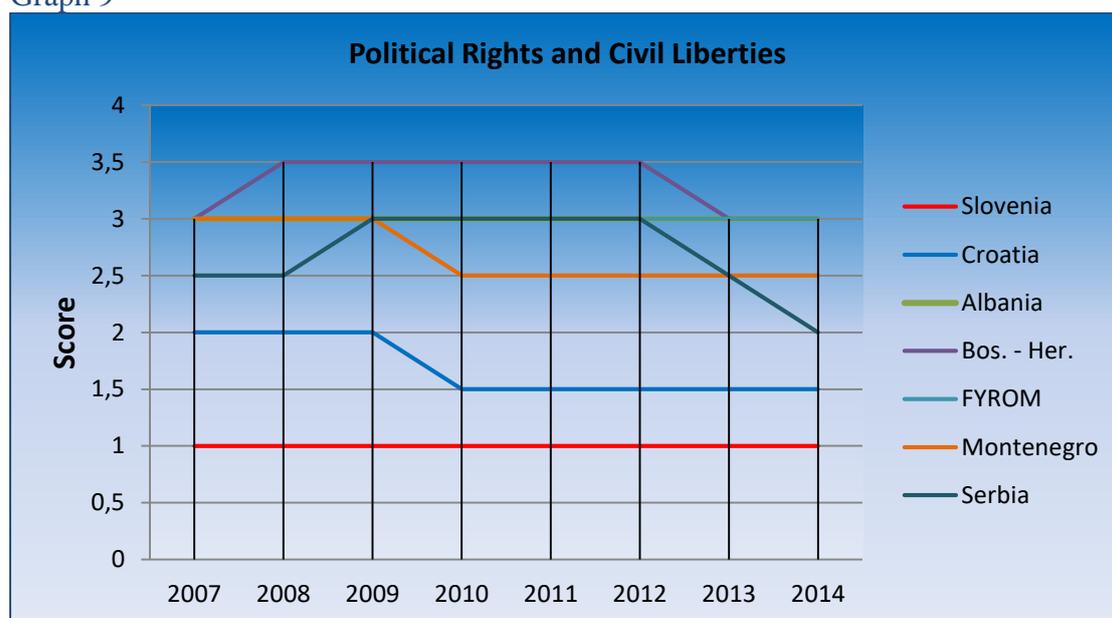
<sup>6</sup> The GCB index ranges from 1 (highly transparent) to 5 (highly corrupt).

## Political Rights and Civil Liberties

During the transition period of post-communist states, like Serbia, it is a frequent phenomenon for the non-state sector of those countries to be developed in both liberal and illiberal directions. As a result, from the one hand the liberal segments of the society want to promote political and civil liberties, but on the other hand the illiberal segments want to suppress them for their own interest (Kostovicova, 2006).

Political rights include free and fair elections, the assurance that candidates who are elected actually rule, competitive political parties, that the opposition plays an important role and enjoys real power, and for minority groups to be able to participate in the government through informal consensus. In addition, civil liberties include freedom of expression, assembly, association, education, and religion. They also include a fair system of the rule of law, free economic activity, and equality of opportunity including women and minority groups (Freedom House, 2015).

Graph 9



Source: Authors' calculation and elaboration based on data provided by the Freedom House Organization

As it is shown in graph<sup>7</sup> 9 Slovenia possesses once again the best results in the region following a totally balanced trend (score: 1) from 2007 to 2014. Croatia is the

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<sup>7</sup>The total score awarded to the political rights and civil liberties sectors determines the political rights and civil liberties rating with 1 representing the highest and 7 the lowest level of freedom according to the Freedom House Organization. Political rights and civil liberties scores for each year of every

second best performer ranging between 2 and 1.5 points. Bosnia, Albania and FYROM are considered only partly free, while Serbia is considered free only after 2012 probably because of certain reforms imposed by the EU concerning Serbia's future EU accession (Freedom House, 2015).

Moreover, table 5 provides the performance of Serbia concerning democratic values in different sectors of the state. As it can be seen, the civil society's rights are almost well protected in the country as the recent successful 1st gay pride parade in Belgrade proved (Freedom House, 2015). Nevertheless, the establishment of a more efficient institutional framework for the protection and promotion of human and minority rights is essential for the country since often ethnic minorities in Serbia are mistreated and not provided the same chances, mainly in education or employment (FER, 2014).

Furthermore, the national and local democratic governance in Serbia are considered only partly free, mainly because of the media manipulation by political elites and certain complains regarding the relations of local authorities with certain internal exploitative business circles that operate within the country (Begovic, 2013).

Table 5 Freedom score Serbia

NIT Edition	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Electoral Process	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
Civil Society	2.75	2.75	2.75	2.75	2.50	2.25	2.25	2.25	2.25	2.25
Independent Media	3.25	3.50	3.75	3.75	4.00	4.00	4.00	4.00	4.00	4.25
National Democratic Governance	4.00	3.75	4.00	4.00	3.75	3.75	3.75	3.75	3.75	3.75
Local Democratic Governance	3.75	3.75	3.75	3.75	3.50	3.50	3.50	3.50	3.50	3.50
Judicial Framework and Independence	4.25	4.25	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Corruption	4.75	4.50	4.50	4.50	4.50	4.25	4.25	4.25	4.25	4.25
Democracy Score	3.71	3.68	3.79	3.79	3.71	3.64	3.64	3.64	3.64	3.68

Source: Freedom House (2015)

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country were added and divided by 2. From 1.0 to 2.5 a country is considered Free, 3.0 to 5.0 Partly Free, and 5.5 to 7.0 Not Free.

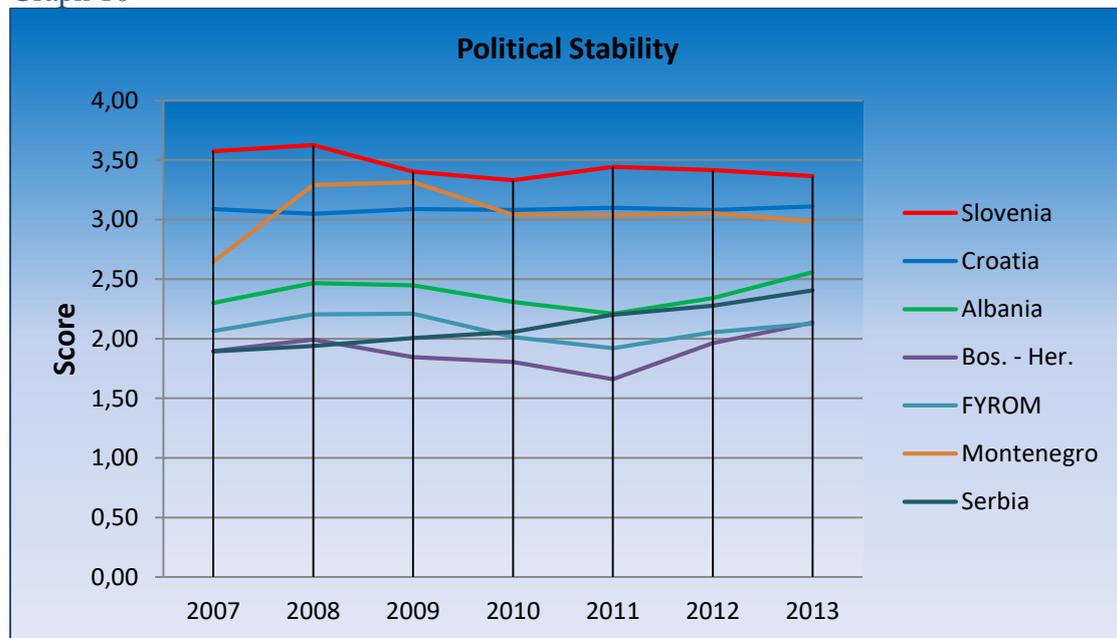
Sadly, Serbia's overall score regarding its democracy performance place the country in the ranking of a semi-consolidated democracy along with: Romania, Serbia, Croatia, and Montenegro. In the category of transitional governments or hybrid regimes the following countries can be found: Albania Bosnia Herzegovina FYROM, while Slovenia is the only consolidated democracy (Freedom House, 2015).

Political Stability

Political stability is one of the main factors that are necessary in order for a country to develop its economic performance. Politically unstable countries do not follow efficient long term macroeconomic policies capable that can provide the feeling of safety to potential investors. On the contrary, because of the inefficient, uncertain and fragile macroeconomic environment that they possess they dismiss every possible opportunity for their present and future economic development (Aisen and Veiga, 2013).

The issues of Serbia can be mostly attributed to the unstable political environment that she had at the past. More specifically, after Yugoslavia's disintegration, the fragmentation of political power and the rise of the Milosevic regime allowed corrupt businessmen and ruthless warlords to rise as power-brokers across the fractured state (Burnell, 2006).

Graph 10



Source: Authors' calculation and elaboration based on data provided by the World Bank

As it is shown by graph<sup>8</sup> 10, Slovenia possesses once again the best results in the region following a balanced trend from 3.6 to 3.4 from 2007 to 2014. Croatia and Montenegro are the second and third best performers respectively balancing between 2.6 and 3.1 points. Finally, the rest of the post Yugoslav states, including Serbia, have a rather disappointing performance in the political stability section ranging between 1.7 and 2.5 points, indicating a very unstable political environment (Freedom House, 2015).

In the parliamentary elections of 2014, Mr. Vucic's SNS and their allies were on 48% of the vote, (158 seats in the 250-seat parliament). Ivica Dacic, the outgoing prime minister and leader of the Socialist Party of Serbia, and his allies, gained only 14% (44) seats (National assembly of the republic of Serbia, 2012). Many fear that Mr. Vucic will indulge to the temptations of authoritarianism. Accusations of media manipulation and censorship are increasing inside the Serbian society. While some observers are concerned about the concentration of power in the hands of one political party, there is also hope that a strong government can finally implement necessary reforms, including fiscal consolidation and reigning in the public debt (Freedom House, 2014).

Nonetheless, if there is not true willingness from Alexander's Vucic's government to reform institutions and to establish a solid and efficient rule of law in the country, then a strengthened long-term economic growth will never really occur, so the main aim of EU accession will seem more distant and political stability will certainly be absent again (Uvalic, 2012).

### Rule of Law

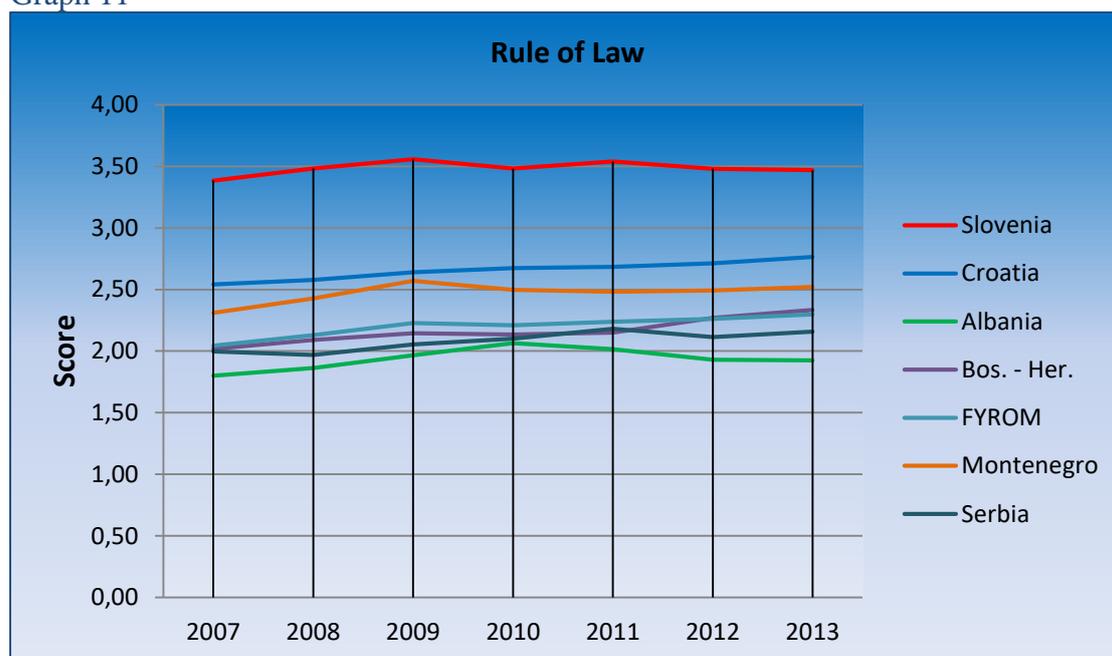
Rule of law is defined as "a principle of governance in which all persons, institutions and entities, public and private, including the State itself, are accountable

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<sup>8</sup>Estimate of governance (ranges from approximately -2.5 (weak) to 2.5 (strong) governance performance), nevertheless to help the reader understand more easily the graph the author of this report redeployment the score rating from 0 (weak) to 5 (strong). According to the Freedom House the Political Stability and Absence of Violence index reflects perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism.

to laws that are publicly promulgated, equally enforced and independently adjudicated, and which are consistent with international human rights norms and standards” (United Nations Rule of Law, 2004). In a country that possesses weak institutions “an increase in democracy is less important than an expansion of law and order, based on enhancement of the rule of law, as a stimulus for economic growth” (Barro, 2013).

Graph 11



Source: Authors’ calculation and elaboration based on data provided by the World Bank

As it can be seen in graph<sup>9</sup>11, the score concerning the levels of rule of law in the post Yugoslav states is extremely low over time for all of them except Slovenia. Unfortunately, Serbia after Albania possesses the second worse score, following an almost stable trend between 2 and 2.3 points since 2007 (World Bank, 2015).

Judicial reforms are necessary if Serbia wants to achieve its main target of entering the EU. Nonetheless more than 200,000 court cases remain unsolved, a number that increased even more after the recent strike by Serbian lawyers that lasted months

<sup>9</sup>Estimate of governance (ranges from approximately -2.5 (weak) to 2.5 (strong) governance performance), nevertheless to help the reader understand more easily the graph the author of this report redeployment the score rating from 0 (weak) to 5 (strong). According to the Freedom House the Rule of Law index reflects perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.

(Freedom House, 2015). Judicial officials are overwhelmed with work and sometimes lack the knowledge and skills needed for efficient enforcement (RoLE, 2015). On the positive side, the private property that was taken away during the communist regime was given back and a law on protection of whistleblowers was adopted. Unfortunately, hundreds of additional court cases are being delayed because of the institutional inefficiencies in Serbian rule of law (Freedom House, 2015).

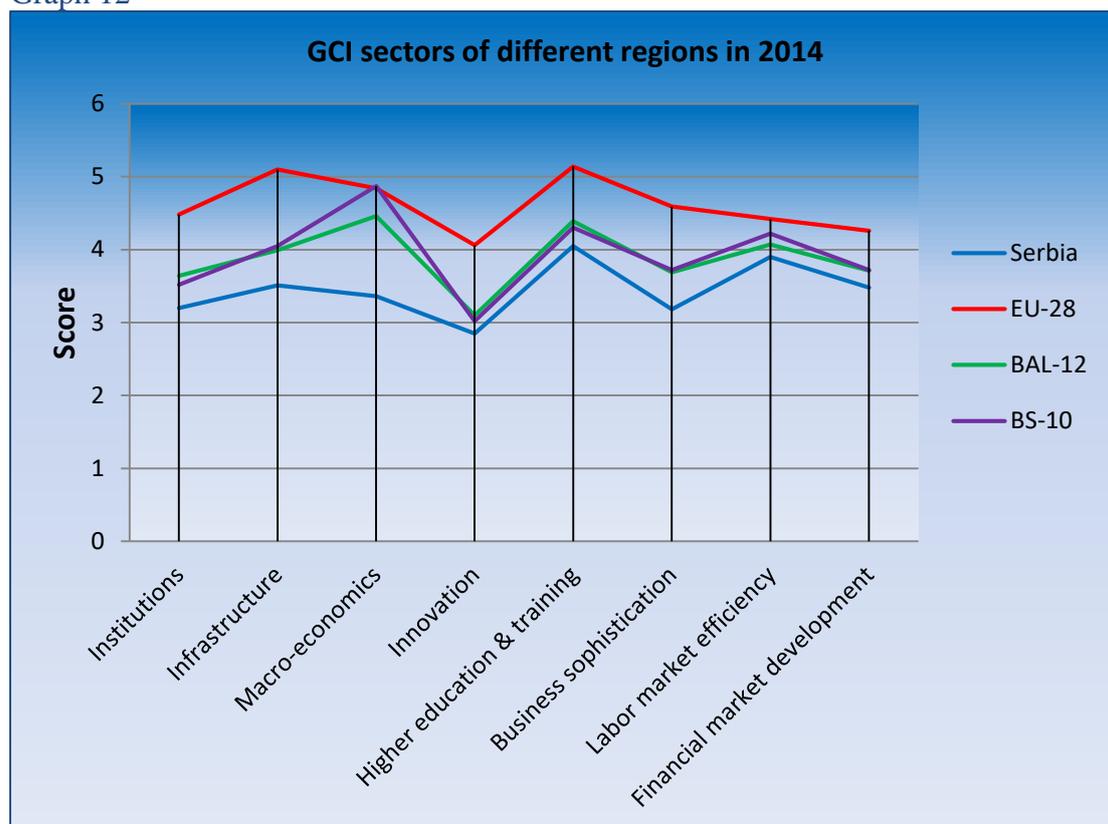
Sadly, Serbia possesses limited government accountability, increased influence of private interests within the political spectrum and extremely low freedom of speech. A reformed and more competitive rule of law may probably be the key to the solution of the previous problems in order for the country to accomplish its basic target of EU accession (Norvenska, 2014). Over the last ten years, Norway instructed over 1,000 of Serbia's judges and another 400 of Serbia's prosecutors, advocates, police and NGO activists on how to apply the ECHR in practice (Aire Centre, 2015).

In the context of bilateral cooperation between Serbia and Norway concerning the improvement of Serbia's rule of law, the Norwegian ambassador Nils Ragnar Kamsvåg stated at the opening of a renovated court building in Leskovac that: "This is part of a program for upgrading courts, within a wider project to help strengthening rule of law in Serbia" (Norvenska, 2014). The European Union also allocated €1.8 million to the Rule of Law and Enforcement project (RoLE, 2015).

Investors select countries that they trust regarding their institutional environment and the efficiency of their rule of law (Acemoglu and Robinson, 2012). When there is little amount of political energy to accomplish institutional reforms, like in the case of Serbia as it was previously discussed, it is wiser to spend it in implementing the rule of law or, more generally, property rights and free markets, since these institutional factors seem to be the most crucial for achieving economic growth. Democracy is the main objective in the long run, but the rule of law is able to generate stable levels of democracy that on their turn can enhance economic growth (Barro, 2013).

In order to compare Serbia's performance to the average of various regions and groups of states, graph 10 illustrates the performance of Serbia in specific sectors in comparison with the EU (28), Balkan (12) and Black Sea (10) countries according to the global competitiveness index (GCI) of the World Economic Forum in 2014.

Graph 12



Source: Authors' calculation and elaboration based on data provided by the World Economic Forum (2014)

As it is seen in graph<sup>10</sup>12, the best performers in all the sectors are the EU (28) countries that fluctuate between 4 and 6 GCI points. The Balkan (12) and Black Sea (10) countries possess a very similar performance in all the sectors examined with higher scores on the Macroeconomics sector and lowest score on the innovation sector. Finally, Serbia is far behind the EU (28) countries' average and sadly lags slightly behind even the Balkan (12) and Black Sea (10) countries average scores (World Economic Forum, 2014).

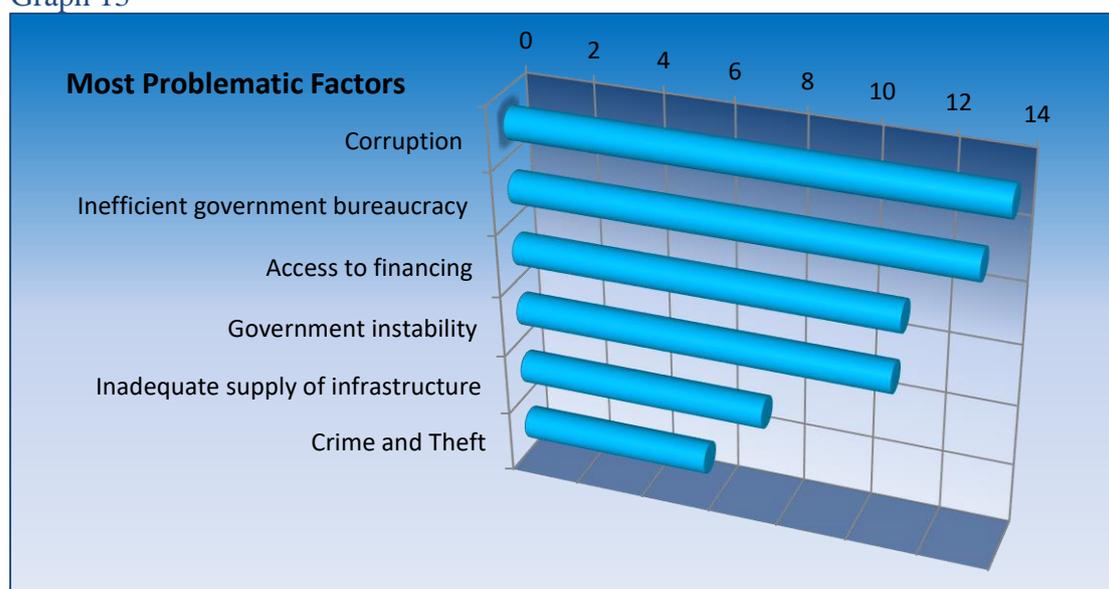
Nonetheless, the most interesting part of graph 12 is that the biggest difference concerning the performance of Serbia in comparison with the EU (28) countries is observed in the institutions sector, something that leads to the conclusion that probably that sector is the one in greater need of reform for a transitional country like

<sup>10</sup>According to the World Economic Forum each country gets a score in each sector, in a scale of 1.00 (minimum) to 7.00 (maximum). The 1.00 reflects the worst performance while the 7.00 reflects the best performance.

Serbia to achieve greater competitiveness and efficient economic growth (Acemoglu and Robinson, 2012).

Consequently, graph 13 shows, in line with the world competitiveness report in 2014, the most problematic factors in Serbia that negatively influence the competitiveness of the country.

Graph 13



Source: Authors 'elaboration based on data provided by the World Economic Forum (2014)

According to the graph, corruption seems to occupy the first place of most problematic factors, with a score of 13.8% closely followed by inefficient government bureaucracy with 13.1%. Right after comes the limited access to financing with a percentage of 11.1%, followed closely by government instability with 10.9% and inadequate supply of infrastructure with 7.3% (World Economic Forum). As it can be concluded from all the above, corruption flourishes in the country because of the long-term institutional inefficiencies that still exist within it (Mladenovic, 2014).

To sum up, after all the previous comparisons and data used in order to evaluate the competitiveness levels of Serbia regarding its political, institutional and economic environment it is most appropriate to mention as a concluding remark which sectors seem to be the most problematic, influencing the country's competitiveness performance most negatively. As was detected before, Serbia sadly possesses a poor performance in all the sectors examined, which are: Institutions, corruption, political rights and civil liberties, political stability, rule of law, crime, infrastructure, macroeconomic environment, health system, higher education and training, goods

market efficiency, labor market efficiency, financial development, market size, business sophistication, innovation and finally the level of entrepreneurial bureaucracy imposed by the state, that to a certain extent have a domino effect and negatively influence each other, finally leading to an even worse overall performance (World Economic Forum, 2014).

Serbia has an extremely uncompetitive performance in all the sectors previously mentioned in this report. It was mainly the inefficient institutions and weak rule of law that led to uncontrolled corruption in the country, negatively influencing all the other sectors as well (Acemoglu, Johnson, and Thaicharoen, 2003). That is the reason why in another section of this report, after the estimates of the empirical results, an extended set of recommendations is going to be proposed for the majority of Serbia's problematic sectors, but mainly targeting the improvement of Serbia's institutional capacity and reducing its high levels of corruption by the enforcement of a more efficient rule of law.

## Empirical Results

Even if not all forms of mixed–method strategies for comparative research provide greater insights into particular research problems, most often LNA<sup>11</sup> provides insights among different explanations and SNA<sup>12</sup> helps to improve the quality of measurement instruments. The combination of the SNA and LNA approach is extremely useful when investigators conducting cross-national analysis are interested not only in general patterns, but in specific country cases (like Serbia in this case) as well (Lieberman, 2005).

Table 6 informs the reader about the selected dependent and independent variables selected concerning the empirical analysis that will be conducted about the post Yugoslav states<sup>13</sup> including, of course, Serbia. More precisely, the GDP per capita PPP (current international \$) is the dependent variable that is going to illustrate the level of economic growth for all the post Yugoslav states for the period from 2006 to 2013. Unfortunately, the time period covered is not so large due to the large amount of data missing for the specific countries, but still, 56 observations will be at least sufficient to provide the crucial information to the reader about the interconnection between economic growth and the other independent variables described in table 6.

Table 6

<ul style="list-style-type: none"><li>• <b>GDP per capita, PPP (current international \$) (Dependent variable)</b> (Data retrieved from the World Bank database)<ul style="list-style-type: none"><li>– GDP per capita based on purchasing power parity (PPP). PPP GDP is gross domestic product converted to international dollars using purchasing power parity rates.</li></ul></li></ul>
<ul style="list-style-type: none"><li>• <b>FDI net inflows (BoP, current US million\$)</b> (Data retrieved from the World Bank database)<ul style="list-style-type: none"><li>– Foreign direct investment are the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor.</li></ul></li></ul>

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<sup>11</sup> LNA: Large N analysis.

<sup>12</sup> SNA: Small N analysis.

<sup>13</sup> Post Yugoslav states in the regression model include the countries of: Serbia, Croatia, Albania, Montenegro, Bosnia-Herzegovina, Slovenia and FYROM.

### • **Corruption**

(Data retrieved from the Transparency International database)

– The CPI is a composite index, a combination of surveys and assessments of corruption, collected by a variety of reputable institutions. It reflects the views of observers from around the world, including experts living and working in the countries evaluated. The CPI is the most widely used indicator of corruption worldwide. The index captures information about the administrative and political aspects of corruption. Finally, the CPI in the regression model ranges from 0 (highly transparent) to 10 (highly corrupt).

### • **Political rights and civil liberties**

(Data retrieved from the Freedom House database)

– Political rights and civil liberties represent the fundamental components of freedom, which include an individual's ability to:

- Vote freely in legitimate elections.
- Participate freely in the political process.
- Have representatives that are accountable to them.
- Exercise freedoms of expression and belief.
- Be able to freely assemble and associate.
- Have access to an established and equitable system of rule of law.
- Enjoy social and economic freedoms, including equal access to economic opportunities and the right to hold private property.

Each country is assigned two numerical ratings—from 1 to 7—for political rights and civil liberties, with 7 representing the most free and 1 the least free.

### • **Political Stability**

(Data retrieved from the World Bank database)

– Reflects perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism. Political Stability (ranges from approximately 0 (weak) to 5 (strong) governance performance.

### • **Rule of Law**

(Data retrieved from the World Bank database)

– Reflects perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property

rights, the police, and the courts, as well as the likelihood of crime and violence. Rule of Law (ranges from approximately 0 (weak) to 5 (strong) performance).

• **Bank NPLs to total gross loans (%)**

(Data retrieved from the World Bank database)

– Bank nonperforming loans to total gross loans are the value of nonperforming loans divided by the total value of the loan portfolio (including nonperforming loans before the deduction of specific loan-loss provisions).

• **Unemployment, total (% of total labor force)**

(Data retrieved from the World Bank database)

- Unemployment refers to the share of the labor force that is without work but available for and seeking employment.

• **Doing Business (Bureaucratic levels)**

(Data retrieved from the Doing Business database)

– Economies are ranked on their ease of doing business, from 1 to 189. A low value of the doing business index means that the regulatory environment is more conducive to the starting and operation of a local firm concerning bureaucratic issues.

In order to select an appropriate linear or multi-linear model that will show the effect of the selected independent variables on economic growth, the detection of a high degree of correlation among them will provide information about the level of their possible interaction and will also assist in avoiding the negative effect of multi-collinearity to the proposed regression model (Wooldridge, 2002).

Table 7

	gdpper~o	corrup~n	politi~s	politi~y	ruleof~w	fdinet~n	banknp~s	unempl~r	doingb~s
gdpper~o	1.0000								
corruption	-0.9129	1.0000							
politicalr~s	0.9555	-0.8453	1.0000						
politicals~y	0.8553	-0.7406	0.8315	1.0000					
ruleoflaw	0.9629	-0.9423	0.8882	0.8394	1.0000				
fdinetin~n	0.0282	0.1544	0.0978	0.0392	-0.1336	1.0000			
banknplsto~s	-0.1095	0.1010	-0.1221	-0.0359	-0.1191	-0.1929	1.0000		
unemployme~r	-0.6855	0.5267	-0.7251	-0.7344	-0.5836	-0.2843	0.0950	1.0000	
doingbusin~s	-0.4370	0.5403	-0.3950	-0.3196	-0.4805	0.3334	-0.1651	0.0332	1.0000

As it can be observed in table 7, the strongest correlation between the included variables is detected between: Rule of law and GDP per capita in PPP (correlation value: 0.9629), Rule of Law and Corruption (correlation value: -0.9423), GDP per capita in PPP and Political rights and civil liberties (correlation value: 0.9555), GDP per capita in PPP and Corruption (correlation value: -0.9129) and finally GDP per capita in PPP and Political Stability (correlation value: 0.8553).

These results are of decisive importance regarding the primary assumptions of this report, that economic growth in the post-Yugoslav states in transition basically depends on the reduction of corruption because of the existence of inefficient institutions within them, and the strengthening of the rule of law together with the protection of political and civil liberties can lead to political stability and eventually to greater levels of democracy and economic growth (Acemoglu and Robinson, 2008). It is also extremely interesting to notice that the correlation value between FDIs and GDP per capita in PPP is only 0.082 indicating that economic growth in those countries will not be achieved, as many policy makers claim, only by an increase of investments on them if an efficient institutional and political environment, free from corruption, is still absent from the country (Acemoglu, 2006a).

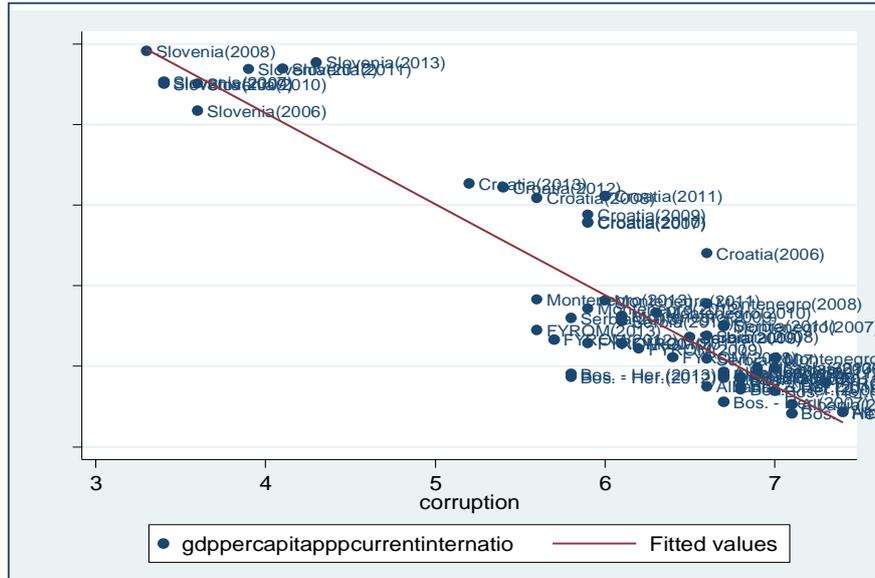
In addition, the strong correlation detected between the independent variables in table 7 and the many significant combinations of variables obviously support Treisman's conclusion that "corruption is hard to study empirically. Its many likely determinants interrelate in complicated ways. Some can change quickly and may be caused by corruption as well as the reverse" (Treisman, 2000). As a result, in our model as well, even if there are many significant interactions between the strongly correlated independent variables, collinearity is still present.

Nevertheless, a simple linear regression model between GDP per capita in PPP and corruption complies with the Gauss-Markov assumptions regarding linearity, heteroskedasticity, normality and independence:

#### Linearity

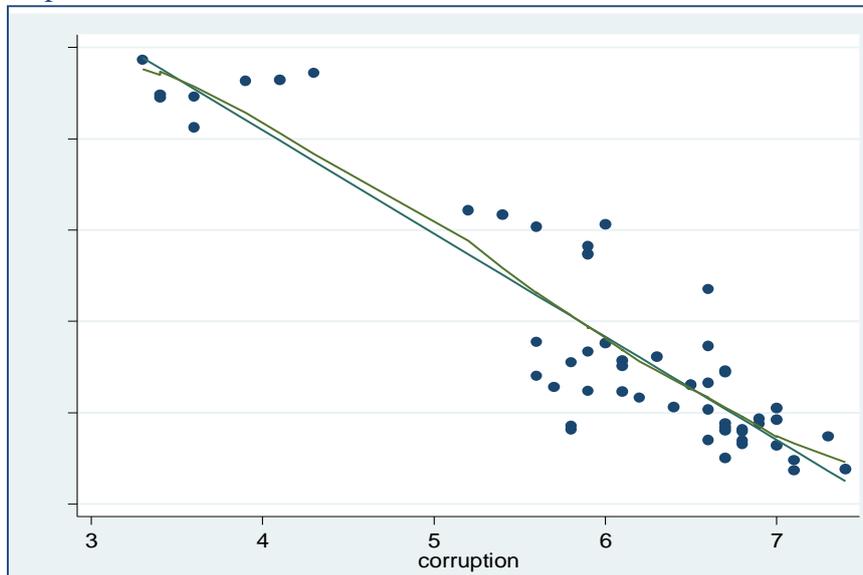
According to the results of graph 14 it can be concluded that a linear relation is present between the dependent variable (GDP per capita in PPP) and the independent variable (corruption).

Graph 14



Moreover even if an augmented component-plus-residual plot is used to detect potential nonlinearities in the data, as it can be seen by graph 15, except for some small inefficiency in the beginning of the regression line we have a trend very close to the linear one.

Graph 15



### Heteroskedasticity

The Cook-Weisberg test about heteroskedasticity was also used. As table 8 shows, the probability result is equal to 0.172, which means that if the null hypothesis that the model has constant variance is rejected there is a great chance of this being wrong. As a result, it can be concluded that the model possesses constant variance.

Table 8

```

. hettest

Breusch-Pagan / Cook-Weisberg test for heteroskedasticity
Ho: Constant variance
Variables: fitted values of gdp per capita ppp current international
       chi2(1)      =      1.14
       Prob > chi2   =      0.2861
    
```

Normality

Another check conducted on the model was the one concerning normality. As table 9 shows, the probability result is equal to 0.5780 that means that if the null hypothesis that the model has a normal distribution is rejected, there is a great chance of that being wrong. As a result, it can be concluded that the model complies with the normality criteria.

Table 9

```

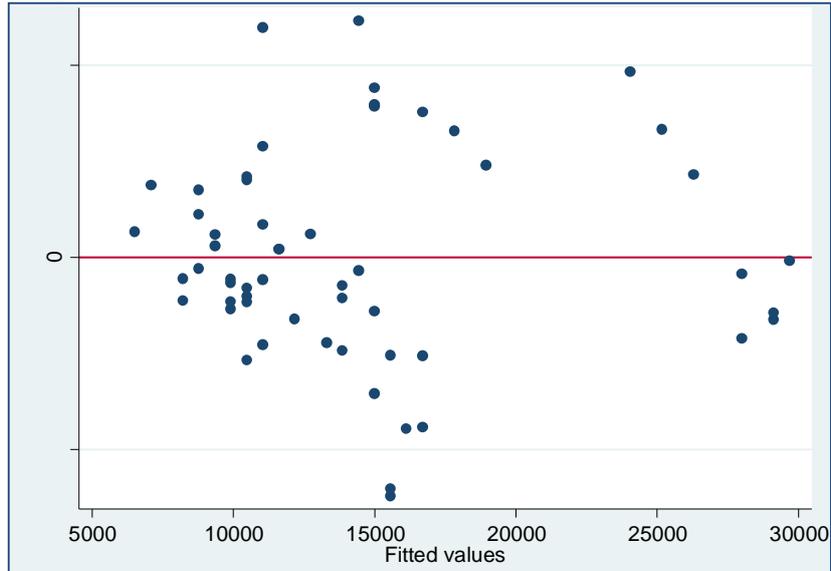
. sktest resss

Skewness/Kurtosis tests for Normality
----- joint -----
Variable | Obs Pr(Skewness) Pr(Kurtosis) adj chi2(2) Prob>chi2
-----|-----
      resss | 56  0.7286      0.3332      1.10      0.5780
    
```

Independence

Statistical independence of errors means that a correlation between consecutive errors must be very unlikely. Statistical independence can be detected from the data points of the residual cases if they do not follow a certain pattern. From graph 16, we can conclude that the residuals do not influence in a great degree each other, as they seem to follow a random pattern, so independence from errors is assured.

Graph 16



In addition, the linear model created must be controlled for possible omitted variables. Omitted variables are variables that significantly influence the dependent variable and so should be in the model, but are excluded. A regression specification error test (RESET) for omitted variables was used. As table 10 shows, the probability is equal to 0.1782 that means that if the null hypothesis that the model has no omitted variables is rejected there is a great chance of it being wrong. As a result, it can be concluded that the model has no omitted variables.

Table 10

```
. ovtest

Ramsey RESET test using powers of the fitted values of gdp per capita
Ho: model has no omitted variables
F(3, 51) = 1.70
Prob > F = 0.1782
```

Consequently, after running the regression (table 11) the following results are obtained:

Table 11

. reg gdp per capita ppp current international corruption						
Source	SS	df	MS	Number of obs = 56		
Model	2.0375e+09	1	2.0375e+09	F( 1, 54) =	269.67	
Residual	408006305	54	7555672.31	Prob > F =	0.0000	
				R-squared =	0.8332	
				Adj R-squared =	0.8301	
Total	2.4455e+09	55	44464409	Root MSE =	2748.8	
gdp per capita	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
corruption	-5651.672	344.1604	-16.42	0.000	-6341.672	-4961.672
_cons	48337.75	2096.772	23.05	0.000	44133.98	52541.53

The “F value” and “Prob (F)” statistics test the overall significance of the regression model. In the previous model the F value is zero which means that the model created is clearly statistically significant. In addition:

- 56 observations are included in the model, a number high enough to run a valid regression model.
- The p\_value of the independent variable (corruption) is  $0 < 0.05$ , which means that the coefficient of the variable corruption is significant at the 95% level of significance.
- R-squared is 83.32 which mean that 83.32% of the variation in the size of economic growth (GDP per capita in PPP) is explained by the independent variable included in our regression (corruption). An 83.32% of the variation explained by our regression is a very large percentage.
- The coefficient of our independent variable is negative indicating that as (corruption) increases, on average, GDP in PPP falls. The coefficient is -5651.672. An increase in the level of corruption by 1 unit is estimated to be associated with a fall in the mean level of economic growth (GDP per capita in PPP) of 5651.67 US \$. If it is considered that the average value of the variable GDP per capita in PPP is almost 15.000 US \$ in our sample, then it can be concluded that for a 1 unit increase in the corruption variable a country in our sample loses almost 30% (5651.67 \$) of its economic performance. The previous coefficient might be a little large because of the starting level of GDP

in PPP per capita in transition states and the unstable macroeconomic environment that the post-Yugoslav states are experiencing during their short transition period examined, but still, it provides the crucial information of the significant dependence between inefficient institutions that allow corruption and its negative effects on economic growth to flourish (Uvalic, 2010).

To continue, before proceeding to the proposed recommendations of this report, it will be interesting to study how rule of law, FDI inflows and political stability are interconnected, through the creation of an additional correlation model, with economic growth (GDP per capita in PPP) specifically for the case of Serbia. The previous indicators are easier to study in a greater depth of time because of the greater amount of information available. The time frame covered in the following correlation, between the four variables mentioned, is between the periods from 1996 to 2013.

As it can be observed in table 12 the strongest correlation between the four variables included, in the case of Serbia, is detected between: Rule of law and GDP per capita in PPP (correlation value: 0.9625), Rule of Law and Political stability (correlation value: 0.8640) and finally GDP per capita in PPP and Political Stability (correlation value: 0.7726). Moreover, it is detected that the correlation value between FDI inflows and GDP per capita in PPP is only 0.5829 indicating a comparatively weaker correlation between them than between Rule of law and GDP per capita in PPP or GDP per capita in PPP and Political Stability.

Table 12

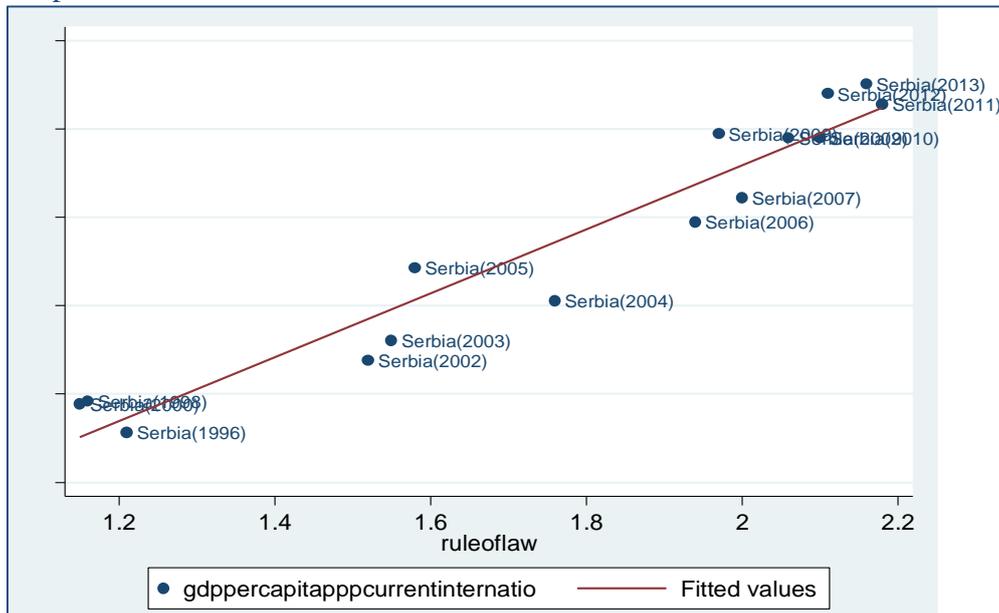
	gdpper~o	fdinet~n	politi~y	ruleof~w
gdppercapi~o	1.0000			
fdinetinfl~n	0.5829	1.0000		
politicals~y	0.7726	0.5173	1.0000	
ruleoflaw	0.9625	0.6505	0.8640	1.0000

The previous results are again of decisive importance regarding the primary assumptions of this report: that economic growth in the transitional post-communist state of Serbia is much more interconnected with the existence of efficient institutions operating under a solid and strengthened rule of law that can lead to greater levels of political stability, than with total dependency on foreign direct investments, which in the case of Serbia were not directed to the needed sectors of the Serbian economy because of its extremely low productivity during its post-communist transition

(Uvalic, 2001). Thus, as stated before, FDIs can significantly promote the growth of an economy, but if they are not driven to certain economic sectors they may produce exactly the opposite effects (Stiglitz, 2000).

Finally, graph 17 illustrates the crucial interconnection between the rule of law variable and economic growth. As it can be seen there is a great positive correlation between the two variables during Serbia's transition years that clearly follows an almost absolute linear trend, indicating the crucial importance of an efficient rule of law on the economic performance of the country.

Graph 17



## Recommendations Regarding the Improvement of the Competitiveness and Growth Performance of the Republic of Serbia

An extensive report will follow for each of the previous problematic sectors, proposing recommendations for the improvement of the country's overall competitiveness. Graph 14 shows these sectors. The recommendations will be focused mainly on the institutional and governmental reforms that are necessary in order to achieve higher growth, through the analysis of the inefficient sectors of competitive performance of the country (Acemoglu and Robinson, 2008). Nevertheless, only the effective combination of all the recommendations that are about to follow can lead to higher and long-term growth rates (Walsh and Yu, 2010). In other words, it is very important to apply the principle of complementarity, which supports that the effectiveness of one institution depends on the design of another (Iversen, 2006).

Graph 14



Problematic sectors regarding the Serbian institutional, political and economic performance

Special attention will be also given to the recommendations concerning corruption, since facing corruption and providing institutional efficiency through a strengthened

rule of law seem to be the largest problematic factors in the country that prevent and downgrade the growth performance of Serbia (Transparency International, 2012).

### **A) Corruption recommendations**

Serbia has a major problem with corruption because of the situation created by the fall of the communist system, but also because of the dramatic conflicts that the country faced with the collapse and fragmentation of Yugoslavia (Todorova, 2009). As it is well known, during the period that the country was at a state of war, paramilitary and extra-governmental groups engaged in a variety of illegal activities from black market trading to money laundering, theft, burglaries, drug trafficking and even assassinations. Right after the war ended those groups did not disappear from the country. On the contrary they were already enormously strengthened and continue to operate inside the new established state (Macek, 2009).

Regarding Serbia's corruption problem and the repercussions on its economy the index of economic freedom stated on its annual report in 2013 that: "Organized criminal groups engage in money laundering, and corruption remains widespread in the country's economy. It is estimated that "nearly 25 percent of spending on public procurement (or about 15 percent of GDP) is diverted by corruption" (Heritage, 2013).

Trying to provide specific solutions to reduce the effect of corruption in the country will be extremely interesting and fruitful for Serbia's competitiveness performance. According to Mauro Paulo, in his article: "Causes and consequences of corruption at countries-economies", the repercussions of corruption in a country's economy can be extremely significant, Paulo mentions: "Regression analysis shows that a country that improves its standing on the corruption index from, say, 6 to 8 (0 being the most corrupt, 10 the least) will experience a 4 percentage point increase in its investment rate and a 0.5 percentage point increase in its annual per capita GDP growth rate" (Paulo, 1998).

It would be helpful to divide the proposed recommendations on corruption for Serbia in recommendations of facing and of prevention of corruption. Accordingly, the recommendations for facing corruption can be further divided in specifically and generally targeted.

- 1) Recommendations on facing corruption.
  - a) Specifically targeted recommendations that will fight corruption in specific sectors on which corruption exists.
  - b) Generally targeted recommendations that will face corruption on a wider level in order to contribute to the general reduction of corruption.
- 2) Recommendations on prevention of corruption (Anticorruption-Serbia, 2013).

Graph 15



Source: Authors' calculation and elaboration

### **Confrontation recommendations (specifically targeted)**

At this point, a review will be conducted on the sectors that are infected to a greater extent by corruption in Serbia, as they were studied before, and for each of those sectors the respective recommendations will follow. The proposal of the specific confrontation recommendations for Serbia will focus on the following crucial sectors: political parties-parliament, media, education, public officials, judiciary, police and health (Transparency international, 2013b).

#### **Political Parties - Parliament**

The political parties in Serbia, as it was explained before, are unfortunately often found to be connected with corruption scandals that also involve vicious business cycles and even the organized crime that exists in the country. The previous phenomenon has proven to be catastrophic for the welfare of the Serbian society since political parties are supposed to fight and prevent corruption and not to be infected by

it so directly (Mladenovic, 2014). Critical recommendations for improving this crucial sector may include:

### **Recommendations**

- 1) Strengthen the legal framework in Serbia according to the European framework, in order to better control the financing of the political parties through transparent mechanisms.
- 2) Eliminate the influence of private interests by persons performing a public function by anti-corruption agencies responsible for regular financial controls over the Serbian political elites (Anticorruption-Serbia, 2013).
- 3) Create local anti-corruption projects created by financially independent organizations that will control and evaluate transparency, including all the economic and political actions of the local deputies, in regular time periods.
- 4) Impose heavier penalties on those who are found to be involved in corruption (Pesic, 2007).

### **Media**

The proportion of people in Serbia that is informed through media regarding corruption reaches 42% of the population, which means that media can play a huge role on the fight against corruption (Begovic, 2013). Nevertheless, before this can take place it is critical to guarantee the freedom of media from corruption, something that can be done with the following solutions:

### **Recommendations**

- 1) Transparent ownership of the Serbian media in order to avoid serving private interests.
- 2) Funding sources of the media to be independent from the government administration, to be funded by totally transparent institutions of the state instead.
- 3) Create independent (economically-politically) organizations that will rate the transparency level of the media every year (Anticorruption-Serbia, 2013).
- 4) Impose heavier penalties on those who are found to be involved in corruption.
- 5) Strengthen the role of productive NGOs and citizens initiatives that promote anticorruption mentality and democratic values concerning media administration (Begovic and Mijatovic, 2002).

## Education

Education is undoubtedly one of the most important factors that can positively influence the growth performance within a country (McGrath, 2010). In Serbia, the educational system unfortunately lacks the proper technological level, as well as the crucial interconnection between education and business absorption. Nevertheless, the highest inefficiency in the educational system is the existence of great levels of corruption within it, which must be resolved according to the following recommendations (Transparency International, 2014).

### **Recommendations**

- 1) Create electronic means of grading in order for the educational system to be more transparent in its procedures and to eradicate bureaucracy that also leads to greater corruption.
- 2) Ensure, through independent and transparent evaluation organizations, that the hiring of personnel takes place according to their real values and abilities and not to their political or economic connections (Pesic, 2007).
- 3) Change the level of powers the deans of faculties and directors of primary-secondary schools possess in order to avoid power misuse.
- 4) Create organizations that will examine the economic needs of every school-university on a yearly basis and provide them accordingly with the necessary funding, but in addition, at the end of each year verify if the previous funding provided was truly invested in sectors needed or if it was misused.
- 5) Impose heavier penalties on those who are found to be involved in corruption in order to prevent others from doing the same (OECD, 2012b).

## Public officials

Public officials in Serbia can also play a tremendous role in the effort of facing corruption in the country. Public officials are the active human capital of the public mechanisms responsible for the provision of public services that lead to social welfare free from fraud and corruption (Payne, 2001). Recommendations on this sector may include the following actions:

## **Recommendations**

- 1) Create an organization independent from economic or political influence by the government, which will be responsible for the discovery and the elimination of corruption within the personnel of the public sector.
- 2) Impose heavier penalties on the public servants who are found to be involved in corruption scandals.
- 3) Create more complex criteria of hiring personnel in the public sector that will more accurately examine the personality and ethics of each candidate (Gray, Cheryl, and Kaufmann, 1998).
- 4) Cancel public officials' permanence and create evaluation mechanisms that will rate and control their working efficiency on a yearly basis, according to which it will be decided whether or not they are capable of serving in the public sector the next year to come (Anticorruption-Serbia, 2013).

### **Judiciary**

The Serbian Judiciary system, as was explained before, is facing a major problem with corruption for a long time (Transparency International, 2013b). In addition, judicial officials are not specialized in issues such as bankruptcy procedures or enforcement of competition law (Begovic, 2013).

Even if democracy is the main aim of every state in transition (like Serbia) in the long run, the best way to proceed in the short run is “to focus more on the rule of law regarding property rights, free markets, contract enforcement and less on the romance of democracy” (Barro, 1999).

In order to resolve this negative phenomenon the judiciary must reform its way of functioning according to the recommendations bellow:

## **Recommendations**

- 1) Prevention of conflicts of interests (political or economic) inside the judiciary profession.
- 2) Reregulate criminal law in order to be compatible with the European standards. It is proven, according to the graphs that were presented earlier on this report, that the EU-28 countries perform better results on facing corruption with the institutional laws that they possess (Transparency International, 2014).

- 3) Reform the rule of law in order to achieve greater efficiency in the protection of property rights and the regulation of a competitive free market (Barro, 1999).
- 4) Provide greater levels of specialization to judicial officials in matters regarding property protection, bankruptcy procedures and enforcement of competition law.
- 5) Secure the transparency of selection for candidates that are about to work for the judiciary system in order to prevent bribes.
- 6) Total independence of the judiciary in terms of budgetary powers (Dallara, 2014).
- 7) Enable closer and more efficient cooperation of the police with the judiciary system in order for justice to be served in a faster and more accurate way.
- 8) Impose heavier punishments for those that are found to be involved in corruption in order to prevent them from doing so.
- 9) Adopt a greater number of electronic means of functioning and surveillance in order for the judiciary to be faster at its decisions and more transparent in its procedures. This measure will also eradicate examples of bureaucracy that as it was detected often leads to greater corruption (Anticorruption-Serbia, 2013).

### Police

Corruption in this sector is unfortunately alarmingly high in Serbia, and it must also be kept in mind that a large proportion of it is not even traced and reported. In Serbia, 90% of the citizens believe that the police are corrupt to a certain extent, mainly because of the negative influence of criminal groups, corrupt politicians and exploitative tycoons on the police personnel. Only 3% of the citizens of Serbia share the view that the police are not corrupt at all (Petrovic, Dordevic, and Savkovic, 2013). Recommendations on this sector may include the following actions:

#### **Recommendations**

- 1) Create an organization independent from the police hierarchy that will be responsible for the discovery and the elimination of corruption within the police.
- 2) Impose heavier penalties on those police officers who are found to be involved in corruption in order to prevent them from doing so.
- 3) Participation of the public, including protection of personal data, in order to evaluate the quality of the services received (Anticorruption-Serbia, 2013).
- 4) Create more complex criteria of hiring personnel in the police academy that will examine the personality and ethics of each candidate.

- 5) Total independence of the police in terms of budgetary powers from private interests companies in order not to be controlled by them (Petrovic, Dordevic, and Savkovic, 2013).

### Health

The ACA Report on Forms, Causes and Risks of Corruption in the Health Care System from 2012 indicates that corruption has a huge negative impact on the Health services in Serbia. The most common problems are: Relations between pharmaceutical companies and doctors, doctors getting money directly from patients in order to serve them more efficiently, conflicts of economic-political interests even inside the hospital hierarchy and finally additional work of doctors (Dickov V., Dickov A., and Milicevic, 2010).

### **Recommendations**

- 1) Create organizations that will evaluate the function of hospitals and their level of performance on a yearly basis and if the evaluation is below average take action against those responsible.
- 2) Participation of the public, including protection of personal data, in order to evaluate the quality of the services they had received.
- 3) Impose heavier penalties on those who are found to be involved in corruption in order to prevent others from doing so (Transparency International, 2012).
- 4) Eliminate deficiencies in the structure of the legal framework (lack of specialized officials, large number of law intermediaries) that gives the opportunity for corruption to flourish in the procedures of the Serbian health system.
- 5) Create electronic means that will assist the function and the surveillance of the health system and that will eradicate incidents of excessive bureaucracy that also leads to greater corruption in the country (Anticorruption-Serbia, 2013).

### **Confrontation recommendations (generally targeted)**

It will be very fruitful to base the proposal of general recommendations for fighting corruption on the 12 conclusions of Daniel Treisman, that were included in his article: “The causes of corruption: a cross-national study”, and mention which of them fit best to the case of Serbia. Daniel Treisman in his report came to some very important conclusions in order to fight corruption in a country using empirical methods as a tool (Treisman, 2000). From the 12 conclusions of Treisman, 6 will be selected as the

most appropriate in the case of Serbia according to its political, institutional and socioeconomic environment.

- 1) Corruption will be lower in democratic countries and those with a free press and more vigorous civic associations.
- 2) Corruption will be lower in more economically developed countries, where populations are more educated and literate, and where the normative separation between 'public' and 'private' is clearer.
- 3) Corruption will be lower in countries with higher relative salaries in public office.
- 4) Corruption will be higher where political instability is greater.
- 5) Corruption will be higher in countries with greater state intervention in the economy (in the form of regulation, taxation, or state commercial activity).
- 6) Corruption will be lower the greater the country's exposure to competition from imports (Treisman, 2000).

The determination of the general recommendations that are going to be proposed for Serbia will be based on Treisman conclusions. Nevertheless, only the effective combination of the recommendations above can be successful for decisively facing corruption in Serbia (Monastiriotis and Petrakos, 2010).

The general recommendations include the following actions:

- 1) Increase the level of competitiveness.
- 2) Increase political stability.
- 3) Reduce Bureaucracy.
- 4) Decrease unemployment rates.
- 5) Increase the level of economic freedom.
- 6) Increase the salaries of the civil servants.
- 7) Increase the proportion of people that are educated.

#### Increase the level of competitiveness

- 1) Competitiveness, as was discussed earlier, leads to higher growth rates which in turn results in the reduction of the most significant problem in the economy of Serbia, which is corruption (Transparency International, 2012). As was mentioned before the most problematic sectors regarding Serbia's performance on competitiveness are the: Institutions – Infrastructure – Macroeconomics – Higher education and training – Financial market development – Business sophistication and Innovation sectors that have a domino effect and negatively influence each

other (World Economic Forum, 2014). Consequently, in order to increase the level of competitiveness in the country institutional reforms with a more trustful and dynamic rule of law that will protect property rights should be established more efficiently. As a result, healthy market competition will occur by allowing entry of new firms, leading to the reduction of the negative effects of market abuse by certain exploitative business circles that exist in the country (Uvalic, 2010).

#### Increase political stability

It can be very clearly seen that political stability helps a solid, common and drastic policy on any internal problem of the state, such as corruption, and prevents dangerous plans that specific corrupt groups may have. This can be seen in graph 13 where the negative influence of the government's instability on Serbia's competitiveness reflects the opinion of 10.9% in the total number of people asked (World Economic Forum, 2014).

In order to achieve greater political stability in Serbia (paragraph J includes detailed policies concerning political stability), political elites should try to: improve the economic environment, increase the institutional, political and socioeconomic freedoms, reduce the number of internal veto players, establish good neighboring relations with Kosovo, Croatia and Montenegro under a common Balkan strategy of institutional reform and cooperation, improve public safety by reducing crime, achieve institutional reforms to the direction of greater efficiency and finally try to fulfill the basic target of the last Serbian governments to enter the EU (Anastasakis and Bojicic, 2002).

#### Reduce bureaucracy

Bureaucracy strengthens the phenomenon of corruption because the more persons get involved in the development of a procedure the bigger the probability that some of them will be corrupt. Accordingly, graph 13 shows that 13.1% of the correspondents consider bureaucracy a negative factor for doing business which also affects the outcome on corruption (World Economic Forum, 2014).

In order to reduce bureaucracy levels in Serbia (paragraph K includes detailed policies for reducing bureaucracy levels in Serbia) political elites should try to: create certain policy targets and set up a control organization in order to evaluate the progress concerning the accomplishment of the government's primary targets, harmonize laws and regulations, collect citizens' feedback to drive the change, establish and support

one-stop shop organizations to provide easier, faster and more transparent help and guidance to companies and citizens and finally strengthen communication technologies to reduce time, cost and unnecessary intermediaries(EBRD, 2014).

#### Decrease unemployment rates

The bigger the proportion of unemployment that a country possesses, the less productive it becomes. As a result the growth rates of the country are reduced and more people are going to be poor and led to corruption (Tanzi, 1998). In order to face the problem of unemployment in the country, the Serbian policy makers should promote a large amount of policy reforms, which can include the following:

- 2) Institutional reforms are necessary in order to control the informal employment that exists in Serbia and puts a significant obstacle on the development of formal employment because of the discrepancies that this generates in the market. Control mechanisms should become more transparent, less bureaucratic and freer from corruption effects by introducing electronic mechanisms of identifying and eliminating informal labor (Anticorruption-Serbia, 2013).
- 3) It is of crucial importance for the educational system of the country to adopt the needs of the Serbian market in a much more efficient way in order to provide the necessary human capital in the sectors of the economy where more people are needed (UNICEF, 2008). According to data from the national employment service (NES), the qualification structure of registered unemployment in Serbia in 2014 was comprised of 66.5 % of job seekers who were skilled (having completed secondary level education and above) and 33.5 % who were unskilled (individuals who have not completed primary or secondary education), indicating that skilled seekers cannot find access to employment because of the lack of connections between education and the market (National Employment service of Serbia, 2014).
- 4) Rearrangement of the structure of the employment offices from spending most of their time in administrative activities that are not related to employment counseling, to providing specific and crucial information to job seekers, to help them find a job. A useful reform that probably will assist in this rearrangement is more efficient training of the public servants on matters concerning job providence and knowledge of the Serbian market (Mills, 2010).

5) Lastly, but of crucial importance, is the improvement and stabilization of the economic and political environment of Serbia. This will greatly assist in attracting foreign direct investments that will contribute to the creation of new job openings. Moreover, the healthy market competition that will occur by allowing entry of new firms inside the Serbian market will cancel the negative effects of monopoly power (Monastiriotis and Petrakos, 2010).

#### Increase the level of economic freedom

The more economically free a country is in the form of regulation, taxation, or state commercial activity the more attractive it becomes in internal and foreign investments that will increase its productivity (Heritage, 2015). Also thanks to healthy competition between the different investments companies, as it was mentioned earlier, the phenomenon that some of the internal companies of the country building relations based on corruption with the local authorities can be avoided (Subotic, 2010).

Serbia possesses extremely low scores on the protection of property rights according to the Heritage Foundation report in 2015. More specifically, the responsible authorities should protect private property by creating new laws that will guarantee property rights to potential investors and will eradicate corruption within the judiciary. In addition, extremely high levels of corruption exist in government spending and this problem should also be treated drastically by creating more transparent methods of information by checking if government spending is truly towards social protection, health, education, public order and safety defense (Heritage, 2015).

Moreover, financial freedoms must be extended in Serbia in order to provide greater availability of financial services and easier access to loans. Finally, business freedoms should be strengthened through creating easier access in getting credit, decreasing the time and number of procedures in order to deal with construction permits and resolving insolvency, protecting investors' property and providing easier access to electricity services (Doing Business, 2014).

#### Increase the salaries of the civil servants

Bigger salaries for the civil servants, according to the empirical methods of Treisman, will lead to a drop in corruption, because public servants will be less vulnerable to corruption phenomena like bribes. Nevertheless, it has to be mentioned

that this solution, like all others mentioned before, cannot play a positive role unless it is combined with all the rest and put simultaneously into force (Treisman, 2000).

#### Increase the proportion of people that are educated

The total enrollment in tertiary education, regardless of age, expressed as a percentage of the total population in Serbia, was only 56% in 2013. As it can be understood, it is necessary for the Serbian government to provide extra funding and educational motives for Serbian citizens, especially the ones that live in remote areas, in order to have a greater number of citizens with higher technical and communicative skills in the near future (World Bank, 2013c).

The increase of the proportion of the population in the educational system will automatically mean that through that process more people will develop stronger ideological and moral defenses against corruption (OECD, 2013). The human capital of Serbia, through the proper education will also lead to improved institutional functioning, that consequently will lead to the empowerment of democracy within the country (Barro, 2001).

Analytical recommendations on the improvement of the educational level of the country are given in paragraph (E).

#### **Prevention Recommendations**

The proposal of the prevention recommendations for Serbia will be based on the following crucial steps:

- 1) Develop an anti-corruption mentality through the educational system.
- 2) Promote the anti-corruption behavior through the media.
- 3) Create laws that will prevent conflicts of interest in the public sector.
- 4) Provide greater economic assistance to the anti-corruption agencies.
- 5) Make the civil society more active.

#### Develop an anti-corruption mentality through the educational system

It is very important for a citizen of a state to be informed about the problem of corruption from a young age and to develop the necessary defensive acquirements, through state mechanisms, such as the educational system, that will not only protect him from corruption but will also lead him into an energetic role against corruption (UNICEF, 2008).

### Promote the anti-corruption behavior through the media

As it is well known, the media play a huge role on the influence of public opinion in many cases. It would be very decisive for facing corruption in Serbia, for the media to try to strengthen the perception of the need to fight corruption in the mind of the people through TV educational programs, newspapers articles or radio broadcasts (Begovic and Mijatovic, 2002).

### Create laws that will prevent conflicts of interest in the public sector

It is important to pass laws in the Serbian legislation that will not only punish people who are involved in corruption, but that will also discourage them from this behavior. This is why it is extremely positive that the legislation that will concern the function and the administration of the Serbian public sector will prevent the existence of those conflicts from their beginning (United Nations, 2012).

### Provide greater economic assistance to the anti-corruption agencies

The powers of the anti-corruption agencies must be strengthened in Serbia in any possible way. One way is to fund them more effectively in order to serve mainly two results: Firstly, with greater economic assistance the anti-corruption agencies will promote finer and more efficient control over corruption. Secondly, with greater salaries the employers of the anti-corruption agencies will become less vulnerable regarding corruption inside the agencies themselves (Vachudova, 2009).

### Make the civil society more active

It would be extremely useful to develop a way of thinking or culture in Serbia's citizens, through NGOs and citizens initiatives (as it already exist in more developed countries that have lower corruption rates like Germany or other Western EU countries) according to which, if a citizen observes any kind of corruption he will provide information about it in the local authorities for the general good of the public (OECD, 2012b).

Finally, it will be useful to mention that some of the recommendations for facing corruption that were proposed earlier, had a nature of prevention and confrontation at the same time, which means that they can be used in both cases.

## **B) Institutions**

The most crucial determinant for creating higher levels of growth and competitiveness in the Serbian economy, according to this report, is considered to be the proper and efficient functioning of the country's institutional and political framework. However, it has to be mentioned that institutional development is a long-term phenomenon that requires significant effort and processes to function properly (Mamoon and Murshed, 2009).

In order to be able to provide recommendations on that sector in Serbia, two important parameters have to be understood initially.

- Firstly, the type of political equilibrium that emerged in the country.
- Secondly, the preferences of different individuals and groups concerning this equilibrium (Acemoglu, 2006a).

Regarding the current political equilibrium that exists in Serbia it can be concluded that the political forces of the country, even if they promote the image of pro EU accession and institutional reforms, are at the same time acting in favor of certain elite circles that are exploiting the country (Uvalic, 2002). In Serbia, as it was mentioned before, reforms imposed by the EU and supported by the liberal fractions of the country are being fulfilled with very slow pace, providing vicious circles of domestic elites with the opportunity to manipulate international norms and use them for their personal advantage (Subotic, 2010).

Regarding the motivation of different groups and individuals the following four groups can be detected:

- Parasitic business circles who exploit the Serbian market for their personal profit (Begovic and Mijatovic, 2002).
- Corrupt politicians that are unwilling to promote institutional and political reforms, in order to maintain their political power.
- Organized criminal groups that increase corruption and crime by influencing and controlling political elites (Pestic, 2007).
- The liberal fractions of the country that desire to take political power and influence from the previous three groups mentioned and establish institutional reforms (Kostovicova, 2006).

After identifying these groups, it is now possible to investigate under which mechanisms the first three groups manage to preserve authority upon the liberal

segments of the Serbian society. More specifically, the elites (exploitative business circles, corrupt politicians and criminal groups), use the following ways to maintain their political power:

- Revenue extraction to extract money from the people.
- Using price manipulation in order to indirectly benefit from changes in factor prices.
- Political consolidation through weakening other groups that are competing for political power (Acemoglu, 2006b).

Consequently, in order to remove political power from corrupt politicians, organized crime and exploitative business circles in Serbia, these three mechanisms of authority must be removed from them by the liberal segments of the society. Recommendations of how to achieve this extremely difficult task are given below:

- Facing political consolidation and revenue extraction

In order to face political consolidation and revenue extraction by the elites in Serbia the liberal segments of the society that want to promote institutional reforms should try to organize in a greater extent in order to claim a greater share of political power (Subotic, 2010). More specifically, civic mobilization against market manipulation, crime and corruption in the country should take place in order for the citizens of the country to create the strong belief that corruption has no place in a future developed Serbia (Transparency International, 2012).

The role of NGOs and citizens initiatives can promote even more anticorruption mentality and democratic values in the Serbian society. NGOs and citizen initiatives should pressure the authorities on issues such as reducing corruption, facing crime, improving health care, extending consumer protection, and providing better levels of education (Vetta, 2009). It should be noted that more than 18.000 NGOs (80 percent of which have no funding) exist in Serbia but many times their efficiency towards the purpose that they are supposed to serve is questionable, and they often face criticism regarding the real purpose of their creation (usually the abuse of public money). Consequently, only NGOs that have a true interest to promote democratic beliefs and anticorruption measures need to be promoted by the liberal segments of the Serbian society (U.S. Agency for International Development, 2013).

Political empowerment can be accomplished more effectively by the solid effort of the liberal society to the EU as soon as possible, in order to adopt greater levels of freedom and efficiency in Serbia's legal and political framework according to the European standards (Begovic, 2013). The international political environment (like the one that exists in the EU) can play a crucial role in the democratization process because of the interconnection of democratic norms between citizens of democratic and repressive regimes (Grzymala-Busse and Luong, 2008).

A well-functioning educational system that will strengthen the human capital of the country is also a policy area on which the liberal parts of the Serbian society should be focused. An efficient educational system will improve institutions which in the long run will lead to greater democratic levels and economic growth within the country (Barro, 2001).

A dangerous threat that can alter the civic mobilization towards institutional reforms in the Serbian society at the present time is the worrying activities of extreme nationalistic groups that seem to increase within the country. These groups, taking advantage of the poor economic conditions of many Serbian citizens, present other nationalities or religions that exist within or across the borders of Serbia as the main cause of Serbia's political, institutional and economic inefficiency (Stefanovic, 2008). Consequently, those extreme nationalistic groups are very dangerous regarding the accomplishment of institutional reforms that the country truly needs, because they can mislead a big proportion of the Serbian society to a self-destructive nationalistic behavior that can lead to political instability instead of a peaceful democratic civic mobilization towards the accomplishment of healthier and more efficient institutional reforms (Uvalic, 2010).

In addition, the creation of a supranational cooperation plan among the Balkan countries against crime and corruption, supervised by EU officials as well, will be extremely useful in order to remove political power from the exploitative business circles and the criminal organizations that act not only in the Serbian state but in the whole Balkan region as well (Monastiriotis and Petrakos, 2010). Cooperation among the Balkan states can be established in matters regarding fighting criminal activities such as: drug or gun trafficking, prostitution trafficking, prevention of terrorist attacks, but also in the level of political and economic cooperation in the direction of improving the unstable political environment that exists especially in

the Western Balkan region among the post post-Yugoslav states because of the heritage of the relatively recent Yugoslav wars (Anastasakis and Bojicic, 2002).

According to the author's opinion<sup>14</sup> the ultimate goal of the previous Balkan plan and cooperation mentioned, should be the future accession of all Balkan countries in the EU in order to transform South Eastern Europe from a politically and economically unstable region where crime and corruption often flourish, to a union of member countries whose citizens feel they belong in a common political and institutional framework that promotes stability and growth all over the Balkan peninsula (Monastiriotis and Petrakos, 2010).

- Facing factor price manipulation

EU accession can also prove to be significantly important for Serbia to face the factor price manipulation that exists because of the actions of its exploitative business circles (Freedom House, 2015). More specifically, the entrance of the country in the EU will lead to all the necessary reforms in the Serbian market in order for the inefficient market regulations and inadequate investors' protection that exist in the country to be upgraded and harmonized with the European standards. As a result, greater level of business competitiveness will be introduced in the Serbian market eliminating with that way the monopoly power that certain exploitative Serbian firms possess due to their political connections (Subotic, 2010).

Finally, it is of crucial importance to mention another important factor that is highly decisive regarding the effectiveness and improvement of the Serbian institutional environment: the number and complexity of regulatory bodies that form institutions in Serbia can be conceived as additional veto points that can alter the institutional efficiency towards growth. That's the reason why the liberal segments of the Serbian society should also try to simplify the structure of the institutions in order for the application of reforms to take place in an even more direct way (Henisz, 2000).

### **C) Infrastructure**

The level of development-infrastructure of the host-country is one of the most crucial factors determining the attraction of investment inflows in the country. Empirical

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<sup>14</sup> Appendix I illustrates with a graphical way the description of groups and mechanisms used in order Serbian elites to preserve authority, as well as policies that the liberal segments of the Serbian society should pursue in order to reduce political power from the ruling elite.

studies show that the coefficient of the infrastructure variable is one of the biggest concerning investment attractions (IMF, 2013a). Many productivity slowdowns in different countries across the world in different time periods are attributed to the lack of infrastructural investments by their respective governments, such as the sharp productivity decrease that occurred in the USA in the 1970s (Aschauer,1989). Nonetheless, increasing government investments towards unproductive sectors of the economy are associated with lower per capita growth (Barro, 1990).

It is proven by the flows of FDI in the past that more developed countries tend to attract much greater FDIs than non-developed. Factors such as innovative technology systems, reducing distances through effective modes of transport, electricity supplies free from interruptions and a solid and extensive telecommunications network play significant role. The level of development-infrastructure is probably another serious reason that Serbia gathers lower investment inflows than many other EU or Balkan countries (World Economic Forum, 2014).

Serbia should strengthen the level of its infrastructure much more, especially in areas where it's easier and more possible to attract investors, such as Belgrade, Nis and Novisad but also in the smaller cities of the country that are facing even greater economic difficulties and infrastructural alienation. To achieve that, the political elites of the country should more effectively face the problem of corruption that makes investments unattractive and also reduces the governmental budget towards growth to a significant extent (Kostovicova, 2006). Also Serbia's government should invest a greater proportion of its public budget in specific infrastructural projects and in creating a healthier macroeconomic environment in the country. Through a consistent and trustful macroeconomic environment the government will be in a position to take governmental loans with low interest rates, if its own budget is not efficient enough, and invest them on specific infrastructural projects needed inside the country (Galbraith, 2011).

#### **D) Macroeconomic instability**

Macroeconomic stability is of great importance for the country of Serbia not only because it is necessary in order to assist in the creation of political stabilization and social welfare, but also because foreign investors are more easily attracted by stable and predictable macroeconomic environments in order to invest their assets. As a result, since Serbia is facing a significant lack of financial liquidity, attracting greater

number of investments through efficient macroeconomic policies can prove to be extremely significant for the country (Montiel and Serven, 2004).

Of course, countries that perform poor in macroeconomic aspects possess inefficient institutions that do not prevent political elites from being infected by corruption and serving only their own private (political or economic) interests (Acemoglu, Johnson, Robinson, and Thaicharoen, 2003). It is also a regular phenomenon for a government to improve the macroeconomic performance of the country only superficially, just some months before upcoming elections in order to deceive voters (Iversen, 2006).

Consequently, in order for Serbia to establish a long term macroeconomic stability its political elites should be focused on policies that will try to promote and achieve the following results for the Serbian economy:

1) Low and stable inflation

The inflation rate in Serbia was recorded at 1.90 percent in June 2015. Moreover, the inflation rate in the country sadly averaged 7.27 percent from 2007 until 2015 (indicating a non-stable performance), reaching an all-time high of 14.90 percent in June 2008 and a record low of 0.10 percent in January 2015 (World Bank, 2015).

It is very important for a state to possess low and stable levels of inflation in order to convince investors and financial markets that the country possesses the necessary financial stability not only in the present, but also in the future (IMF, 2015). Negative effects of inflation include an increase in the opportunity cost of holding money and uncertainty over future inflation which may discourage investment and savings. As inflation rises purchasing power decreases, fixed-asset values are affected, companies adjust the pricing of goods and services, financial markets react and there is an impact on the composition of investment portfolios (Grimes, 1991).

2) Low long term interest rates

The benchmark interest rate in Serbia was last recorded at 6 percent. Interest rates in Serbia averaged 11.08 percent from 2006 until 2015, reaching an all-time high of 18 percent in October 2006 and a record low of 6 percent in June 2015. As it can be concluded, Serbia should create more low and long term interest rates (World Bank, 2015).

A strong economy possesses high interest rates, if the economy is weak the interest rates will be low. Banks can control the interest rate in order to slow down or speed up the economy's growth. Banks can raise interest rates to slow the economy down,

or lower them to promote economic growth. Nevertheless, lowering interest rates can give the economy a short-run boost that will soon be offset by inflation (Friedman and Kuttner, 2010).

### 3) Low national debt relative to GDP

Serbia recorded a government debt to GDP of 70.90 percent in 2015. Government debt to GDP in Serbia averaged 62.17 percent from 2000 until 2014, reaching an all-time high of 201.20 percent in 2000 and a record low of 28.30 percent in 2008. According to all the previous data, it can be unfortunately concluded that Serbia possesses an extensive government debt to GDP ratio (World Bank, 2015).

A low debt-to-GDP ratio indicates an economy whose production power is sufficient to pay back debts without creating further debt. Debt to GDP measures the financial stability, credit and leverage of an economy (OECD, 2012a). One of the Euro convergence criteria, that the Serbian government should take very seriously into consideration regarding the European future of the country, is that the debt to GDP ratio of a potential Eurozone country should be below 60% in order to prove to the EU representatives the economic health and sufficiency of the candidate's country economy. A country with a higher level of debt can still adopt the euro provided its debt level is falling steadily (European Central Bank, 2015).

### 4) Low deficits

A fiscal deficit is created when a government's total expenditures exceed the revenue that it generates, without taking into account possible government borrowings. Serbia recorded a government budget deficit equal to 4.55 percent of the country's GDP in 2014. Government budget in the country averaged -2.53 percent of GDP from 2002 until 2014, reaching an all-time high of 0.80 percent of GDP in 2004 and a record low of -5.37 percent of GDP in 2012 (World Bank, 2015).

The majority of economists argue that governments should avoid deficits in favor of a balanced budgetary policy. Unfortunately, fiscal deficits often occur in a large number of countries. In order to counter those deficits the Serbian government could increase taxes and reduce government spending, but another efficient solution is to promote in a greater level the economic growth and as a result the revenues in the country filling with this method the gap detected between revenues and expenditures (Roubini and Sachs, 1989).

#### 5) Low unemployment

Unemployment rates in Serbia increased to 19.20 percent in the first quarter of 2015 from 16.80 percent in the fourth quarter of 2014. Unemployment rates in the country averaged 19.45 percent from 2008 until 2015, reaching an all-time high of 25.50 percent in the first quarter of 2012 and a record low of 13.30 percent in the first quarter of 2008. Youth unemployment, which refers to the share of the labor force ages 15-24 without work but available for and seeking employment is close to 50%. The previous results indicate the extremely worrying levels of unemployment across the country and especially among the young population (World Bank, 2015).

When a country is experiencing high and increasing levels of unemployment, then as a result, higher payment from the country's government in unemployment benefits is expected, which means that social welfare decreases. At the same time, the government is no longer collecting the same levels of income tax by its citizens because of the limited transactions and working force (Junankar, 2011). This outcome can lead Serbia's government to borrowing money or cutting back on other spending in order to deal with the problem, creating even worse economic and social repercussions in the future.

#### 6) Currency Stability

The USDSRB<sup>15</sup> traded at 109.78 SRB on Friday July 31 in 2015, according to interbank foreign exchange market quotes. The Serbian dinar averaged 77 from 2007 until 2015, reaching an all-time high of 113.33 in March 2015 and a record low of 48.55 in July 2008. As it can be seen, great levels of fluctuation are also detected regarding the currency stability of the Serbian economy (World Bank, 2015).

Currency stability through time provides great amounts of certainty in the financial markets and for potential investors that the country possesses a solid base of macroeconomic stability. Inflation is the main cause that a currency can lose its value. In order to cancel the negative effects of inflation the Central Bank of the country can increase its interest rate to limit the expansion of credit and money supply, moderating that way the demand for goods and services and resulting in the reduction of prices rise (IMF, 2015).

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<sup>15</sup> The USDSRB spot exchange rate specifies how much one currency, the USD, is currently worth in terms of the other, the SRB.

## **E) Higher education and training**

As it was explained before, higher education in Serbia suffers to a great extent by the problem of corruption and that's why solutions like electronic means of grading, creation of independent evaluation organizations, changing the level of powers the deans of faculties possess and heavier penalties for those found to be involved in corruption were proposed (Transparency international, 2014).

In addition, some general approaches and conditions must be established in order for Serbia to strengthen and develop its educational environment that will increase its human capital towards greater productivity and growth (Barro, 2001). Some of the most important recommendations on this direction regarding Serbia's educational system can include:

- 1) Increase the enrolment rate to primary education for disadvantaged groups, and prevent drop-outs.
- 2) Increase the salaries of teachers at the greatest possible degree in order to provide financial incentives for a better and more efficient education (OECD, 2012b).
- 3) Modernization of curriculum by adopting modern teaching methods, arranging teaching material and improving the quality of school textbooks.
- 4) Establish systematic evaluation of the educational system and schools/ universities by transparent institutions in order to control and develop the performance of the educational system every year (Anticorruption-Serbia, 2013).
- 5) Changing the system of assessment of student achievements in the classroom (to support quality of teaching/learning process).
- 6) Decrease the inefficiencies in learning during regular school hours which create the proliferation of private tutoring-more than 25% of Serbian households with children in primary or secondary schooling attend to private teaching that costs extra money for their families (UNICEF, 2008).
- 7) Create stability regarding the policies that will form the educational system of the country in order in order for the policy changes to be absorbed by all stakeholders, including staff, parents and students.
- 8) Even if the financial resources of the country are limited, an effort in improving funding for research must take place in order to provide motives for top level research and innovation to the largest possible degree (Damme, 2014).

- 9) Create greater number of student dormitories in order to provide financial help to students of low level incomes to attend higher education in the country.
- 10) Improve oversight and content of current faculty examinations and internal faculty marking to the direction of achieving greater and deeper knowledge instead of unproductive grade hunting (UNICEF, 2008).
- 11) Yearly control of the ability and academic performance of educators to efficiently teach and transmit knowledge to their students.
- 12) Improve the functioning and impact of student representative bodies concerning important educational miss-functions that, according to their belief, must be reformed (OECD, 2012b).

#### **F) Financial market development**

Many academic researchers believe that economic development is important in order to promote democratization in a country in transition, and they argue that countries with low levels of democracy possess problematic economic environments. Nevertheless without the proper institutions democratization in these countries seems incredibly distant (Grzymala-Busse and Luong, 2008).

As it was detected before in this report, the financial market of Serbia significantly lags behind in: Availability of financial services, affordability of financial services, financing through local equity markets, ease of access to loans, venture capital availability, inefficient soundness of banks and finally regulation of securities exchanges (World Economic Forum, 2014).

Serbia continues to face serious economic difficulties and risks. Overall, the country recorded negative growth rates in 2014, and prospects for 2015 are not better, since there are no major internal or external growth drivers at present (World Bank, 2015).

According to the current conjuncture and expectations in the banking sector in the near future, we should not expect significant growth in bank loans, or any serious boost in economic growth. Remittances, a major source of income and foreign exchange in many West Balkan countries including Serbia, have fallen due to the crisis in the Eurozone, from where most of the remittance flows to the region originate, though they are still significant (Ganic, 2013).

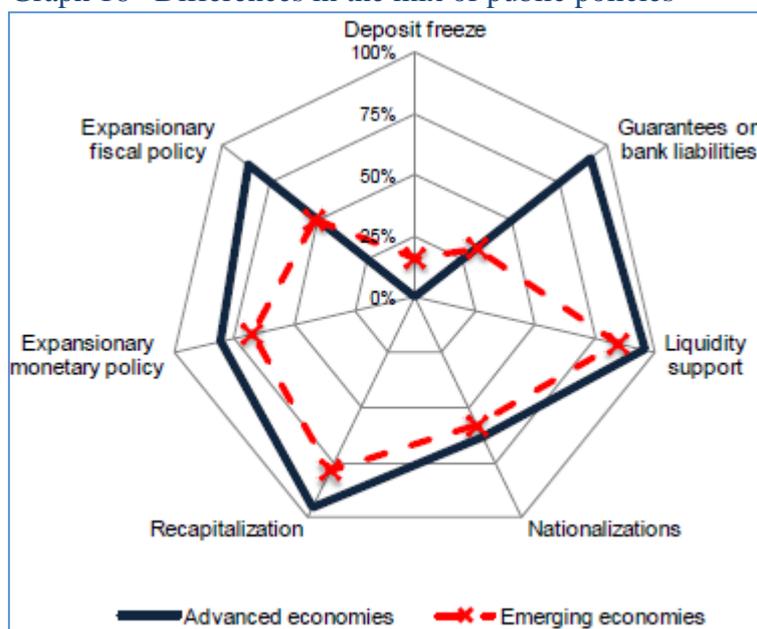
It is increasingly recognized that Serbia will have to rely more on its own resources and an enhanced reform agenda if it is to move to a sustainable growth path. So far, however, reform efforts have been hesitant and constrained by the difficult economic

environment that was challenged even more by the recent severe floods, pushing the economy back into recession of an estimated 1.8 percent. Energy production and mining were significantly affected, with a major negative contribution to growth (Freedom House, 2015).

Serbia remains vulnerable to weaknesses in the Eurozone, its main export market. Financial sector risks are also significant, given the high level of non-performing loans and the possibility of contagion from peripheral Eurozone economies (EBRD, 2014).

Moreover, the Western Balkans region, including Serbia, is characterized by relatively large share of banks in Greek and Italian ownership, countries that face extreme difficulties in their banking sector at the moment and so complicate the future of the banking sector in the Balkans even more. If those foreign banks face liquidity and solvency problems in their parent countries then those problems are also going to be transferred to a significant degree in the SE Europe region (Institute for Regional and International studies, 2010).

Graph 16 Differences in the mix of public policies



Source: Laeven and Valencia (2012)

Regarding policies on improving the financial environment in Serbia, as graph 16 illustrates: recapitalization, liquidity support and expansionary monetary and fiscal policy are usually followed as solution strategies in emerging economies like the Serbian one. Nevertheless, the political elites of Serbia should also try harder to

finance the internal market in order to enhance productivity and reduce unemployment which is constantly increasing. In other words, Serbia should try to create a stable and healthy economic environment that will be strengthened by its European partners but not to depend on them exclusively (Laeven and Valencia, 2012).

In addition, property rights institutions, by constraining elite and government expropriation, can play a major role on promoting investment attraction and, as a result, higher growth rates (Acemoglu and Johnson, 2003). The role of institutions is once more so much important that can have an impact even on governments' preferences. If, for example, Serbian governmental actions towards growth include the establishment of a minimum wage or securing benefit levels, still the actual effect of these policies towards the Serbian society will continue to be blocked by the inefficient institutions that the country possesses (Wren, 2008).

Actions that can also prove to be decisive on the development of the financial sector of the country may include:

- 1) Institutional cooperation and convergence regarding the functioning and procedures of important financial matters, between the institutions that are connected with financial market development and infrastructure of the country such as the successfully launched projects between the ASB credit bureau initiative of the Association of Serbian Banks, supported from the start by banks and the National Bank of Serbia and ASB Bank Settlement and Clearing Institution (Association of Serbian Banks, 2013).
- 2) Independence of the judiciary from politics may have an important effect on the security of property rights against expropriation of the political elites by powerful business groups (Acemoglu and Johnson, 2003).
- 3) Greater effort to establish macroeconomic stability, as was mentioned earlier in this report, through low and stable inflation, low long term interest rates, low national debt relative to GDP, low deficits and currency stability that indicates the stability of a country's economy (Montiel and Serven, 2004).
- 4) Harmonization of the laws that govern the functioning of capital markets, which unfortunately at the present time possess great differentiations between them, which contribute to inefficient financial results.
- 5) Harmonization of domestic regulations with the EU directives in the direction of improving the capital market in general. Through the cooperation of the Ministry

of finance of Serbia and the EU directives, many institutions in Serbia in 2013, resulted with the analysis and concrete proposals for the amendment of more than 20 systemic laws in this field: law on capital market, law on banks, law on foreign exchange operations and law on investment funds (Association of Serbian Banks, 2013).

- 6) Implementing the policy of “dinarization” which supports the idea of reducing the use of foreign currencies (particularly euro) and increase the dinarization (use of the local Serbian currency) of the economy. In Serbia, as it was mentioned earlier in this report, almost 80% of both assets and liabilities in the banking system are either held in a foreign currency or indexed to it (IMF, 2013b). Moreover, Serbia is characterized by relatively a large share of banks under Greek and Italian ownership, countries that face extremely difficulties in their banking sector at the moment and so complicate even more the future of the banking sector in Serbia. Through the process of dinarization, the Serbian economy will slowly and efficiently develop greater stability in its financial sector that will gradually be less vulnerable to foreign financial fluctuations (Markovic, 2010).
- 7) Improve the level of education, regarding financial matters, in:
  - Corporations: It is very useful and important for the corporations that act within the country to develop to a greater extent necessary financial skills and knowledge that can lead to deeper and more effective understanding of the nature and performance of financial markets. In that way, corporations will adopt business decisions that will strengthen their economic prospects as well as the general economic growth of the country (Doing Business, 2014).
  - Citizens: The development of information on the operation of financial markets will also be extremely useful for the citizens of the country, especially the young generation. Many economically advanced countries such as: Japan, Canada, Unites States of America, Australia and the United Kingdom have already created state fund programs and operations that aim to provide further financial knowledge and information to their citizens. In 2008 the OECD launched the international gateway for financial education in order to provide information and research worldwide (OECD, 2008b).

## **G) Rule of Law**

Kenneth J. Arrow, Nobel laureate in economics in 1972 stated that: “The openness of a society, its willingness to permit creative destruction and the rule of law appear to be decisive for economic development.” Investors are mainly concerned about the institutional efficiency of the state in which they are about to make their investment as well as about the capacity of its legal system to enforce contracts (Barro, 2013).

The inefficient rule of law within the state of Serbia has extremely negative consequences for the attraction of investments, the promotion of economic development and the decrease of corruption, resulting inevitably in the downgrading of the social welfare of its citizens (Uvalic, 2007).

Policies on improving the Rule of Law in Serbia may include the following actions:

- Create a more efficient analysis of the current legislation in Serbia, under the direction of experienced EU officials, in order to better detect legislature inefficiencies within it, which might affect the enforcement and support for amending it (RoLE, 2015).
- Simplification and harmonization of the internal procedures within the judiciary and the prosecutorial services in order to be closer to the EU legislation structure (Europa, 2015).
- Provide greater levels of specialization to judicial officials in matters regarding property protection, bankruptcy procedures and enforcement of competition law (Begovic, 2013).
- Independence of the judiciary in terms of budgetary powers (Dallara, 2014).
- Establish closer EU cooperation with the Serbian Ministry of Justice to improve the efficiency of the Serbian prosecution and penalty system through the development of a case management system, including document handling and data collection (RoLE, 2015).
- Enforce civic mobilization promoting the knowledge of individual duties and rights.
- Focus in the protection of property rights and the regulation of a competitive market free from the negative influence of internal exploitative business circles (Barro, 1999).

- Create a more efficient organization responsible for the yearly evaluation of the capability of judges, prosecutors and other relevant staff in the Serbian judiciary.
- Adopt a greater number of electronic means of functioning and surveillance in order to significantly reduce bureaucracy within the legal system (Anticorruption Serbia, 2013).
- Provide technical assistance through closer cooperation between EU and Serbian officials for the continuous mandatory training of judges, prosecutors and law enforcement officers (RoLE, 2015).

## **H) Business sophistication**

As it was mentioned before, business sophistication leads to greater and more efficient production levels. As a result of the increased productivity, Serbia will become more competitive. Business sophistication is of great importance for the country, as it must have a certain production plan and structure to achieve efficiency and decrease its high rates of unemployment. Effective measures should be taken by the public and private authorities of Serbia in the direction of improving business sophistication (Doing Business, 2014).

Some interesting recommendations about actions capable of increasing business sophistication can be the following:

### **Establish cluster development**

When companies and suppliers from a particular sector are interconnected in geographically proximate groups, called clusters, efficiency is heightened, greater opportunities for innovation in processes and products are created, and barriers to entry for new firms are reduced. Individual firms' advanced operations and strategies (branding, marketing, distribution, advanced production processes, and the production of unique and sophisticated products) spill over into the economy and lead to sophisticated and modern business processes across the country's business sectors (World Economic Forum, 2014).

### **Increase the local supplier quantity**

The political elites of Serbia should try to increase the number of local suppliers in the market, with that way the government will achieve a reduction in unemployment, a rise in growth levels and at the same time the creation of more efficient and competitive production of local products. Different supplier companies will try to

create better products than the rest, that way eliminating exploitative behavior by certain Serbian firms in the market (Monastiriotes and Petrakos, 2010).

#### Foster the Extension of marketing

The government of Serbia should provide greater incentives and financial support to companies that are determined to use sophisticated marketing tools and techniques in order to produce more efficient products that can increase the growth levels in the country (Gilson and Kraakman, 1984).

#### Promote the competitive advantage

Promoting competitive advantage emerges from internal sources where companies have greater creative or innovative capabilities and from external sources around changing customer demands, prices and technological change (World Economic Forum, 2014).

#### Strengthen the production process sophistication

Strengthening the production process sophistication will act as a catalyst for the development of economic growth in Serbia. Highly educated personnel, external liberalization and good information flows are important prerequisites for developing sophisticated goods and services. In addition, an efficient macroeconomic policy by the government will promote all the necessary macroeconomic conditions that will guarantee the efficient operation of the production process (Anand, Mishra, and Spatafora, 2012).

### **I) Innovation**

As it was mentioned before in this report, innovation is one of the most critical sources of development for a country. The productivity of a country increases through innovation techniques, because the same or better result on production can be achieved by using a smaller amount of human, capital or natural resources (Grossman and Helpman, 1994). General approaches and recommendations in order to strengthen and develop innovation techniques in Serbia to a greater extend can include:

#### 1) Finance company spending on research and development

Probably the most significant action for enhancing innovation in Serbia is for the Serbian government to try to finance public and private companies to the largest possible degree in order to promote research and development projects. Also

additional measures like decreasing tax regulations for these companies can positively affect R&D techniques (Rodriguez-Pose and Crescenzi, 2008).

2) Discover users' needs

Listening more to users' needs will provide crucial information to the production sector about which specific area to focus on in order to create and develop the most efficient products possible in order to fulfill customers' needs to the greatest extent (Vigier, 2007).

3) Strengthen the collaboration between universities and industries on R&D

In Serbia significant gap exist between universities and industries regarding the creation of working vacancies for academically educated individuals. It is of significant importance, especially in the present time when unemployment is extremely high in the country, to strengthen the interconnection between higher education and employment. The previous policy will be more easily adopted if the government of Serbia tries to promote financial incentives to industries in order to cooperate with skilled academics that can create greater profits for those companies by focusing on R&D projects (OECD, 2007b).

4) Improve education and training

The educational system of Serbia lacks of the appropriate level of knowledge and training that can prepare students effectively for their entrance to the market. "Decentralization, greater complexity, multiplication of stakeholders, broader dispersion of knowledge and expertise, more levels of decision-making all make education systems more difficult to steer and to change" (Damme, 2014). Detailed recommendations for improving Serbia's educational environment were proposed in paragraph (E).

In addition to the previous difficulties that the Serbian government has to overcome, it also has to increase the tertiary education enrollment in the country (in 2013 it was 56% of the total population) but mainly a great effort has to be made regarding the current structure of learning in tertiary education, which lacks systematic knowledge on the promotion of innovative techniques in order to achieve deeper market orientation (Trumbic, 2012).

5) Reward creativity

The government and managers of public or private businesses must support innovation by rewarding the developers of successful innovations. Reward programs and techniques can include financial and promotional prizes for the businesses that

manage innovation in their products or services, making them known to the public and promoting them as successful entrepreneur examples (Grossman and Helpman, 1994).

6) Guarantee of property rights

Guarantee of worldwide property rights over innovations motivates researchers to consider the global benefits of their R&D. (Barro and Sala-i-Martin, 2003). The protection of property rights not only increases the R&D efforts of the technologically advanced firms, but also strengthens the R&D efforts of less advanced firms to reach greater levels of technology in order to receive higher levels of property rights protection once they promote their innovative power (Acemoglu and Ufuk, 2012).

7) Establish a cluster approach

The cluster approach can foster innovation to a superregional level, while national reform programs on specifying users' needs will strengthen and reform the regional level of innovation (Vigier, 2007).

**J) Government instability**

Political instability has a negative influence on growth. According to empirical findings of Robert J. Barro, the number of political revolutions per year and the number of political assassinations per million of population per year are significant and negatively related variables to growth across countries (Barro, 1991). A critical factor concerning the process of democratization in post-communist states is the political fragmentation and the density of competing sources of authority that exist after the collapse of the previous regime. When the political fragmentation is intense democratization policies are more difficult to accomplish because of the large degree of veto players with different ideologies within the country (Grzymala-Busse and Luong, 2008).

In order to establish political stability the political elites of the country must eliminate the possibility that the government will be destabilized or overthrown by unconstitutional or violent means, including politically motivated violence and terrorism (World Bank, 2014b).

To achieve political stability the political elites of Serbia should strengthen the institutional, political and economic environment and further develop transnational cooperation (Anastasakis and Bojicic, 2002). Sources of political instability can mainly be traced to the large number of veto players (Tsebelis, 2000), bad economic

performance, oppressive regimes and high unemployment within a country. Recommendations regarding the achievement of political stability in Serbia may include the following:

1) Improve the economic environment

The economic environment of Serbia definitely needs a great number of necessary reforms in order to become more competitive. Financial reforms driven by political elites are mainly responsible for the economic outcomes of certain economic policies produced (Acemoglu, Johnson, Robinson and Thaicharoen, 2003). Recommendations for achieving this may include the following:

- Create macroeconomic stability

The most crucial determinants(that were analyzed in detail in the macroeconomic recommendations before) in order to achieve and preserve macroeconomic stability in Serbia are: low and stable inflation, low long term interest rates, low national debt relative to GDP, low deficits, low unemployment and finally currency stability (World Bank, 2004).

- Invest on growth policies as a source of future finance

The government of Serbia should promote growth policies instead of increased taxation or excessive borrowing from other external sources. More specifically, the government should invest an important proportion of the country's budget into the real market in order to provide significant assistance to entrepreneurs to increase their business activity leading to the reduction of unemployment and to greater growth rates (EBRD, 2014). Through the previous policy, the country will be in a position to collect a greater amount of taxes from the increased production and the higher employment rates that will occur, without overcharging the Serbian market, in order to balance its primary budget. In other words, the country should follow a Keynesian economics policy (Blinder, 2008).

- Attract investors

Attracting investors is undoubtedly a critical source of growth and finance for every country. Nevertheless, attracting and benefiting from investment depends not only on investment policy in one area, but on a combination of policies (Monastiriotis and Petrakos, 2010). If for example Serbia possess an attractive policy in tax rates but not in fighting corruption then

the results on its competitiveness or its business environment will not be satisfactory for the country (Mauro, 1995). Serbia's political elites must also guarantee to the potential investors that macro-economic and political stability will exist in the country for the years to come. Investors are attracted mainly by the predictability of a country's economic policy ranging from tax to trade to environmental and labor market policies (UNCTAD, 2013).

In that context, the Prime Minister of Serbia, Aleksandar Vucic, during his recent visit in the USA has arranged talks with some of the biggest US companies, such as the General electric, Microsoft and NCR, hoping that with the support of the USA a stable basis can be created for the political and economic prosperity of Serbia (Embassy of the Republic of Serbia Washington DC, 2015a). In addition, the strong will of Serbia to enter the EU will lead to a more efficient and democratic regulation of the market, in the free movement of workers, in the right of establishment, in the supply of services and movement of capital. This will encourage EU companies to invest and create jobs in Serbia and to also facilitate the ability of Serbia's companies to compete in the EU market (European Commission, 2013).

- Reliability of access to energy resources

Economic development is closely related to the reliability of access to energy resources. This implies that access to stable sources of energy can increase the level of the state's economic and political stability (OSCE, 2002). Nonetheless, the number of veto players can still prove a crucial determinant. More specifically, regulatory bodies can be included as additional veto points that can alter efficient policies in sectors concerning the supply of energy resources such as electricity, or the protection of the environment by certain production industries (Henisz, 2000).

Serbia imports natural oil and gas at a percentage of 83% and 91% respectively. On the other hand, Serbia is self-sustaining regarding the production of electricity and coal to one million TOE<sup>16</sup> (graph 17). Reliable sources of electricity can play a critical role in the development

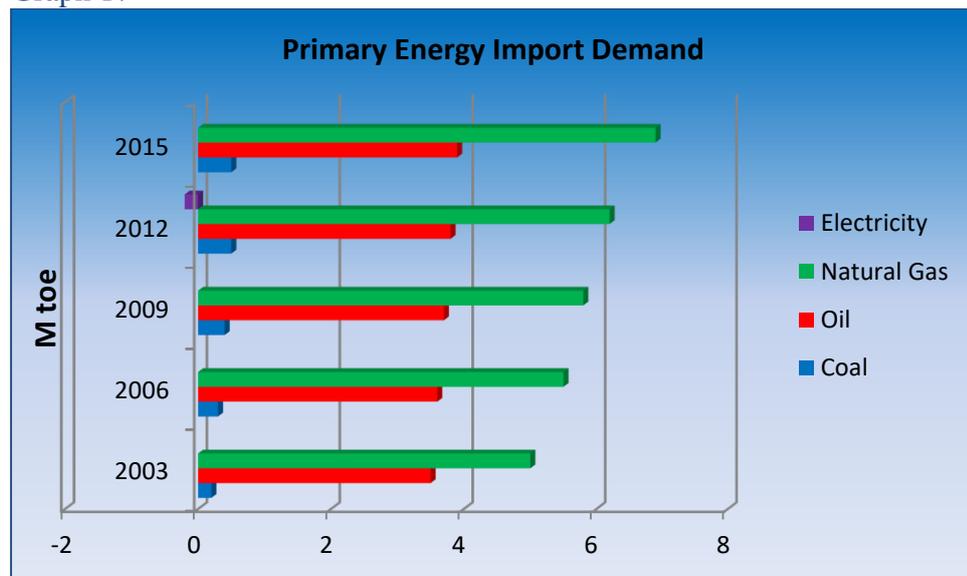
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<sup>16</sup> The tonne of oil equivalent (toe) is a unit of energy defined as the amount of energy released by burning one tonne of crude oil.

procedure of a country, especially if the country is in a developing stage of its economy (like Serbia) (IMF, 2014). As Mustafa Balat describes in his article called: Electricity from Worldwide Energy Sources and Energy Sources, “World net electricity consumption is expected to nearly double over the next two decades. Total demand for electricity is projected to increase on average by 2.3% per year, from 13,290 billion kWh in 2001 to 23,072 billion kWh in 2025” (Balat, 2006).

The authorities responsible for the production of energy resources in Serbia should always be in a position to guarantee a sufficient amount of natural oil and gas for the country, try to modernize their production units of electricity and coal even more and finally provide greater attention to renewable sources of energy in order to achieve greater production results (Energy agency of the Republic of Serbia, 2007).

Graph 17



Source: Energy agency of the Republic of Serbia (2013)

Finally, environmental protection is also of great importance regarding stable rates of economic growth. That’s why Serbia works in close cooperation with the EU in order to fulfill EU regulations regarding the modernization of its energy production units for air emission reduction, reduction of cross-border sulphur transport, air quality improvement around power plants and reduction of the number of people with respiratory illnesses. As table 6 shows, the anticipated effects of the Serbia-EU cooperation will have extremely

successful results in the decrease of dust, SO<sub>2</sub> and NO<sub>x</sub> emissions(Energy agency of the Republic of Serbia, 2013).

Table 6 Anticipated effects of planned air protection measures

	Without Modernization	After Modernization
Dust	66.900 t/a	5.850 t/a
SO <sub>2</sub>	360.440 t/a	40.720 t/a
NO <sub>x</sub>	43.200 t/a	16.350 t/a

Source: Energy agency of the Republic of Serbia (2013)

## 2) Increase the level of freedom in the country

Increasing the level of freedom in the economic, political, civil society, economic, media and judicial sectors of Serbia is of crucial importance in order achieve social and economic prosperity and, as a result, government stability within the country (Anastasakis and Bojicic, 2002). Recommendations for this may include the following:

- Economic freedom

As it was mentioned before regarding the recommendations on reducing corruption in Serbia (paragraph A), the country possesses extremely low scores in the protection of investors property rights (Heritage Foundation, 2015). Serbia's political elites and policy makers should be focused in a) the creation of reforms that will protect private property and financial freedoms by creating easier access to credit b) decreasing the time and amount of procedures needed in order to deal with construction permits and resolving insolvency by reducing government intervention c) protecting investors through judicial reforms and more specialized judicial officials and finally d) providing easier access to electricity services by spending more in the infrastructural level of the country (Doing Business, 2014).

- Civil society freedom

Regarding freedoms in the civil society of Serbia, it can be said that despite some threats by radical groups against the pride parade, the country generally performs well on the protection of its democratic social values.

Nevertheless, the role of NGOs and citizens initiatives can strengthen the democratic values of the Serbian society even more. NGOs and citizen initiatives should target criminal groups, exploitative business circles and violent nationalistic rhetoric more, while at the same time pressure the authorities on issues such as health care, consumer protection, and education (Vetta, 2009).

- Media freedom

There is a growing concern that Serbian media are in a large extent controlled by the political forces of the country. Opposition parties in Serbia claimed that they were underrepresented in election campaign coverage in 2014 due to political pressure on media by the ruling parties. Freedom of media should be strengthened in Serbia through transparent ownership and less funding from political sources that often aim at controlling the information transferred to the citizens of Serbia (Freedom House, 2013).

- Judicial independence

The operation of the judicial system in Serbia should be free from bureaucratic effects that create a large number of procedures and a significant amount of time in order to solve differences that occur between parties, and also reduce their cost that most of the times make them inaccessible to many Serbian citizens, by introducing more e-government techniques (Freedom House, 2015).

### 3) Establish good relations with neighboring countries

During the presidency of Boris Tadic (2004 to 2012) Serbia won its EU candidate status and developed better relations with its neighboring countries including Kosovo. Serbia does not recognize the breakaway province as an independent state, but is in close cooperation with it in order to solve differences that exist in their relations (European Commission, 2014a). However, in the latest presidential elections of 6<sup>th</sup> and 20<sup>th</sup> of May in 2012 the political party of Boris Tadic (Choice for a Better Life Coalition) lost in the second round of the elections to the Serbian Progressive Party of Tomislav Nikolic probably because of Tadic's failure to improve the economic situation in the country and to reduce the high rates of unemployment, especially

among the young population (Embassy of the Republic of Serbia Washington DC, 2015b).

Tomislav Nikolic had an extreme right wing background and some of the political positions of his Serbian Radical Party at the time supported an enlargement of Serbia and a reunion with Montenegro, as well as that the Srebrenica war crimes that took place during the disintegration of Yugoslavia do not constitute genocide (BBC, 2013).

Nonetheless, a few days before the 2012 elections, Nikolic stated that territorial boundaries with Serbia's neighboring countries cannot be questioned and he assured the local and international audience that he will work towards the improvement of relations between Serbia and its neighbors. In addition, on 25 April 2013, Nikolic apologized for war crimes committed by the Serbian army in Srebrenica. Finally the prime minister of Serbia, Alexander Vucic, that had also been also known for his radical right wing beliefs, during his visit to Kosovo in 2014, stated that Serbs in the region should live the past behind and think towards a better future (Reka, 2015). Moreover, during his recent visit at the Johns Hopkins University in Washington, Vucic stated that "Serbia is a pillar of stability in the region" and outlined the details of reconciling foreign policy activities in the past year, starting from the first visit of the Albanian prime minister to Serbia after almost 70 years, to his visits to Sarajevo and Zagreb and his first historical visit to Albania (BalkanInsight, 2014).

If the transition from Mr. Tadic to Mr. Nikolic takes place smoothly, Serbia could prove to be a stabilizing factor in the Balkan region, a role that was only played by Greece since the 1990s, and this will also contribute to Serbia's economic growth and development (Nick Thorpe, 2012).

#### 4) Improve the feeling of safety in the Serbia society

Crime in Serbia, including organized crime, as was mentioned earlier in this report, exists in worrying levels across the country, taking the form of bribes, robberies, burglaries, assault threats, car thefts and personal thefts. Detailed recommendations on facing crime levels in the country will be presented in paragraph (L). Those recommendations include: Raising the salaries of the officers of law enforcement, increasing communication by reducing bureaucracy, developing more efficient training and finally providing modern equipment to the police (Unites Nations office on drugs and crime, 2011).

#### 5) Create institutional reforms

According to the empirical results of Jack Goldstone study, found in his article: “A global model for forecasting political instability” it was concluded that “political institutions, properly specified, and not economic conditions, demography, or geography, are the most important predictors of the onset of political instability”(Goldstone, 2011), an opinion also shared and by Acemoglu and Robinson and reflected in their article: “Persistence of Power, Elites, and Institutions”(Acemoglu and Robinson, 2008).

Well-established institutions are based on the human capital of the country, which will lead to improved institutional functioning through a proper education. A well-functioning educational system will improve institutions, a fact which in the long run will lead to higher democratic levels and greater economic growth within the country (Barro, 2001).

In conclusion, Serbia should apply all the necessary institutional reforms discussed earlier (in paragraph B) that will make citizens feel greater trust in the political elites of the country, and potential investors feel greater safety about investing their money in the Serbian market.

#### 6) Try to fulfill the basic target of entering the EU

The fact that Serbia is aiming to be a future member of the European Union is probably one of the most efficient ways to strengthen the political environment of the country, which will in turn fulfill the necessary socioeconomic requirements to achieve this target (Anastasakis and Bojicic, 2002). Thanks to the potential of its EU membership, the country will adopt its institutional-political and economic framework closer to the more efficient and stabilized European standards. At the same time intensified regional cooperation with other EU members can significantly brightened economic prospects and the region’s stability (EBRD, 2014).

#### 7) Try to reduce veto power of certain actors

As it was mentioned earlier on this report, veto players are individual or collective decision makers whose agreement is required for the change of the status quo (Tsebelis, 2000). In Serbia it’s not only the politicians or the political parties that can affect policy outcomes. Domestic exploitative business cycles and also organized crime circles have successfully managed to exercise influence on political elites (that possess veto power) in order to maintain or to create policy outcomes in favor of their lawless activities (Mladenovic, 2014).

Nonetheless, if the transparent and uncorrupt political elites and policy makers of the country manage to eliminate the two problematic groups mentioned or at least reduce their influence to a significant extent, then decision making procedures will be more free to create institutional and political reforms that will guarantee greater stability and growth (Kostovicova, 2006). The removal or reduction of the influence and veto power of domestic exploitative business groups and organized crime can be achieved by introducing competition into the Serbian market and by strengthening its legal framework against crime and corruption (Subotic, 2010).

### **K) Reduce bureaucracy**

Bureaucratic mechanisms and procedures in Serbia's public or private institutions put serious obstacles on the improvement of competitiveness and the increase of growth in the country (World Economic Forum, 2014). Drastic measures should be taken by the government in order to cancel or at least reduce the negative effects of bureaucracy. Some interesting recommendations concerning actions responsible for reducing bureaucracy can be the following:

#### 1) Create a certain policy target

The political elites of Serbia should establish a certain target implementation chart, describing the levels at which it is possible to reduce bureaucracy in the different sectors where it mainly exists, and create regular controls regarding the progress of their policies towards that target (U.S. Agency for International Development, 2013). For example, the target of the last Serbian government for EU accession through aiming for and achieving certain policy outcomes in specific policy areas such as fighting corruption, reducing unemployment or extending economic freedoms, is an example of the general concept of setting a policy aim and trying to fulfill it through constant evaluation controls (European Commission, 2013).

#### 2) Strengthen communication technologies

One of the most efficient ways of reducing bureaucracy is often through maximizing the use information and communications technology in order to achieve administrative simplification and eliminate unnecessary paperwork and intermediaries that often increase bureaucratic procedures. Through efficient use of information technologies, the corruption that is associated with bureaucracy in Serbia can be drastically reduced and, as a result, an increase in the trust of citizens and, especially, possible investors can occur (Anticorruption-Serbia, 2013).

### 3) Establish and support one-stop shops

A one-stop shop is a business or office where multiple services are offered. Many economically advanced countries are using this model in order to provide easier, faster and more transparent help and guidance to companies and citizens. These agencies can provide information to Serbian citizens regarding, among other things, tax obligations, issuance of documents and issuance of licenses or permits. Finally, virtual agencies can also be created, providing exactly the same services in order to help citizens in an even more efficient way (Mahmood, 2013).

### 4) Harmonization of laws and regulations

Through harmonization of laws and regulations, investors and entrepreneurs will not have to submit documents that include similar information to different government agencies, thereby eliminating unattractive bureaucratic procedures that contribute to delays, the rise of corruption and the fragmentation of growth in the country. In addition, by reviewing existing regulations, inconsistencies and needless repetitions can be significantly reduced, leading to the use of more integrated and efficient laws (Monastiriotis and Petrakos, 2010).

### 5) Set up a control organization

Based on the certain policy targets for reducing bureaucracy that were mentioned before, a transparent organization, independent from governmental budgets, should also be established in order to control and evaluate the progress concerning the accomplishment of the government's primary targets and to draft regular reports of possible inefficiencies or miss-functions of the project (Anticorruption-Serbia, 2013).

### 6) Collect citizens feedback to drive change

It is of major importance in the effort of reducing bureaucracy in Serbia to create efficient information-gathering mechanisms that will collect citizens' complains, regarding their experience with the country's bureaucratic procedures. The most efficient and effective way of achieving that is probably by introducing e-services focusing on the collection of feedback from citizens (Transparency International, 2012).

## **L) Crime**

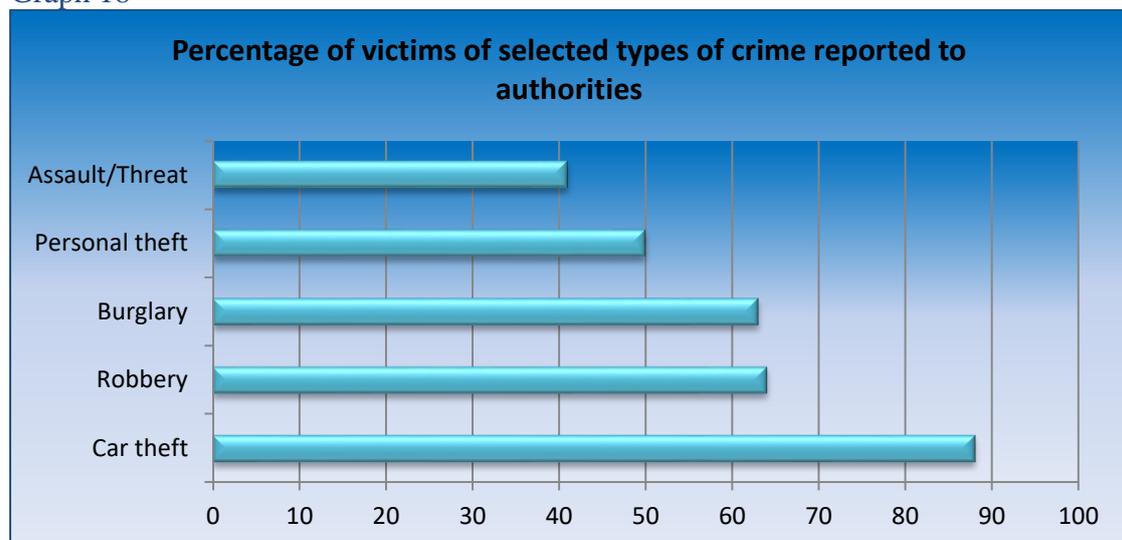
Crime in Serbia unfortunately exists in alarming levels across the country. The characteristics of crime are multidimensional and take the form of bribes, robberies, burglaries, assault threats, car thefts and personal thefts (Unites Nations office on

drugs and crime, 2011). In addition, civil unrest occurs regularly because of inefficient policies of the government on facing unemployment and the sluggish progress on economic development in the country.

Moreover, ethnic sources of violence can also be traced mainly to Kosovo's declaration of independence from Serbia in early 2008, or because of the war crimes that took place during Yugoslav wars. Nationalism and its repercussions still remain influential in the long transition period of the former Yugoslav states (Kuzio, 2001).

In addition, because Serbia is geographically placed between the Middle East and Western Europe, transnational terrorism concerns are on par with the rest of the Balkans. Especially when the conflict in Syria escalated, this attracted fighters from a variety of Muslim communities in the Balkans, and there is a general concern that combatants may return to Serbia radicalized, creating possible terrorism concerns locally. Graph 18 provides useful information about different types of crime reported by Serbian authorities (OSAC, 2015).

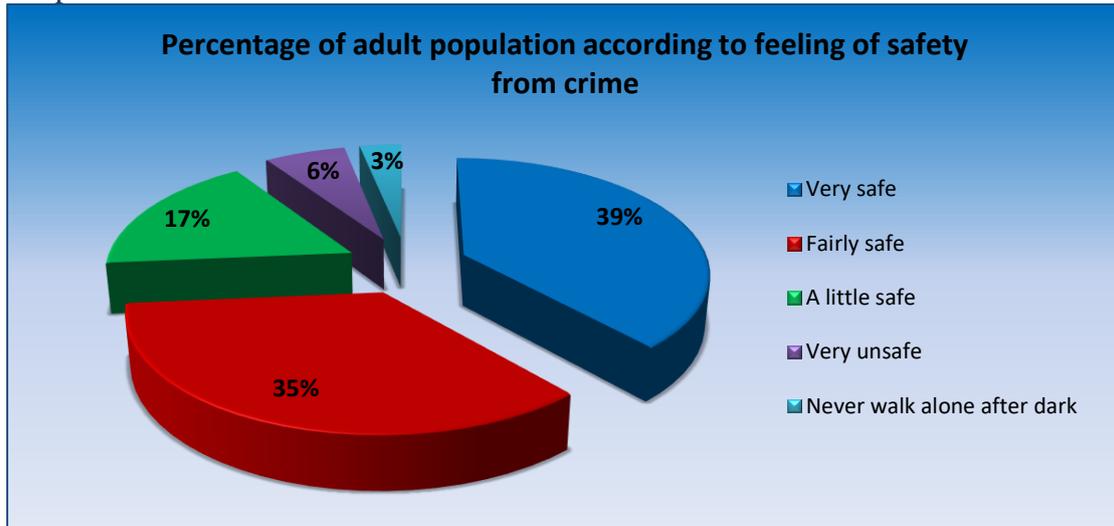
Graph 18



Source: United Nations office on drugs and crime (2011)

It is also very alarming that a big proportion of the population doesn't feel safe in the country because of corruption and its impact on society. From the graph below (graph 19) it is clear that 26% of people asked in 2010 don't feel comfortable even walking alone after dark in Serbia (United Nations office on drugs and crime, 2011).

Graph 19



Source: United Nations office on drugs and crime (2011)

The police are trying to decrease crime rates but, unfortunately, their effort is not paying off. Recommendations for improving police efficiency may include:

1) Provide modern equipment to the police

The role of the police must be strengthened if greater results are to be achieved on its main target of fighting crime. Modern equipment is of critical importance because it can solve many of the problems that police departments in Serbia are facing on a regular basis. Technological equipment may include: crime lights, in-car camera systems, photo enforcement systems, criminal investigations records systems, external cameras, thermal imaging, lasers, crime mapping applications, global positioning system and language translators (Schultz, 2008).

2) Develop more efficient training

Police training in Serbia can be further improved by cooperation between the country, the European Union and the United States in matters regarding national safety and terrorism in which the latter two are much better informed and organized. Especially the EU can provide significant assistance in restructuring the organization of Serbian police training, since Serbia is willing to make the necessary reforms in order to enter the EU in the near future (OSCE, 2004).

3) Increase communication by reducing bureaucracy

Effective organization and communication between police units should be established in order to minimize bureaucratic procedures inside police departments. The most efficient way of reducing bureaucracy is probably through the use of information technologies that will eradicate unnecessary paperwork and

miscommunication between police officers and departments (Anticorruption-Serbia, 2013).

4) Raise the salaries of the officers of law enforcement

A very strong motivational factor for increasing the performance of the Serbian police will be to raise the salaries of its officers because the current long hours and low pay for police are major challenges for Serbian law enforcement. Of course, it is understandable that the Serbian government possesses a very limited budget towards that purpose, but still the rise in the salaries of police officers will contribute to a significant decrease in crime and theft, something that will provide the government with additional sources of finance in the near future (Treisman, 2000).

To sum up, only the successful combination of all the previous recommendations mentioned (from paragraph A to paragraph L) is capable of increasing growth in the country, according to the concept of complementarity (Iversen, 2006). In addition, regarding the improvement of economic growth in Serbia, it is now clear that without the decrease of corruption and the achievement of institutional reforms the country will almost certainly fail to accomplish an efficient growth performance. In every sector (from paragraph A to paragraph K) the need for institutional reforms is always present, regardless of the exact nature of the solutions proposed, in order for greater efficiency and greater growth to be achieved in Serbia (Acemoglu, Johnson, Robinson, and Thaicharoen, 2003).

## Conclusions

On this report, it was made clear that political researchers and policy makers continuously try to support and increase the levels of economic growth and competitiveness in their countries (Barro, 1989). Of course, the key challenge is for policy makers to understand why growth outcomes differ so much across different countries in order to be able to provide recommendations on improving the growth performance of countries lagging behind (Barro and Lee, 1994).

Undoubtedly, there are many political, economic and institutional factors known at the present time that, according to the structure, number and complexity of regulatory bodies, can affect the level of growth within a country's economy (Henisz, 2000). Nevertheless, regardless of whether the previous determinants are of economic or political nature, it was observed and pointed out that institutional and governmental efficiency is always required in order to boost democracy levels and economic growth (Acemoglu and Robinson, 2008). Moreover, it was explained that when there is little political energy to accomplish institutional reforms, as it was observed in the case of Serbia, democracy is the main objective in the long run, and the rule of law is able to generate stable levels of democracy that in turn can enhance economic growth (Barro, 2013).

Concerning the analysis of the competitiveness performance of Serbia, the main conclusion is that, unfortunately, the country has a poor performance in all the sectors examined. However, as this report showed, the main weaknesses were inefficient institutions and a weak rule of law, which led to high corruption, which in turn influenced all the other sectors negatively as well (Acemoglu, Johnson, Robinson, and Thaicharoen, 2003).

The results of the study strengthened the primary assumptions: that economic growth in the post-Yugoslav states, as well as in all Southeastern European states in transition, basically depends on the reduction of corruption, countering the influence of inefficient institutions that are responsible for its spread, and on the strengthening of the rule of law together with the protection of political and civil liberties that can lead to political stability and, eventually, to greater levels of democracy and economic growth (Acemoglu, 2006a), than on total dependency on foreign direct investments, which in the case of Serbia were not directed to the required sectors of the Serbian economy because of its extremely low productivity during the post-communist

transition (Uvalic, 2001). FDIs can significantly promote the growth of an economy, but if they are not driven in certain economic sectors they may produce the exact opposite effects (Stiglitz, 2000).

Especially for countries that are still within their post-communist transition periods, like Serbia and most of the other Southeastern European countries, factors such as state-institution and civic nation-building can play a catalytic role on those countries' growth and development (Kuzio, 2001). Moreover, the liberal segments of the political elites of the country should work towards simplifying the structure and processes of regulatory bodies that form institutions in order to reduce the number of veto players within them, which will allow the making of decisions and implementation of reforms to take place in a more effective and direct way (Henisz, 2000). Economic growth has the tendency to "lock itself" in political systems that contain veto players with significant ideological differences between them (Tsebelis and Chang, 2004). Moreover, EU accession and the formation of a Balkan plan towards transnational cooperation can prove to be catalytic for improving Serbia's institutional capacity and reducing its high levels of corruption by the enforcement of a more efficient rule of law (Uvalic, 2002). Of course, because of the concept of complementarity, only the successful combination of all the previous recommendations mentioned will be enough to increase growth in the country (Iversen, 2006).

Finally, regarding Serbia's transition process, it can be concluded that inefficient market liberalization, the political unwillingness for institutional and political development in combination with the strong influence of internal veto players (Pavlovic, 2013), the inefficiency in fighting the alarming levels of corruption (Transparency International, 2013b), the uncontrolled exploitation of the market by parasitic business circles, the almost total dependency on uncontrolled foreign direct investments, the decrease of the industrial facilities in the country that led to great imbalances between imports and exports (Uvalic, 2012), the low income per capita and high unemployment that reduced the purchasing power of the citizens of the country and the political insolvency between Serbia and Kosovo regarding Kosovo's declaration of independence are leading Serbia to a rather unstable and unpredictable political, institutional and economic future (Monastiriotis and Petrakos, 2010).

Nevertheless, if the liberal political forces of the country manage to perform the necessary institutional reforms needed in order to reduce corruption through a more

efficient rule of law, Serbia may enter a new period of political stability, democratic consolidation and, eventually, long term economic growth (Begovic, 2013).

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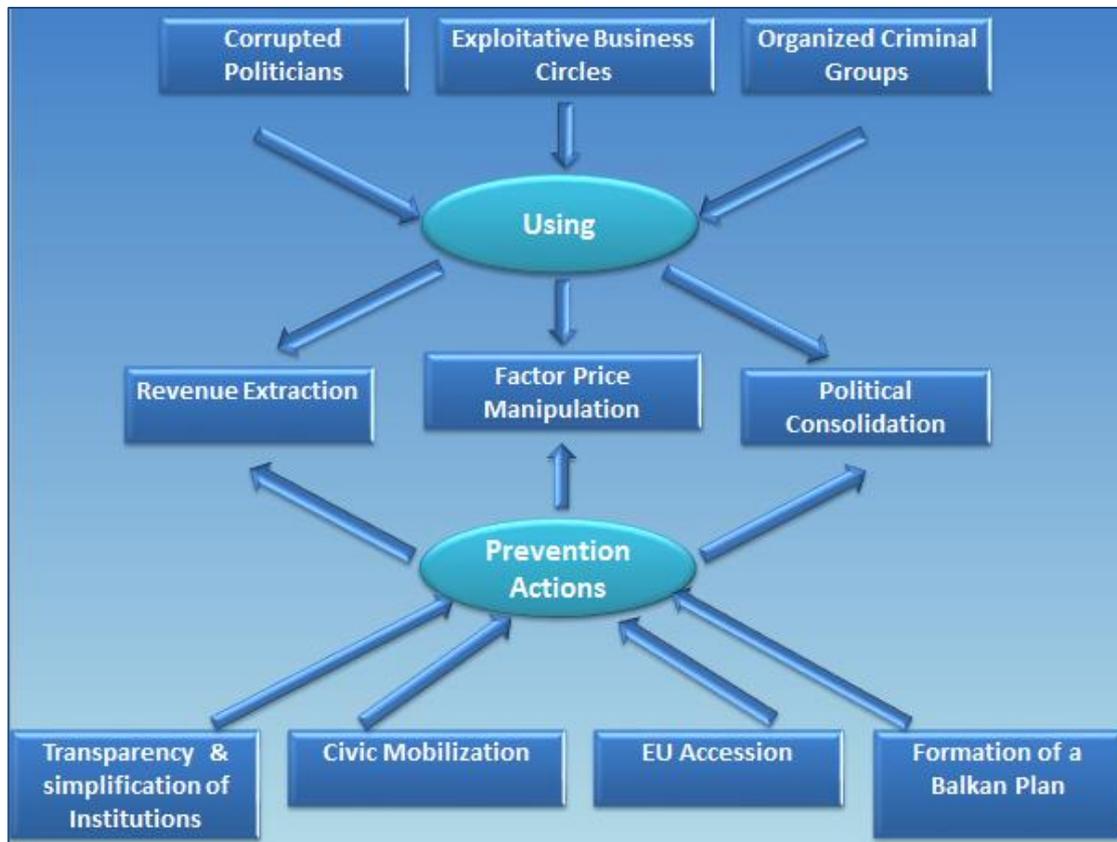
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## Appendix I

Description of groups and mechanisms used in order Serbian elites to preserve authority, as well as policies that the liberal segments of the Serbian society should pursue in order to reduce political power from the ruling elite.



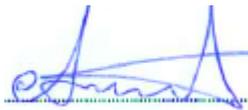
Source: Authors' elaboration based on the article of Daron Acemoglu (2006b), A Simple Model of Inefficient Institutions

## DECLARATION OF AUTHENTICITY

I, the undersigned, Ananikidis Alexandros, declare that this report is my original work, gathered and utilized especially to fulfill the purposes and objectives of this study, and has not been previously submitted to any other university for a higher degree. I also declare that the publications cited in this work have been personally consulted.

Signature

Date 23/9/15

A handwritten signature in blue ink, appearing to be 'Ananikidis Alexandros', written over a horizontal line.