

ECONOMY AND FINANCE

# INDUSTRIAL POLICY IN SERBIA

Towards major reliance on  
internal sources of growth

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Industrial policy has acquired a particularly important role after the strong impact of the 2020-21 COVID-19 pandemic and the urgency of the green and digital transitions, placing many new issues on the agenda that will require long-term planning and strategic action by governments.



Serbia will also need to adapt to this new agenda, by adopting a new type of industrial policy. Rather than focusing primarily on attracting foreign investors, Serbia's post-pandemic economic recovery will have to rely much more on internal sources of growth - including human capital, SMEs, entrepreneurship - since some of the main external sources that have fuelled growth may soon dry up.



Instead of a growth model that relies primarily on outward processing FDI with limited linkages to the domestic economy, Serbia needs to implement a more elaborated industrial policy that would promote the digital and energy transition, as this is likely to facilitate Serbia's potentially best performing sectors to be integrated into global value chains.



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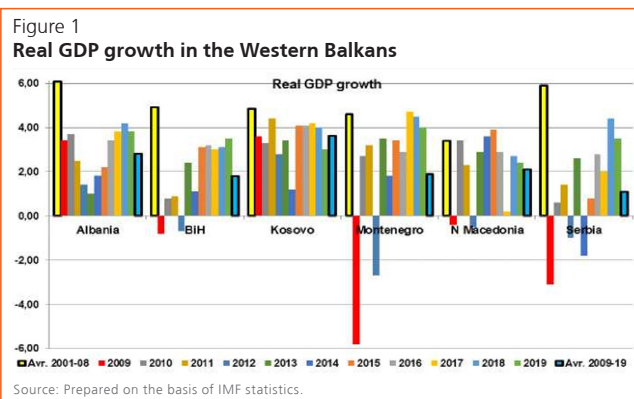
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## Introduction<sup>1</sup>

Serbia has done remarkably well in 2020, despite the global downturn caused by the COVID-19 pandemic. The Serbian economy has registered a mild 1 percent GDP reduction, the lowest among all the Western Balkan countries. Serbia has also attracted substantial foreign direct investments (FDI) in 2020 amounting to 6.2 per cent of its GDP, despite a global decline in FDI flows throughout the world. Serbia's current Economic Reform Programme is based on optimistic projections of a very strong economic rebound in the forthcoming years. Are these signs that Serbia may indeed have much stronger economic growth over the medium term and that "it's time has finally come?" (Udovički, 2021).

These excellent results ought to be viewed in a longer-term perspective, however, since a few years of much faster growth may not be sufficient to secure Serbia's catching up with the more developed parts of Europe. It should be recalled that Serbia's growth performance over the past decade has been illusory. The three recessions - in 2009, 2012 and 2014 - have practically annulled the positive growth achieved in the other years, so the average GDP growth rate during 2009-2019 was just over 1 percent (as compared to 6 percent during the 2001-2008 period), much lower than in the other Western Balkan countries (see Figure 1). The return of strong GDP growth in 2018-2019 (around 4 percent) was interrupted by the COVID-19 pandemic in 2020. Regarding the level of economic development, Serbia in 2019 was still at 41 percent of European Union (EU) average GDP per capita (in Purchasing Power Standards, Eurostat statistics). According to the author's rough calculations, Serbia is one of the few countries that has still not reached its pre-transition 1989 real GDP.

In order to narrow the income gap with respect to the more developed countries in Europe, Serbia will need to achieve much higher growth rates over the next years. This objective will have to be supported by a more adequate industrial policy. The paper outlines the key elements of a new industrial



policy that could potentially help achieve faster economic growth, based on a major reliance on Serbia's internal sources of growth. In the next section 2, some definitions of key concepts of industrial policy are briefly recalled, given that the interpretations of industrial policy differ widely. In section 3, the main achievements and failures of industrial policy implemented by the Serbian government during the last decades are analysed. In section 4, the most important elements of a different type of industrial policy in Serbia are outlined. The last section contains the main conclusions.

<sup>1</sup> I would like to thank Will Bartlett for useful comments on an earlier version of this paper

# 1 THE MULTIPLE MEANINGS (AND MISUNDERSTANDINGS) OF INDUSTRIAL POLICY

The concept of industrial policy has evolved continuously during the post-Second World War period. The rapid transformation of our economies and of related economic objectives has brought major changes in the conceptual framework and the types of instruments of industrial policy used by policy-makers, in both the national and European Union context. Since we are often confronted with different interpretations of industrial policy it is useful to briefly recall the key objectives and definitions of industrial policy.

One of the possible definitions suggests that industrial policy has at least two broad aims: (1) to improve the efficiency of individual firms and sectors, which normally involves restructuring and investment; and (2) to achieve structural change, using policies that favour more dynamic and productive activities generally, irrespectively of the sector or industry in question (see EBRD, 2008). In both cases, industrial policies can be horizontal or vertical. Horizontal policies provide the framework in which firms and industries operate and where market mechanisms ultimately determine survival and prosperity. Horizontal measures include the protection of property rights, improvement of the business environment, major transparency of transactions, or more specific measures such as general incentives for attracting foreign direct investment (FDI), providing support to SMEs, or developing national research strategies. Vertical policies are targeted to specific firms or sectors and have been used to support both failing industries and those considered to have potential for expansion. Vertical measures include providing loans, infrastructure provision, tax incentives or trade protection for specific firms, sectors or regions, but also the establishment of special economic zones or the provision of ad-hoc incentives for specific foreign investors.

The main motivation for pursuing horizontal industrial policy is the existence of market failures, which can be of different types. Information failures derive from a lack of information or discrepancies in access to information, which often result in a divergence between private and social returns. Coordination failures can appear whenever a project/industry requires large investments and high fixed costs that deter potential entrants, or when new activities bring wider spill-over effects since some projects require simultaneous investment in different sectors. Market failures can also be the consequence of lack of knowledge spillovers; for example when markets do not provide sufficient incentives for private in-

vestment in research because of the public good, intangible character of knowledge and its risky nature (Tagliapietra and Veugelers, 2020). In addition, private producers often require specific inputs including legislation, accreditation, R&D and infrastructure, that need to be provided by public authorities (EBRD, 2008).

There has recently been a revival of interest in industrial policy especially after the strong impact of the global financial and economic crisis, both among academics and in public policy debates. Most scholars agree that the main objective of industrial policy is not to “pick winners”, but to identify externalities and address market failures by appropriate government measures (see Rodrik, 2008, 2014; Chang, 2009; Lin and Monga, 2010; Lin, 2012; Greenwald and Stiglitz, 2012; Warwick, 2013; Stiglitz and Greenwald, 2014; Moran, 2014; Cerović, Nojković, Uvalić, 2014). During the past decade, there has been increasing acceptance of the need for state intervention and a more focused, vertical, industrial policy, although this is sometimes contested on purely ideological grounds. Most recent studies on industrial policy acknowledge both theoretical reasons for state intervention rooted in market failures, and the implementation difficulties rooted in government failures. Moran stresses the need for an interventionist state with a mechanism for selecting industries and providing packages of public sector support to address coordination externalities (Moran, 2014). Rodrik (2014) argued for a new industrial policy to be a “process of institutionalised collaboration and dialogue rather than a top-down approach” in which the government picks sectors or firms and transfers money to them. The private sector should be a stakeholder in such collaboration, alongside government and civil society (Bowles and Carlin, 2020); in such a bottom-up policymaking, civil society, trade unions, activist groups and citizens initiatives ought to be as engaged as the private and public sectors. These arguments seem highly relevant for a country like Serbia, where important stakeholders are frequently not actively involved in devising economic policies.

Mazuccato (2011) goes a step further to argue in favour of designing an industrial policy for activities that do not yet exist, introducing the concept of an “entrepreneurial state”. The notion of the entrepreneurial state implies that not only should the state step into the economy, promote existing industries and solve their market failures, but also that govern-

ment agencies should act as market creators. She proposes a “mission-oriented” approach to industrial policy, giving as examples of such missions the UN Sustainable Development Goals (Mazuccato, 2018). Meeting these goals requires new policies and instruments that go beyond fixing failures in existing markets.

A common factor in most definitions of industrial policy is that it targets a set of economic activities to achieve long-term benefits for society, that today go beyond short-term economic issues. Industrial policy ought to be based on a broader multi-dimensional objective, which can be captured in the notion of long-term social welfare (Tagliapietra and Veugelers, 2020, pp. 13-14).

The European Commission has also continually changed its approach to industrial policy (see Bartlett, 2014; Tagliapietra and Veugelers, 2020). The initial period (1950 - 1980) was characterised by interventionist policies, when European governments mainly used vertical industrial policies to support selected industrial sectors and build national champions that were considered to be strategic and promising. During the next phase of liberalisations in the second half of the 1980s, government intervention was mainly seen as detrimental for economic growth so it was replaced by a *laissez-faire* approach within which industrial policy was to be limited to setting the right general framework. The measures for the completion of the EU Single Market focused on competition policy and reducing state aid, while structural reforms such as privatisation were to reduce the role of the state, along with the creation of a business-friendly investment climate (Bartlett, 2014). In the 1990s and 2000s, a consensus was built around the horizontal approach to industrial policy, where EU industrial policy was to ensure the right framework conditions through the use of internal market and competition instruments and by stimulating R&D and innovation (Tagliapietra and Veugelers, 2020). The measures of horizontal industrial policy also included support for small and medium sized enterprises (SMEs) through the creation of decentralised business networks and industrial clusters, as well as regional innovation systems. The 2000 *Lisbon Strategy* stressed the importance of the knowledge-based economy and knowledge transfer from public research and higher education institutions to the business sector as the basis for improving EU competitiveness, to be obtained through increased expenditure on R&D, promoting Information and Communication Technologies (ICT) and developing innovation poles linking regional centres, universities and businesses.

After the strong effects of the global economic crisis, the European Commission announced a new approach to industrial policy (European Commission, 2010). In order to enhance the global competitiveness of the EU, the Commission called for the reindustrialisation in the EU, stressing the importance of manufacturing (European Commission, 2013; Uvalić, 2014; Damiani and Uvalić, 2018). In addition, it proposed an EU-level industrial policy, in an attempt to create European champions to compete against companies from China, India and other emerging economies. Industrial policy in the EU should now be based not only on existing horizon-

tal measures, but also on sector-specific policies. The new industrial policy targets certain industrial sectors that are regarded crucial for strengthening EU competitiveness, including space technology, clean and energy efficient motor vehicles, transport equipment, healthcare, environmental goods, energy supply industries, security industries, chemicals, engineering, transport-equipment, agro-food and business services. One of the common characteristics of these industries is the focus on advanced technologies and the application of highly skilled labour (Bartlett, 2014).<sup>2</sup> Similarly, the *Europe 2020 Strategy*, in addition to horizontal measures, also stresses the sector-specific dimension of industrial policy, identifying the above-mentioned sectors for development at the European level.

Industrial policy has acquired an even more important role today, after the strong impact of the 2020-2021 COVID-19 pandemic and the urgency of the green and digital transitions. Due to the current crisis, a new economic, social and ecological paradigm has emerged. The new perspective elevates the industrial policy discussion out of the realm of strict economic goals such as competitiveness, productivity and GDP growth, to include broader societal goals that involve climate stability, health, poverty prevention, the creation of quality jobs and reduced inequality (Tagliapietra and Veugelers, 2020).

As a response to the pandemic, the European Commission adopted *A New Industrial Strategy for Europe* in March 2020, that lays the foundations for an industrial policy that will support the twin transition (green and digital), make EU industry more competitive globally and enhance Europe’s strategic autonomy (see European Commission, 2020a). The Strategy seeks to strengthen Europe’s global competitiveness, pave the way to climate neutrality and shape Europe’s digital future. The European Parliament has also adopted a Resolution in November 2020, stressing that the European Union needs a new industrial strategy to attain the objective of climate neutrality by 2050 at the latest and to support the dual green and digital transition, while maintaining and creating quality jobs. The new industrial strategy should also strengthen Europe’s global leadership and reduce the Union’s dependence on other parts of the world in strategic value chains.

The Next Generation EU initiative will be the cornerstone of the first phase of the Union’s industrial recovery from COVID-19. It will dedicate substantial resources to combating climate change and environmental damage. The Next Generation EU initiative has placed many new issues on the agenda that will require long-term planning and strategic action by governments. The climate change policies and the environmental goals of the Green Agenda add further complexity to industrial policy. In addition to tackling market failures as the core of classic industrial policy, green industrial policy must also address market failures associated with climate change and environment degradation.

<sup>2</sup> The new industrial policy draws on the provisions of the Lisbon Treaty, Art. 173 TFEU on industrial policy (see Bartlett, 2014).

In the Western Balkans, the process of EU integration during the past fifteen years has guided the candidates and potential candidates in adopting laws and regulations in line with EU principles and norms. As part of the conditionality of the EU accession process, it is the more liberal market interpretation of industrial policy that has been transposed to the Western Balkan countries. A horizontal approach to industrial policy has dominated also after 2010, despite the reliance in the EU on more direct vertical forms of industrial policy. In the Western Balkans emphasis has been placed on the creation of competitive market-based economies through market liberalisation, privatisation, anti-trust legislation, reduction of state aid, further improvements in the business environment. This type of horizontal industrial policy has left the Western Balkan economies vulnerable to adverse spill-over effects from the EU and has not facilitated the post-crisis economic recovery (Bartlett, 2014). Until fairly recently, the European Commission's recommendations also to Serbia have continued to reflect a rather liberal approach to industrial policy (see European Commission, 2020b).

## 2 ACHIEVEMENTS AND FAILURES OF INDUSTRIAL POLICY IN SERBIA

After the political changes in Serbia in 2001, industrial policy mainly consisted of horizontal-type measures. This is in part understandable, given that the adverse political and economic conditions that prevailed throughout the 1990s led to the postponement of many market-oriented economic reforms, while the government maintained a very strong role in the economy (Uvalić, 2010). At that time, a hyper-liberal model seemed the safest way to radically break with the past and leave behind the negative legacy of the Milosević regime. Economic reforms from 2001 onwards included a new privatisation law aimed at privatising and restructuring a large part of the economy, along with efforts to attract FDI, liberalise foreign trade and economic activities. A series of measures were introduced to improve the business environment by simplifying or eliminating unnecessary administrative procedures.

Despite the strong orientation of the government towards liberal pro-market policies, the economic and institutional reforms after 2001 were not able to achieve many of the desired objectives. Given that there were substantial delays in implementing privatisation and in the meantime some 30 percent of deals were cancelled because the new owners failed to respect their legal obligations, the government has continued to extend state subsidies to firms that have still not been privatised, as well as to some strategically important state-owned enterprises. Anti-trust legislation was adopted only in 2005 and the Competition Commission was set up in 2006, but was not given sufficient implementation power. During the 2001-2008 period, Serbia has attracted substantial FDI, but foreign capital has gone predominantly into the non-tradable service sectors - retail trade, banking, telecommunications, real estate, in this way contributing only indirectly to the restructuring of the industrial sector of the economy (Uvalić, 2010; Estrin and Uvalić, 2014).

Structural problems that were inherited from the 1990s proved particularly difficult to address, let alone resolve. The key structural problems include (1) high and rising trade deficits due to the relatively low competitiveness of Serbian products on foreign markets; (2) long-term problems on the labour market, due to structural factors and lack of aggregate demand for labour that have led to high unemployment, low employment and participation rates and the diffused informal economy; and (3) the long process of deindustrialisation

of the Serbian economy, that by 2010 reduced industrial production to 50 percent of its 1989 level. It was naively believed that economic liberalisation and privatisation, in a stable macroeconomic environment, supported by foreign investors and donors' financial assistance, would lead to rapid restructuring and modernisation of the Serbian economy, thus not requiring a specific industrial policy. The policies applied were in line with the EU horizontal approach to industrial policy. What was missing was a longer-term strategy of economic development that would offer a clear vision of where Serbia was heading and what were the measures of industrial policy needed to achieve the desired objectives (Uvalić, 2010).

In the meantime, Serbia signed a Stabilisation and Association Agreement with the European Union, obtained candidate status and started its accession negotiations. As part of the negotiations framework, Serbia has been developing an industrial policy in line with its obligations, as envisaged in Chapter 20 of the *Acquis Communautaire*. After the severe effects of the global financial and economic crisis, the Serbian government adopted an ambitious *Strategy and Policy of Industrial Development for the 2011 - 2020 Period* in June 2011 (Government of Serbia, 2011). This document of over 200 pages proposed a new model of economic development that was to be based on three main objectives: (1) strong investment growth; (2) export-orientation of industry; and (3) increase of employment in industrial sectors. Although some priority sectors were mentioned, the core of Serbia's industrial policy essentially remained horizontal, consisting of various measures in 13 main areas: corporate governance, education, technological development, research and development, information and communications technology (ICT), employment, competition, restructuring and privatisation, foreign direct investment, entrepreneurship, regional development, protection of the environment and energy efficiency. Although in 2011 the mainstream view, that vertical industrial policy is unacceptable, had already been abandoned, this was not the case in Serbia where the focus of the institutional capacity-building effort was on attracting FDI, selling domestic companies and expecting that investors would do the restructuring job (Udovički, 2021).

Industrial policy in Serbia over the past ten years has continued to provide general measures of support to enterprises, promote innovation, offer some investment incentives and



eliminate administrative procedures to make the business environment less burdensome. The Ministry of Economy and the Serbian Chamber of Commerce have been helping SMEs with specific measures of export promotion and information about access to foreign markets. Favourable loans and guarantees for SMEs have been provided by the Ministry of Economy and the Development Fund through joint programmes with commercial banks. Serbia participates in the EU's COSME programme for SMEs, which provides financial support for the purchase of production equipment, for start-ups and for development projects. In order to encourage innovative firms, the Serbian Innovation Fund was set up to provide finance for innovative projects (though the resources have been rather limited). Four Science and Technology Parks have been created in Serbia: in Belgrade, Novi Sad, Niš and Čačak.

The main focus of recent industrial policy in Serbia, however, has been to attract FDI through improved legislation, the creation of special economic zones (called "free zones" in Serbia) and direct government subsidies. The new Investment Law adopted in 2015 aims to additionally stimulate foreign investments by extending national treatment to foreign investors, allowing the transfer or repatriation of profits and dividends, providing guarantees against expropriation, allowing customs-duty waivers for equipment imported as capital-in-kind and enabling foreign investors to qualify for government incentives (Bartlett, Krasniqi and Ahmetbašić, 2019). The free zones, established as export-processing zones within duty-free areas, have attracted a relatively large amount of new FDI, mainly in the motorcar and components industries, which are often aimed at export markets. The incentives offered for the creation of free zones have led several municipalities to establish such zones, competing for investors by offering a range of incentives and subsidies to attract both domestic and foreign businesses (Avlijaš and Bartlett, 2011). Some 14 free zones have been created in Serbia hosting 221 firms by 2017 (Bartlett, Krasniqi and Ahmetbašić, 2019). The Serbian Development Agency (RAS) has provided investment subsidies to foreign investors located either inside or outside free zones, depending on the level of municipal development, the size of investment, the number of jobs created and level of development of the municipality. An additional subsidy is available for labour-intensive companies that employ more than 200 workers. Subsidies in the manufacturing sector may be granted for investment projects valued above 100,000 euros that employ at least ten workers. All large investors can benefit from an investment subsidy package (grants for eligible costs of investment, subsidies for new employment, local subsidies). Investors that have negotiated agreements with RAS received an average subsidy of 9,000 euros per job created in 2014, 7,000 euros in 2015, and 5,000 euros in 2016. These programmes have benefited companies located both within and outside free zones (see Bartlett, Krasniqi and Ahmetbašić, 2019).

What have been the overall results of such industrial policies? Table 1 gives an overview of the Serbian Government's projected objectives set in 2011 (see *Strategy and Policy of Industrial Development for the 2011-2020 Period*) and their actual fulfilment by 2017. The data reported show that the

2011 Strategy was based on over-ambitious targets; except for the increase in manufacturing employment, none of the other strategic objectives has been fully realised. GDP growth has been one sixth, while investment one fourth, of the projected growth rates. The most striking underperformance regards productivity growth that amounted to only 2.7 per cent for the whole 2011-2017 period, as compared to the projected 50 percent increase.

Table 1  
Serbia's strategic objectives, 2011- 2020 (projected and realised)

Objectives	Projected average growth rate (%), 2011-20	Realised growth rate (%), 2011-2017
GDP growth rate	5.8	0.9
Investment	9.7	2.4
Domestic final demand	4.7	0.5
Consumption	3.5	0.1
Exports of goods	14.2	10.7
Manufacturing industry	7.3	3.3
Construction	9.7	0.0
Employment in manufacturing	0.38% per annum	0.4% per annum
Cumulative increase in productivity (by 2020)	50	2.7

Source: Government of Serbia (2020), pp. 12-13, based on data of the Statistical Office of the Republic of Serbia and estimates of the Serbian Ministry of Economy.

The Serbian government has also set excessively ambitious targets regarding FDI. The projections were based on unrealistic estimates, as confirmed by data in Table 2. Although this was one of the government's top priorities, not a single target has been entirely realised by 2017. The under fulfilment of these objectives was partly due to external factors - the unfavourable external environment after the global financial and economic crisis that also influenced a general reduction in global FDI.

Table 2  
Foreign Direct Investment objectives (projected and realised)

Indicator	Projected, 2011-2020	Realised, 2011-2017
Net FDI - total (€ bn)	22.7	12.7
Net FDI - Average annual share of GDP (%)	5.8%	5.3%
FDI in manufacturing industry - total (€ bn)	9.1	4.5
FDI into manufacturing (% share in total)	Over 40% (until 2020)	31.1%

Source: Government of Serbia (2020), p. 15, based on data of the Statistical Office of the Republic of Serbia and estimates of the Serbian Ministry of Economy.

Despite the underfulfilment of many objectives, Serbia's economic policies have produced some positive results. Among the main achievements has been strong export growth, confirming Serbia's improved export competitiveness and a switch to a more export-oriented growth model. During the 2012 - 2019 period, the ratio of exports of goods and services to GDP more than doubled, reaching 50 percent of GDP by 2019, thus making Serbia the second most open economy among the Western Balkans (after North Macedonia). Serbia's strong export growth has been the result of a combination of three groups of supply-side factors (Uvalić, Cerović, Atanasije-

vić, 2020). First, after the implementation of severe austerity measures aimed at fiscal consolidation, local firms looked for new markets abroad due to the low purchasing power of the domestic market. Second, foreign firms that have invested in Serbia, attracted primarily by low labour costs and high government employment subsidies, have mostly been producing products for exports; in fact, foreign companies comprise most of the top 15 exporters today. Third, export growth has also been supported by local entrepreneurship and a strong increase in exports by local ICT companies (that, however, are not sufficiently present on the local market).

The incentives offered to foreign investors have ensured a steady entry of FDI, on average more than 6 percent of GDP per annum during the past decade. The inflow of FDI has also displayed a more favourable sectoral structure - around 30 percent of total FDI went into manufacturing. Some of the most important labour market indicators have also improved (unemployment, employment). Measures to support innovative SMEs have contributed to Serbia being classified among the “moderate innovators” in the EU’s Innovation Scoreboard in 2020. Serbia’s expenditure on R&D has increased to 0.92 percent of GDP by 2019, which is less than half of the EU average of 2.2% but higher than in the other Western Balkan countries; about two fifths of this expenditure has been made by the private sector. The country’s rank in World Bank’s Ease of Doing Business has significantly improved with respect to previous ranks (44th rank in 2020), though some sub indicators remain problematic (getting electricity - rank 94, or paying taxes - rank 85). These are all positive results, but they do not seem to have fuelled much faster GDP growth (at least until 2018).

Serbia has recently prepared a new *Strategy of Industrial Policy for the 2021-2030 Period* adopted by the government in March 2020 (Government of Serbia, 2020a). The new Strategy aims at replacing the current model of competitiveness based on cost advantage deriving from cheap low-skilled labour, with a model based on a skill-based advantage, namely knowledge-based industries (European Commission, 2020b). The main priority of industrial policy is to achieve dynamic, smart, sustainable and inclusive growth, but now it is explicitly recognised that industrial policy should incorporate both horizontal and vertical (sectoral) policies. The Strategy is based on a mix of horizontal measures aimed at the development of SMEs, entrepreneurship and competitiveness, and vertical policies based on the *Smart Specialisation Strategy* adopted in February 2020 (Government of Serbia, 2020b). Contrary to the previous approach that was not sector-specific, four sectors have now been identified as sectors with the highest growth potential: food processing, wood and furniture, rubber and plastic, and machinery and equipment. Horizontal industrial policy will focus on education, innovation, digital transformation, investment, infrastructure, internationalisation, the circular economy and an appropriate business environment. Vertical industrial policy will rely on the *Smart Specialisation Strategy* and will target both traditional industrial sectors that can improve comparative advantages and new industrial sectors that can increase value added of goods and services.

The final priority areas of the *Smart Specialisation Strategy of the Republic of Serbia* adopted in February 2020 are the following: (1) food for the future; (2) information and communication technologies (high-knowledge content services); (3) future machines and manufacturing systems (mid-tech manufacturing such as metal processing, machine construction, rubber/plastics); and (4) creative industry (see Government of the Republic of Serbia, 2020b). A new programme of support of industrial enterprises has also been planned to enable their greater inclusion into value chains of multinational companies. The aim of the programme is to offer enterprises in the chosen targeted sectors financial support for the development of their capacities and harmonisation of quality standards, in order to facilitate their inclusion into global supply chains. The planned measures also aim to increase efficiency of the instruments for the Strategy’s implementation and provide better coordination of industrial policy among Serbian line ministries. The Action Plan for implementation of the Strategy has been drafted and is currently in the process of consultations.

## 3

## WHAT TYPE OF INDUSTRIAL POLICY FOR SERBIA?

In order to achieve faster economic growth, Serbia needs a long-term strategy of economic development sustained by a new type of industrial policy that would need to include different but coordinated measures in several important areas - rather than focusing primarily on attracting foreign investors, as has been the case to date. Post-pandemic economic recovery will have to rely much more on internal sources of growth, since some of the main external sources that have fuelled growth, primarily FDI, are likely to dry up at some point in the future. In view of diminishing privatisation opportunities in Serbia and the volatile nature of FDI, a greater reliance on domestic sources of growth will be essential.

The new industrial policy in Serbia will need to encompass both horizontal measures aimed at improving firms' competitiveness, and vertical measures to support priority sectors, along with structural change and technological upgrading of the Serbian economy. Contrary to the Strategy for the 2011-2020 period, the new *Strategy of Industrial Policy* adopted in 2020 explicitly stresses that both horizontal and vertical measures of industrial policy are necessary.

In our view, the new industrial policy will need to pay particular attention to the following policy areas which could potentially strengthen Serbia's internal sources of growth, making it less vulnerable to unpredictable interruptions in external capital inflows:

1. higher investment rate and better targeting of priority sectors;
2. investments in human capital (education, R&D, innovation);
3. more adequate support of local SMEs;
4. specific measures to encourage networks between domestic and foreign companies; and
5. promotion of the digital and energy transition.

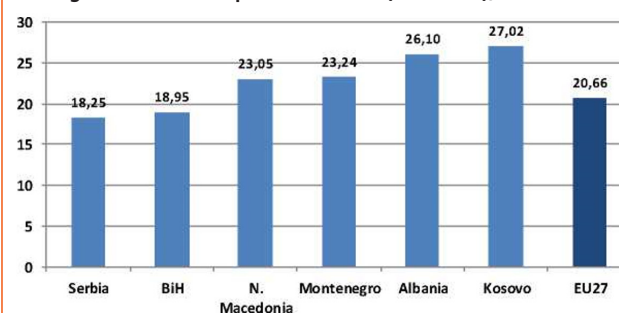
### 1. Increasing the investment rate and better targeting of priorities

As known from traditional growth theories and many theories of economic development the key condition for economic growth is a minimum rate of investment, a hypothesis that has been firmly confirmed by extensive empirical evidence from many countries worldwide. Socialist Yugoslavia has achieved very fast economic growth rates for over thirty

years, to a large extent thanks to investment rates that were close or over 30 percent of GDP.

By contrast, Serbia has had a relatively low investment/GDP ratio during the past decade, well below the 25 percent of GDP that is considered the threshold for sustained high growth and below the 30 percent recorded by emerging markets at similar levels of development (Kekić 2018). During 2009-2019, Serbia has had the lowest average investment rate (18.25 percent) among all the Western Balkan countries. During this 10-year period, Serbia's investment rate was also lower than the EU's average rate (20.66 percent), despite the EU being more than twice as developed (in terms of GDP per capita) than Serbia (see Figure 2). If these trends continue, this difference in investment rates risks to undermine Serbia's growth prospects and quick convergence with EU income levels.

Figure 2  
Average Gross Fixed Capital Formation (% of GDP), 2009-2019



Source: Compiled on the basis of Eurostat on-line statistics.

Despite government plans to increase the investment/GDP ratio from 18.6 percent of GDP in 2010 to 28 percent in 2020, this objective has not been realised. Only in the last two years has Serbia's investment/GDP ratio somewhat increased, to 22.5 percent in 2019.

Relying primarily on foreign investors to increase Serbia's investment rate has been a short-sighted and risky policy. Although FDI throughout the last decade represented around 30 percent of total investment and over 6 percent of GDP, contributing to growth, increasing employment and exports, policies in favour of FDI have neglected the importance of internal sources of growth. In a wider context, even the best public policies to attract FDI may not be able to eliminate some disadvantages of the Western Balkan countries including Serbia, that originate from small size, fragmentation, lack

of economies of scale or political risk (Estrin and Uvalić, 2014). Favourable public policies in Serbia will not be able to stop foreign investors moving elsewhere, once labour costs increase and privatisation opportunities are exhausted.

The government should explicitly offer the same type of investment incentives to both domestic and foreign enterprises and avoid discriminatory practices. Although legally this is already the case, there is ample informal evidence that foreign investors continue to receive generous public support, while domestic firms, particularly SMEs, are in a much less favourable position. According to recent estimates by Labus, the unintended side-effect of the growth of FDI during 2010-2017 was the reduction of domestic investment (Labus, 2019). Major incentives should be offered to domestic private enterprises to invest their profits locally, both through tax and other favourable provisions and a more predictable business environment.

Higher investment is necessary by both the private and the public sector. During 2011-2015, public investment has been very low, 2.3 percent of GDP on average, increasing only slightly thereafter (Bajec, 2018). The Serbian Fiscal Council has convincingly argued that public investments in Serbia would need to increase to at least 6 percent of GDP. The resources could be secured by cutting other budgetary expenditure (e.g., subsidies to loss-making enterprises). Better governance and management of public investment financed with international resources must also be ensured, in order to speed up the implementation of important infrastructure projects (roads, railways, energy).

Considering the high priority attributed to investment in infrastructure by the EU's *Economic and Investment Plan for the Western Balkans* (see European Commission, 2020c), public investments could be an important driver of industrial policy that could also attract additional private funding. Serbia has already had some positive experiences of vertical industrial policy backed by public investment (see Bartlett et al, 2017). The United Arab Emirates' commercial investment in Serbia has focused on four key sectors: aviation, urban construction, military technology and agriculture, chosen to reflect different strategic imperatives. Whereas investments in agriculture and military technologies are part of a strategy of risk mitigation in respect of food security and military security, the investments in aviation and construction form part of a wider strategic policy of economic diversification in anticipation of the post-oil economy. Although some of these investments have been criticised in Serbia because of their lack of transparency, allegations of corruption, and lack of public debate over plans to transform downtown Belgrade (Bartlett et al, 2017), public investment made in the Serbian defense industry - one of the most successful and innovative industries powered by public investment - could be seen as a good example of vertical industrial policy.

A higher investment rate could have a strong multiplier effect on GDP growth (Labus, 2019). In devising the right instruments, Serbia's sectoral priorities should be considered and the variable impact of investments in various sectors (see La-

bus, 2019; Atanasijević et al. 2021). The government needs to influence much more the sectoral structure of investment, in order to facilitate structural change towards higher productivity sectors. Recent FDI into the manufacturing sector in Serbia has mainly been directed into low and medium-low technology industries that produce low complexity products (Atanasijević et al, 2021). The choice of priority sectors must also take into account investment efficiency of different sectors, as recently calculated for Serbia by Nikolić and Kovačević (2019).

Empirical evidence has shown that governments that want to use FDI to diversify and upgrade their production and export base should not merely sit back and wait to see what international market forces bring; on the contrary, sector targeting by investment promotion agencies (not simply opening to FDI) can double FDI flows into the chosen sectors and result in higher unit-value exports (Moran, 2014; Estrin and Uvalić, 2016). Serbia's comparative advantages should be translated into specific measures of targeted industrial policy, building on the main findings of the recently prepared Smart Specialisation Strategy, but closely coordinated with the other measures described further below.

## 2. Investing in human capital (education, R&D, innovation)

There is limited awareness in Serbia about the importance of human capital for economic growth. In the current phase of Serbia's development, economic growth will crucially depend on the development of the knowledge-based economy, requiring more investment in science, R&D, education at all levels (including skills, life-long training, re-qualifications) and innovation. These are the most important sources for increasing productivity and economic competitiveness in the long run. Although the 2000 Lisbon Strategy aimed at making the EU the most competitive knowledge-based economy by stimulating the "knowledge triangle" - Research, Education and Innovation - has encountered difficulties in its implementation, there is no doubt that the Strategy has drawn public attention to the importance of "smart growth", leading to the adoption of specific policies for these important areas. Serbia should also place human capital development among the top government priorities. Although Serbia has implemented fundamental reforms of its higher education institutions in line with the Bologna Process, these reforms have not been fully satisfactory as they have not yet reduced the high level of graduate mismatch or eased the transition to work for higher education graduates (Uvalić and Bartlett, 2016). There have even been some recent setbacks, since in February 2020 Serbia's membership in the European Association for Quality Assurance in Higher Education (ENQA) was suspended.

One of the main constraints on economic growth in Serbia is the supply of skilled labour that is insufficient to meet the demands of new (foreign) investors. There is a mismatch between educational profiles of the labour force and labour demand by enterprises that have been complaining about the lack of skills of certain professions (Uvalić and Bartlett,

2016). Without the right labour skills, the Serbian economy will not have the absorptive capacity necessary to attract future investments and to assimilate and gain access to foreign knowledge (Estrin and Uvalić, 2016). The quality of human capital and skills are key intangible assets that affect a country's ability to take advantage of technology developed elsewhere. Serbia still does not have an organised well-defined system to stimulate innovative activities and wider networks. In order to strengthen competitiveness, additional measures should be implemented to improve labour skills, stimulate innovation and knowledge transfer.

### 3. SME sector development

Another key internal source of growth are SMEs, which represent more than 99 percent of all Serbian enterprises, 66 percent of employment, 57 percent of value added and 39 percent of exports. Serbia had the largest number of SMEs per inhabitant in 2017 among all Western Balkan countries, but their contribution to exports is still lower than in the other countries in the region (see GRETA, 2021). The SME sector could be a key instrument in Serbia for increasing competitiveness, employment, productivity and economic growth in the future.

Yet the SME sector still faces various barriers to growth and expansion in Serbia - including financial, institutional and competition barriers. SMEs should be ensured better access to finance under more favourable conditions (lower interest rates, less stringent collateral requirements) in order to be able to expand their activities. Recent survey evidence suggests that SMEs in Serbia are reluctant to borrow from banks to undertake new investments (though this is similar to other countries, as SMEs mainly finance their investments from retained earnings). SMEs often use outdated technology, but do not have sufficient capital to modernise their capacities, which is one of the reasons why they are rarely included into international supply chains. SMEs should also be offered more appropriate technical assistance, market information, help in accessing external markets and internationalisation. Serbia still lacks specialised business-related services for SMEs. SMEs need a more transparent institutional environment and should be better informed about regulatory and legal changes.

In addition to financial and institutional barriers, SMEs in Serbia are also strongly constrained by competition barriers. SMEs face unfair competition from large enterprises that in some sectors have maintained strong market power due to quasi-monopolistic positions and/or insufficiently rigorous application of competition policy. Well defined rules are not always implemented regarding state aid, due to strong political pressure for financial assistance which is channelled primarily to state-owned enterprises and large foreign investors (European Commission, 2021). In addition, SMEs also face strong competition from firms operating in the informal economy, where unregistered entrepreneurs, by avoiding the obligation to pay taxes, have a competitive advantage over firms in the formal sector.

### 4. Spillovers: cooperative networks between local and foreign firms

Additional measures are needed to stimulate the creation of cooperative networks between foreign and domestic firms in Serbia. Several recent studies on Serbia have provided evidence that there are not many linkages between foreign companies and domestic firms, resulting in limited technology spill-overs from foreign firms to the Serbian economy (Bartlett, Krasniqi and Ahmetbašić, 2019; Atanasijević et al., 2021). The import intensity of production (measured by the import/export ratio) in foreign firms operating in free zones in Serbia is extremely high (96.8% in 2017), implying few linkages to the local economy (Bartlett, Krasniqi and Ahmetbašić, 2019). The top 15 exporters in Serbia are mainly foreign-owned firms, but they continue to import parts and other inputs from abroad since local products lack quality standards or are more expensive. The lack of innovative capacity and appropriate skills among the workforce within domestic firms is another factor that hinders their effective engagement with foreign-owned companies and with new export market opportunities in the EU. Estrin and Uvalić (2016) have found that FDI in the Western Balkans has had very limited, if any, spillover effects on value-added, employment and exports in most manufacturing sectors of the Western Balkan countries.

In order to take advantage of the opportunity offered by free zones, the government should introduce new measures to facilitate the development of local supply chains (Bartlett, Krasniqi and Ahmetbašić, 2019). The stronger integration between domestic SMEs and foreign companies can be ensured both through stronger incentives for collaborative networks and specific programs assessing needs of foreign investors, facilitating contacts with local suppliers, improving skills and training of the local labour force and improving R&D capacity (Atanasijević et al., 2021).

### 5. The green and digital transition

*The Economic and Investment Plan for the Western Balkans (EIPWB)* adopted by the European Commission in October 2020 will support economic recovery in the Western Balkans through investments and support to competitiveness and inclusive growth, sustainable connectivity, and the twin green and digital transition, providing 9 billion euros in the form of grants over the next seven years and an additional guarantee facility to stimulate potential investments of up to 20 billion euros (European Commission, 2020c). Industrial policy will be crucial in achieving these aims, both in the EU and in the Western Balkans (see Uvalić and Cvijanović, 2018). The new Agenda will require the modernisation of enterprises, investments in the industrial eco-systems and innovation, adoption of additional export prerequisites and development of skills.

Serbia should make best use of EU assistance and funding opportunities offered through the EIPWB and its eight Flagship initiatives. In order to benefit from the investment package, Serbia should urgently adopt specific policies regarding some of the priorities of the EIPWB - in addition to those for

building infrastructure (the first 3 Flagships) - in the area of renewable energy (Flagship 4), transition from coal (Flagship 5), “renovation wave” (Flagship 6), waste and waste water management (Flagship 7) and digital infrastructure (Flagship 8) (see further below). The current economic, health and social crisis could be an opportunity for Serbia to introduce specific measures of support to enterprises to implement the main goals of the green and digital transition, and to use this occasion to impose stricter norms regarding environmental standards on foreign companies.<sup>3</sup> These measures could strengthen the competitiveness of Serbian firms on EU markets and facilitate their inclusion into global supply chains.

Current indicators suggest that Serbia is at the very beginning of these two transitions, especially the green transition. The energy sector is the main source of pollution in Serbia, responsible for 80 percent of the country’s greenhouse gas emissions and for the alarmingly poor air quality levels (European Commission, 2021). Serbia’s competitiveness continues to be hampered by a polluting and inefficient energy sector that is characterised by high carbon intensity, outdated infrastructure, intensive use of coal and low energy efficiency. About 66.4 percent of domestic electricity production in Serbia comes from coal (lignite), 28.4 percent from hydropower, 1 percent from gas, and 4.2 percent from wind, small hydro, biomass and solar together. Major investments are needed to modernise the country’s energy infrastructure and to reduce carbon emissions. Serbia for now lacks a coherent long-term strategy that combines energy and climate targets.

Serbia’s transition to more sustainable green sources of energy must be urgently addressed, not only on paper but also in its implementation, using EU funds provided for these purposes. There are many measures that can facilitate the low carbon transition and increased use of renewable energy sources (EIPWB’s Flagships 4 and 5). The “renovation wave” (EIPWB’s Flagship 6) could facilitate the renovation of Serbia’s public and private buildings to meet minimal energy performance standards; this could make a very significant contribution to the reduction of greenhouse gas emissions, improve the living standards of citizens and health standards. Sustainable and reliable ways of managing water supply, wastewater and waste disposal (EIPWB’s Flagship 7) are equally important for the protection of the environment and health of Serbian citizens.

There is limited awareness currently among businessmen in Serbia about the importance of the environment and climate change policies in general, particularly regarding the question of waste management and the circular economy. Some

associations in Serbia have been recently involved in developing enterprises “greening” policies by providing information and guidance to firms on adopting environmental norms, but this must be done on a much larger scale. Although large investments are being planned for the protection of the environment, the government should offer substantial technical support and the right incentives to firms to start implementing the necessary measures.

In the area of digitalisation, the further development of national broadband infrastructure is extremely important, particularly in the rural areas, as this could positively influence the economic development of underdeveloped regions. Somewhat surprisingly, according to the Serbian government (2020), a large number of SMEs does not plan projects in the area of digital transformation. The main reasons are their low profitability due to limited demand for digital products on the domestic market and the lack of labour skills needed for sales on international markets. Such an attitude may have changed in the meantime, as a consequence of the COVID-19 pandemic.

3 Not only Chinese and Asian companies, but also firms from the EU seem to be ignoring environmental standards in Serbia. The latest alarming story is from Beočin, where a cement factory was sold to the French company Lafarge in 2002; this was at that time considered one of the most successful privatisations in Serbia (see Uvalić, 2010, p. 189). In the meantime, Beočin has become one of the most polluted Serbian towns, since the company decided to substitute natural gas with the cheaper but highly health-damaging coal petrol, so the town has seen an increasing number of deaths due to cancer (see Ivanović, 2021).

## 4

## CONCLUDING REMARKS

The limited impact that Serbia's industrial policy has had on accelerating economic growth over the past decade suggests the need for a more interventionist role of the government. Many would argue that the Serbian government already intervenes excessively in the economy and that the safest recipe is to continue with pro-liberal market reforms. There is no doubt that Serbia needs additional economic reforms that come under the umbrella of horizontal industrial policy, but this should be carried out in parallel with a more targeted industrial policy, directed towards key economic objectives. The current agenda of industrial policy for increasing Serbia's competitiveness should include both national priorities based on Serbia's comparative advantages partly identified in its Smart Specialisation Strategy, and measures to implement the twin green and digital transition. In this way, Serbia's potentially best performing sectors could more easily be integrated into global value chains that have recently been identified as EU priorities. The challenge for Serbia today is to engage with the new agenda that includes these multiple objectives.

Instead of a growth model that relies primarily on outward processing FDI with limited linkages to the domestic economy, Serbia needs to strengthen its internal sources of growth that so far have not been sufficiently recognised and supported, yet do have the potential of contributing to faster longer-term economic development - including human capital, SMEs, entrepreneurship. Relying primarily on foreign investors to increase Serbia's investment rate and to restructure and modernise its economy has been a risky and short-sighted policy that has not led to a fast and much-needed technological upgrading of the Serbian economy. Foreign investors may soon move to other regions that offer lower costs and other advantages. This is an opportunity for Serbia to implement a more focused industrial policy aligned both with its own development objectives and the current EU targets regarding the green and digital transition.

For such policies to be successful, Serbia needs a deep transformation of government institutions. The new role of the state requires not just *less* government, but a *different role* of the government (Uvalić, 2010). The quality of government institutions is essential for enforcing laws, collecting taxes, supervising the financial sector, but so is the quality of non-state institutions. Markets will not function well if they are not competitive, if competition authorities do not ensure fair

competition, or if there are barriers to firm entry and expansion; enterprises will not function well if corporate governance is poor, or minority investors are not protected by a well-functioning judiciary and legal system. Most importantly, the current "predatory state" often pursuing narrow interests of the minority in power must be transformed into a "developmental state" (or an "entrepreneurial state" to use Mazzucato's term), in which the state's pursuit of economic growth would be guided primarily by national interests, to the benefit of all Serbian citizens. The combination of a "predatory state" and weak governance institutions can be detrimental for firm performance and economic growth in the long run (Estrin, 2020), as confirmed by many examples worldwide (some Latin American countries are among the best examples). When institutions are weak and governance ineffective, agency problems will also beset private firms, which may suffer from managerial aggrandisement and dominant shareholders expropriating minority shareholders (Estrin, 2020). The role of the state in Serbia needs to be re-defined in order to improve the quality of both its public and private institutions.

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## INDUSTRIAL POLICY IN SERBIA

### Towards major reliance on internal sources of growth



The limited impact that Serbia's industrial policy has had on accelerating economic growth over the past decade suggests the need for a different industrial policy, that would place major emphasis on increasing the investment rate, targeting priority sectors, increasing investment in human capital (education, R&D, innovation), offering more adequate support to local SMEs and further developing specific measures to encourage networks between domestic and foreign companies.



The current agenda of industrial policy for increasing Serbia's competitiveness should include both national priorities based on Serbia's comparative advantages identified in its Smart Specialization Strategy and measures to implement the twin green and digital transition.



Although large investments are being planned in Serbia for the protection of the environment, the government should offer substantial technical support and the right incentives to firms to start implementing the necessary measures. In the area of digitalization, the further development of national broadband infrastructure is extremely important, particularly in the rural areas, as this could positively influence the economic development of underdeveloped regions.

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