

Ekonomika preduzeća



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Journal of Business Economics and Management**

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Serbian economy is going through the third consecutive quarter of recession. This is a consequence of structural crisis. Vulnerability of the economy to stress factors is significant, which puts the downside risk high on the agenda. Sustainable economic growth cannot be achieved on a narrow economic base. Sustainable employment means transformation of the economy from import and debt dependent into balanced and growing one.

It is finally time for policy makers in Serbia to tackle the perennial problems that have somehow never been adequately addressed – away from excessive short-term thinking in wrongly defined economic growth model and policy platform. Changes require a new strategy for economic growth and new conceptual policy platform. This edition of *Ekonomika preduzeća* is dedicated to previous issues. The papers are arranged to cover microeconomic and macroeconomic topics, one after another.

D. Đuričin and *I. Vuksanović* have showed the importance of strategic thinking for industrialization of the economy and modernization of the society. The basic condition for turnaround is implementation of the so-called "heterodox" approach in policy platform based on harmonization of industrial policies on the one hand, and core and supporting policies, on the other. The authors identified priority sectors with comparative, competitive and sustainable competitive advantage. Also, they provided conceptual framework for strategy formulation in tradable sector.

In their paper *M. Labus* and *M. Labus* use DSGE model to perform what-if analysis based on adopted policy measures in the last year. The authors compared results of the measures' effect on Serbian economy with *status quo* situation, i.e. scenario in which no measure was implemented. They concluded that the social costs of fiscal consolidation will be significant in the absence of adequate monetary and foreign exchange policy. Delayed monetary easing was identified as a worst case scenario.

In the following article, combining *D. Malinić's* analytical expertise with inputs from empirical research, impressive collection of data has been produced. It is a must-read for everyone who seeks to understand financial health of public companies in Serbia. Public enterprises as well as enterprises with mixed ownership represent a significant portion of Serbian economy. Their performances influence budget liquidity and liquidity of the private sector. Namely, due to illiquidity of public enterprises there is a huge spillover effect on the liquidity of entire Serbian economy. Also, due to negative cash flow from operations, it is impossible to finance new investments from internally generated sources. Finally, the author provides concrete measures for restoring financial health of public enterprises.

In his paper, *D. Šoškić* analyzes the problem of growth financing from the perspective of SEE countries in the context of the Great Recession and the EU sovereign debt crisis. The author explores potentials for accelerating economic growth through measures of increased access to financing for SMEs and other local companies with potential to become competitive players in tradable niches of GDP. In doing so, he shed some light on key vulnerabilities of SMEs, notably reflected in high NPLs and credit risk growth, and pointed to the vital role of the monetary policy and banking regulation in solving previous problems.

N. Savić, G. Pitić and A. S. Trbovich describe the new paths in industrialization to avoid middle income trap. The authors' main idea is that the development of clusters and creative industries buttresses innovation processes and overall conditions for competitiveness of the economy. They pointed out a need to shift from investment-driven stage of competitiveness to innovation-driven stage. The findings are both practical and intriguing.

D. Lončar explores the possibilities of the New Public Management approach implementation into public administration in Serbia. The author analyzes characteristics of the Neo-Weberian State and Public Value Management, and suggests necessary reforms in Serbian public administration in order to approach more closely to contemporary models.

The following paper, written by *E. Jakopin*, treats regional economic growth drivers in the context of economic recession and output gap. The author underlines that there are only 1.2% fast-growing companies in Serbia, which is deterioration compared to pre-crisis period when this number amounted to 3%. The author offers a dozen of suggestions in terms of measures for regional strategic development planning.

In their paper *G. Petković, S. Lovreta and R. Pindžo* point to the favorable global trends in tourism industry despite adverse macroeconomic environment for service sector, and analyze possibilities for Serbia to catch a portion of these positive trends. As regards the trade sector, the analysis reveals deteriorating conditions. The authors analyze both existing strategies in mentioned sectors and their implementation in order to find missing gaps in achieving better and sustainable results in the next planning cycle.

The next paper, written by top executives of City of Belgrade, *S. Mali and B. Milosavljević*, represents a case study of the City of Belgrade's organizational and financial restructuring. The authors present measurable results in the form of revenues and net financial results and conclude that the clear demarcation between the function of the founder and the function of management has provided immediate and notable effects in operating efficiency.

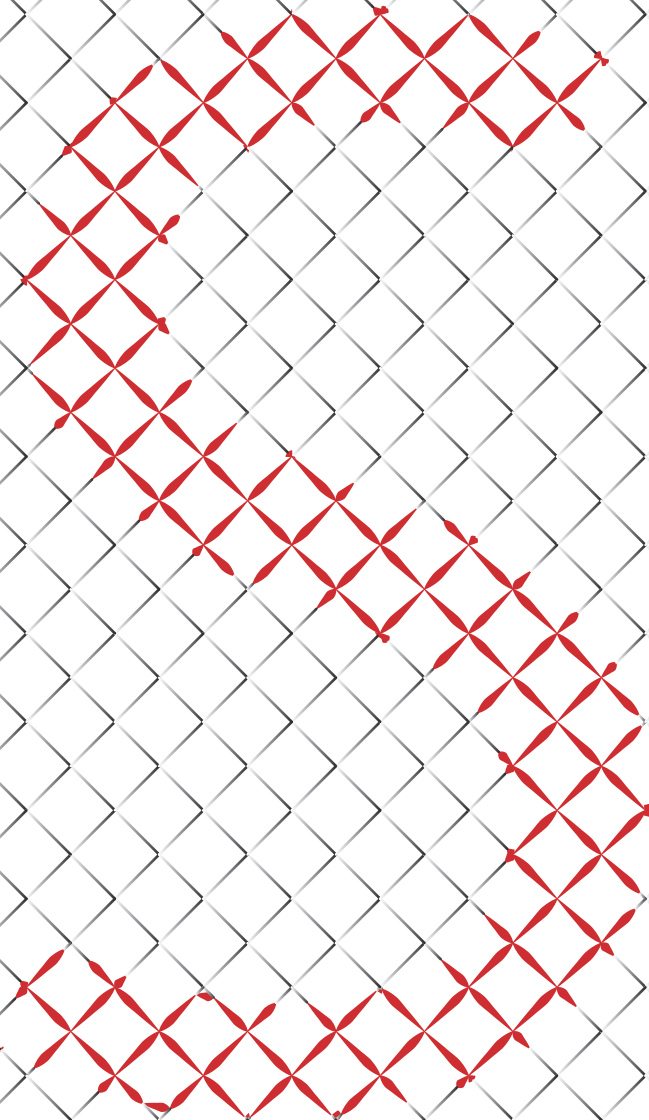
The last paper by *J. Atanasijević, D. Aleksić and V. Štimac* provides an overview of the situation in the area of policy planning in Serbia. The authors' starting position is an undoubted need for development planning in the reform processes and Serbia's back end position in terms of the use of strategic tools in public administration compared to EU countries. In their analysis, they revealed several fields with room for improvement and suggested possible solutions.

The general impression from all papers in this volume is that in the economy with thin market crust, unless the business leaders fix the flaws in the system, they will be watching from the sidelines as the government does it for them.



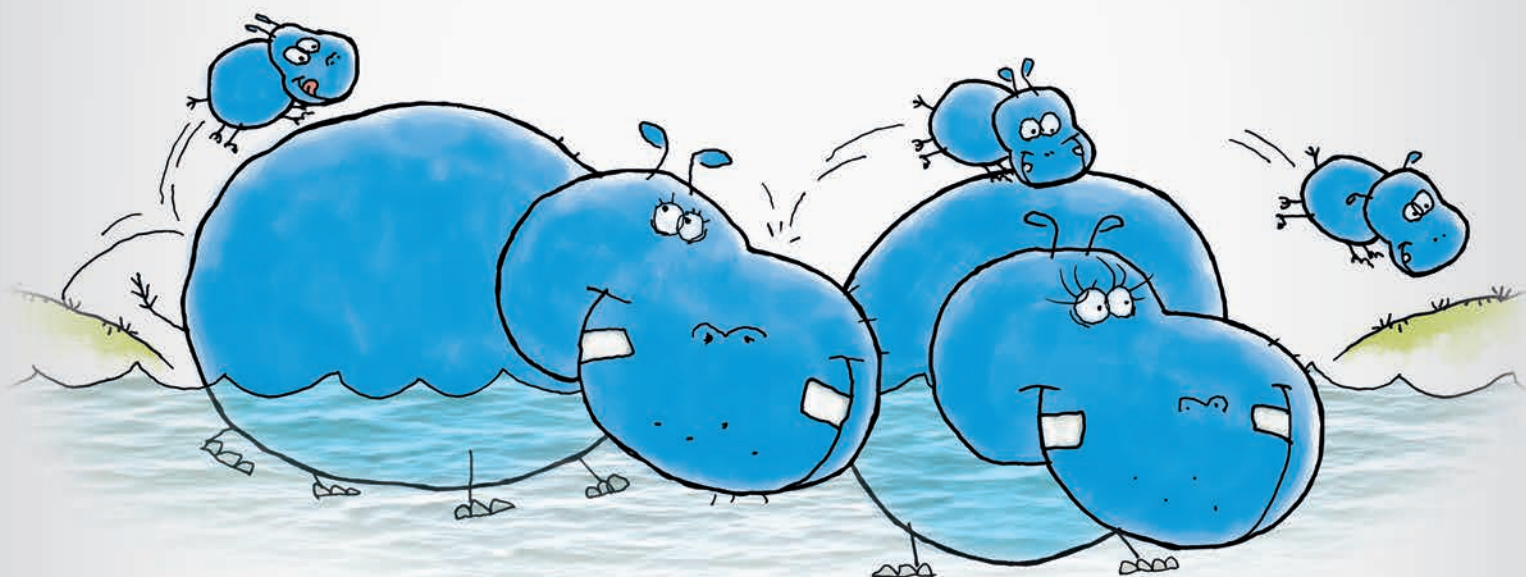
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THINK THROUGH STRATEGY: NEW VISION FOR INDUSTRIALIZATION OF ECONOMY AND MODERNIZATION OF SOCIETY

Strategijsko razmišljanje - nova vizija industrijalizacije
privrede i modernizacije društva

Abstract

In strategizing about Serbia's economy, there are two related questions. Where is it now? What it could be in the future? As far as the answer to the first question is concerned, Serbia is microscopic economy in long regression, late developer with delay in transition toward the road to higher development. Strategic audit of Serbia's position reveals long list of vulnerability indicators. Dangerous mix of structural imbalances and geopolitical stuck in the middle exists. In import and debt dependent country, high financialization undermines its economy in many ways.

In the last 25 years, Serbia lost roughly 1/10 of population and approximately 1/6 of its territory rich with significant natural resource endowment. Output in constant prices in 2014 is almost 1/3 lower in comparison with 1989 level.

The previous facts raise fundamental question: Why do people in the long period act against their own interest? The answer is simple: wrong system. We do not want to fix it up. We must change it. It is not easy because in the age of discontinuity great strategy and efficient model of economic growth are moving targets. In the new context the core competence for each national economy, small or large, early developer or late developer, stagnating or fast-growing, is going to be strategic flexibility. In thinking through strategy, the key question is not what is right? But, what would have to be right? In the new context, the role of government is not only to achieve greater geopolitical positioning and maintain political stability and social cohesion, but also, and predominantly, to encourage development of new model of economic growth and related economic policy platform.

The orthodoxies governing the economy in Serbia are so entrenched that we need breakthrough to articulate the paradigm change in theory and policy. In quest for solution, pendulum should not be shifted from one extreme institutional choice that the market is the best regulator to

the other which assumes that the state is the only master. In our previous articles [2], [3], and [4] we opt for heterodox approach which realigns development model and economic policy platform based on conceptually more complex approach of new structural economics. Industrial policy is a crucial element of the new wisdom. In this article, we concentrate on the strategy for economic growth in Serbia supporting previous choices.

Key words: *Serbia, economic policy, industrial policy, strategy choice cascade, strategy logic flow, sustainable competitive advantage*

Sažetak

U stratejskom razmišljanju o privredi Srbije postoje dva povezana pitanja. Šta ona trenutno predstavlja? Šta bi mogla da bude u budućnosti? Povodom prvog pitanja, odgovor je da je Srbija mikroskopska ekonomija u dugoj regresiji, kasni sledbenik u razvoju koji beleži zaostajanje u tranziciji prema putanji višeg nivoa razvoja. Ocena strateške pozicije Srbije govori o prisustvu duge liste indikatora ranjivosti. Postoji opasna kombinacija strukturnih neravnoteža i geopolitičkog zaglavljivanja. U državi koja je zavisna od uvoza i kredita, visoka finansijalizacija višestruko narušava stanje u ekonomiji.

U poslednjih dvadeset pet godina Srbija je izgubila skoro 1/10 svog stanovništva i skoro 1/6 svoje teritorije bogate značajnim prirodnim nasleđem. Autput u stalnim cenama u 2014. je za skoro 1/3 manji u odnosu na 1989. godinu.

Prethodne činjenice otvaraju suštinsko pitanje: zašto se ljudi u dugom periodu ponašaju u suprotnosti sa svojim interesima? Odgovor je jednostavan, pogrešan sistem. Njega ne treba popravljati. Njega treba promeniti. To nije jednostavan zadatak zbog toga što u vreme diskontinuiteta dobra strategija i efikasan model rasta predstavljaju pokretne mete. U

novom kontekstu, ključna kompetentnost svake nacionalne ekonomije, male ili velike, razvijene ili nerazvijene, stagnantne ili brzorastuće, postaje strategijska fleksibilnost. U strategijskom razmišljanju ključno pitanje nije: šta je ispravno? Već: šta bi trebalo da bude ispravno? U novom kontekstu uloga vlade se ne sastoji u tome da se ostvari samo dobro geopolitičko pozicioniranje i održi politička stabilnost i socijalna kohezija, već, takođe, i dominantno, da se podstakne razvoj novog modela ekonomskog rasta i odgovarajuće platforme za vođenje ekonomskih politika.

Ortodoksije vođenja ekonomske politike u Srbiji su toliko ukorenjene da je neophodno napraviti zaokret kako bi se mogla ispratiti promena paradigme u ekonomskoj teoriji i politici. U potrazi za rešenjem, klatno se ne može pomeriti iz jednog ekstremnog institucionalnog izbora, po principu da je tržište najbolji regulator, ka drugom koji podrazumeva da je država jedini donosilac odluka. U našim prethodnim radovima [2], [3] i [4] mi smo se opredelili za heterodoksnu pristup koji povezuje model razvoja i platformu za vođenje ekonomskih politika pomoću složenijeg pristupa nove strukturne ekonomske teorije. Prema novom pogledu, industrijska politika predstavlja kritičan elemenat. U ovom radu skoncentrisaćemo se na strategiju ekonomskog razvoja Srbije koja podržava prethodni izbor.

Ključne reči: *Srbija, ekonomska politika, industrijska politika, kaskada strategijskih izbora, logičan tok formulisanja strategije, održiva konkurentna prednost*

Serbia 2015: Epilogue of misconceptions and overestimations

Strategic audit is the first step in strategic thinking. Sometimes the results of that process are not encouraging. In that case, the primary role of strategists is to declare crisis. It is the step in the right direction. After that, strategic thinking continues with searching for the solutions.

Does Serbia's economy matter? Not particularly. Serbia is a landlocked country, microscopic economy without significant natural resource endowment and demographic dividend. Small, impotent and out of tune economy has no meaningful comparative and competitive advantage, nothing that is strong enough to counter the universe of stress factors.

Economy has slipped into recession in 2014. Forecast for Q4 shows that GDP contracted by 3.6% yoy. Industrial activity in Q4 fell 10.5% on Q/Q. Export declines 5.7% (vs. 26% growth in 2013). Import stagnates so the trade gap falls by 1.6%. Inflation is still low (2.1%) predominantly due to weak domestic demand (investment and final). RSD depreciated nominally and really, first time after 11 years, mostly as result of deteriorating export-import movement, strong bank's deleveraging, and increased risk aversion.

Key problem of Serbia's economy is low economic base due to output gap, both transitional and current. Moreover, economy is out of tune, full of structural imbalances like distortions in structure of prices, really appreciated FX rate, and too high cost of capital. Among them, the most important one is disharmony between real economy and financial sector. Deindustrialization along with high financialization is the main contradiction of the system. As consequence, Serbia's economy is constantly experiencing insolvency threat.

For more than a decade in Serbia leading politicians as transition strategists, state bureaucrats as architects of the system, and economics professionals as policy and/or opinion makers have been explicitly guided by neo-liberal doctrine. Privatization, liberalization, and deregulation were the main pillars, and inflation targeting was the key tool of that wisdom. Politicians blindly following neo-liberal economic doctrine made great number of wrong decisions in setting goals of transition and corresponding strategy, bureaucrats implemented mechanically these decisions through policies, and economists were continually trying to explain the related absurd. Economists with technical skills, but without political leverage, were calculating negative consequences of wrong doing while "court" economists were engaging themselves in covering that up.

Current model of growth and economic policy platform in Serbia are not in line with general conditions and sustainability proposal. Focus on inflation control by using exclusively monetary measures makes sense when economy does not suffer from inherent structural imbalances which uphold recession or deflation. Moreover, when cost-push inflation dominates the system, keeping inflation (actually CPI) under control is not enough because, among all, inherent volatility in global commodity markets influences core inflation. Moreover, keeping inflation under control by monetary measures is very expensive journey. When strong transitional output gap exists, massive liberalization in financial sector, combined with ineffective privatization in commercial part of the economy and public sector protected from restructuring, leads to another deepening of structural imbalances. Without public sector restructuring and significant

investment, public debt is wagging its own tail. Low investment particularly affects the economy with high level of public debt due to difficulties to maintain fiscal balance. Austerity is additionally shrinking purchasing power and strengthening recession spiral.

After 25 years of transition toward the capitalism, Serbia's economy has thin crust of the market (see Figure 1). So-called "partocracy sector" dominates in assets and net equity with three concentric layers (public COs, state-owned COs and mixed ownership COs). Quasi-market sector consists of privately-owned S&Ms targeting partocracy sector as business partner. In this sector, political connections are the critical success factor. Market sector is a thin layer with share in assets and net equity between 20-25%, and in net income between 30-35%. Market sector consists of subsidiaries of multinationals from finance and real economy and large companies of local entrepreneurs.

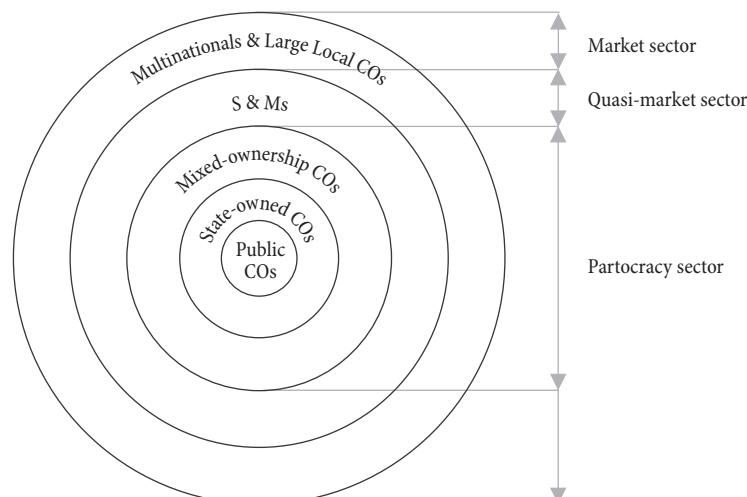
Partocracy sector is oversized. It is true burden on the economy. Inefficiencies from that sector are accumulated in budget deficit and passed through to public debt. According to the forecast for 2014, public debt of 70% GDP and budget deficit of 7% GDP are on alarming levels and bellow the EU rules [5], [6]. Unreasonably high cost of capital due to monetary policy concentrated exclusively on inflation control as well as crowding out of market sector from debt financing are the main causes of its low (many times negative) profitability. Position of the market sector is continually being eroded which is obvious from growing indebtedness and still sizable NPL level. The strong departure of prices of different kind of assets

from fundamentals is clear indicator of deep structural imbalances.

Analyzing the financial health of large, medium-sized and small companies for the period 2006-2013, *D. Malinić et al.* [10] conclude that small companies have greater exposure to financial risk and smaller exposure to operating risk than medium-sized and large companies. Higher financial leverage, in the first case, and lower fixed costs, in the second case, are main causes of such distribution of risk exposure. Analysis of risk exposure based on EBIT margin is in line with previous finding. General conclusion is that viability of economy, independently of size of company, is very low primarily due to negative effect of financial leverage. In many cases, companies cannot generate sufficient operating income to cover high borrowing costs [8, p. 346].

Without any doubt, previous strategy of transition and economic policy were not inspired by relevant goals and, hence, did not use the efficient tools. They constantly focused on less relevant goals (for instance, low and stable inflation). More relevant goals for sustainable development, like low and stable output gap, were below the radar. In addition, policy makers regularly missed the proclaimed goals. The best example is capital market development. The capital market in Serbia is not only thin, but also in retardation. The level of savings is higher than the market capitalization on Belgrade Stock Exchange. Another example is inflation. With the exception of the last two years, in the whole period, neither the target levels were reached, nor was the inflation corridor respected.

Figure 1: Partocracy sector vs. market sector



As far as the policy tools are concerned, good example is monetary policy treatment of capital inflow in the period of massive privatization. Namely, the treatment of privatization proceeds as an export, rather than divestment, triggers increase in money supply, creates artificial inflationary pressure, and leaves space for restrictive monetary policy measures, outcome that unequivocally acts against the real economy. Monetary policy escape from inflation, influenced partly by its own mistakes, led to cost of capital increase and really appreciated RSD. Paradoxically, maintaining FX rate stable through selling currency reserve exactly to the buyers of securities that the NBS had issued to sterilize liquidity surplus, privatization proceeds ended, through banks, out of domestic monetary system. In period 2006-2014, the level of FDI amounted to approximately EUR 13/billion and costs of defending the FX by selling currency reserves were around EUR 8/billion (see Figure 2).

List of vulnerability indicators confirms serious missteps and oversights (see Figure 3). At the top of the list are double macro deficits (current account and budget). The most worrisome indicator is unemployment gravitating around 20%. The youth unemployment (15-24 years) rate that stands at 40% is of particular concern. The employee-to-retiree ratio of 0.9 has an adverse effect on

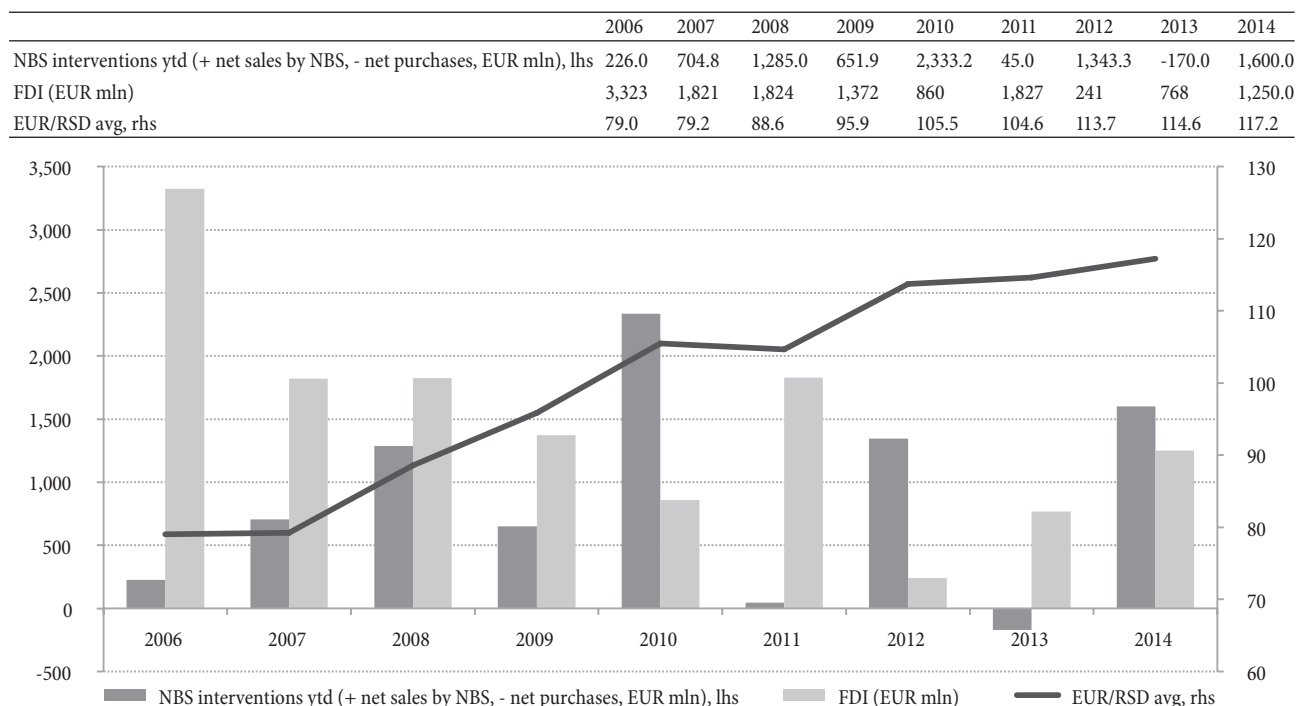
state functioning (pensions and health care, education, science, culture, etc.). The NPL ratio of 22.8% crosses twice the tolerance level. Credit rating is still on the speculative (S&P BB-) and highly speculative level (Fitch B+ and Moody's B1). Export share in GDP (35.3%) stays on the level too low to provide external liquidity of the system (< 50%). As far as the competitiveness is concerned, Serbia is considerably lagging behind near competitors from Central and Eastern Europe.

The legacy of misconceptions and overestimations in current generation tremendously burdens future generations. Economy is import and debt dependent. Output gap causes inflationary pressure, twin deficits (current account and budget), unsustainable employment and related inconveniences like depopulation. Depopulation goes hand in hand with low economic base. As consequence, quest for solution must start from the output gap.

Economic theory and policy rethinking after 2008: New framework for strategizing

Before the *Great Recession* 2008- , there was strong dissonance between economists from early developers and late developers regarding the question: Which institutional arrangement primarily influences development model

Figure 2: Cost of defending FX and level of FDI, 2006-2014



and economic policy platform? Economists from the early developers preferred free market, while economists from the late developers opted for government intervention through industrial policies.

In post-crisis period convergence emerged in opinions. The last crisis was the signal that the model of liberal capitalism was broken. Anti-crisis measures confirmed that the government's intervention providing lifelines to economy was the only way of escaping collapse, even in early developers with high income and well-functioning capital market. Namely, crisis resolution requires proactive government instead of passive one choosing wait-and-see behavior against what the market forces dictate. Previous leads to rejuvenation of industrial policy as a common sense institutional choice.

According to neo-liberal doctrine, the government is not welcome in the economy even when market prices do not reflect general policy tenets like equal opportunities, technology-driven competitiveness, pollution control, etc. Market imperfections, asymmetric information and character of externalities are well-known defects of the invisible hand. Most important defect is ignorance of technological change. In case of technology-driven

competition, market forces exist in vacuum. Namely, high-tech industries tend to be imperfectly competitive. Connected problem is character of knowledge and best practice, more or less as a public good. Market forces are not efficient in public goods spillover. It means that marginal cost of next economic agent acquiring the knowledge is zero, excluding transfer costs. In technology-driven industries industrial policy, instead of market forces, helps in creation of more competitive economy with cost efficient technology, spillover of high value added products, and lower gap between best practice and average competitors.

In post-crisis period, there is major rethinking of orthodox economic wisdom based on market fundamentalism. Additional factor in rethinking is unquestionable success of the countries that did not follow neo-liberal doctrine nor inflation targeting led policy platform, and their growing share in the global economy (BRICS and "next 11", primarily). Previous facts inspired conclusion that core macroeconomic policies (monetary and fiscal) and industrial policies are unavoidable parts of comprehensive economic policy platform called heterodox approach.

Industrial policies have been used to correct market failures as well as previous government failures. They are

Figure 3: Vulnerability indicators, 2014f

Indicators	Value	Reference point	Type of vulnerability
Transitional output gap	28%	0%	OPERATIONAL
Okun index	19.7%	<12%	
Macro deficits			
Current account	6.1%	<5%	
Budget (off budget items excluded)	4.8%	<3%	
Employee to retiree	0.9	>2	
Youth unemployment	41.7%	<20%	
Indebtedness			FINANCIAL
Public debt/GDP	68.8%	<45%	
Foreign debt/GDP	79.1%	<90%	
Foreign debt/Export	184.2%	<220%	
NPL ratio	23.0%	<10%	
Credit rating			
S&P	BB-/stable	investment ranking > BB+	
Fitch	B+/stable	investment ranking > BB+	
Moody's	B1	investment ranking > Ba1	
Export (goods)/GDP	33.7%	>50%	COMPETITIVENESS
Currency change yoy			
Nominal depreciation	5.5%	<5%	
Real depreciation	3.6%	<0%	
Global competitiveness index	94th of 144	65-SEE average	
Corruption perception index	78th of 175	59-SEE average	
Ease of doing business	91st of 189	60-SEE average	
Economic freedom index	90th of 178	62-SEE average	

Source: NBS database & authors' own calculations

not just about manufacturing. Support to technological change and support of infant industries (export expansion and import substitution) are also critical tenets in agri-food and service industries (ICT, finance and life science). Competitive exchange rate policy and infrastructure development are typical examples of sector neutral (or horizontal) policy. But, these policies are mistakenly presented as “neutral”, even though related decisions always involve some value judgments of policy makers. As recently *J. Stiglitz* pointed out, “the question is not whether any government should engage in industrial policies, but how to do it right?” [14, p. 9].

But, there are some problems with government intervention in an economy, notably institutional overhang, rent-seeking mindset, corruption, uncontrolled indebtedness, etc. Critics of conventional industrial policies argued subsidies to some industries, sectors and even companies as a main distortion in shaping the structure of the economy. Indirect subsidies, as sector neutral measures, regularly involve overvaluation of FX rate or suppressing interest rate for high priority sectors. To reduce the burden of indirect subsidies, government sometimes resorts to administrative measures, granting companies in some industries (high priority infant industries from strategic perspective or important for national security) monopolistic position and/or introduces price control for basic inputs connected with them. By doing so, government actually introduces further distortions in price structure causing shortages in commodities and foreign currency or crowding out of other companies from debt financing.

According to the new structural economics, two main choices lie ahead of late developers trying to perform industrial policy as a part of the quest for higher and sustainable growth [9, pp.162-163]. First, a focus on sectors with tradable goods and services that have been nurturing economic growth (for about 20 years) in countries with similar endowment and of at least twice as high *per capita* income. The logic that stands behind that reasoning is that late developer has the opportunity to produce these goods and services with lower costs by using comparative advantage. But, breakthroughs in economic development are not possible by making improvements in already familiar fields but “by traversing empirically

infrequent distances” [7, p. 7]. In knowledge-intensive technologically advanced and fast-moving industries there is no chance to make a breakthrough from periphery to the core by producing goods and services that are close to those currently produced. It leads to the second option for late developer to take considerable strategic risk to jump into non-mature, emerging industries to be able to compete with early developers, this time, on competitive advantage base. Competitiveness improvement of ICT sector in China is good example.

Repetitive imitation in the first solution hides the danger for the economy of falling into so-called “middle income trap”. Industrial policy is not only the way of energizing the growth, industrialization of the economy and modernization of the society, but also an antidote to drugginess in catching up the leaders in competitiveness after the late developer country reaches middle income status. Technology and capabilities failure, rather than market failures, are the main causes of middle income trap. As a consequence, industrial policy is a way to move from trade-based to technology-based specialization. According to [11], the strategy to build technological breakthrough in the middle-income countries includes three following stages. First, assimilation of the state of the art technology by using licensing, technology transfer, FDI, etc. Second, co-development of leading edge technology through PPP. Third, “leap frogging” to emerging technologies which involve PPP in R&D.

History reveals that late developers usually start their industrialization in the assembly or production segment of the value chain in labor-intensive industries. Namely, policy makers neglected the possibility (and necessity) of wide government support in education, R&D and infrastructure development (digitalization, for example). But, industrial policy based on import of technology for tradable sectors does not lead to sustainable balance of payment. Import of technology and financing of that import cause deficits in both current account and capital account. Development of own technology in sectors reaching technological frontiers leads to surpluses and balance of payment sustainability.

No doubt, for late developers industrial policy can play critical role in creation of competitive advantage through development of strategically important sectors

and industries based on complex technologies and ICT driven transformation. The new structural economics tends to emphasize “winners picking themselves” principle through experimentation and positive reinforcement. So-called “technological platforms” are the essence of the new approach.

According to [14, pp. 7-8], industrial policies can have three focuses on: a. particular sectors (sector specific or vertical industrial policies), b. the economy as a whole (non-discriminatory, neutral or horizontal industrial policies), and c. future opportunities (e.g. creation of new strategically important industries).

The effectuation of industrial policy depends largely on tenets and measures that must be in harmony with current level of development. Vertical policies are most suitable for late developers. Horizontal policies that provide better conditions for all sectors in the economy come with higher income level. Namely, as capacity of the private sector improves, the government gains the opportunity to shift to sector neutral approach which supports overall competitiveness improvement. The last type of policies, usually, appears as the last stage of government interventionism. Economies that wish to go through structural adjustment have to implement industrial policies in coordination with compatible macro management measures and follow lead-edge technologies for priority sectors.

According to [13, p. 348], structural adjustments depend on three main externalities. First, the coordination externalities in combined institutional choices of market and government interventionism (invisible hand of the market and the visible hand of the state). Second, innovation externalities in creation of technological breakthrough and utilization of its results (spillover of innovation and product diversification). Finally, institutional externalities influenced by the quality of institutional settings. As far as coordination is concerned, in early stages of development the benefits of visible hand of the government exceed the costs of its action but it is expected to decline in influence as the rhythm of development starts to accelerate. Things are different when it comes to innovation externalities. Namely, as the economy grows at higher rates and approaches technological frontier, the role of government

as a risk taker in technological development remains critical. Particularly, the government stays important player in providing support to technological change until the capacity of private sector improves.

Fostering industrial policy assumes numerous institutional advances. The main purpose is providing technical support and filling institutional gaps that hinder policy implementation. These include creation of bodies responsible for reindustrialization (Industrial Development Agency, for example). Providing easier access to finance, as well. Usually, Development Bank facilitated implementation of industrial policy and coordinated distribution of available funds to priority sectors by lower cost of debt, concessional financing, etc. In the case when Development Bank was not providing credits directly, the government used guarantees given to financial institutions that provided credit financing for priority sectors.

Now we stand on the brink of the new wave of ICT transformation. There is general recognition that without close integration of ICT solutions and industrialization (implementation of breakthrough innovations through investment and their spillover across different industries), no economy in the world has been able to close the development gap between themselves and those at the frontier. In this stage ICT becomes an integral part of the product itself in so-called “smart connected products” and, by doing this, ICT has the capacity to unleash a new era of industrialization [11]. The phrase “internet of things” has risen to reflect the growing power of smart connected products in business ecosystem.

Smart connected products will have a broader impact on economic growth than post-crisis innovations (mainly cost leadership innovation and muted innovations across large part of the economy). They have capability to deal with output gap and jobless recovery, and by doing so, to substantially affect the trajectory of the overall economy toward sustainable employment.

The impact of innovations on growth shifts the categorization of innovations to performance-improving, efficiency, and market-creating innovations [1, pp. 62-63]. Performance-improving innovations replace old products with new and better models. They generally create few jobs because they are substitutive by nature. Efficiency

innovations help company make and sell mature, established products to the same customer at lower prices. So-called “low-end disruptions” involve the creation of the new business model. Efficiency innovations play two important roles: they increase productivity, which is essential for maintaining competitiveness, and they free up capital for more productive use. Market-creating innovations transform complicated or costly products so radically that they create a new class of customers or new markets.

The extent of government intervention in economy *via* industrial policies is demarcation line between early developers and late developers. Minimum density of relevant economic agents is prerequisite for multiplicative effect of new investments on output level and sustainability of growth. “Smart” industrial policies are at the center of the rejuvenated wisdom known as the new structural economics. The economic system following the new economic policy platform is known as “managed capitalism” in terms of *R. Rajan* [12]. It is different from free-market capitalism based on neo-liberal doctrine and state capitalism following conventional structural economics.

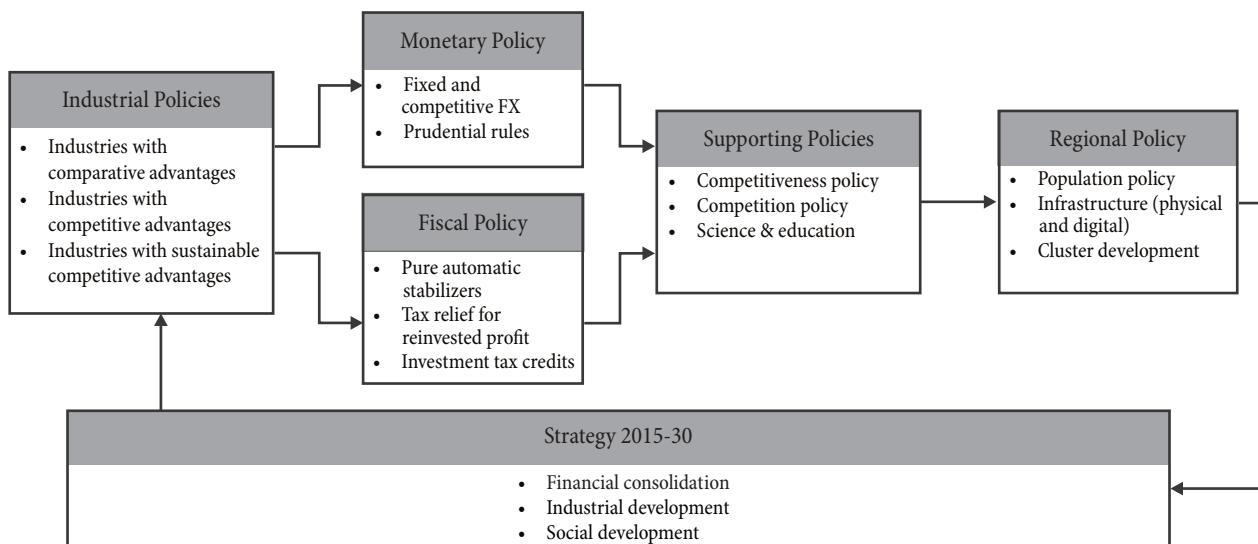
From the very beginning in case of late developers, and recently for early developers, industrial policy is treated as common sense policy choice by mainstream economists and politicians from all sides of ideological spectrum.

In the case of Serbia, industrial policy is relevant platform for economic policy, too. Serbia is a good example that universal efficiency of the market is not common in cases of major macroeconomic distortions like output

gap. In such situation, invisible hand of market unleashed recession, instead of booming prospects. Namely, anti-crisis measures based on market forces did not follow sustainable employment and led to the jobless recovery, at best. Economic growth model in Serbia must respect microeconomic (or business) perspective, while not ignoring macroeconomic one. In corresponding strategy framework, industrial policy supports expansion of tradable sectors. Cost leadership in sectors with comparative advantage and technology development, spillover of innovation and product/service diversification in sectors with competitive advantage are the ways to substitute import and expand export and, by doing that, to eliminate liquidity problem due to double macro deficits. In the new context the government could not escape responsibility in choosing priority sectors and defining adequate policy measures.

Given the aforementioned, comprehensive framework for economic policies has to be based on three pillars (see Figure 4). First pillar refers to industrial policies. In defining list of priority sectors focus must be shifted from services to infrastructure and real economy both in state and private sector. Industrial policies are sector based and are dedicated toward tradable sectors. Tradable sectors are sectors with comparative advantages, competitive advantages, and sustainable competitive advantages. Second pillar represents macroeconomic policies (monetary and fiscal). Macroeconomic policies lubricate industrial policies and operate on automatic stabilizers basis. In monetary policy, for example, fixed and competitive (real or slowly

Figure 4: Heterodox economic policy framework



depreciated) FX rate is automatic stabilizer. Within tax policy, treatment of investment income like ordinary income could be automatic stabilizer. Lower tax rate on reinvested profit could be also fiscal automatic stabilizer. Competitiveness policy, competition policy and science and education constitute the third pillar of supporting policies. Regional policy is fourth pillar. Strategy of economic growth and social development acts as framework for all pillars of economic policy.

Serbia 2015-30: Thinking through strategy

Sometimes “strategy” is a confusing notion. At its core, it is choosing to do some things and not to do other things. Sometimes strategy can seem mystical and mysterious, unknowable and unexplainable in advance but obvious in retrospect [6, p. 3]. A key part of strategy is to do something that is inimitable. Achieving extraordinary results by doing ordinary things is not logical.

Strategy is a set of choices about winning. If you do not try to win, somebody else inevitably will. If somebody else is winning, the results of your actions will not be sustainable. You will not aspire to play. You will aspire to win. That is strategy. Great organizations, whether state, company, political party, whatever you do, choose playing to win instead playing to play.

To be effective, national strategy of economic growth and social development must be rooted in a desire to meet people’s needs for prosperity in a way that creates value for both the state and citizens. To survive and prosper Serbia must be: a decent place to leave, a decent place to work, and a decent place to invest.

The strategy playbook can guide strategic thinking. Creation of strategy is a holistic process. To think strategically means making the choices. It is thought provoking process, which acts as catalyst in making choices for controlling events instead of allowing events to control the choices. Namely, strategy formulation is methodology for thinking through choices.

Strategy is a coordinated and integrated set of choices that uniquely positions the organization in its environment to create sustainable advantage and superior value relative to the competition. Following the idea of

A. Lafley & R. Martin [8, pp. 14-30], national strategy for economic growth could be the answer to the following five interrelated questions:

1. What is winning aspiration?
2. Where to play, and where not to play?
3. How to win?
4. What capabilities must be in place?
5. Do macro management system and key macroeconomic and vulnerability indicators support previous strategic choices?

It is a reinforcing cascade, with the choices at the top of the cascade setting the context for the choices below, and the choices at the bottom influencing and refining the choices above. For a national economy, there are multiple levels of choices and interconnected cascades. Strategy on each level articulates the strategic choices. Each strategy influences and is influenced by the choices above and below it. For instance, state level where to play choices guide complementary choices at the regional level, which in turn affect city (or municipality) level choices. The result is a set of nested cascades that cover the full national economy (see Figure 5).

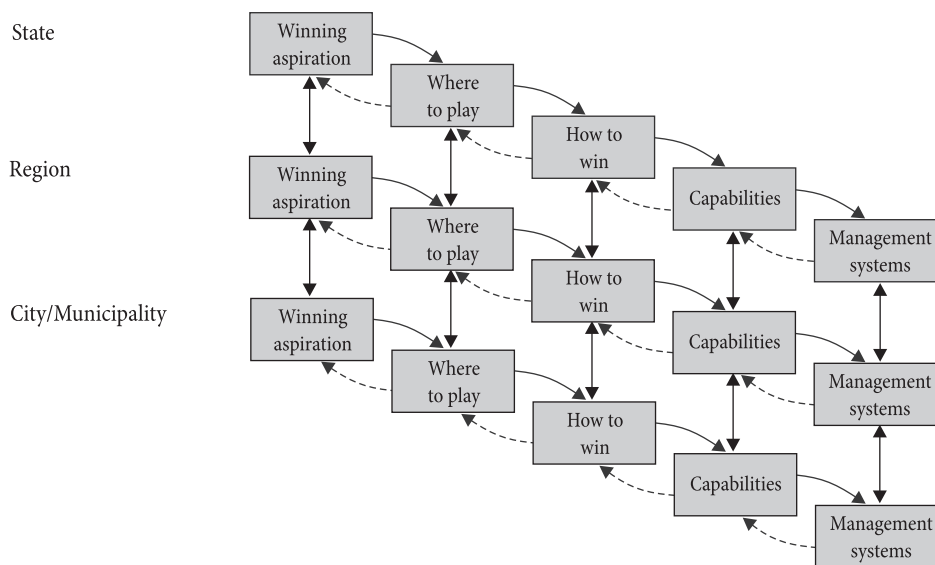
A government must understand existing core capabilities (connected with comparative and competitive advantages) of national economy and consider them when deciding where to play and how to win. However, it may need to generate and invest in new core capabilities to support important, forward-looking strategic choices (sustainable competitive advantage) considering dynamic feedback loop between them.

A/ Winning aspirations

The first question from cascade (What is our winning aspiration?), sets the framework for the following choices. Aspirations exist to align policy measures consistently, so they must be design to last for some time. They should not change day to day.

Winning aspiration defines the purpose of economy, its guiding mission, and aspiration, in strategic terms. To play merely to participate is self-defeating. It is recipe for mediocrity. Winning is what matters, and it is criterion for success. A too-modest aspiration is far more dangerous than too-lofty one.

Figure 5: Nested choice cascade inspired by [8, p. 16]



Aspirations are statements about desirable future. The abstract concept of winning is translating into aspirations. National economy, in general, and tradable sectors in particular, tie to those aspirations some specific benchmarks that measure progress toward them.

For each national economy the winning aspirations mean sustainable employment. In the process of setting the speed of growth and investment intensity, strategists must respect so-called “3+ & 40+” principle. Namely, CAGR > 3%, and ratio Investment/GDP > 40%.

A national economy must seek to win in tradable sector and, notably, through industrial policies for high priority industries. Clarity about the winning aspirations means that actions and measures in industrial policies for priority sectors are directed towards pro-export and anti-import ideal.

To set winning aspirations properly, it is important to understand whom you are playing with, and against. When setting winning aspirations, you must look at all competitors, not just at competitor you know best.

B/ Where to play

The next two questions from cascade are where to play, and how to win. These two choices, which are tightly bound up with one another, form the hard core of the strategy. Winning aspiration implicitly defines the priority sectors of national economy. Where to play and how to win define the specific activities to achieve its aspirations. Choosing where to play explicitly involves choosing where not to play, as well.

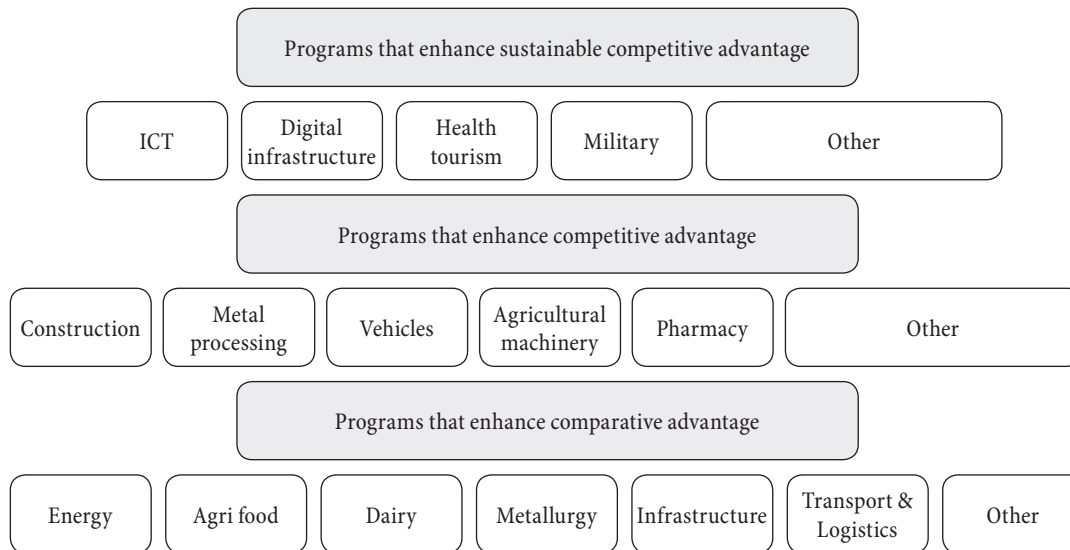
Where to play choice means choosing the segments of tradable sector for implementation of industrial policies and corresponding markets. Figure 6 shows landscape of tradable sector presented in [4, p. 247] for industrial policies enhancing comparative advantage, competitive advantage and sustainable competitive advantage.

As far as market is concerned, there are two broad choices: expand into domestic market when anti-import goals dominate in strategy formulation, and expand into foreign markets when export goals dominate strategy formulation. For the second choice, there are three options. First, growth in core business with the focus on existing international core consumer segments, channels, and geographies. Second, higher penetration in fast growing emerging markets with demographic dividend. Third, to build position of niche player through diversification in structurally attractive market segments.

Tradable sector may compete in any number of demographic segments and geographies (local, national, global, early developer, late developer, fast growing, etc.). It can compete in a myriad of services, product lines and categories. It can participate in different channels (direct to consumer, on-line, mass merchandise, grocery, department store). It can participate in the upstream part of its industry, downstream, or can be vertically integrated.

According to [8, pp. 61-65], there are three dangerous temptations in connection with this choice. First, failing to choose. Attempting to form competitive champions in

Figure 6: Tradable sector landscape in Serbia



every industry of tradable sector at once is wrong. Focus is critical. Second, trying to play your way in an unattractive field. Third, accepting a current choice as inevitable or unchangeable. It is not easy to change playing fields, but it is doable and can make all the difference. Avoiding previous pitfalls requires deep understanding of the competitive landscape, leading trends, and core capabilities.

C/ How to win

Where to play is half of the strategy. The second half is how to win. Where to play selects playing field. How to win defines the choices for winning on that playing field. It is formula for success.

To determine how to win, priority industry from tradable sector must determine what will enable it to create unique value and sustainably deliver that value to customers. It is the specific way a priority industry utilizes its advantages to create superior value for consumer and, by doing so, superior returns to owners.

Winning means providing better consumer and customer value proposition than competitors do. In addition, it means providing it on a sustainable basis. There are just two generic ways of doing so: cost leadership and differentiation.

In cost leadership strategy, value is driven by having a lower cost structure than competitors do. Competitor reaching cost leadership position does not necessarily charge the lowest prices. Low cost players have the option

to reinvest the margin differential in ways that create sustainable competitive advantage.

The alternative to cost leadership is differentiation. In great strategy, the priority industry offers products or services that are perceived to be distinctively more valuable to customers than are competitive offerings and is able to do so with approximately same cost structure competitors have. In this strategy, different offerings have different consumer value proposition and different prices associated with them.

Differentiation advantage means that when a competitor wants to gain market share, it can cut its prices without destroying profitability, and its competition will not have the resources to respond. Alternatively, it can invest some of the premium to add new, desirable feature to products. In doing so, it can actually reinforce its differentiation advantage.

In some cases, priority industry can employ both generic strategies at the same time, driving a significant price premium over competitors and producing at lower cost than those same competitors. This dual strategy approach is rare, but it is possible if industry in question has overwhelming share advantage and substantial scale-sensitive costs. In the last decade, the strategy winner-takes-all has gained credibility. The notion is that the industry in question finds the killer way to compete and generates such scale that the player can continue to press its advantage until it takes the entire market.

Where to play and how to win choices do not function independently. The two choices should reinforce one another to create a distinctive combination. If, after lots of searching, one cannot create a credible how-to-win choice, he should find a new playing field or get out the industry from priority list.

Tenets of fiscal policy complementary with how to win choice in tradable sectors includes: a. expansion of public investment in tradable sectors in order to reach balance of payments and budget robustness, b. encouragement of private investments in missing gaps in tradable sectors value chains, c. innovation capacity increase through PPP in ICT and digital infrastructure.

For any industry from priority list, there is almost an infinite amount of data that could be crunched, a wide area of strategic tools that might be brought to bear on the problem, and many possible strategic choices that could be selected. Sometimes it could be overwhelming, even paralyzing. The bad news is that there is no simple algorithm for choice. The good news is that there is a framework for thinking (see Figure 7).

Ultimately, there are four critical dimensions in choosing where to play and how to win: industry, customers, relative position, and competitor’s reaction. These four dimensions can be understood through the framework we call the “strategy logic flow”. This process ends with the formulation of the strategy for the current context (“as is” strategy). Strategy logic flow starts with strategic attractiveness of the industry in question and its existing

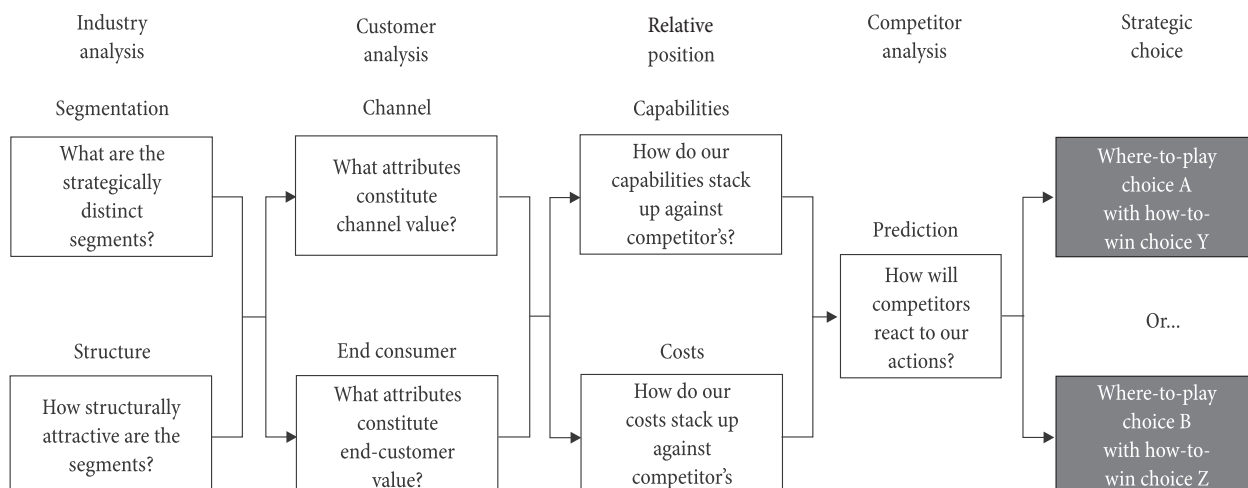
market segments. Strategic attractiveness is measured by average profitability (EBIT margin, for example) and probability of default (z-score, for example). Analysis continues with customer side along with distribution channels and end consumers. Afterwards, focus is shifted towards internal aspects of tradable sector under question (capabilities and relative cost position). The last step, before formulation of feasible strategy options, is anticipation of competitors’ reaction. The “as is” strategy formulation requires at least two alternatives with precise core elements (where to play, and how to win).

It is shown that the logic flow starts from the existing context and picks the best solution from the scope of strategies that adequately fit the current context organization is operating within.

However, there is parallel path in thinking through strategy, the reverse order. Ever changing and dynamic context requires proactive thinking, meaning ability to foresee possible changes in the environment and adapt proposed solution to it. Reverse order in strategy formulation might be even more suitable. It assumes formulation of a “to-be” strategy based of future trends as well as inflection points.

When the “as is” or “to be” strategy are determined, capabilities and management system are adopted to fit it (see Figure 8). Capabilities and management system are examined to determine whether they support selected solution. Alternatively, eventual constraints in terms of capabilities and systems provide reshaping of the initial solution to come to the final one.

Figure 7: Strategy logic flow according to [8, p. 161]



D/ Core capabilities

The capability choice relates to the range and quality of activities that will enable a tradable sector to win where it chooses to play.

Identifying the capabilities required to deliver on the where to play and how to win choices crystalizes the area for investment. It enables an industry to continue to invest in its current capabilities, to build up others, and to reduce the investment in capabilities that are not essential to the strategy.

The range of capabilities is broad and diverse. Nevertheless, only a few capabilities are fundamental to winning in the places and manner that are chosen: consumer understanding, innovation, go-to-market ability, and sale crediting.

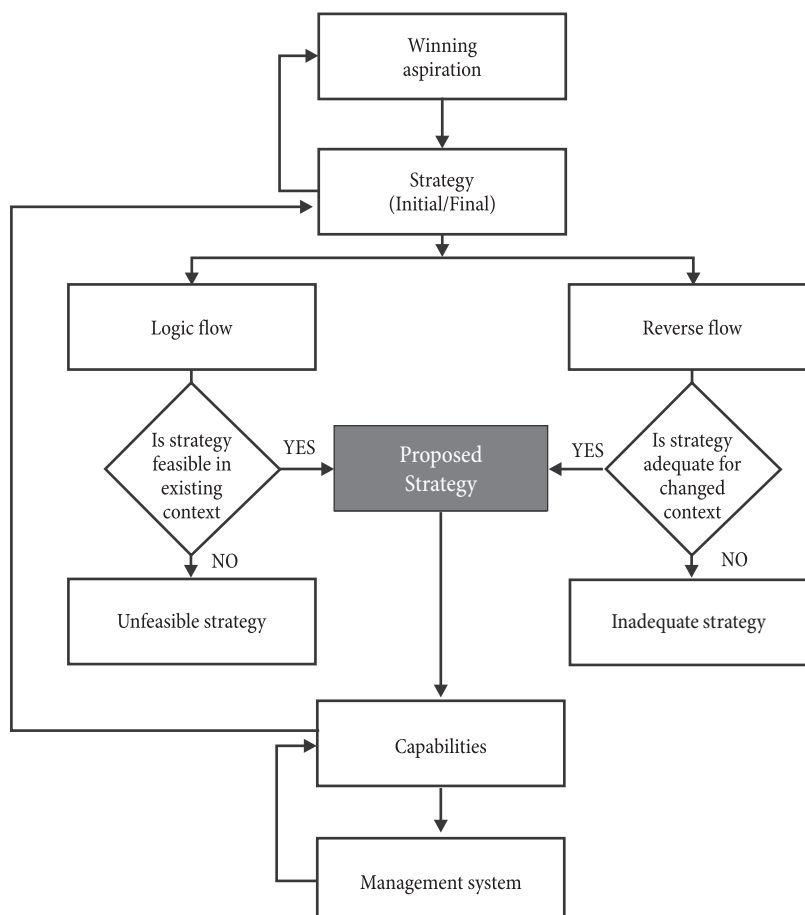
Capabilities are the map of activities and competencies that critically underpin specifics of strategy. An integrated and mutually reinforcing set of capabilities that underpin the where to play and how to win choices must be feasible, distinctive, and defensible.

E/ Management system

The final choice in the strategic cascade focuses on management system. It is a key piece of the strategy puzzle. It fosters, supports, and measures the effects of strategy. It is an old saying that what gets measured gets done. There is more than a little truth to this. If aspirations are to be achieved, capabilities developed, and management systems created, progress needs to be measured. Measurement provides focus and feedback.

The last box in the strategic choice cascade is the most neglected one. Often, government formulates national strategy of economic development and then broadcasts the main subjects to the rest of the economy. Strategy can fail spectacularly if you fail to establish management systems that support those choices and capabilities. Without supporting structures, systems, and measures, a strategy remains a wish list, a set of goals that may or may not ever be achieved. To truly win in the global marketplace for creating, reviewing, and communicating about strategy, it requires structures to supports its core capabilities and

Figure 8: “As is” strategy and “to be” strategy



it requires specific measures to ensure that the strategy is working.

Every industry from priority list needs systems to formulate, refine, and clearly communicate the essentials of its strategy. It requires systems to measure attainment of its goals. In addition, it requires systems to support and invest in its core capabilities.

Due to strong involvement of government in implementation of industrial policies, state budget must be in line with EU anti-crisis governance model, namely, new surveillance systems for budgetary and economic policies. The new EU's rules introduced through the *Six Pack* [5] in December 2011 and the *Two Pack* [6] in May 2013. The previous regulations respect the following rules:

- a. Headline deficit (3% of GDP) and debt limit (60% of GDP)
- b. Focus on debt (reduction of 5% on average over three years in case that debt is above 60% of GDP)
- c. Public costs benchmark (public spending must not rise faster than medium-term growth)
- d. Stricter budgetary objectives (introduction of safety margin against breaching the 3% headline limit in case when public debt is over 60% of GDP)
- e. Strict structural deficit (0.5% limit, in exceptional circumstances 1% of GDP)
- f. Budget resilience (extra time for correction of deficit in case when budget deficit is more than 3% of GDP)

Policy toward hard budget constraints and corresponding indicators should be respectable on all levels of governance (state, region, and city/municipality).

Conclusion

Serbia's economy is permanently under the threat of insolvency, primarily due to low economic base. In the last period, new challenges are geopolitical spillover on economy and deglobalization. They have strong impact on capital and trade flows. From Serbia's perspective, it leads to the fundamental question: How to transform the economy from import and debt dependent to balanced and sustainable in the new context? In looking for strategic flexibility of the economic system, we must start with

rethinking conventional development model and related policy platform. It is a question of new strategy of economic growth and social development.

Complex and interrelated problems require systematic approach. To do that, Serbia, first of all, must return to itself. Serbia must reshape the growth model and economic policy platform and discover new transmission mechanisms to energize investments and, by doing this, expand economic base. The new strategy could solve the crisis of investor's confidence, enabling the creation of level playing field compatible with industrial economy growth model. Such strategy is unavoidable if Serbia intends to be a part of the EU club. Serbia will be compatible with the EU only if it significantly expands the output by using its comparative and competitive advantages, if it creates stable currency and financial system, and develops an investment-friendly environment. Previous preconditions are critical for social development because economy is foundation of a society.

For strategist the current times with shifting balance of power, radical technological changes and various security threats, seem to be more challenging than ever. The new context calls for the government to be visionary, proactive, and not afraid to step outside the comfort zone. Strategy can help to win, but it is not a guarantee for that. Strategy can shorten odds considerably. To be responsive to challenges, the government must be responsible. Invisible hand of the market should not be alibi for inert government anymore.

Starting point must be to consider what legacy of previous strategy and macro management we leave behind. Serbia desperately needs breakthrough in thinking. In thinking through strategy, the government should be striving for sustainability in all relevant aspects of its responsibilities (confident state, social cohesion, and viability of economic system). Sustainability should be long-term vision. It means that country intends to operate with the respect for both current and future generations, and economy with respect for not only macroeconomic, but also, and, predominantly, microeconomic (or business) perspective.

Certain hard choices are components of new strategy. Government must decide to take decisive measures and

step out of the comfort zone of soft budget constraints and financing consequences of previous mistakes by raising debt. In doing this, austerity is inescapable. Nevertheless, it is not the only solution. Restructuring of public sector and infrastructure development (including digitalization) are absolute must.

New strategy in ambiguous times and with legacy of past misconceptions and overestimations requires contextual skills and constructive mindset in searching for solutions with international stakeholders (from the EU to the WB/IMF). At home, we need to reinvent ourselves, so as to follow changes in theory and competitive arena.

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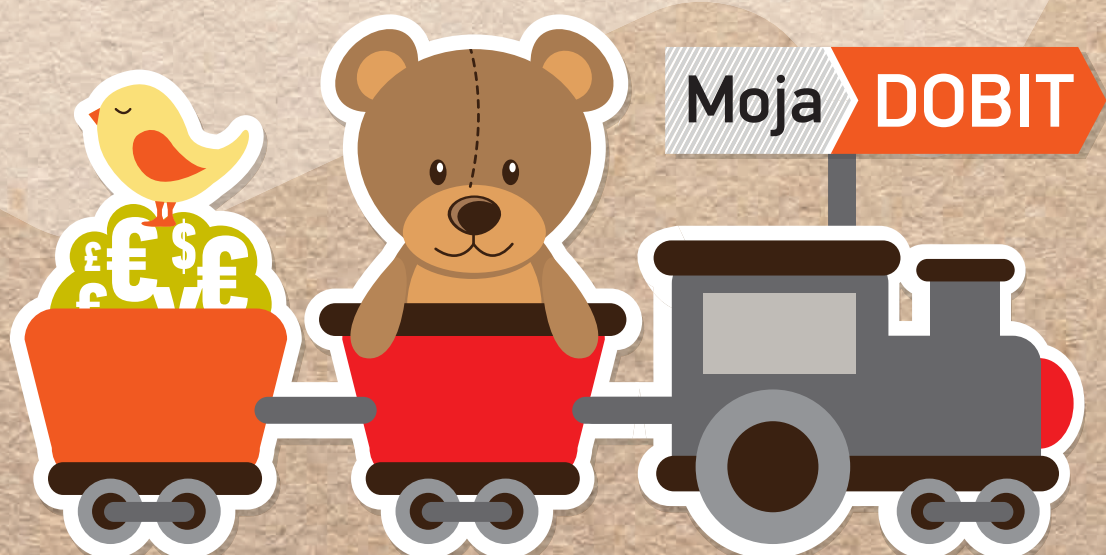
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POLICY MIX FOR FISCAL CONSOLIDATION IN SERBIA: CONDITIONAL FORECAST APPROACH*

Povezivanje ekonomskih politika radi fiskalne konsolidacije u Srbiji – ocena mera na osnovu uslovnih prognoza

Abstract

The Serbian Parliament has adopted the fiscal consolidation program recognizing an exponentially rising public debt as a real threat to the economy that must be contained in order to avoid sovereign default. Despite the legacy of unfavorable macroeconomic development due to last-year's flood, a challenging expenditure cuts approach was adopted. It will keep domestic demand at depressed levels for some time even if austerity measures are not front-loaded but phased-out over three years. The reverse of the debt trend is projected for 2017, when the debt-to-GDP ratio will reach 80 percent.

We use in this paper QUEST_SERBIA DSGE model to assess what would happen to the Serbian economy if the policy maker consistently implemented the policy package. Results are compared with model-based estimates of what would happen if the policy maker did nothing at all. The differences between these experiments are considered as net effects of the fiscal consolidation package. Assessment of the spontaneous development is based on an unconditional forecast from the model, while controlled development is based on a conditional forecast.

The social costs of fiscal consolidation will be significant if the fiscal policy is not supported by an adequate mix of monetary and foreign exchange policies. Among alternative scenarios we had designed, a delay in monetary easing was the worst case. A timely easing of the monetary policy followed by a relatively stable real exchange rate shows the best simulation results.

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Fiscal consolidation as proposed is a workable policy, which will keep the rising debt-to-GDP ratio at sustainable level, but it is still not sufficient to reverse debt trend in 2017. Perhaps the other structural measures will do this job, but they are beyond the scope of this paper.

Key words: *fiscal consolidation, monetary policy, exchange rate policy, DSGE model, conditional and unconditional forecast, Serbian economy*

Sažetak

Parlament Srbije usvojio je program fiskalne konsolidacije i ocenio da je rastući javni dug realni izazov za srpsku ekonomiju, koja bi u budućnosti mogla da doživi slom ako se odmah ne preduzmu odgovarajuće mere. Iako okolnosti u privredi nisu povoljne nakon prošlogodišnje poplave, usvojen program mera zasniva se na zahtevnom principu smanjenja javnih izdataka. To će značajno smanjiti domaću tražnju iako su efekti mera ravnomerno raspoređeni na tri godine. Zaokret u trendu rastućeg duga predviđen je tek za kraj 2017. godine kada će dug dostići 80 odsto BDP.

U ovom radu mi smo koristili QUEST_SERBIA DSGE model da bi ocenili efekte primene mera fiskalne politike pod pretpostavkom da će se one dosledno sprovoditi tokom celog perioda konsolidacije. Te efekte smo uporedili sa spontanom razvojem ekonomije bez navedenih mera. Razliku u efektima tumačimo kao neto rezultat primene paketa fiskalne konsolidacije. Ocena spontanog razvoja je zasnovana na bezuslovnim prognozama u okviru našeg modela, dok je kontrolisani razvoj ocenjen postupkom modeliranja uslovnih prognoza.

Društveni troškovi fiskalne konsolidacije ne bi morali da budu preterano visoki ako bi fiskalna politika bila podržana sa odgovarajućom

monetarnom politikom i politikom kursa. U okviru razmatranih scenarija takve koordinacije, odugovlačenje sa monetarnim popuštanjem daje najslabije rezultate. Rezultati su mnogo bolji ako se blagovremeno popuštanje monetarne politike poveže sa politikom održavanja relativno stabilnog realnog kursa dinara.

Fiskalna konsolidacija je izvodljiva i može da kontroliše rast duga u odnosu na GDP, ali je malo verovatno da će okrenuti njegov rastući trend u 2017. godini. Za to su potrebne druge strukturne mere, čije razmatranje izlazi izvan okvira ovog rada.

Ključne reči: *fiskalna konsolidacija, monetarna politika, politika deviznog kursa, DSGE model, uslovne i безусловne prognoze, srpska ekonomija*

JEL CLASSIFICATION: E17, F47

Introduction

The design of a fiscal consolidation programme was a subject for discussion at last year's Kopaonik Business Forum, see *Labus* [8], *Petrović* and *Brčerević* [11]. This year, it is actually at hand, since the Serbian parliament has adopted such a programme within the fiscal framework for the budget for 2015 year. There are no more uncertainties with respect to the Serbian government's policy stance. An exponentially rising debt-to-GDP ratio is recognized as a real threat to the Serbian economy, which must be contained in order to avoid sovereign default in the near future. For that reason an expenditure cuts approach was adopted that would keep domestic demand at depressed levels for some time. Austerity measures are not front-loaded but are phased-out over the mid-term period of three years. The reverse of the debt trend is projected for the end of 2017, when the debt-to-GDP ratio will reach 80 percent.

Serbia is about to complete a precautionary stand-by arrangement with the IMF (SBA), which will be anchored by the fiscal consolidation programme. Monetary and exchange rate policies will continue to rely on the inflation targeting framework, but fiscal adjustment is expected to create room for a gradual rebalancing of the policy mix towards monetary easing, *IMF* [5]. The intended switch of fiscal and monetary policies is unprecedented in recent history and draws therefore a considerable public and professional attention. We address in this paper two key issues: whether the fiscal consolidation programme

can stabilize the public debt, and how monetary and exchange rate policies can mitigate social costs of the fiscal consolidation.

It is always a serious professional challenge to assess the potential impacts of any economic policy measures. We live in a changing and uncertain world, which also might be responsible for missing targets. However, some risks can be modelled and predicted. DSGE models serve this purpose. We use in this paper the QUEST_SERBIA model – a DSGE model of the Serbian economy – in order to assess the impacts of the fiscal consolidation package. Our main goal is to perform a model-based counterfactual experiment of what would happen to the Serbian economy if the policy maker consistently implements the policy package. Results will be compared with our estimates of what would happen to the same economy if the policy maker did nothing at all. We consider the differences between these two experiments as the net effect of the fiscal consolidation package. Technically speaking, assessment of the spontaneous development is based on an unconditional forecast from our DSGE model, while controlled development is based on a conditional forecast.

The paper is structured in the following way. We demonstrated the model's accuracy of doing one-step-ahead forecast in the first part of the paper, since we already described the model elsewhere. Our (unconditional) forecast of main macro variables for the next three years is presented in the second part. Technical details how a conditional forecast is done in a DSGE framework are elaborated in the third part. We present and discuss the counterfactual experiment, which embodies key measures of the fiscal consolidation package, in the fourth part. This is the central part of the paper. The fifth part addresses monetary easing and its potential contribution to moderate social costs of the adjustment. Finally, we briefly conclude in the last part, and indicate what the principal risks and challenges are associated with the fiscal consolidation package.

In-sample forecast

We have developed a DSGE model of the Serbian Economy that is called QUEST_SERBIA. It is based on the European Commission's QUEST III model that has been used for

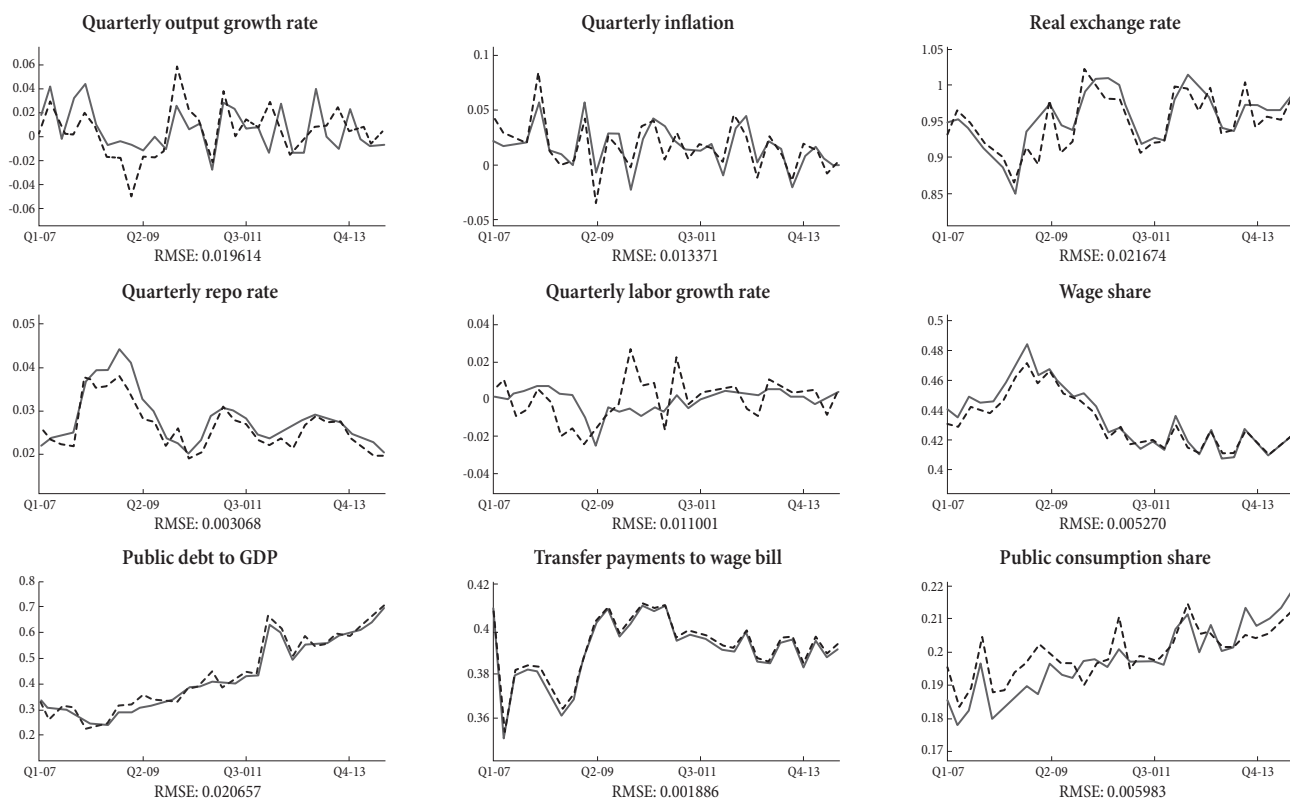
some time for macroeconomic policy analysis and research. As a member of the class of New-Keynesian Dynamic Stochastic General Equilibrium (DSGE) models, QUEST III has rigorous microeconomic foundations derived from utility and profit optimization and includes frictions in goods, labor and capital markets. *Ratto et al.* (2009) provide a detailed exposition of the core version of the QUEST III model applying it for the euro area data and using Bayesian techniques to estimate parameters. This model encompasses three regions: a small open economy in the European Monetary Union (EMU), the other euro area, and the rest of the world. The main property of such a DSGE model is that households, firms and governments make rational decisions based on first-order conditions, derived from their behavioral equations, subject to intertemporal budget constraints.

QUEST_SERBIA follows this line of modelling with some substantial differences. In our model there are two regions: the domestic economy and the foreign economy where the euro zone is treated as the rest of the world. The differences are due to the distinct properties of the Serbian economy compared to the EU area. The Serbian economy

is a small open market economy, which is imperfectly integrated into the wider international market. Contrary to this, the EU economy is a large open economy with full mobility of capital, goods and financial assets. Differences in size and adjustment costs due to imperfect international integration must be taken into account in defining the steady-state properties of the Serbian economy.

In Serbia there is no full mobility of financial capital across the border lines, and households that save income and invest it in domestic and foreign bonds face no pressure to adjust their intertemporal preferences. The real interest rate in Serbia is permanently above the EU real interest rate. Additionally, the real interest rate convergence cannot be detected over past ten years. It means, in terms of the model, that the rate of time preference in Serbia is permanently lower than in the EU. In terms of utility, domestic households value present income over future income far more than their counterparts in the EU. QUEST III assumes that in the steady state, domestic and foreign rates of time preference are equal. We cannot do this since there is a permanent gap between domestic and foreign rates of time preference.

Figure 1: Original and in-sample one-step-ahead mean forecast



Note: Solid lines show historic data, dotted lines represent forecast

There is also no perfect mobility of goods across the border lines. Due to transaction costs, domestic inflation is permanently higher than the foreign inflation. In the steady state these differences are doomed to vanish if purchasing power parity holds. However, it does not hold in Serbia and QUEST_SERBIA had to respect this fact. Therefore, even in the steady-state the rate of inflation in Serbia is higher than in the EU. QUEST III, on the other side, assumes zero difference between domestic and foreign inflation rates.

QUEST III restricts the trade balance to zero in the long run. Quite the opposite, it is hard to expect that the Serbian economy will balance exports and imports over next ten years. The steady state value of the trade balance will be negative. Therefore, we need to assume a negative trade balance steady state level. The only doubt is how much it will be negative.

The Serbian economy is a small economy bound to grow much faster than large mature economies in the world, including the EU zone. There is no doubt that we need somehow to model the convergence process in which the steady state GDP rate of growth in Serbia must be higher than the GDP steady state rate of growth of the euro zone. The Serbian economy is currently in recession, which might veil this fundamental relation, but in the longer run the Serbian economy will resume a faster pace of growth compared to the EU economy.

Our steady state values for these fundamental differences are as follows. The rate of time preference is set at 0.989817, the convergence factor at 1.33, quarterly inflation difference is 0.0186, and the trade deficit is set at 15 percent of GDP.

Finally, the QUEST III model's equations are revised in order to capture specifics of the Serbian economy related to public debt management. The QUEST III assumes that the European authority sets a target level of the public debt and adjusts the fiscal revenue to achieve this policy goal. Things are different in Serbia. Despite the fact that the target level of public debt is set by law, it is not in practice a binding constraint for economic policy¹. Instead, the Serbian government commits itself to a certain level of the public debt and consequently restricts public expenditures. The

primary fiscal deficit has not to adjust to a target level of the public debt, as it is the case in the QUEST III framework, but quite the opposite, it is the main driving force of the public debt in Serbia and a key variable in the QUEST_SERBIA model. The level of public debt is a concern, but is assumed that the government can borrow as much as needed to meet a committed level of the public debt.

The data set for the Serbian economy was recently revised in line with the newly released European System of Accounts methodology for compiling national accounts, Eurostat and European Commission [3]. The new ESA 2010 is a major development of the previous version of 1995. It was released in 2013, and adopted rather quickly by the Statistical Office of Serbia. The Statistical Office of Serbia released on November 28, 2014 the latest update of quarterly data set for Serbia's GDP. GDP series – by final demand components and by sectors of value-added origin – were re-estimated for the period from Q1Y2003 to Q3Y2014 according to the new standards. The new methodology adjusted upward GDP for an average of 5.8%. This new data set forms the empirical background for the current version of QUEST_SERBIA model. We use 47 quarterly data points and estimated the model for the period between Q1Y2003 and Q3Y2014. All details about calibrated parameters, Bayesian estimation, steady states and the set of behavioral equations can be found in *Labus* [9].

Our approach for testing the fiscal consolidation package of the Serbian government depends on forecasting. For that reason, we reveal the model's accuracy of forecasting in Figure 1. Solid lines show historic data of selected macroeconomic variables, while dotted lines represent corresponding in-sample one-step-ahead forecasts. Below each graph the root-mean-squared-error (RMSE) is displayed. The one-step-ahead forecast was more accurate than the four-or-eight-step-ahead forecast. Thus, we rely on the one-step-ahead forecast, and report forecast figures which only take into account uncertainties about parameters. We skip forecasts that additionally integrate uncertainties about shocks, since their graphic presentation is far more complex. The general conclusion is that variables with share value are better forecasted compared to variables that are expressed in terms of growth rates. According to RMSEs, we assess that the model does

1 The debt target is set by law at 40 percent of GDP.

forecasts fairly well, and this fact justifies our decision to use a conditional and unconditional forecast for testing alternative macroeconomic policies.

Unconditional forecast

The QUEST III DSGE model of the European Commission was used to assess the effects of structural fiscal adjustment in the euro area. For example, the impact of a tighter credit policy on the effectiveness of discretionary fiscal policy was studied by *Roeger et al.* [13], while the influence of structural fiscal reforms on the temporary and permanent general-equilibrium effects on external balances in the euro area was addressed by *Vogel* [14]. The applied methodology in both cases relies on impulse response functions (IRF) and implied fiscal multipliers. In this paper we will use the QUEST_SERBIA model, and an alternative method of policy simulation based on a conditional forecast. We will compare the conditional forecast for selected macroeconomic variables with the values of the same variables that can be obtained by an unconditional one-step-ahead forecast.

This method, compared to a traditional IRF/multipliers approach, contains both benefits and risks. On the benefits side, let us note that the economy evolves over time even with no government interventions. For instance, it is possible that public consumption for some periods in the future will be reduced without restrictive fiscal measures, because the government faces financial constraints anyway and has to restrict its purchases. If restrictive fiscal measures are applied - which reduce government purchases of goods and services over the reference period - it is highly recommended to distinguish government policy effects from hands-off policy development. Comparing conditional to unconditional forecasts of the same variables suits that purpose. On the risk side, we need to mention that forecasts are generally highly uncertain, due to unanticipated shocks and model-based biases. The IMF in the last release of World Economic Outlook [6] had to admit that one-year-ahead forecasts for global growth in 2011-14 were, on average, too optimistic, and felt a pressure to elaborate in details what factors contributed to such errors².

2 These forecasts have already been updated every quarter, so the potential size of forecast errors was substantially minimized.

Having said this, we dared to carry on with the baseline unconditional 12-quarter forecast and present in Table 1 the average annual growth rates of key macroeconomic variables. We used MATLAB and Dynare software to calculate the presented figures, *Adjemian et al.* [1]. Forecasted values refer to annualized growth rates. The IMF forecasts a smooth recovery of the Serbian economy over next three years, with annual growth rates of 1, 1.5 and 2 percent respectively³. The government's fiscal strategy for 2015-17, Government of Serbia [4], accepted the IMF's figures for 2016 and 2017, but reduced the growth rate in 2015 to a fall of -0.5 percent. The National Bank of Serbia (NBS) also expects the same drop of GDP growth rate in 2015. The European Bank for Reconstruction and Development (EBRD) revised its earlier prediction of growth in Serbia in 2015 from 2 percent to 0.5 percent⁴. We expect the Serbian economy to stagnate in 2015 – achieving a “zero-negative” growth rate – with a modest growth of 0.8 percent in 2016, and slightly stronger growth in 2017 of 1.6 percent. The IMF forecasts a 1.3 percent growth for the Euro Area in 2015, which is very close to our forecast of 1.2 percent with a low inflation of an average 0.7 percent⁵. Our forecast assumes that the NBS will effectively stick to the inflation targeting policy with a transparent rule of linking the repo policy rate to one-quarter-ahead expected inflation rate⁶, and regularly update size of the repo rate.

Conditional forecast

Making unconditional forecast is very similar to obtaining an IRF, except that the forecast does not begin at a steady state, but at the point corresponding to the last set of observations. We will now briefly explain the process of

3 It is still not clear whether this forecast will remain in place after the IMF adopts the SBA with Serbia in February this year.

4 “Serbia's economic woes are likely to continue this year and we now expect just 0.5 percent growth, rather than the 2 percent predicted last September. The introduction of a new IMF programme in Serbia, expected in the spring, will help restore fiscal discipline and investor confidence but will also be accompanied by front-loaded austerity measures that will keep domestic demand at depressed levels in the short term”, EBRD [2]

5 We did not take into account the latest easing of the ECB monetary policy, which might easily increase GDP growth with a higher inflation rate.

6 Different Taylor rule for conducting monetary policy will affect simulation results. However, this rule is generating lower RMSEs than the one based on four-quarter-ahead expected inflation rate.

Table 1: Unconditional one step ahead mean forecast

Annualized rates	2015	2016	2017
GDP	-0.1%	0.8%	1.6%
Domestic demand	-2.4%	5.3%	4.9%
Consumption	-0.1%	2.3%	2.5%
Public Consumption	-0.7%	2.3%	2.5%
Investment	0.2%	1.8%	0.1%
Public Investment	2.4%	1.8%	3.2%
Export	-1.6%	2.1%	1.4%
Import	1.5%	2.6%	1.4%
Transfers	2.7%	3.9%	3.3%
CPI	3.3%	1.3%	2.6%
Import prices	-1.2%	3.5%	-0.4%
Export prices	3.2%	-1.8%	-0.1%
Exchange rate	-0.4%	0.6%	0.3%
Employment	0.5%	0.1%	0.6%
Real wage rate	-0.7%	1.5%	0.9%
Repo policy rate	7.7%	5.8%	5.1%
EU GDP	1.2%	1.9%	1.7%
EU HICP	0.7%	1.2%	1.3%

computing IRFs, following *Juillard* [7], before moving to conditional forecasts. A DSGE model of rational expectations can be represented in general form by a set of first order and equilibrium conditions:

$$(1) \quad \begin{aligned} E_t \{f(\mathbf{y}_{t+1}, \mathbf{y}_t, \mathbf{y}_{t-1}, \mathbf{u}_t)\} &= \mathbf{0} \\ E(\mathbf{u}_t) &= \mathbf{0} \\ E(\mathbf{u}_t \cdot \mathbf{u}_t') &= \Sigma \mathbf{u} \end{aligned}$$

where E_t is an expectation operator, f are structural equations, \mathbf{y} is a vector of endogenous variables, and \mathbf{u} is a vector of stochastic shocks. The system of equations (1) comprises linear and non-linear first-order difference equations, with leads and lags, which have no explicit algebraic solution. The solution has to be numerically computed in the form of policy functions, which relate all endogenous variables in the current period to the endogenous variables of the previous period, and current shocks. To be more precise, endogenous variables in the current period are to be expressed as a function of only state variables in the previous period and current shocks:

$$(2) \quad \mathbf{y}_t = g(\mathbf{y}_{t-1}, \mathbf{u}_t)$$

The policy function g is computed by linearizing the system (1) around the steady state (\mathbf{y}_{ss}) using the first-order Taylor expansion and the certainty equivalence principle⁷:

⁷ DYNARE provides also the second and the third-order Taylor approximation around the steady state. The certainty equivalence holds only for the first-order Taylor expansion. However, if a higher-order approximation is performed, the conditional forecast is based only on a first order approximation.

$$\mathbf{y}_t = \mathbf{y}_{ss} + \mathbf{g}_y \cdot (\mathbf{y}_{t-1} - \mathbf{y}_{ss}) + \mathbf{g}_u \cdot \mathbf{u}_t$$

or

$$(3) \quad \tilde{\mathbf{y}}_t = \mathbf{g}_y \cdot \tilde{\mathbf{y}}_{t-1} + \mathbf{g}_u \cdot \mathbf{u}_t$$

where $\tilde{\mathbf{y}}_t = \mathbf{y}_t - \mathbf{y}_{ss}$. IRFs are directly calculated from the policy function (3). One has to start from the initial value of variables given by the steady state and the initial shock to one variable of interest, and iterate on as many times as the number of future periods has been chosen. The results are IRFs.

The conditional forecast implies that variables are split into two subsets: predetermined (controlled) variables and non-predetermined (uncontrolled) ones. For predetermined variables the future paths are given by the policy maker in accordance with the policy scenario, which the policy maker aims to implement. The controlled variables are fully under control of the policy maker for all forecast periods and have the status as exogenous variables in a DSGE model. Uncontrolled variables are endogenous variables, which equilibrium values are solution of the underlying non-linear DSGE model. Not all endogenous variables have corresponding stochastic shocks. However, empirical or measurement variable must have associated stochastic shocks in order to facilitate Bayesian estimation of parameters. Each controlled variable must have an associated stochastic shock in order to perform a conditional forecast. In a DSGE framework shocks are stochastic variables with a known probability density distribution, variance and stochastic path modelled by a first-order autoregressive equations. Solutions of the conditional forecast suppress these autoregressive equations and compute the corresponding shocks that are needed to match the restricted paths from the reduced form first order state-space representation of the DSGE model (3). However, the state space representation (3) should be augmented with both predetermined and non-predetermined variables. Vectors of variables and shocks $(\tilde{\mathbf{y}}_t, \mathbf{u}_t)$ are split up into controlled $(\bar{\mathbf{y}}_t, \bar{\mathbf{u}}_t)$ and uncontrolled $(\hat{\mathbf{y}}_t, \hat{\mathbf{u}}_t)$ ones to get:

$$(4) \quad \bar{\mathbf{y}}_t = \mathbf{g}_y \cdot \bar{\mathbf{y}}_{t-1} + \mathbf{g}_u^{\hat{\mathbf{y}} \hat{\mathbf{u}}} \cdot \hat{\mathbf{u}}_t + \mathbf{g}_u^{\bar{\mathbf{y}} \bar{\mathbf{u}}} \cdot \bar{\mathbf{u}}_t$$

Creating the vector of last model's observations \mathbf{y}_0 and putting $\mathbf{y}_{ss} = \mathbf{y}_0$, the system of equations (4) can be solved algebraically for controlled shocks ($\bar{\mathbf{u}}_t$). Then, using system (3) all uncontrolled variables can be easily obtained. Of

course, this should be done in a recursive way. As we see, running a forecast is very similar to making an IRF after a Bayesian estimation, except that the forecast does not begin at a steady state, but at the point corresponding to the last set of (historical and model updated) observations. Although controlled exogenous variables are taken as instruments perfectly under the control of the policy-maker, they are nevertheless random and unforeseen shocks from the perspective of the households and firms. Households and firms are in each period surprised by the realization of the shocks that keep the controlled endogenous variables at their respective level. They revise their optimal positions in each period according to new realization of shocks and available information. With a conditional forecast, therefore, a DSGE model does not lose its stochastic substance.

Fiscal consolidation

Reduction of the historically high general government deficit and the level of public debt are currently the main task for the Serbian government, and are a major challenge for it. The last year's external shock due to flood destruction of infrastructure and productive resources in energy and mining sectors made the starting point for fiscal consolidation particularly difficult. In principle, fiscal consolidation can follow expenditure-based or revenue-based approaches, reducing the debt-to-GDP ratio by lower government expenditure, higher government revenues, or a mix of expenditure and revenue components. Despite the legacy of an unfavorable macroeconomic framework, the government decided primarily to cut expenditures. Of course, there are some revenue measures also, but they are difficult to simulate in our model; hence we will neglect their effects.

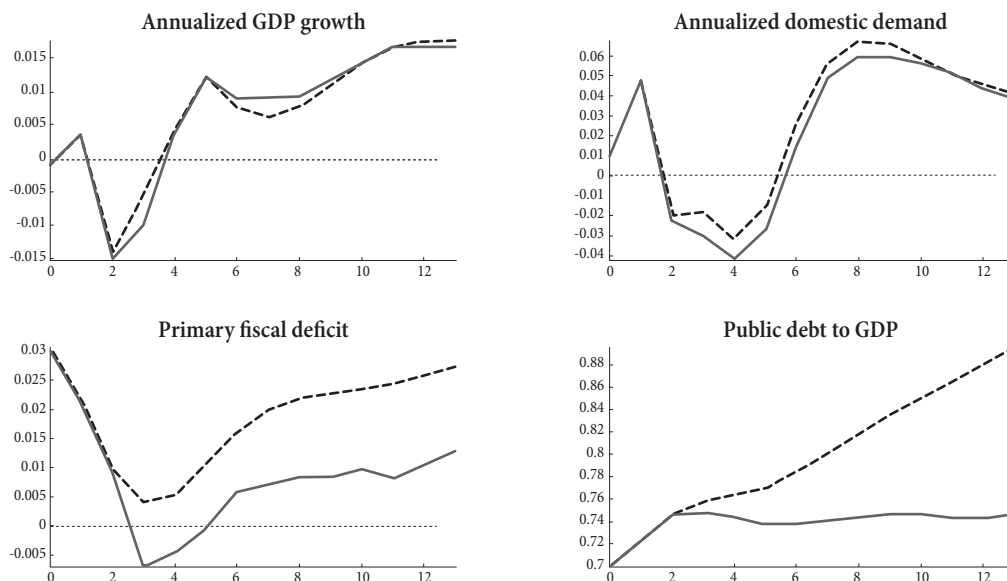
Among the expenditure-based measures, two classes of instruments are adopted. Firstly, one type of instrument addresses government consumption. Government consumption – as a final demand component of GDP – comprises compensation for public services, and purchases of goods and other services. Gross wages of public sector employees represent the market value of these services. They roughly contribute to 70 percent of the government

consumption. The wage bill in the public sector – including state owned enterprises (SOEs), public agencies, budget beneficiaries, public administration, and social services in health and education system – is scheduled to shrink by 0.5 percent of GDP. The reduction rate is linear and is set to 10 percent. It will apply to all public wage rates higher than RSD 25,000 monthly. Saving on public purchases is the other part of expenditure reduction. The spending base is quite large, since purchased goods and services account for one-third of total public spending or 7 percent of GDP. However, it is envisaged a rather modest reduction of public purchases with the estimated effect of only 0.1 percent of GDP. Finally, restructuring SOEs will require an improvement in their efficiency and shedding of the redundant workforce. It is estimated that reduction in unproductive workforce will save at least 0.3 percent of GDP. All together, these measures will reduce the government consumption between 0.9 and 1 percent of GDP.

Secondly, the other class of measures refers to transfer payments. The principal reduction is related to monthly pension checks for the value over RSD 25,000. The rate of reduction is progressive, and the total fiscal saving will amount to 0.5 percent of GDP. The other type of transfer payment saving is related to budgetary transfers to local governments. These transfers will be reduced for 0.2 percent of GDP. All together, they will roughly contribute to fiscal savings of 0.7 to 0.8 percent of GDP.

The Government already applied some of these measures at the end of last year, and incorporated their initial effects in the revised budget for 2014. The measures will automatically apply to 2015 year with a commitment to continue with them in the subsequent two years. The fiscal consolidation package is not a one-off policy change, but has a three-year time horizon. Within this period there will be no linear reduction of the public debt-to-GDP ratio. Initially, the debt-to-GDP ratio will rise for the first two years reaching the peak in the fourth quarter of 2016. Public debt-to-GDP was 69.9 percent in the fourth quarter of 2014. It is envisaged to expand to 77.7 percent in 2015 and 79.2 percent at the end of 2016. The upward trend will be reverted in the 2017 fiscal year with a slight decline to 78.7 percent of GDP in the fourth quarter.

Figure 2: Three-year fiscal consolidation effects: Key variables



Note: Solid lines show fiscal consolidation, dotted lines show hands-off policy

In order to perform a conditional forecast, we need to choose proper inputs for the model's simulation. On that account, we stuck to the official figures about expenditure reduction that will be generated by above described fiscal measures. With this information, we proceeded with a conditional forecast of the key variables. We reduced the government consumption share in GDP by 1 percent for 12 consecutive quarters (three years). The starting point was our unconditional forecast for the fourth quarter of 2014, since the last historic data was available only for the third quarter of 2014. In this way we completed a data base for the whole year 2014 and prepared forecasting for the next three years. Then we inserted the target expenditure figures, period by period, and set them as the constrained path of the government consumption for 2015-17. The benchmark values, against which the target values were compared, were the share of government consumption in GDP that would be spontaneously achieved without any policy interventions - as these values had been forecasted by the model. The ratio between two of them should reveal a 1 percent GDP reduction of the government consumption during the forecasted period. This means we did not fix any particular level of the government consumption, but reduced its ongoing share in GDP for 1 percent, which otherwise would be spontaneously completed. Next, the same method for preparing input data was applied to transfer payments. Transfer payments were reduced

by 1 percent of GDP compared to the forecast of such payments that had been obtained by the model assuming no governmental actions.

Additional revenue measures as well as called-in guaranties of the SOEs (below-the line public debt) were not integrated into this calculations, partially because we don't have time series data for them, or partially because the model is not calibrated to take into account such specific non-tax revenue and expenditure items.

After inserting the input data, we performed a conditional forecast. Results are presented in Figures 2 and 3. How to interpret these figures? Figure 2 displays a conditional forecast (solid line) and unconditional forecast (dotted lines) of key variables for 12 quarters (the initial point refers to unconditional forecast for the last quarter in 2014). These variables are: (annualized) GDP growth rate, (annualized) growth rate of domestic demand, and share of primary fiscal deficit in GDP and debt-to-GDP ratio. Let us now infer basic macroeconomics from Figure 2.

Even without government intervention the Serbian economy will highly likely stagnate this year, then slightly recover in the next year, and resume growth in 2017. The fiscal consolidation package was designed to work through demand-side channels with restrictive fiscal measures that would initially reduce domestic demand. Ignoring the supply-side effects, it is reasonable to expect negative GDP growth or, in the best case, stagnation this

year. However, with the government intervention, the GDP growth rate will be depressed this year. Positive effects of the policy package can be expected in 2016 when the realized growth rates will be slightly higher than the benchmark growth rates predicted by the base-line scenario. In 2017 the positive effects of the fiscal consolidation package will disappear and the economy will resume growth as would be achieved without any governmental interventions.

Expectations that reduced expenditure will depresses domestic demand are correct. In any case domestic demand would decline this year, but fiscal consolidation would reduce it even more. Our forecast indicates that the domestic demand will stay below the base-line trajectory in the entire period of consideration.

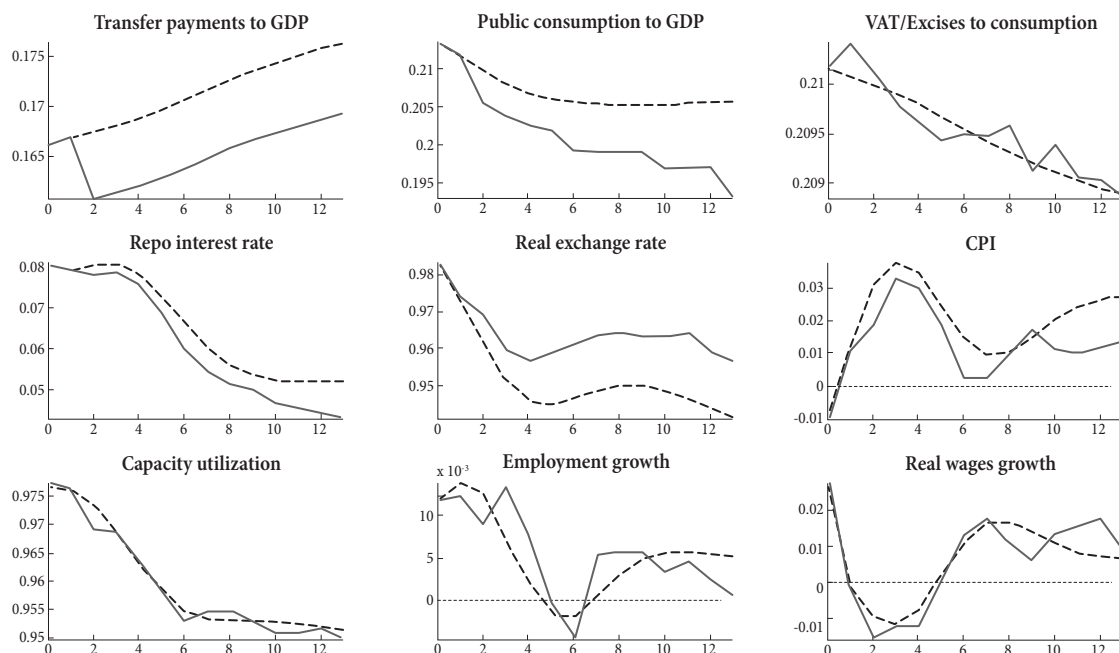
This inference from the model justifies the severity of the fiscal measures, since the cost in terms of forgone growth will be similar to those as if doing nothing at all. At the end of the forecasted period, the spontaneous and the policy managed growth path will match each other. However, there is a crucial difference. The debt-to-GDP ratio under the spontaneous scenario is not sustainable. After the fourth quarter of this year, it sets up to an exponential path that cannot be control or revert any more. At the end of 2017, it will be higher than 85 percent of GDP. In

order to avoid sovereign default, fiscal consolidation was the correct policy option.

The fiscal consolidation will be quite successful in stabilizing the public debt fairly quickly, but may not be sufficient to reverse its trend in 2017 as expected by the policy maker. Our conditional forecast is warning that debt might be a concern beyond the planning horizon. As our conditional forecasts specify, primary fiscal deficit will improve strongly in the first years of implementing the new policy package. Indeed, it will turn to a surplus which, however, will not stay for a long period. It will resume a rising path in the second and the third year with a very slow pace of growth. There are no hints for reversing the upward trend of primary fiscal deficit. Nevertheless, the debt-to-GDP ratio will not increase since the corresponding costs of financing debt will go down. We predicted GDP growth rate in 2017 at the level of 1.6 percent, the policy maker expects stronger growth for 0.4 percent points or growth rate of 2 percent, but no one of these rates is sufficiently high to reverse the public debt.

The model’s policy simulation points to another important conclusion. The indicated debt-contained growth scenario would only be realized *mutatis mutandis*, i.e. if other things changed which need to be changed. Those other things are presented in Figure 3.

Figure 3: Three-year fiscal consolidation effects: Key instruments



Note: Solid lines show fiscal consolidation, dotted lines show hands-off policy

Figure 3 displays conditional (solid lines) and unconditional (dotted lines) paths of policy instruments. In the first row of Figure 3 fiscal instruments are located: VAT proceeds (including excise duties) with respect to consumption, transfer payments and government consumption of goods and services (including gross wages of the public administration) as shares in GDP. In the second row of Figure 3 there are monetary instruments: repo interest rate, real exchange rate (depending on domestic and foreign inflation and the nominal exchange rate) and inflation represented by the annualized change of GDP deflator (partially controlled by the government, as administrative prices are concerned, and partially under the influence of the inflation targeting monetary policy). The last row of Figure 3 is reserved for factors of production: capacity utilization (under the business control and the institutional environment influence how easy it is to do business in Serbia), (annualized) labor growth rate and (annualized) real wage change (under the influence of trade unions, associations of domestic and foreign investors, and the government). Competences over policy instruments are divided between the Ministry of Finance (fiscal instruments), the NBS (monetary instruments), and labor and capital markets (use of productive factors).

In our policy experiment, we controlled the path of two out of nine policy instruments. Remaining seven instruments had to be adjusted by policy makers in the indicated way if the debt-to-GDP target would have been attained.

Let us discuss first how fiscal instruments have to adjust in order to achieve the target debt-to-GDP ratio. In this context we refer only to VAT rates and excise taxes since transfer payment and government consumption were already integrated in the policy experiment. There is still ongoing discussion on whether the VAT rate should be increased or not, whether excise duties should compensate for falling crude oil prices, and so on. Our variable links total VAT and excise proceeds with the value of the private consumption. As from the historic perspective, its peak value was achieved in 2007 with the size of 21.5 percent. It dramatically dropped below 18 percent at the beginning of 2009. Since then, there is a permanent, but

cyclical, recovery in tax collection, and this share reached 21 percent at the end of 2014. The government is serious on fighting against the shadow economy with a view to get additional fiscal revenue of at least 1 percent of GDP. We agree that improving fiscal discipline and shrinking the shadow economy is a legitimate and important goal, but we should notice that our model does not support tightening of the indirect taxation on private consumption. The reason is simple and appealing: indirect taxes discourage consumption and growth. In line with this view, it will be reasonable to relax this restriction and align domestic demand with the target debt-to-GDP ratio.

We will skip discussion about the second row in Figure 3 for the next section of the paper, and address now the third row in Figure 3. Functioning of the labor market is mostly neglected in the fiscal consolidation package. In our view, flexibility of the labor market is an absolutely vital point for better outcomes of the fiscal consolidation policy. It is tacitly assumed that institutional changes related to the labor law and the privatization law adopted last year are sufficient to promote a better business environment and improve employment. This may or may not be the case. So far there is no evidence for either one. Our model reminds us about the fundamental relation between employment and real wages. Both the unconditional base-line forecast and the conditional forecast reveal a U shape of employment and real wage growth rates. The lowest points are strictly negative. This will happen this year with the average real wage rate, and the next year with the employment rate. The fiscal consolidation package will not generate employment. Equally important, the fiscal consolidation will not depress real wages. The real wage rate will decline anyway due to the down stage of the business cycle and the fiscal consolidation will not contribute to this drop. The question is whether these subtle details will be publicly recognized or not. A moderate employment increase will be achieved in the second half of the forecasted period, and it corresponds to a moderate GDP growth and an increase in real wages.

It is equally important to notice capacity utilization rate. The model-consistent solution shows a persistent downward trend of capacity utilization. The fiscal

consolidation package neither made this development worse nor improved the situation. There is no doubt that higher growth rates require better utilization of the existing productive capacity. Restructuring of SOEs may reverse this trend, but this analysis is beyond the scope of our paper.

Monetary easing

The NBS controls the repo interest rate and makes money cheap or expensive, plenty or scarce. Generally speaking, money has been scarce and pricey in Serbia since the dawn of the global recession. This fact rises doubts about functioning of the inflation targeting system in time of crises in Serbia, but we now do not challenge it. We will review the policy which may govern the size of repo rate under the framework set by the fiscal consolidation programme. For that purpose we will perform two basic experiments. In the first one, it is assumed that the NBS will adjust its repo rate according to the model-consistent trajectory generated by the fiscal consolidation programme. We call this option an active accommodation of the monetary policy, since the fiscal programme is implicitly calling for monetary relaxation. The NBS, by assumption,

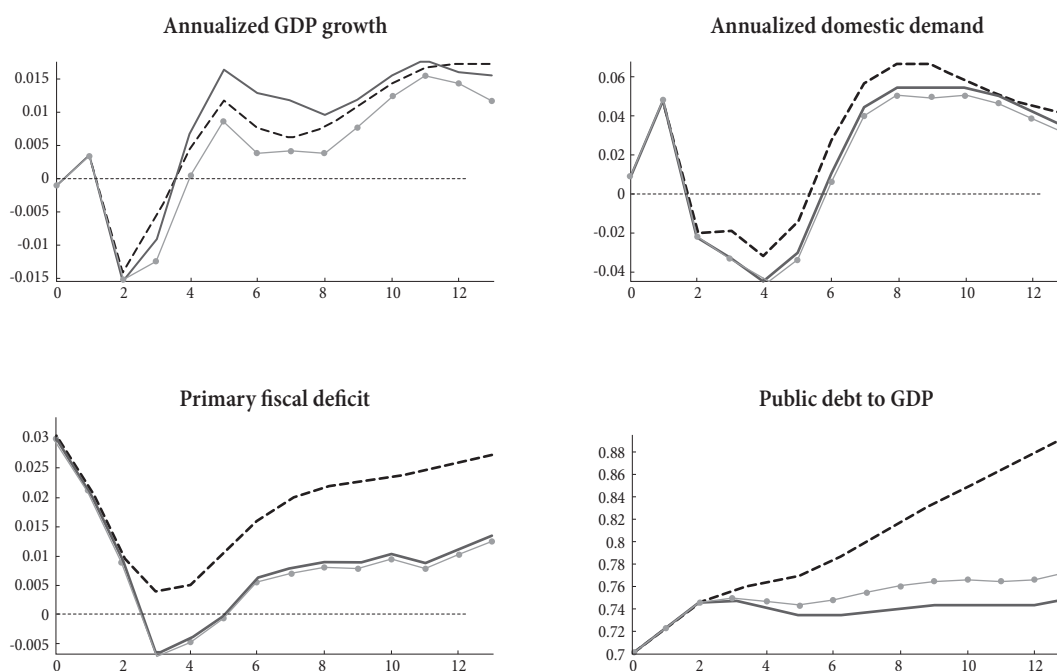
immediately proactively reacts, which qualifies this policy as being an active and accommodative one. This result will be confronted with a spontaneous development of the economy without any fiscal intervention, but under the same assumption that monetary policy quickly satisfies market requirements.

In the second experiment we will confront the active accommodative monetary policy with a slow and reluctant response of the NBS. The alternative policy is defined as a sluggish accommodative monetary policy. In that case the NBS makes money more available and cheaper but with some delays. This may be or may not be followed with an adjustment of the exchange rate.

As indicated, in both experiments we stay in a framework of easing monetary policy. Tightening of the monetary policy is beyond our concern, because it strongly contradicts to the fiscal consolidation programme. Finally, to complete the framework for our discussion, we will take into account the expected paths of inflation and real exchange rate.

In fact, we have already done the first experiment by launching the fiscal consolidation programme. We analyzed a part of it in the previous section. By now, we examine the monetary instruments, which responses are presented

Figure 4: Monetary reaction on fiscal consolidation: Key variables



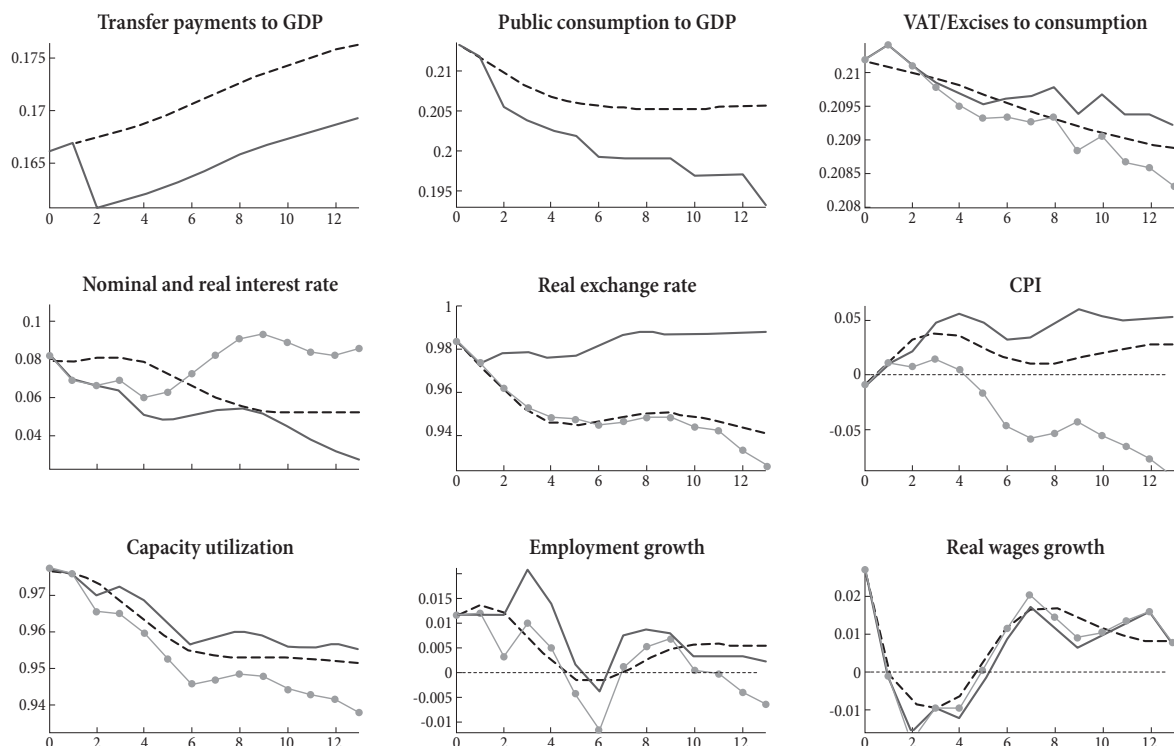
Note: Solid lines represent the policy mix, lines with dots show sluggish monetary easing, dotted lines show hands-off policy

in the second row of Figure 3. The model-consistent repo rate – the repo rate unconditionally forecasted within the model’s base-line scenario – is somewhat lower than its historic counter-part in the first quarter of 2015. It oscillates around 7.5 percent for the next three quarters, and after that point in time it steadily declined to the level of 5.5 percent annually. The unconditional model solution implies monetary easing in any way. The fiscal consolidation package is not expected to make fundamental deviations from this scenario even if details show some differences. The corresponding model-consistent repo rates (solid line) will have the similar shape and path as the base-line interest rate (dotted line). However, the gap between these two lines will widen as the time goes on. At the end of the planning period, the fiscal consolidation requires one percent lower interest rate than otherwise it will be. The model-consistent solution anticipates easing of the monetary policy. The fiscal consolidation programme reiterates this trend and calls for extra relaxation of the monetary policy.

In the same period, conditional forecast of consumer price index (CPI) is persistently below the base-line inflation. Since the inflation calculation does not include administratively controlled prices, we need to ignore the state control of the market⁸. Under this assumption, inflation will be at historically low level all the time. This fact will provide a room for easing of the monetary policy. As risks are concerned, there is no risk of high inflation in the entire period of consideration. Quite the opposite, there is a risk of deflation.

Nevertheless, we expect that inflation in the Euro zone will be even lower than in Serbia. The nominal exchange rate will initially regain purchasing power against the EURO and afterwards stabilize at the achieved level. The nominal exchange rate change will oscillate around the zero path and will not compensate for price differentials between the domestic and foreign inflation rate. Therefore, the real exchange rate will appreciate over the first year, and since then stabilize. The fiscal consolidation package will slightly slow down the real exchange appreciation.

Figure 5: Monetary reaction on fiscal consolidation: Key instruments



Note: Solid lines represent the policy mix, lines with dots show sluggish monetary easing, dotted lines show hands-off policy

8 This fact must not be ignored in conducting actual economic policy. A more elaborated design of the conditional forecast should include the path of expected changes in the administratively controlled prices.

Let us now turn to the second experiment with a sluggish accommodative monetary policy within the fiscal consolidation framework. We consider this scenario to be highly likely adopted by the monetary authority. The rationality behind this view is the following. The NBS is an inflation-averse institution. For this reason it is reluctant to reduce the repo rate as much as the model-consistent trajectory indicates. Also, it has a fear-of-floating relating to the nominal exchange rate, and is ready to defend its stable level by interventions on the foreign exchange market. Serbia does not have a free-float, but managed exchange rate regime. Thus, the exchange rate is heavily managed by both the repo interest rate and the NBS's foreign exchange interventions financed from the official reserve.

We model monetary and exchange rate policies in two steps and present their outcomes in Figure 4 and Figure 5. In the first step, we input into the model restrictions based on 1 percent of GDP reduction in both the government consumption and transfer payments shares in GDP. On the top of these figures, we constrained the path of the repo interest rate to mimic the trajectory as in the case of no fiscal consolidation, but with the two-quarter delay. This is how we define "sluggishness" of the monetary policy. The monetary policy adjusts to a spontaneous development of the market, but with a delay.

The outcomes of the conditional forecast are displayed as lines with dots in corresponding figures. What are the main conclusions from this scenario? A delay in easing the monetary policy may have the following effects:

- The rate of GDP growth is permanently lower than in the base-line scenario,
- The aggregate demand growth is not only lower with respect to the base-line case, but is also absolutely depressed for the first half of the planning period,
- The both outcomes are a consequence of the lower capacity utilization and decreasing employment,
- Additionally, prices deflate, which dramatically drives up the real interest rate,
- The real exchange rate further appreciates, and
- The debt-to-GDP ratio rises; it is still below 80 percent, but has a rising trend with no sign of the reverse at the end of 2017.

The negative effects of such a monetary policy are evident. They will not prevent the fiscal authority to reduce the public debt, but this policy mix is unbalanced and hardly sustainable. However, the negative effects of the sluggish monetary adjustment might be mitigated by an adequate exchange rate policy. If we reiterate the constraints from the previous scenario, but allow the exchange rate to nominally increase in such a way as to keep the real exchange rate fluctuating around the starting level, we will get new outcomes represented by solid lines in Figure 4 and Figure 5.

Comparing to the above scenario, the right policy mix shows the improved results as follows:

- The rate of GDP growth is similar to the base-line scenario in the first year, but higher in the remaining two years,
- The aggregate demand growth is still slightly lower than in the base-line case, but
- The capacity utilization and employment are higher than expected in the base-line scenario, which indicates that the economic recovery is driven up by the supply-side,
- CPI will be above the base-line level, which might be considered as a threat to market stability, but it is still manageable by the monetary authority,
- The exchange rate policy will resemble a crawling peg regime, and finally
- The debt-to-GDP ratio stabilizes around the level of 75 percent.

An adequate fiscal-monetary-cum-exchange rate policy mix is able to stabilize public debt with reasonable social costs of adjustment.

Conclusion

The fiscal consolidation as proposed is a doable policy, if the policy mix of monetary and exchange rate policies is properly designed and timely implemented. Under these assumptions, the rising debt-to-GDP ratio will be contained and stabilized at the affordable level. For the more optimistic expectations that the debt-to-GDP ratio will reverse its trend in 2017, the economy needs additional structural measures.

In order to document this conclusion, we presented in this paper four policy scenarios: the base-line scenario with no government interventions, the alternative fiscal consolidation scenario, and two policy-mix scenarios of monetary and exchange rate policies reaction to the fiscal consolidation. The first scenario is simulated by using unconditional forecast, the all remaining scenarios are done by enforcing conditional forecast. In a DSGE framework, conditional forecast approach requires that an endogenous variable and its related exogenous stochastic shock swap their status in the model. A predetermined path is assigned to the originally endogenous variable, which then become an exogenous variable. In such a way, the variable reflects the policy target that is set by the policy maker. The DSGE model is still able to achieve a solution since the associated shock adjusts to new equilibrium conditions.

The chief counterfactual experiment simulates the fiscal consolidation package that has been adopted by the Serbian government and parliament at the end of 2014. We extracted two critical components of this package both related to expenditure cuts. One is related to cuts in the public wage bill, government purchases of goods and services, and restructuring of SOEs that will generate redundant employment and further reduction in public wage bill. From the point of view of compiling national accounts, all three components belong to the government consumption. These reductions amount to fiscal savings of 1 percent of GDP. Another fiscal saving of a similar size is related to reduction in transfer payments due to lower pension checks and restricted fiscal transfers to local municipalities.

The government envisaged various measures with the impact of another percent of GDP, but we have skipped them due to their temporary character. We assume that government will stick to the announced fiscal policy over next three years. Therefore, the fiscal effects of expenditure cuts are by definition permanent, not temporary. We specify the target paths for government consumption and transfer payments for each 12 quarters in the forthcoming period. We apply expenditure cuts not to the empirical level of variables preceding the simulation, but to the unconditionally forecasted levels which would be obtained without any governmental actions. In this way, we separated

the induced effects of the fiscal consolidation policy from those effects that would spontaneously take place.

We also assumed in the base-line scenario that all other policies – particularly monetary and exchange rate policies – smoothly adjust to the trajectories generated by the fiscal measures. Under this assumption, the social costs of fiscal consolidation are not dramatically high. The IMF has indicated a potential easing of monetary policy with no further elaboration of this idea. There is a risk that adjustment of the monetary policy might be done with some delays and an improper mix with the exchange rate policy. Our simulations clearly demonstrate that improper monetary easing is a bad scenario. We suggest that a proper monetary policy should encompass an exchange rate policy that will promote a rather stable real exchange rate level. This policy mix is the most superior response to the fiscal consolidation policy that the monetary authority might design.

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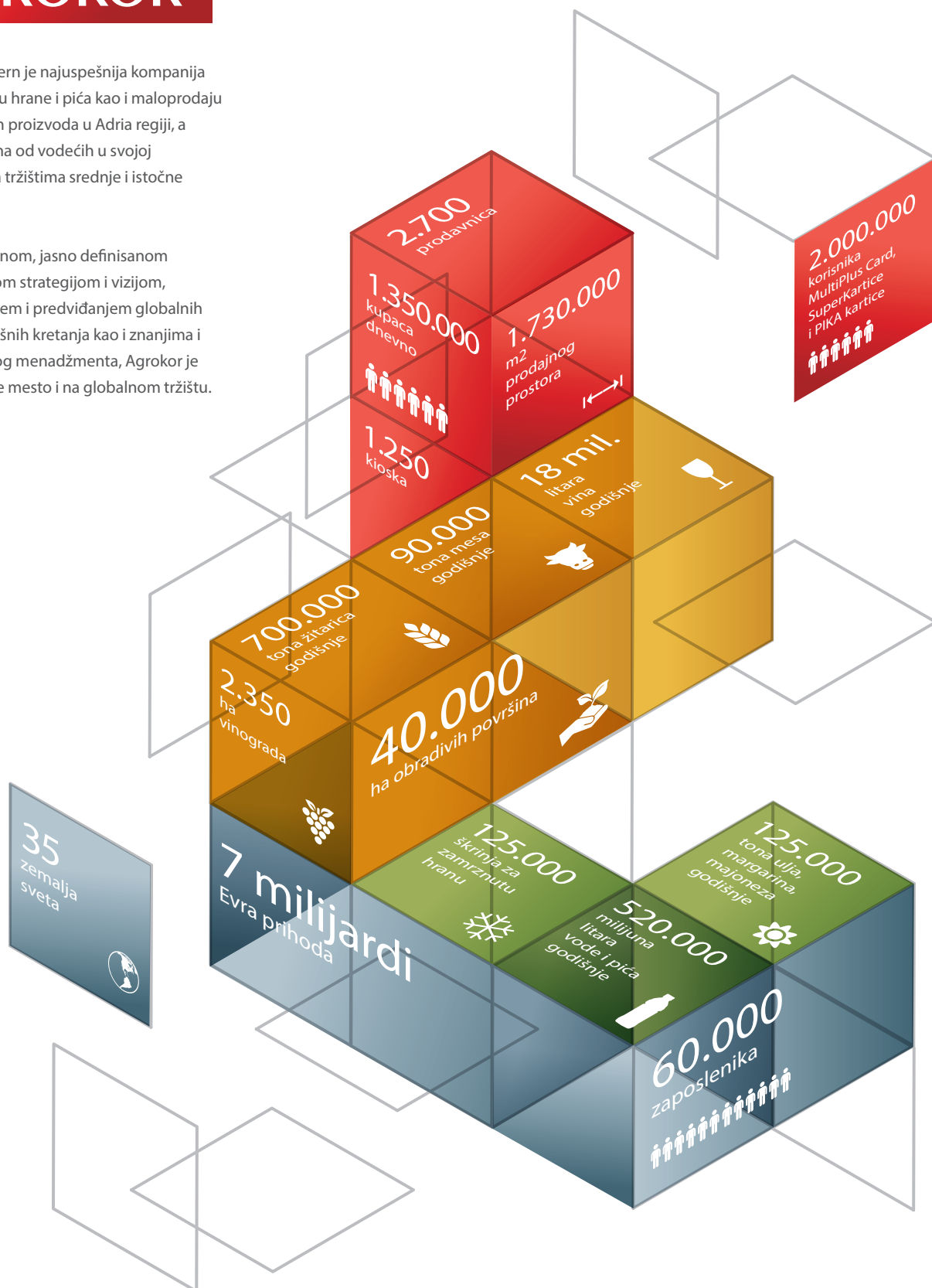

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THE RELEVANCE OF POSITIONAL RISKS IN CREATING DEVELOPMENT STRATEGY: THE CASE OF PUBLIC ENTERPRISES

Relevantnost pozicionih rizika u kreiranju strategije razvoja – slučaj javnih preduzeća

Abstract

Public enterprises have considerable economic and political importance in many countries around the world. The state is largely involved in infrastructure sectors of strategic importance for the development of the national economy. State-owned enterprises often significantly contribute to GDP and total employment. Also, we should not overlook their effect on the operating and financial performance of companies that do not belong to the public sector. However, a number of research studies have shown that the state does not perform its ownership function in an effective manner and that state-owned enterprises are usually less successful than private companies. The same holds true for Serbian public enterprises. Inadequate management, lack of transparency in their operations and absence of an efficient monitoring system lead to irrational use of resources and huge losses. Serbian public enterprises have become one of the generators of public debt, mainly due to the policy of government guaranties for their loans. Substantial subsidies coming directly from the budget or indirectly through unpaid obligations to other public enterprises, coverage of their losses and write-offs of their debt place a heavy burden on the state budget. Therefore, reform of public enterprises is not a matter of choice, but an urgent need.

The financial problems of public enterprises in Serbia are so deeply embedded that their ignorance could undermine the reform processes and implementation of the strategy for economic development of Serbia or its results might fall below expectations. In this paper we put special emphasis on the quantification of inherited risks. In the first and second part we point out particular characteristics of public enterprises and their importance in some national economies. In the third part of the paper we deal with dimensioning of operating and financial risks with the aim of shedding some light on the scope of the problem, not only from the perspective of public enterprises, but also considering

a negative impact of these risks on the performance of the overall economy. In the fourth part the focus is on the problems of poor quality of corporate governance, need for fundamental changes in the state's attitude toward public enterprises, and means of enhancing corporate governance. Finally, in the last part of the paper we draw attention to potential manipulations in financial statements and their consequences as well as to a lack of the government's commitment to raising the quality of financial reporting in general.

Key words: *public enterprises, corporate governance, performance, operational risks, financial risks, liquidity, solvency, profitability, hidden losses*

Sažetak

U mnogim zemljama širom sveta javna preduzeća imaju veliki ekonomski i politički značaj. Država je često prisutna u infrastrukturnih sektorima od strategijskog značaja za razvoj nacionalne ekonomije. Preduzeća u državnom vlasništvu često imaju značajno učešće u GDP i ukupnom broju zaposlenih. Ne treba zanemariti ni uticaj ovih preduzeća na poslovanje i performanse drugih, nedržavnih preduzeća. Međutim, u brojnim istraživačkim studijama je dokazano da država svoju vlasničku funkciju ne obavlja na najbolji način i da su preduzeća sa državnim vlasništvom manje uspešna od privatnih preduzeća. Ista situacija je i u Srbiji. Neadekvatno upravljanje, nedovoljna transparentnost njihovog poslovanja i izostanak kvalitetnog sistema monitoringa uslovljavaju neracionalno trošenje resursa i velike gubitke. Srpska javna preduzeća su, kroz davanje državnih garancija za uzete kredite, postala jedan od generatora javnog duga. Značajne subvencije, neposredno iz budžeta ili

posredno preko neplaćanja računa drugim javnim preduzećima, pokriće gubitaka i otpis dugova u značajnoj meri opterećuju državni budžet. Otuda, sređivanje stanja u javnim preduzećima nije stvar izbora, već urgentna potreba.

Finansijske dubioze u javnim preduzećima u Srbiji su toliko velike, da bi njihovo ignorisanje moglo da ugrozi reformske procese i realizaciju strategije razvoja srpske privrede ili barem da rezultati ne budu na nivou očekivanih. Kvantifikovanje nasleđenih finansijskih rizika je najvećim delom predmet naše pažnje u ovom radu. U prvom i drugom delu rada akcenat je stavljen na specifičnosti javnih preduzeća i značaj koji ona imaju u pojedinim nacionalnim ekonomijama. U trećem delu rada bavimo se dimenzioniranjem poslovnih i finansijskih rizika, sa osnovnom namerom da skrenemo pažnju ne samo na veličinu problema u javnim preduzećima, već i na njihov negativni uticaj na poslovanje cele privrede. U četvrtom delu u središtu pažnje su problemi niskog kvaliteta korporativnog upravljanja, potreba korenitih promena u odnosu države prema javnim preduzećima i pravci unapređenja korporativnog upravljanja. Konačno, u poslednjem delu rada skrećemo pažnju na moguće manipulacije u finansijskim izveštajima, posledice koje iz toga mogu da proizađu i nedovoljnu brigu države za kvalitet finansijskog izveštavanja u celini.

Ključne reči: *javna preduzeća, korporativno upravljanje, performanse, poslovni rizici, finansijski rizici, likvidnost, solventnost, profitabilnost, skriveni gubici*

Introduction

Drawing clear demarcation lines between the public and private sector is quite complex. Criteria that can be used to distinguish them are manifold and have changed over time. As a result, boundaries between these sectors have also shifted. The private sector is primarily oriented toward commercial activities, while the state is mainly concerned with the establishment of legal system, production of certain goods and services of public interest, regulation of economic activities, securing funding for goods and services for the purpose of education, health care, national security, culture, social security, and so on. However, the state also takes part in certain commercial activities in a similar way as the private sector (electricity production, construction of transport infrastructure, provision of postal services, etc.). On the other hand, due to privatization process the private sector is becoming ever more involved in the areas that were traditionally associated with the public sector.

Public enterprises have often been equated with stated-owned enterprises (SOEs), which is not entirely true. In the past public enterprises were predominantly owned by the state. In many countries, the state still has

100% ownership interest in many enterprises. However, the fact is that many large enterprises have been partially or fully privatized and that ownership structure has changed significantly. Thus, for example, hundreds of large SOEs in China have differentiated ownership structure and now operate as publicly listed companies [12, pp. 3-5]. The reforms that were carried out in China in the period 1995-2000 reduced the size of the state sector. The state's share in total number of industrial enterprises decreased from 39.2% in 1998 to 4.5% in 2010, its share in total industrial assets dropped from 68.8% to 42.4%, while its share in employment shrank from 60.5% to 19.4%. In Russia, SOEs contribution to industrial production fell from 9.9% in 1994 to 6.7% in 2004, while the state has maintained ownership in strategically important sectors (machine building, natural resource exploration and extraction, broadcasting, etc.) [28, p. 5].

Public enterprise as a form of business entity can be established by the state, under the law or decision by the government (railways, trade of crude oil and natural gas, post offices and the like), following a decision by municipalities (public utilities), then by concluding concession contract that gives concessionaire the right to use and manage the goods granted by concession with the obligation to protect the public interest and pay agreed fee (road infrastructure, mining, etc.), by establishing mixed companies or the so-called "public-private partnerships", etc. [25, pp. 480-482]. Besides, competent authorities may also entrust the performance of the activities of public interest to other business entities and entrepreneurs. In some countries the most common form of public enterprise is joint stock company (e.g. Bulgaria, Chile, Peru, and Singapore), while in others public enterprises can take different legal forms [29, p. 7]. Sometimes public enterprises that are 100% owned by the state may be owners of other public enterprises which are organized as joint stock companies or limited liability companies.

Legal framework may vary depending on the government's goals, privatization process (model), the need to keep a particular level of control and the like. Namely, the state could remain the sole owner, maintain majority ownership or keep only minority ownership. The existence of various legal forms and possibilities of

different state’s ownership stakes in public enterprises may create the wrong impression of the size of these enterprises. However, a wide variety of legal forms provide the state with greater flexibility in conducting ownership policy of public enterprises, performing its control function as well as in finding the ways to raise their efficiency.

Bearing in mind the foregoing facts, it does not come as a surprise that the literature abounds with terms referring to companies of public interest: public enterprises, state-owned enterprises (along with the variations such as wholly or partially state-owned enterprises), statutory corporations, government limited companies, etc. In this paper, we opt for the term ‘public enterprises’.

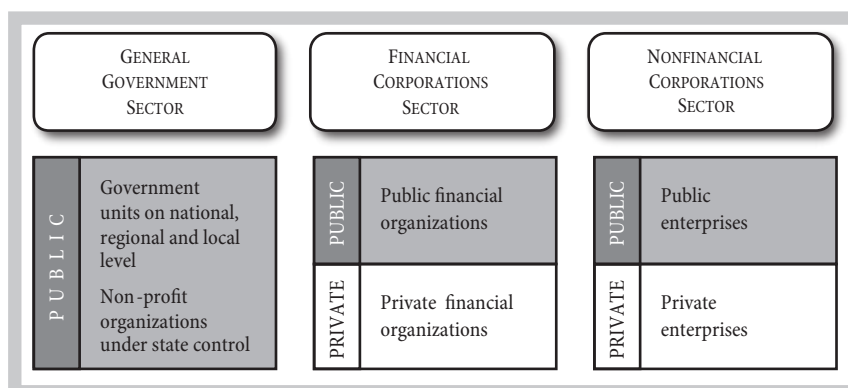
It is a well-known fact that public enterprises have considerable economic and political importance. The state is involved in potentially profitable infrastructure sectors that are of strategic importance for the development of a national economy. On the other hand, public enterprises are often unsuccessful, or rather, less successful than private ones. Their actual or prospective new losses are ultimately covered from the budget. Various subsidies do not provide a long-term solution to the problems faced by these enterprises, but they undoubtedly put a heavy burden on the budget. A particular problem is impact of public enterprises on the level of public debt (through activation of government guarantees for loans to public enterprises). The announced reform of public enterprises, among other things, should take account of the existing, inherited financial risks. Ignoring these risks may lead to a failure in this area or results falling below expectations. The primary focus of our paper is quantification of these risks.

Distinctive characteristics of public enterprises

Generally speaking, companies are business entities that are established for the purpose of producing particular goods and services with the aim of generating returns for their owners. Public enterprises that are involved in commercial activities could be defined in a similar manner. If public enterprises are organized as joint stock companies they must be accountable for their performance to shareholders, while enterprises that are wholly owned by the state must have responsibility to the public. According to *OECD Guidelines on Corporate Governance of State-Owned Enterprises*, the term SOE “refers to enterprises where the state has significant control, through full, majority, or significant minority ownership” [20, p. 11] or “any state-owned corporate entity recognised by national law as an enterprise should be considered as an SOE (this includes joint stock companies, limited liability companies and partnerships limited by shares)” [21, p. 11]. The Law on Public Enterprises defines it as “an enterprise that performs activities of general interest, established by the Republic of Serbia, autonomous province or local self-government unit” [30]. Public enterprises are an integral part of the public sector. The public sector comprises all activities and entities that are funded from public revenues as well as all other economic entities that are owned or controlled by the state. Bearing the above in mind, the structure of public sector and place of public enterprises within it could be presented as in Figure 1.

The general government sector is responsible for the judicial system, funds and directorates, maintenance of public order, national security, health care, social security,

Figure 1: Distinction between public and private sector



education, environmental protection, and the provision of other public services. This part of the public sector may as well include some non-market and non-profit organizations controlled by the government. The public sector also comprises public enterprises and institutions that may belong to financial (development banks, development funds, etc.) and nonfinancial sector (public enterprises under the authority of the state or provincial and local governments such as railways, national airlines, postal services, electric power transmission, gas transportation, utilities, etc.). Apparently, both public and private enterprises could operate within financial and nonfinancial sectors.

In order for an enterprise to be considered as public, the state does not need to be its exclusive owner. It is sufficient that it has controlling interest. In this regard, control is defined as the ability to influence general business policy of an enterprise or key financial and business policies related to its strategic objectives. The most significant factors in assessing the ability to control are as follows [22, pp. 8-10]: ownership of the majority package of voting rights (directly or indirectly through other public entities), control over the board of directors or other management bodies (based on the right to appoint or replace their members, whereby the mere existence of the veto power over the appointment can be viewed as a form of control), control over the appointment or removal of key executives (this could be decisive under the circumstances where the control over the board of directors is weak), control over key committees (if such committees have an important role in setting up the company's key business and financial policies), owning a golden share (this practice is especially found in privatized companies when the state decides to reserve certain rights with the aim of protecting the public interest, but so far it has remained an open question whether it exerts sufficient influence on the company's general business policy), the possibility of control by regulatory bodies (relevant only if control is strict enough to efficiently determine the direction of the company's business operations), control by a dominant customer (if company's total sales are directed toward one or a group of customers coming from the public sector), control imposed by the direct use of state funds or state guarantees (such a control is possible only if the state shows

readiness to enter into similar arrangements). Besides, control can be determined by only one influencing factor or by simultaneous effects of several factors. Therefore, sometimes it seems very easy to make a clear distinction, while in other situations that may be quite challenging and require a great deal of thought.

Public enterprises involved in commercial activities follow a very similar approach to business operations as private companies [15, pp. 135-136]. Still, despite similarities, public enterprises have a set of distinctive characteristics which distinguish them from private companies. For the sake of better understanding of the problems burdening the functioning of public enterprises, the key ones are listed below.

Firstly, public enterprises often have strategic importance for the development of a national economy. They usually operate in the so-called infrastructure sectors, such as energy sector (production and transmission of energy), transportation (road, rail, airport and waterway infrastructure), and telecommunications. Since these enterprises are big and financially strong they play a crucial role in improving performance of an economy as a whole and increasing GDP, but also in enhancing the quality of health care services, increasing energy efficiency, raising the efficiency of public administration, etc.

Secondly, public enterprises often require large investments. Examples thereof comprise investment in electricity production in the energy sector, investment in the development of broadband network in telecommunications, investment in road and rail infrastructure, investment in the production and transportation of gas and the like. This fact leads to very serious concerns regarding how to ensure their financing and sustainable growth.

Thirdly, it is not unusual for a public enterprise to have a monopoly position. But here we do not refer only to natural monopolies. Public utilities may also hold a monopoly position. The presence of monopoly power raises some very important questions about the efficiency of such enterprises, pricing policy with regard to utility services, quality of management, frequent reliance on subsidies, etc. It should not be forgotten that financially strong public enterprises could jeopardize competition in some market niches.

Fourthly, owing to the fact that public enterprises are controlled by ruling political structures, the management of these enterprises is likely to enjoy a pretty comfortable position in the absence of an adequate control. Although such enterprises are often inefficient, they are considered as “socially necessary”, which allows them to avoid bankruptcy even in the case of substantial losses and illiquidity since both the settlement of losses and their revitalization are financed from the budget.

Fifthly, a part of public enterprises falls under special regulatory regime. Specialized regulatory bodies are established particularly in sectors of telecommunications, energy, and air traffic. Among other things, their purpose is to ensure that enterprises under their authority operate in a socially responsible manner (in terms of service quality, price, efficiency, etc.). Accordingly, these regulators ought to protect customers against potential consequences of monopoly behavior but also to enable these enterprises to create reasonable profits, thus allowing them to remain attractive to investors and maintain sustainable growth.

Sixthly, by order of government public enterprises may be entitled to offer services at prices that are below market prices. A good example is the price of electricity. State financial institutions (development funds, state banks) could approve loans to enterprises at interest rates which are lower relative to the ones available in the market. Moreover, public enterprises are under pressure to make room for additional employment. All of the aforementioned adversely affects their performance.

Seventhly, public enterprises have been often criticized for the lack of transparency in their business operations. The transparency requirement entails a consistent way of financial reporting, focused not only on the performance of individual enterprises but also on the performance of the public sector as a whole, objective reporting on risks, reporting on transactions with related parties, public procurement, etc. Because of their importance, these enterprises are subject to double auditing: independent external audit in accordance with the Law on Auditing and, due to their public character, audit by the state auditor.

With a view of addressing the issue of inefficiency of public enterprises, but also seeking to maintain an adequate level of control, the state becomes a co-owner

through the process of privatization. This situation creates a need for the adoption of a new regime of corporate governance that implies the existence of an organized system of relationships among key stakeholders, greater competence and accountability of the management, hard budget constraints and adherence to financial discipline. Owing to public-private partnerships, ownership dispersion and transformation into joint stock companies, a number of formerly state-owned enterprises are now becoming important players in the capital markets around the world. Many companies from China, Russia, Brazil and India have become large investors in the international market.

Size and composition of public enterprises

Despite extensive privatization of public enterprises, it should be emphasized that they continue to play a significant role in national economies all over the world. Due to political and economic reasons the state remains if not an exclusive, then a key owner of numerous companies engaging in commercial activities. Typically, operations of such companies are always connected with a broader public interest or the production of goods and services of an appropriate quality at affordable prices. One of the reasons for their existence is solving the problem of natural monopolies. Examples thereof include the construction of water supply network, construction of railways, electric power transmission, natural gas transportation, etc. These kinds of operations require large initial investment, but in subsequent phases the costs are relatively small [24, pp. 193-200]. Also, the rationale for the presence of large public enterprises in the areas of infrastructure is their substantial contribution to the development of a national economy.

Political reasons for maintaining state ownership are also of paramount importance. They are characterized by different levels of legitimacy. If motives for maintaining state ownership in some enterprises arise from the need to preserve strategic national interests (e.g. to keep control over natural resources and companies of strategic importance for economic development, regional development, etc.), hence such efforts are understandable. But, if efforts toward maintaining ownership control over large material

resources serve only to safeguard the interests of ruling political parties, then the obstructions of the process of full or partial privatization of some public enterprises are unacceptable.

A certain number of large SOEs in developing countries now have the status of listed companies and are becoming major economic players in emerging markets (China, India, Russian Federation). Some countries are establishing new SOEs to develop strategic sectors and boost their competitiveness in the global arena. For instance, Russia has created state-owned holding companies and state corporations such as the United Shipbuilding Corporation and the Joint Stock United Aircraft Corporation [28, pp. 3-7]. Similar examples can also be found in other countries.

With the idea to provide a better understanding of the size and importance of SOEs in the world, we will present results of the research study undertaken within the OECD area [6, pp. 5-10]. The findings are based on questionnaire responses submitted by 27 OECD countries (Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Italy, Israel, Korea, Mexico, New Zealand, Netherlands, Norway, Poland, Portugal, Slovenia, Spain, Sweden, Switzerland, and the United Kingdom). In this regard, we should point

out that the analysis did not encompass all SOEs, but only those controlled by the government, namely the Ministry of Finance or the Ministry of Economy, including majority owned listed entities (MOLE), majority owned non-listed entities (MONL), and statutory corporations (SC).

The analysis has showed that in the reporting OECD countries 2,085 enterprises operate in SOE sector, employ more than 4.3 million people and have an estimated equity value of over USD 1.3 trillion. Since the analysis did not include the data from the USA, Japan and Turkey, it is estimated that, taking into account these countries, the total employment would exceed 6 million people while the value of the entire SOE sector would exceed USD 1.9 trillion. Figures 2, 3 and 4 show the number of SOEs, number of employees and value of equity for 12 out of 27 countries covered by the analysis.

Even though the quality of data is not at the highest level since all countries did not submit complete information, we can draw several conclusions from the results. *Firstly*, in spite of intense privatization of public enterprises, the state remains largely involved in commercial activities. *Secondly*, the state acts as a sole owner in a considerable number of enterprises. Also, it is interesting to note that in a relatively large number of enterprises the state holds

Fig. 2: Number of enterprises

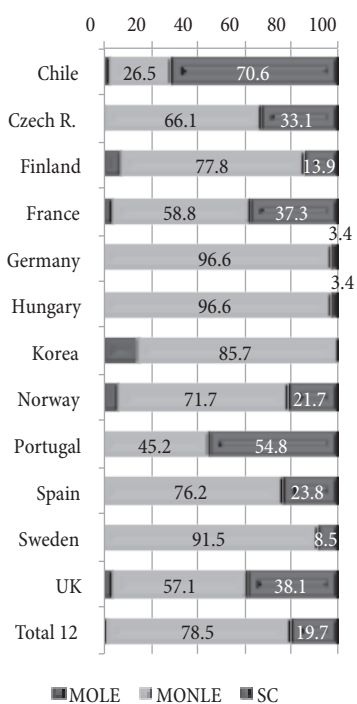


Fig. 3: Number of employees

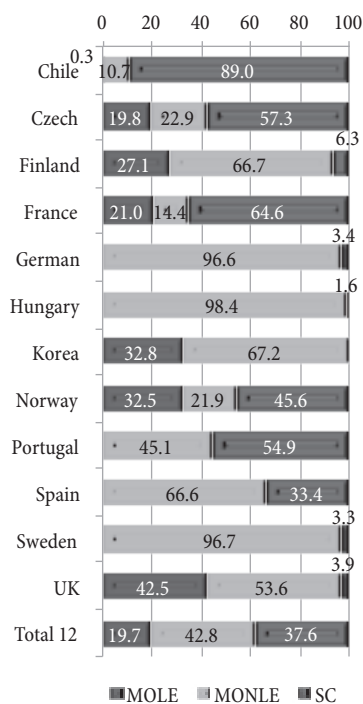
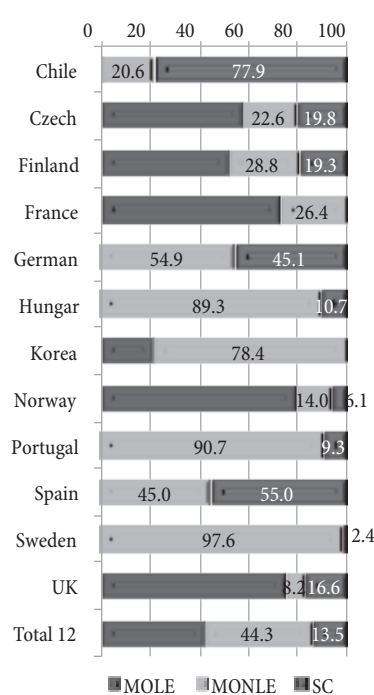


Fig. 4: Value of enterprises



Source: [6, pp. 7-8], author's own selection of countries and graph representation

significant (majority or significant minority) stakes in equity. In this regard, we can differentiate between publicly listed and unlisted companies. Despite the fact that the number of listed SOEs is smaller (about 2%) and that they have less employees relative to other SOEs (in 27 countries that were analyzed there are only 48 listed SOEs which account for about 20% of the total employment in SOE sector), their market value amounts to almost USD 520 billion, thus making up about 30% of the value of the entire SOE sector. *Thirdly*, in all analyzed countries the state holds 100% ownership in only 20% of enterprises, but the situation is markedly different between the countries. In Chile the state holds 100% ownership in 70.6% of SOEs, in Portugal 54.8%, UK 38.1%, France 37.3%, while in many countries this figure is less than 10% (Germany, Hungary, Sweden). For 7 out of 27 countries (26%) it was impossible to get data on the value of equity of wholly state-owned enterprises, which speaks volumes about the lack of transparency in business operations of these enterprises.

In addition to the listed companies in which the state has a majority stake, there are also the listed companies in which the state holds a minority stake. Thus, for example, in the aforementioned countries there are 54 enterprises in which the share of state ownership ranges between 10% and 50%. Partly state-owned companies (PSOEs) employ around 2.6 million of people and have market value of USD 767 billion. In France, for example, nine companies (including, among others, Air France KLM, EADS, France Telecom and Renault) employ around

925,000 people and have market capitalization of USD 244 billion. Three German PSOEs (Deutsche Telekom, Deutsche Post and Commerzbank) have around 757,000 employees and market capitalization of USD 77 billion, while Italian PSOE sector employs around 224,000 people and has market capitalization of just over USD 156 billion [6, pp. 9-13].

The reasons why the state opts for minority shareholdings may be different. The most commonly cited ones include unfinished privatization, avoidance of squeeze-outs (in most cases the threshold is 10%), prevention of hostile takeovers as well as the need to maintain a majority voting rights and dominant influence by entering into agreements with other shareholders [6, pp. 9-10].

It is evident that in almost all countries state-owned enterprises operate in the most important sectors: manufacturing, energy, natural resources, transportation, banking and other financial services (see Figure 5 and Figure 6). Accordingly, enterprises operating in infrastructure sectors (transportation, telecommunications, electricity and gas) have by far the largest value, accounting for around half of the total value of SOE sector. They employ about half of the total number of employees in SOE sector, notwithstanding the fact that they make up only about 25% of the total number of enterprises in SOE sector.

In order to provide a more complete picture of SOEs size, let us add a few more examples. In China, the central government controls 17,000 SOEs and over 150,000 SOEs are controlled by local governments. Moreover, 1,200 listed

Figure 5: Percentage of SOEs by sectors

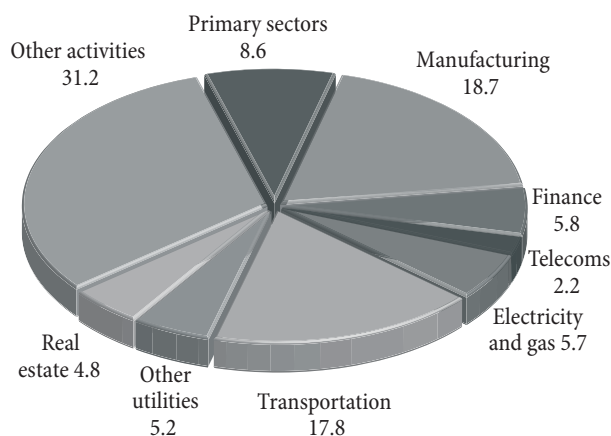
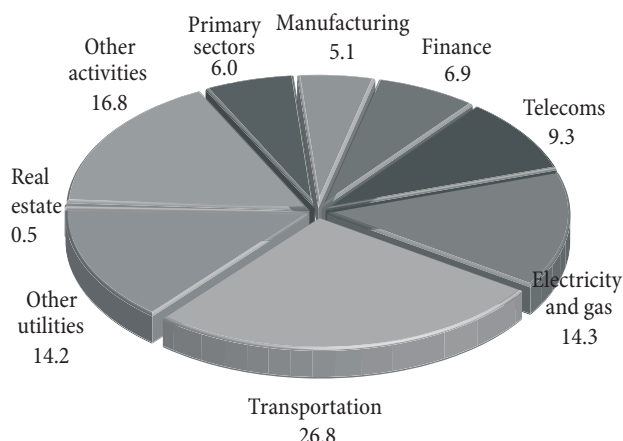


Figure 6: Employees of SOEs by sectors



Source: [6, pp. 7-8], author's own graph representation

Chinese SOEs generate about 18% of GDP, while their market capitalization accounts for about 40% of GDP. In India, there are around 240 SOEs which produce 95% of India’s coal, 66% of its refined oil, 83% of its natural gas, 32% of its finished steel, 35% of its aluminum, and 27% of its nitrogenous fertilizer. Indian Railways alone employs 1.6 million people. Financial sector SOEs account for 75% of India’s banking assets. In Russia, enterprises controlled by the federal government produce 20% of the total output of industrial sector, while the federal government controls over 20% of banking sector [29, p. 2].

Bearing all this in mind, the question arises as to what is the situation in public enterprises in Serbia. Our analysis encompasses all enterprises that are legally established as public enterprises and therefore are required to submit their financial statements to the Serbian Business Registers Agency. However, we have to underscore that this group does not include the enterprises which are wholly or partially owned by the state but have a different legal form. For this very reason, the companies such as Serbian Railways, Airport Nikola Tesla, Telekom Srbija, Corridors of Serbia, etc., have remained beyond the scope of the analysis.

To gain a better insight into the financial position of public enterprises and their importance in Serbian economy, first it is necessary to look into the share of public enterprises in the total number of companies as well as the share of their employees in the total employment in Serbia. The relative importance of these values will be assessed in relation to other legal forms. Apart from

public enterprises (PE), our analysis will also cover limited liability companies (LLC) and joint stock companies (JSC), while all other legal forms (general partnerships, limited partnerships, social enterprises, cooperatives, business associations, branches of foreign legal entities and other legal forms) will be grouped into a category hereinafter referred to as “Other legal forms” (OLF).

The structure of the economy in terms of the number of companies and the number of employees by individual legal forms in 2013 is displayed in Figure 7 and Figure 8. Please note that the groups relating to joint stock companies and limited liability companies also include some enterprises in which the state holds, directly or indirectly, whole or partial ownership.

In 2013 there were 510 state-owned enterprises in Serbia, which are required to prepare their financial statements in accordance with the Law on Accounting. From the perspective of the number of companies, limited liability companies have a dominant share, amounting to 93% of the total number of companies. However, the share of public enterprises is not significant and accounts for about 0.5% of a total of 94,362 companies doing business in Serbia. The fact that the share of public enterprises was stable throughout the entire analyzed period from 2007 to 2013 does not mean that their number has not changed. For instance, their number in 2013 (510) was by 13.3% larger relative to 2010 (450).

The number of employees in public enterprises (9.91% of the total number of 999,030 employees in all companies) is not in proportion to the number of public

Figure 7: Structure of the economy in terms of the number of companies

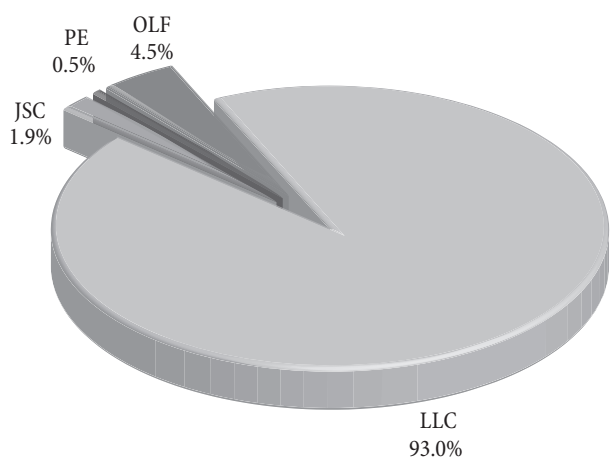
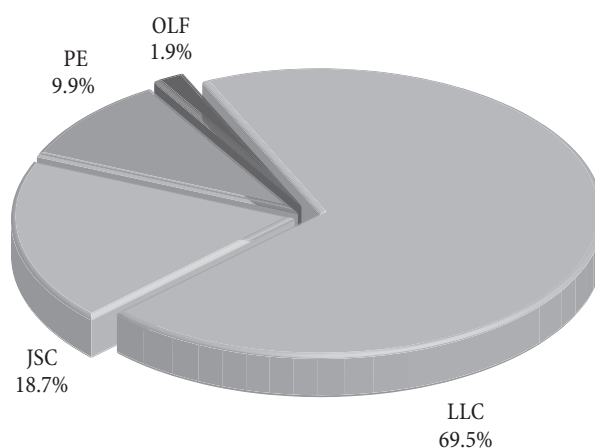


Figure 8: Structure of the economy in terms of the number of employees



enterprises. We can observe that in the seven-year period covered by the analysis the share of public enterprises in the total number of employees was over 19 times greater than their share in the total number of companies in the economy. The largest share in the employment structure in 2013 belongs to limited liability companies (60.5%) and joint stock companies (18.7%). The remaining 1.9% fall into the category of other legal forms.

In order to examine in more detail the financial position of public enterprises, we will analyze several important balance sheet items, such as: total assets, net owner's equity, accumulated losses, operating revenue, financial expenses, net income, and net losses. A share of individual legal forms in overall performance of the economy is shown in Table 1.

Table 1: Positioning of public enterprises

	2007	2008	2009	2010	2011	2012	2013	Average
1. Share of total assets								
LLC	51.92	55.96	58.75	59.50	61.69	63.06	63.78	57.50
JSC	25.77	23.93	22.25	22.30	21.78	20.68	19.97	23.15
PE	19.45	17.52	16.86	16.02	14.57	14.20	14.34	16.86
OLF	2.86	2.59	2.15	2.18	1.96	2.06	1.91	2.49
Economy	7,498.1	8,614.0	9,117.2	9,648.5	11,230.1	12,073.8	12,289.7	9,580.0
2. Share of net equity								
LLC	44.58	47.47	50.87	50.92	56.50	59.27	61.31	51.18
JSC	24.05	22.19	20.03	20.93	19.50	17.51	15.97	20.75
PE	30.52	30.09	29.26	28.07	24.31	23.52	23.00	27.81
OLF	0.85	0.26	-0.17	0.08	-0.31	-0.30	-0.28	0.26
Economy	3,531.0	3,562.9	3,501.9	3,385.6	4,452.4	4,486.1	4,485.0	3,801.6
3. Share of accumulated losses								
LLC	40.90	43.45	44.41	48.55	50.72	50.46	50.44	45.16
JSC	29.04	29.62	31.10	28.47	34.70	34.20	34.55	31.73
PE	20.12	18.08	17.45	16.57	8.57	9.71	10.41	15.51
OLF	9.94	8.85	7.04	6.40	6.01	5.63	4.60	7.60
Economy	1,100.9	1,374.3	1,649.9	1,947.9	2,233.1	2,507.1	2,856.7	1,823.2
4. Share of operating revenue								
LLC	66.75	69.82	72.12	72.39	73.70	75.60	76.77	71.28
JSC	24.61	22.08	19.34	19.05	18.15	16.82	15.30	20.22
PE	6.40	6.13	6.71	6.61	6.03	5.54	5.91	6.31
OLF	2.24	1.97	1.83	1.95	2.13	2.04	2.02	2.19
Economy	5,323.9	6,209.0	5,889.0	6,638.0	7,445.1	8,188.5	8,268.4	6,546.4
5. Share of financial expenses								
LLC	48.99	55.72	59.42	60.83	65.59	63.86	64.20	57.64
JSC	37.51	33.99	30.55	27.12	28.26	26.36	25.48	31.22
PE	8.86	7.68	7.41	9.77	4.47	7.29	8.74	7.93
OLF	4.63	2.61	2.62	2.28	1.68	2.49	1.58	3.21
Economy	201.9	476.8	419.2	525.0	420.2	561.4	333.3	389.4
6. Share of net income								
LLC	70.33	74.51	73.93	69.85	69.17	70.84	71.35	70.99
JSC	25.32	21.16	20.92	24.84	27.28	25.82	24.72	24.45
PE	2.96	2.79	4.09	3.51	1.99	1.63	1.99	2.87
OLF	1.39	1.54	1.06	1.80	1.55	1.71	1.94	1.69
Economy	328.9	300.0	282.9	316.5	458.6	433.2	446.0	356.6
7. Share of net losses								
LLC	64.37	51.45	52.76	64.94	61.54	56.45	53.19	55.74
JSC	21.03	30.05	37.22	23.39	30.90	28.14	32.40	29.95
PE	9.39	10.74	4.91	8.49	4.48	11.80	12.69	9.17
OLF	5.21	7.75	5.11	3.19	3.07	3.61	1.72	5.14
Economy	279.0	343.5	385.1	406.2	373.7	520.2	469.2	369.8

Note: All values are shown in billions of RSD

The data presented in Table 1 help deepen our understanding of the importance of public enterprises. Consequently, we can draw several important conclusions from the presented overview.

Firstly, financial indicators suggest that the dominant position belongs to the companies that have a legal form of limited liability companies. Their average share in total assets for the whole analyzed period was 57.5%, in net owner's equity 51.2%, in operating income 71.3%, and in net income 71%. However, one should not lose sight of the fact that these companies have the largest share in financial expenses (57.6%), as well as in accumulated losses (45.16%) and net losses (55.7%). Bearing in mind that these companies are dominant in terms of number compared to other legal forms (75,473 companies or slightly more than 86% in 2007, while in 2013 their number increased to as much as 87,760 enterprises or 93%), and that during the entire analyzed period they employed slightly more than 650,000 workers on average (more than 60% of total employment in the economy), it is realistic to expect their performance to be far better than it currently is. However, a more thorough analysis of this issue is beyond the scope of this paper.

Secondly, a similar trend is present in joint stock companies. Financial indicators show that they are somewhat between limited liability companies and public enterprises. Yet we should have in mind that in developed market economies joint stock companies, albeit their relatively small number, generally have the best performance, generate the greatest revenues, deploy the largest amounts of capital, and create a substantial shareholder value. As far as Serbian economy is concerned, they make losses (almost a third of total accumulated losses are attributed to them), account for about 20% of total assets and only about 16% of net equity.

Thirdly, a cursory glance at all parameters analyzed herein gives an impression that public enterprises lag behind limited liability companies and joint stock companies. On average, 16.9% of total assets, 27.8% of net equity, and 2.9% of net income belong to public enterprises. But if we remember that there are only about 500 public enterprises (0.5% of a total number), we can conclude that public enterprises are far more important than we might think

based only on the data on their number. Regardless of such financial strength, public enterprises generate modest revenues, with an average share of 6.3% in total operating revenue, and even more modest net income amounting to 2.9% of total net income. The situation has turned out to be much worse given that such a small number of public enterprises account for, on average, 15% of total accumulated losses and 9.2% of net losses.

Fourthly, if we observe changes in the structure of financial performance in 2013 compared to 2007 (when financial statements were not burdened by the effects of economic crisis), we can get more insights about the extent of their recovery from the consequences of the crisis. Unfortunately, we can see that the share of public enterprises in total assets, net equity, operating revenue and net income declined, while they increased their share in net losses.

In order to grasp the gravity of the problems faced by public enterprises, it is necessary to quantify the degree of their exposure to particular types of risk. Further analysis of public enterprises will be based on official abridged financial statements for the period 2007-2013. Once again, we have to underline that the analysis encompasses all entities which submitted their financial statements to the Business Registers Agency as public enterprises, whereas the enterprises that are wholly or partly owned by the state were not covered by this analysis. Abridged financial statements, i.e. balance sheet and income statement, can be found on the author's webpage.¹

Dimensions of operational and financial risks

Analysis of the performance of a company or a group of companies and associated risks is important for at least two reasons. First, insight into performance allows us to assess the company's ability to create value for shareholders and other stakeholders, potential threats to its continuity as well as the quality of asset management. Second, evaluation of existing risks is even more critical considering the fact that already present, inherited risks place a huge burden on the future performance and growth not only of individual companies, but also of the overall

¹ See: http://w3.ekof.bg.ac.rs/dejan_malinic

economy. Ignorance of inherited risks is often seen as one of the main reasons why the implementation of adopted strategies fails.

Financial statements serve as a valuable source of information for the research on liquidity risk, solvency risk, profitability risk, credit risk, bankruptcy risk, financial reporting manipulation risk, etc. The results of the analysis of financial statements of public enterprises which may be used for the evaluation of these risks are summarized in Table 2.

Analysis of liquidity risk. Lack of liquidity is often proclaimed the greatest and most urgent problem of Serbian economy. This view partly stems from the misunderstanding

of the fact that illiquidity is actually a consequence of other serious financial and structural disorders [14, pp. 41-62]. As regards its causes, public enterprises are perceived as one of the key generators of illiquidity mainly due to the inability to meet their maturing obligations. The question is whether there are reasonable grounds for similar views. In this section, we will try to quantify existing risks arising as a result of illiquidity.

Traditional indicators of liquidity (i.e. current ratio and quick ratio), which are most frequently used in Serbia, have values that are far below standard ones (2 for current ratio and 1 for quick ratio). In the last year of analyzed period the value of current ratio is by 72%

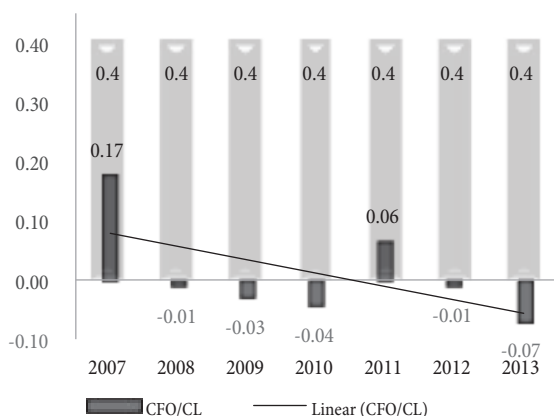
Table 2: Indicators of liquidity, solvency and profitability of public enterprises

Indicators	Public enterprises							PE Average	Economy Average
	2007	2008	2009	2010	2011	2012	2013		
LIQUIDITY									
1. Current Ratio	0.63	0.63	0.65	0.65	0.66	0.60	0.56	0.62	0.97
2. Quick ratio	0.49	0.51	0.53	0.52	0.55	0.49	0.45	0.51	0.60
3. Cash ratio	0.19	0.19	0.20	0.19	0.20	0.15	0.14	0.18	0.18
4. Defensive Interval	42.49	46.92	55.80	57.11	60.60	57.40	53.53	53.41	37.97
5. Cash Flow from Operations Ratio	0.17	(0.01)	(0.03)	(0.04)	0.06	(0.01)	(0.07)	0.01	0.00
6. Average No. Days Inventory in Stock	30.8	28.4	29.6	33.8	35.6	34.2	35.3	32.5	76.9
7. Average No. Days Receivables Outstanding	70.4	72.3	85.8	87.3	93.7	106.1	108.2	89.1	89.9
8. Average No. Days Payables Outstanding	197.3	186.4	192.7	158.9	165.1	197.9	219.4	188.2	148.4
9. Cash Cycles	(96.0)	(85.6)	(77.2)	(37.8)	(35.9)	(57.7)	(75.9)	(66.6)	18.4
SOLVENCY									
1. Fixed Assets Coverage Ratio	0.82	0.80	0.76	0.72	0.77	0.72	0.69	0.75	0.66
2. Fixed Assets and Inventories Coverage Ratio	0.91	0.90	0.89	0.87	0.89	0.85	0.83	0.88	0.77
3. Debt to Equity	0.35	0.41	0.50	0.63	0.51	0.62	0.71	0.53	1.55
4. Deficiency NWC/Total asset	7.59	8.54	9.08	10.66	9.67	12.32	14.41	10.33	16.29
5. Interest Coverage Ratio	0.05	0.14	0.69	0.47	0.53	(0.41)	(0.81)	0.09	0.92
6. Cash Flow from Operations/Interest Expenses	1.98	(0.07)	(0.26)	(0.27)	1.17	(0.08)	(1.03)	0.21	0.11
7. Cash Flow from Operating to Debt	0.10	(0.01)	(0.02)	(0.02)	0.04	(0.01)	(0.04)	0.01	0.00
8. CAPEX ratio	28.17	(4.41)	(16.06)	(25.70)	21.72	(3.63)	(30.83)	(4.39)	(0.55)
PROFITABILITY									
1. Fixed assets turnover	0.27	0.29	0.29	0.33	0.33	0.32	0.33	0.31	1.19
2. Current assets turnover	2.60	2.52	2.21	2.11	1.98	1.89	1.92	2.18	1.81
3. Total Assets Turnover	0.24	0.26	0.26	0.28	0.28	0.27	0.28	0.27	0.72
4. EBIT Margin	0.24	1.31	5.45	5.46	2.20	(3.74)	(4.85)	0.87	5.48
5. Return on asset -ROA (3 x 4)	0.06	0.34	1.41	1.56	0.62	(1.01)	(1.36)	0.23	3.92
1. Operating revenues	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
2. Operating expenses ratio	102.56	102.77	97.71	97.63	100.51	100.52	95.97	99.67	96.22
3. Operating income margin	(2.56)	(2.77)	2.29	2.37	(0.51)	(0.52)	4.03	0.33	3.78
4. Operating assets turnover	0.35	0.36	0.36	0.39	0.38	0.36	0.36	0.36	0.85
5. Return on operating asset -ROOA (3x 4)	(0.88)	(1.00)	0.82	0.92	(0.19)	(0.19)	1.46	0.12	3.21
1. Leverage	1.34	1.38	1.45	1.56	1.56	1.57	1.67	1.50	2.50
2. Total assets turnover	0.24	0.26	0.26	0.28	0.28	0.27	0.28	0.27	0.72
3. EBIT Margin	0.24	1.31	5.45	5.46	2.20	(3.74)	(4.85)	0.87	5.48
4. Interest burden	(19.89)	(5.73)	(0.34)	(0.98)	(0.77)	3.20	2.14	(3.20)	(0.08)
5. Return on equity - ROE (1x2x3x4)	(1.57)	(2.65)	(0.70)	(2.37)	(0.75)	(5.08)	(4.86)	(1.12)	(0.80)

lower than desirable value, while the value of quick ratio is by 55% lower than desirable value. Cash ratio indicates that only 14% of current liabilities in 2013 were covered by cash and cash equivalents. Finally, defensive interval reveals that operating expenses could be financed from current assets only about 53 days on average for the entire analyzed period. Such a discrepancy between current assets and current liabilities suggests why these companies tend to encounter problems with the settlement of their maturing liabilities.

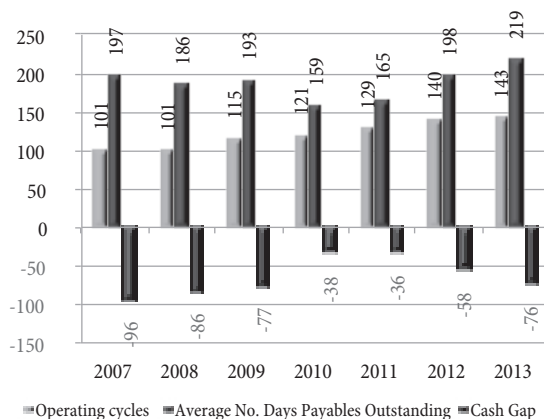
The ratio of cash flow from operations to average current liabilities represents a much more reliable measure of liquidity. It refers to the company's ability to cover maturing current liabilities from internally generated cash flow. The movements of this indicator are displayed in Figure 9. Wide lighter bars indicate liquidity threshold, while narrower darker bars inside them show the values achieved by public enterprises. Public enterprises were far from passing this important liquidity test since they reported negative cash flow from operations in five out of seven analyzed years, which in the case of private companies would mean being on the sure path to bankruptcy. The average value of this indicator for the entire analyzed period is 0.01, which is 40 times lower than its standard value of 0.4. Moreover, the fact that this indicator shows a downward trend is another serious cause for concern. Empirical research studies that explored the interdependence between movements in this indicator and bankruptcy of companies have found that as much as 90% of companies which for several years in a row had the values of this ratio below 0.4 faced bankruptcy [4, pp. 61-66].

Figure 9: CFO/CL



All things considered, a logical question arises as to how these companies are able to operate at all. The analysis of cash cycles presented in Figure 10 gives a clear answer to this question. It is well known that in order to ensure normal functioning companies must provide financing of their operating cycle, encompassing the period from the procurement of raw materials, through production and sales of their products, to the collection of receivables. In part, financing is secured from the so-called spontaneous sources of financing (where suppliers have a key role). Difference between operating cycle and spontaneous sources of financing represents the so-called cash gap that is closed by having recourse to additional sources, which is usually done by means of short-term credit sources [3, pp. 27-32]. In normal functioning economies where financial discipline is not called into question, reduction in cash gap is most often a consequence of increased efficiency across the operating cycle (i.e. reduced number of days inventory held and accelerated collection of receivables). However, cash gap does not exist in public enterprises. The average length of operating cycle, including days inventory held and days accounts receivable outstanding, is 122 days, which is by 67 days shorter period than days accounts payables outstanding. Besides, the trends are unfavorable. The length of operating cycle constantly extends, which is an obvious sign of inefficient asset management in public enterprises, while at the same time the average number of days payables outstanding increases, which points to unfair treatment of suppliers in the process of financing the activities of public enterprises.

Figure 10: Analysis of cash cycles



If we compare the movements of previous indicators with the average values for the economy as a whole, we can see that no matter how the performances at the economy level look bad, they nonetheless have proven to be better relative to comparable performances of public enterprises. This fact allows us to conclude that the liquidity problem is deeply embedded in public enterprises and that they actually are one of the greatest generators of illiquidity in the whole economy. In this regard, a huge burden of the financing of operating cycle is passed on suppliers. The liquidity problem is further exacerbated by the fact that suppliers are unable to meet the obligations toward their own suppliers, thus taking the form of liquidity spiral. As a result, even the healthy parts of the economy become affected by liquidity risk [16, pp. 105-106]. Since a delay in fulfilling obligations toward suppliers does not provide for long-term sustainable cash flow [27, pp. 386-387], the liquidity problem is only postponed, becoming even more complex to deal with.

Analysis of solvency risk. Solvency risks are related to the inability to pay interest and debts as they fall due. The crisis of insolvency may arise as a consequence of inadequate financial structure, decline in profitability, inability to generate a sufficient amount of positive cash flow from operations, and high cost of capital. The indicators of solvency and profitability, systematized in Table 2, seem informative enough to provide a detail insight into long-term solvency risks faced by public enterprises.

Specific financial structure of public enterprises may lead us to draw erroneous conclusions on their long-term financial stability. Therefore, we must bear in mind that public enterprises are capital-intensive, which means that they dispose of large amount of fixed assets. Over the entire analyzed period the share of fixed assets in total assets of public enterprises accounted for 87.1% on average, while at the economy level this share was considerably lower, amounting to 60.2%. Since fixed assets are considered the most risky part of assets, it would be reasonable to expect them to be financed from own equity as high-quality source of funding. A potential decision to rely on short-term sources in the financing of fixed assets bears a high degree of risk.

Different structure of assets calls for a cautious approach when comparing the indicators of public enterprises with the indicators for the overall economy whose calculation is based only on the balance sheet [11, p. 68]. At first glance, the analysis leads us to conclude that, in terms of solvency, public enterprises are in a far better position compared to the average values for the economy as a whole. The changes in values of fixed assets coverage ratio, fixed assets and inventories coverage ratio, debt to equity ratio, and deficiency net working capital (NWC)/total assets ratio support this conclusion. However, a more thorough analysis reveals a few important things. *First*, the values of fixed assets coverage ratio and fixed assets and inventories coverage ratio (although higher than the average for the economy) fall below values that would reflect financial stability of a company (below 1). *Second*, over the entire analyzed period the value of long-term equity was less than the value of fixed assets, which suggests that fixed assets are partly financed from short-term sources. This situation increases the exposure of public enterprises to financial risks. *Third*, negative net working capital continuously increases (see Figure 11), which jeopardizes not only a company's growth but also its very survival. For example, NWC deficiency exceeds EUR 2 billion in 2013. In the same year the share of NWC deficiency in total assets is 14.4% (see Figure 12), which points to the mismatch between the maturity structure of assets and the maturity structure of sources of financing. *Fourth*, the value of public enterprises capital is substantial due to a high share of fixed assets in total assets, but not sufficient. Its share in total net equity and liabilities is about 65.6% on average, which is not enough given the fact that an average share of fixed assets in total assets stands at already mentioned 87.1%. Anyway, a specific structure of assets and sources of financing in public enterprises is the reason for a much more favorable value of debt to equity ratio in comparison to the average value of this ratio for the economy. This is certainly a good sign, but it does not provide enough evidence in favor of the conclusion that the financial position of public enterprises is better from the rest of the economy. Furthermore, we have to take into account that the equity structure of public enterprises is somewhat questionable, given a relatively high share of

revaluation reserves in equity. *Fifth*, an issue of particular concern is the fact that all of the above-mentioned indicators show a significant negative trend, including debt to equity ratio whose value of 0.71 in 2013 is twice as high as in 2007 when it stood at 0.35.

The previous indications of public enterprises serious exposure to solvency risks were fully confirmed as soon as the indicators that take into account profitability and cash flow were introduced into analysis. Let us briefly enumerate the key results. A ratio of earnings before interest and taxes (EBIT) to financial expenses is a widely used to measure the solvency risk. An average value of this indicator for public enterprises is 0.09, which is 10.2 times lower than the average value for the economy. Besides, in 2012 and 2013 its values are negative amounting to - 0.41 and - 0.81, respectively. To illustrate the gravity of the situation, let us note that some authors stress that the values in the range 5 to 7 point to good performance [18, pp. 70-77], while the values below 2 indicate an extremely risky situation [23, pp. 298-299]. Similar conclusions can be made based on the values of the ratio of cash flow from operations to interest expenses, which are negative in five of seven years covered by the analysis (desirable value should be greater than 0.2). At the first glance, its positive value in 2011 seemed encouraging but more detailed analysis of the origins of this positive cash flow reveals that it is a consequence of unpaid accounts payables (they increased by RSD 16.1 billion year-on-year) and increase in liabilities in the form of VAT and accruals (about RSD 7 billion). At the same year, financial expenses are the lowest in the observed period from 2008 to 2013.

The presence of serious risks related to solvency is confirmed by the values of CFO to debt ratio that indicates the company’s ability to cover total debt with its internally generated cash flow. The above-mentioned empirical studies have shown that most of the companies having the value of this ratio less than 0.2 over a period of five years go bankrupt [4, pp. 61-66]. In public enterprises in five out of seven analyzed years these values were negative and far away from the reference value of 0.2. In general, we can conclude that public enterprises experience huge difficulties in paying off their debts. This means two things. First, activated guarantees that were granted by the government for individual loans directly affect public debt and budget and, second, public enterprises must continue to borrow. Anyway, debts are not the only problem. Another one is how to finance new capital investments that are necessary for maintaining or extending the existing capacities. The analysis of CAPEX ratio shows that investments cannot be financed from internally generated sources since the cash flow from operations is negative (as we have already seen, even the positive one from 2011 is not sustainable in the long run). Such a situation again creates the need for additional borrowing. The problem is that the financing of growth exclusively by debt is not sustainable in the long term. Consequently, the problem of profitability in public enterprises comes to the fore.

Profitability of public enterprises. Profitability is a prerequisite for the survival and sustainable growth of companies. Only profitable companies are able to provide more wealth for their owners and a national economy, stable growth rates, higher employment, greater certainty

Figure 11: Analysis of net working capital

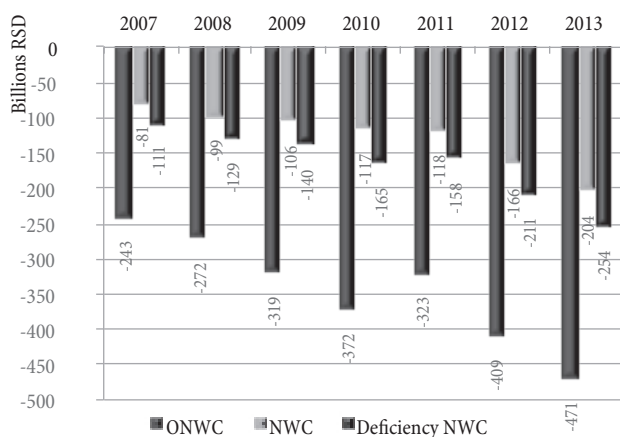
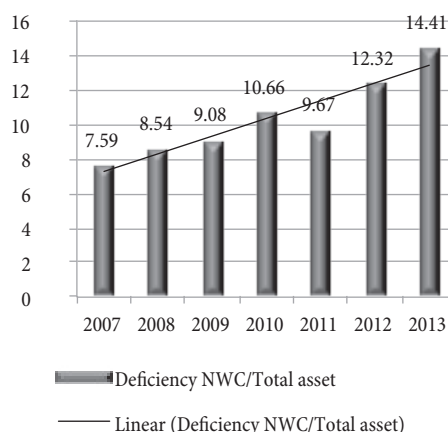


Figure 12: Deficiency NWC/Total asset



for investors, more favorable borrowing terms, and lower cost of capital. On the other hand, the lack of profitability is associated with the problems such as illiquidity, insolvency, increased risk of bankruptcy, fall in employment, and the like. Having all this in mind, profitability makes a suitable measure of the quality of management.

Numerous empirical studies have proved that the state is not a good owner. Therefore, the problem of profitability of public enterprises is a highly sensitive issue for their managers, but also a very interesting field of research for financial analysts. Analyses of the amount and structure of net income and loss and changes in corresponding rates of return (see Figures 13, 14, 15 and 16) are the most common instruments for evaluating the profitability of public enterprises.

The fact is that public enterprises report net losses over the entire analyzed period. In order to detect the causes of their losses let us look at Figure 13 which presents income and loss figures for different areas of business. A matter

of special concern is the fact that they reported losses in the sphere of operating activities that includes results of core business activities. In four of the seven years covered by the analysis, public enterprises reported net operating losses (i.e. the sum of net operating losses is greater than the sum of net operating incomes). Moreover, even in the years when net operating income is recorded, operating income margin is quite modest (see Table 2) in the sense that the average operating income margin for the whole analyzed period amounts to only 0.33%. In comparison to very low average operating income margin at the level of the economy of 3.78%, this margin is 11.5 times lower. The fact that in three fiscal years (2007, 2009, and 2011) the growth of operating income significantly lags behind the growth of operating revenues is especially worrisome and clearly illustrates the inefficiency of public enterprises. A general pattern of behavior of fixed costs implies that the growth of revenues is followed by a faster growth of operating income.

Figure 13: Analysis of structure income/loss

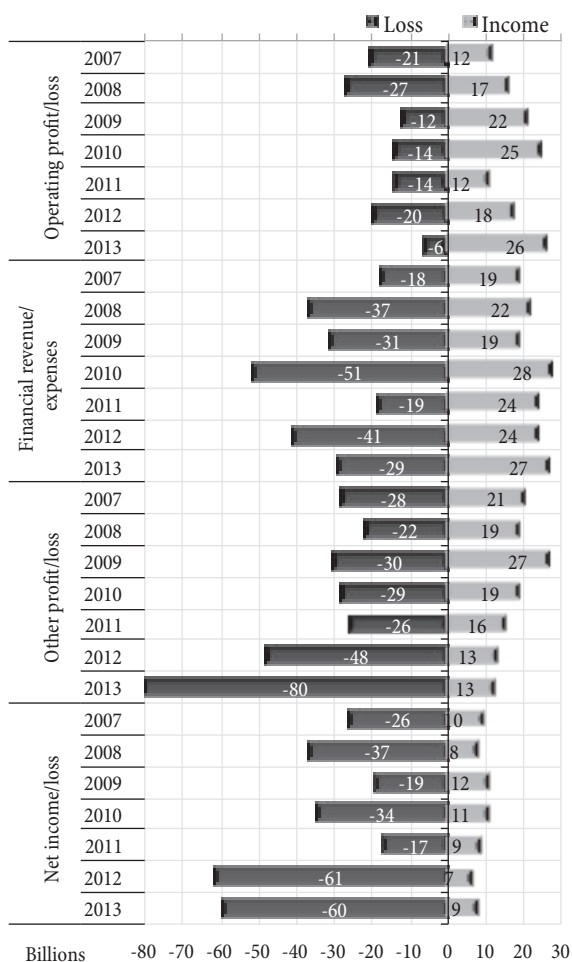


Figure 14: ROA

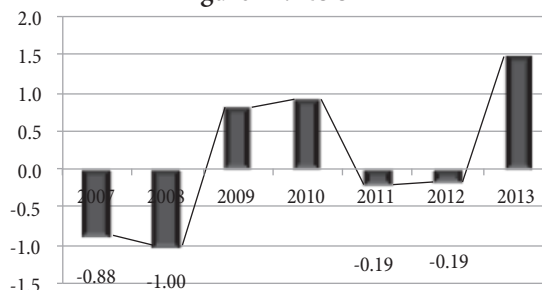


Figure 15: ROA

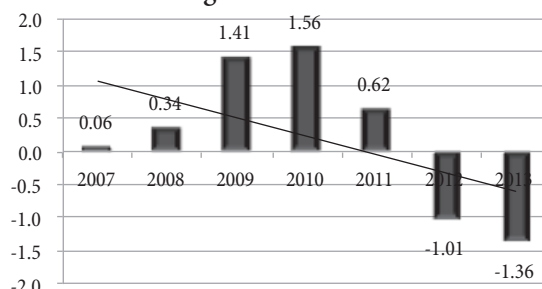
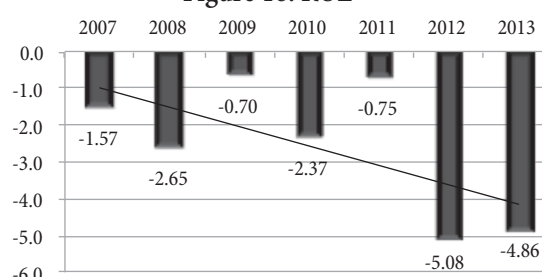


Figure 16: ROE



There are also obvious problems in the area related to the use of external credit sources of financing and allocations of internal sources. Financial revenues are lower than financial expenses in all years, except in 2007 and 2011. We could say that the situation in 2013 is not particularly unfavorable compared to other years, given that public enterprises reported financial revenues that are by about RSD 2.2 billion lower than financial expenses. Such a conclusion stems from the fact that this year was marked by an increase in long-term and short-term loans of RSD 46.1 billion, but nevertheless financial expenses were reduced relative to 2012 by RSD 11.8 billion. In all other years (2008, 2009, 2010, and 2012) public enterprises reported serious losses in this section of income statement. The explanations for this trend should be sought in increasing borrowing, but especially in changes in foreign exchange rate. Namely, it is precisely in 2007, 2011 and 2013 that the dinar exchange rate was stable and only in those years financial expenses margin was below 10% (9.91%, 6.29%, and 8.93%, respectively). It is apparent that occasional reduction in financial expenses of public enterprises is not a consequence of debt repayment. The most substantial losses in this section of income statement are reported in the years when there was a significant drop in the value of the dinar [17, pp. 7-42].

Moreover, it would be also interesting to observe changes in net other gains (expenses) which were negative in all analyzed years. In this section of income statement for 2013 public enterprises reported income of RSD 12.8 billion, while the losses amounted to as much as RSD 80.2 billion. What concerns us is the fact that this section includes expenses incurred as a result of depreciation of property, plant and equipment, revalorization of assets, and direct write-offs of receivables and similar items. All this shows a significant impact of accounting policies on the companies' performance. In spite of their transitory nature, these expenses are recurring year after year and are constantly growing. In 2012 they were by 86% higher relative to 2011, while in 2013 they were by 66% higher than in 2012.

Trends in the values of ROA, ROOA and ROE as well as their components (see Figures 14, 15, and 16, and Table 2) make more visible the consequences, but also the causes, of

unenviable position of public enterprises. The mentioned rates of return are burdened by low assets turnover, whose values are affected by high capital intensity and inefficient asset management. In this regard, the average total assets turnover in public enterprises is 2.7 times lower than the average for the economy, while operating assets turnover is 2.4 times lower than its equivalent. Low level of turnover in combination with very low income margins (often negatives) which, in addition, show a downward trend, leads to unacceptably low rates of return (often negative) that lag far behind comparable rates of return (also very low) for the economy as a whole.

All things considered, what are the consequences for the state as an owner? The answer is easy to find if we look at ROE, which measures the profitability of owner's equity (in this case – the state's equity). From Table 2 we can see that the values of ROE were less than zero in all years. That means that the return achieved on borrowed capital is not sufficient to cover the costs of the same capital. The negative difference has spillover effect on ROE which then becomes lower than ROA. The effect of financial leverage, as a measure of financial risk, is therefore negative in all analyzed years. Public enterprises have left the state only with losses and debts. Let us recall that in private companies owners bear the greatest risk and, consequently, expect the highest returns.

When it comes to profitability, a general conclusion is that public enterprises are unprofitable due to inefficient asset management (low values of turnover ratios), low level of the profitability of revenues (low income margins), growing indebtedness, and a huge burden of financial expenses. There a number of reasons for this state of affairs. *Firstly*, revenues of public enterprises are not sufficient to allow them to be profitable. The previous may be a consequence of technical and technological obsolescence of assets that cannot generate higher revenues, insufficient volume of activities, and inadequate pricing policy conceived with the aim of ensuring a social peace. *Secondly*, when there are shortages on the revenue side, as is often the case in public enterprises, the management than turns to costs, thereby attempting to achieve better performance by means of more efficient cost management. Unfortunately, modern management techniques that can lead to improved

performance are almost non-existent in public enterprises primarily due to the lack of effective management and adequate control. *Thirdly*, collection of otherwise insufficient revenues is seen as particularly problematic. Unsatisfactory collection of receivables endangers cash flows, which could result in a smaller or greater degree of discrepancy between operating income and cash flow from operations. Write-off of uncollectible receivables is actually recognition of losses, whereas keeping them in financial statements implies the existence of hidden losses. *Fourthly*, poor quality of corporate governance and operational management is one of the key reasons for disappointing performance of public enterprises.

The quality of corporate governance

The financial risks that have so far been identified are very worrying. Remedies such as granting subsidies to public enterprises to ensure their survival or transferring their obligations to the state with the view of enabling them for a fresh start do not provide a long-term solution to these risks. We could say that the long-standing, intolerably high risks arising from underperforming management have brought public enterprises into serious financial troubles. The attitude of the state toward public enterprises must be radically changed. The first step in the right direction would be to create conditions for raising the quality of corporate governance in public enterprises.

Ongoing trends in the field of corporate governance may reduce or increase the existing risks. Numerous studies have shown that in many countries (China, India, Malaysia, etc.) the level of financial performance of public enterprises has been significantly improved during the last decade, mainly thanks to various measures of operational and financial restructuring, ownership dispersion, access to capital markets, and creation of level playing field for all businesses. Hence the increased contribution of these enterprises to the state budget [28, p. 9].

Corporate governance involves a set of relationships between management, shareholders, and other stakeholders affecting the operations of companies, their approach to goal setting, and the means of attaining these goals. Corporate governance defines expected behavior of management

with respect to financial performance, efficiency, growth, financial structure, employment, attitude toward investors, etc., and therefore represents a major determinant of a company's value. From the perspective of normative framework, corporate governance implies that companies should behave in accordance with the rules established by the current legal system, judiciary system, and regulations governing the functioning of financial and labor markets [7, p. 2]. Consequently, the establishment of a robust regulatory framework and strengthening of internal and external control mechanisms are key prerequisites for enhancing the quality of corporate governance.

Regardless of the fact that a number of company generally deal with similar problems of corporate governance, we have to bear in mind that there are differences depending on whether companies are under state or private ownership. Also, the situation could be somewhat different depending on whether the state is in the position of sole, majority or minority owner. A special character of public enterprises calls for a specific approach to the area of corporate governance. In that regard, we can identify several important issues.

- Presence of information asymmetries. More precisely, information asymmetries in public enterprises exist between the board of directors and government institutions that control it, executives and the board of directors, as well as between internal and external members of the board, but one should have in mind that the former are always in a superior position in terms of access to information compared to the latter.
- Composition of the board of directors. The fact is that the board's agenda and decisions could be directly influenced through the agency of their members. Since the composition of the board is often under the influence of political authorities, we can easily imagine that it is rather tailored to follow instructions and do what should be done, which is not always in accordance with the general interest [1, pp. 96-97].
- Incompetence of members of the board of directors. Competence is often overshadowed by a member's political partisanship, which is in stark contrast to the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* that state the following

[20, p 17]: “The boards of state-owned enterprises should have the necessary authority, competencies and objectivity to carry out their function of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions.”

- Conflicting goals. Dominance of political over economic goals leads to conflicts in priority setting. In this regard, underestimation of the importance of the objective of achieving a reasonable return on equity and prioritization of political goals instead increase agency costs, destroy the company’s value, and erode its competitiveness in the market economy.

Numerous empirical studies have confirmed the link between political affiliation of the board’s members and performance of public enterprises. *Agrawal* and *Knoeber* found a negative correlation between the presence of external members on the board of directors and the enterprise’s value [2]. *Menozzi*, *Gutiérrez Urtiaga* and *Vannoni* showed that politicians dominate the boards of directors in Italian SOEs, that the presence of these directors triggers an increase in employment (increase in the number of employees is more pronounced if the boards of directors are greater in size or mostly composed of politicians), as well as that there is significant negative correlation between composition of the board of directors (percentage share of politicians on the board) and performance of Italian SOEs [19, pp. 694-696]. It would be interesting to mention the study of *Faccio* (on a sample of about 20,202 enterprises from 47 countries) who concluded that the enterprise value increases after one of the top officers enters politics (CEO, director, large shareholder) [9, pp. 384-385]. Comparing enterprises with political connections (enterprises where large shareholder holds at least 10% of voting rights or a top officer, such as CEO, vice-president, chairman, or secretary, is a member of parliament, a minister, or is closely related to a top politician or party) with enterprises that are not associated with politicians. The same author concludes that enterprises with political connections exercise greater market power, pay less tax, report lower value of ROA and lower market value. The differences between these groups of enterprises become even more marked when connection is established through a minister

rather than through a member of parliament, as well as when enterprises operate in the countries with higher level of corruption [8, pp. 924-925].

It is more than obvious that the management of public enterprises is in much more favorable position in relation to the management of private companies. Such a position is a consequence of their connection with political authorities that appoint them, inadequate control, and lack of competition. Besides, we should not forget that public enterprises are less likely to be subject to external control mechanisms than private ones. Unlike private companies, these enterprises are not exposed to the risk of a hostile takeover which, among other things, results in the change of management team. This situation directly reflects in the lack of initiative of top managers to maximize the value of company. Furthermore, the fact that most of public enterprises do not have the option of filing for bankruptcy and that their losses are covered by the state implies the need for soft budget constraint, which additionally diminishes the efforts aimed at increasing revenues and reducing costs. In the absence of important external control mechanisms, there is a dominant use of rather ineffective internal control mechanisms by various political authorities that are far from being immune to the practice of taking advantage of public enterprises to attain political goals.

There is no doubt that we have to take decisive steps to improve the corporate governance of public enterprises in Serbia. The state should first learn from its own mistakes and solutions that have turned out to be unsustainable in the past as well as from positive experience of other countries that have reformed public enterprises, and then to create a framework that would allow ownership rights to serve as a basis for deriving benefits which would be of general, rather than of particular interest. The key elements of the reform of corporate governance could be as follows [28, p. 18]:

- Establishing a sound legal and regulatory framework for corporate governance in public enterprises (enacting high-quality, consistent and harmonized legislation, formulating and adopting a code of ethics that would provide guidelines on best practice in public enterprises);

- Enhancing the state's ownership role (increasing accountability, separating the state's ownership function from its regulatory function, limiting state intervention, etc.);
- Developing an accountability system based on monitoring of the performance of public enterprises (setting mandates, objectives and strategies, selecting key financial and non-financial performance indicators, measuring and comparing performance with targeted values, etc.);
- Strengthening financial and fiscal discipline of public enterprises (reducing public enterprises' preferential access to public finance, managing the fiscal risk, etc.);
- Professionalizing boards of directors of public enterprises (transparent nomination of directors, increasing responsibility for the implementation of objectives, putting in place evaluation and remuneration procedures, providing training to directors, etc.);
- Enhancing transparency and disclosure (applying the private sector's reporting standards, strengthening control mechanisms, carrying out independent external audits, etc.);
- Ensuring investors protection in mixed-ownership companies (providing for equitable treatment of all shareholders, ensuring participation of minority shareholders in shareholders' meetings, protecting against the abuse of related-party transactions);
- Building support and capacity for implementation (sincere commitment to reform, building institutional capacity to manage processes, disclosing information on the enterprises' true performance, imposing discipline on public enterprises by listing them on capital markets, publishing results of reform processes, gaining public support, etc.).

Of course, the reform of public enterprises requires the implementation of a wide range of measures that go beyond the improvement in corporate governance. Apart from enhancing corporate governance, it is also necessary to simultaneously undertake the processes of restructuring, privatization, establishment of public-private partnerships, to lift barriers to public enterprises

access to capital markets and so on. Addressing major challenges in the functioning of public enterprises could bring considerable benefits for both enterprises and their employees and the state and wider community.

Improvement of operational performance of public enterprises is closely associated with raising the quality of corporate governance. Increasing profitability and strengthening financial structure of public enterprises are expected to ensure greater protection of enterprises' assets, their more productive use, efficient internal allocation of resources, adequate financing, increased awareness of the necessity of fulfilling obligations toward creditors, etc. Profitability stands out as the best protection against potential financial difficulties. Requirement for more accountability of public enterprises' managers is aimed at motivating them to put more efforts in managing revenues, expenses and profits. This implies a broad application of modern management accounting techniques that could largely contribute to improving operational performance of public enterprises. Higher net income provides more opportunities for financing capital projects from internally generated sources, thus reducing the need for additional borrowing. *Greater transparency* of operating performance also comes with the increase in quality of corporate governance. Requirement for transparency and disclosure restricts behavior that is not in accordance with the general interest, reducing the space for eventual misrepresentation of results and corruptive actions. Transparency mitigates the risk of moral hazard and increases owner's protection. The importance of transparency lies in the fact that it makes more visible whether the state is efficient in performing its ownership function, to what extent public enterprises rely on government assistance, whether there are considerable related party transactions and the like. *Reducing budget and fiscal deficits* is of paramount importance. Enhanced profitability of public enterprises helps alleviate pressures on the budget. If earnings are achieved there is a strong likelihood that a portion of these earnings will end up in the budget. As a part of efforts toward improving the corporate governance of its major SOEs, the Lithuanian government has estimated that annual dividend could be increased by 1% of GDP as a result of better quality of corporate governance, thereby helping to significantly

reduce its budget deficit. Improvement in profitability of Serbian public enterprises would cut down the number of requests for subsidies and reduce fiscal risk [28, p. 17]. Of course, the issue of distribution of income, i.e. the portion of earnings that will be returned to owners versus the one that will be retained in company, is a highly sensitive and goes beyond the scope of this paper. In addition to the aforementioned, it should be pointed out that improvement in the quality of corporate governance *also allows public enterprises to be better equipped for privatization, public-private partnerships and access to capital market.*

Substantial results could be achieved in public enterprises in which the state is a majority shareholder or holds a significant stake as a minority shareholder. By going public and entering the capital market public enterprises *would gain access to alternative sources of financing.* Availability of a broad spectrum of sources of financing reduces the costs of financing. IPOs of large, financially strong enterprises would contribute to the development of the capital market. Shallow capital markets, like Serbian market, look forward to high-quality securities as they tend to energize their activities. Finally, participation in the capital market could *increase the value of enterprise as well as its attractiveness to investors.*

Financial reporting manipulation risk

Undertaking serious reform action is possible only with sound financial statements. Unfortunately, there are a number of cases from practice which testify about dramatic jeopardizing of otherwise extremely high informational capacity of financial statements, primarily because of managers' behavior. Contaminated financial statements impede proper risk assessment, mislead the state as an owner, prevent effective decision-making, increase the risk of adopting wrong policies and strategies, and discourage potential investors. In this regard, practice in public enterprises attracts a great deal of interest of researchers in this field.

Although there are differing opinions, it is generally considered that financial statements of public enterprises are of lower quality compared to those of private companies, especially the ones that are listed on the stock exchange.

Based on a sample consisting of 4,500 companies from 19 countries *Chaney, Faccio and Parsley* found that the quality of accounting information reported by politically-connected companies is significantly poorer than of the companies that do not have such connections [5]. The key reasons include: hiding of the benefits gained by virtue of their favorable "political" position, lower requirement regarding the transparency of reporting in relation to the companies involved in capital markets, which is in line with "demand hypothesis" [10, p. 222], considerable irresponsibility of executives who do not afraid of being penalized for the low quality of financial reporting since they enjoy strong political support. Besides, it should be outlined that public enterprises, as a rule, do not suffer the consequences of an increase in cost of debt incurred as a result of poor-quality financial reporting as is the case with other companies. In contrast to the foregoing and similar conventional views, there are also research studies that show that the quality of financial reporting is better in public enterprises [26, p. 810]. A main argument in favor of this view is the fact that protective attitude of the state toward public enterprises implies that managers are less prone to manipulate information in financial statements.

Irrespective of the previous argument it is apparent that the motives for manipulation of financial reporting in public enterprises exist. The most important are: executives' intention to keep their positions at any cost, even by hiding true performance when targets are not met, opportunity to receive larger bonuses, need to avoid the public pressure due to poor performance, cover-up of unjustified expenses, preparation for privatization or IPO, etc. Hence the need to address potential financial reporting risks with due care [13, pp. 7-32].

Undervaluation or overvaluation of assets, liabilities, income and losses distorts information in financial statements, thus making them an unreliable basis for decision making. The biggest threat comes from hidden losses appearing as a result of overvalued assets and undervalued liabilities, leading to overvalued earnings and undervalued losses. Because in this way overestimated earnings and underestimated losses tend to adversely affect future performance, their disclosure causes damage to all stakeholders, and especially to shareholders who

suffer substantial losses. Although hidden reserves, in terms of financial reporting considered as the opposite of hidden losses, are less harmful, their presence in financial statements is not always welcome. Here we do not refer to reasonable hidden reserves recommended by accounting best practice, but to excessive hidden reserves. Anyway, in our paper we mainly deal with public enterprises that do not have access to capital market and are wholly state-owned, and therefore not exposed to risks of hostile takeover and undervalued equity. But with the creation of hidden reserves a portion of achieved income is left aside, which means that it is not available for distribution and, as a result, the state does not collect revenues on that basis. A particular problem is the fact that hidden losses and hidden reserves are not visible in financial statements so that an average reader of these financial statements most probably will not be able to discern them.

Is there a problem of hidden losses in public enterprises in Serbia? The answer to this question requires a much thorough analysis that would be based on individual financial statements rather than on summary statements which are the subject of our analysis. Though there is not enough room for such an analysis in this paper, let us at least give some basic information on potential risks related to the quality of financial reporting in public enterprises. To this end, we will observe a few indicators that are widely used to evaluate financial reporting manipulation risk. Their overview is given in Table 3.

Obtained results have led us to several conclusions. *Firstly*, operating income quality, measured by a ratio of operating income to cash flow from operations, varies from year to year, which indicates that income is shifted across accounting periods and has lower quality. Of course, the quality of income of individual enterprises

may be better or worse relative to herein reported results. *Secondly*, the quality of assets declines in the first five years as a result of an increasing share of intangible assets in total assets. This finding is especially important given that a number of manipulations are often associated with this type of assets and the practice of capitalizing certain categories of expenses within these intangible assets. However, it should be outlined that the share of intangible assets in total assets is relatively small, thus leaving less maneuvering room. *Thirdly*, there is a very high risk inherent to account receivables. Receivables growth rate shows that this part of assets grows at faster pace than sales revenue, indicating collection problems and potential risk that some of these assets could be potential hidden losses. During the whole analyzed period (2007-2013) receivables increased 2.23 times, while operating revenues increased 1.43 times. Furthermore, the share of receivables in revenues of over 15% implies the risk of hidden losses. As far as public enterprises are concerned, the share of receivables accounted for much more than 15% in all years, showing a continuous increase (except in 2013). *Fourthly*, a greater share of transitory income (loss) which in this paper is referred to as other income and loss, points to significant informational risks. Other revenues come from the sale of buildings, plant and equipment, raw materials inventories, etc., adjustment in asset value, etc. On the other hand, other expenses arise as a result of depreciation of assets, write-off of uncollectible receivables, devaluation of assets, etc., which explains their transitory character. In the entire analyzed period public enterprises recorded net transitory losses exceeding net operational income 8.92 times. For example, as much as 71.9% of total net losses of public enterprises in the period 2007-2013 are attributed to other net losses.

Table 3: Manipulation risk evaluation in financial statements

	2007	2008	2009	2010	2011	2012	2013
1. Operating Income Quality	(0.25)	4.09	(1.13)	(0.76)	(0.11)	0.68	(0.66)
2. Asset Quality Index	1.17	1.25	1.71	1.06	1.33	0.81	1.00
3. Receivables Growth Rate	0.98	1.31	1.17	1.10	1.09	1.19	1.02
4. Share of receivables in revenues	19.09	22.46	25.21	24.98	26.68	31.49	29.75
5. Total return on operating asset	(1.65)	(1.28)	0.49	0.10	(1.03)	(2.93)	(3.54)
• Sustainable return	(0.88)	(1.00)	0.82	0.92	(0.19)	(0.19)	1.46
• Transitory return	(0.77)	(0.28)	(0.33)	(0.82)	(0.83)	(2.74)	(4.99)
6. Revaluation Reserves Growth Rate	1.57	1.11	1.00	0.99	2.75	1.06	0.45

Namely, when we decompose total return on operating assets (i.e. to sustainable and transitory components), we see that the share of transitory return in total return is substantial and the volatility of transitory return is high. This situation should be regarded with the utmost caution as it may indicate possible errors in the classification of particular revenues and expenses, but also the need to reconsider existing accounting policies relating to items classified under other revenues and expenses. *Fifthly*, special attention should be paid to revaluation reserves. They were constantly growing until 2012, recording an increase of RSD 265 billion by that time, but in 2013 they suddenly shrank by RSD 212 billion. At the same time, reserves increased by RSD 263 billion. Having in mind the way in which these reserves are formed, their purpose, as well as the possibilities for their use, we must say that this trend is quite worrying. Revaluation reserves are the only component of equity that have significant upward trend, thereby creating an illusion that there are some real inflows on the basis of the growth of internal sources. This situation creates a false impression of the changes in debt of public enterprises.

Taking into account the above-mentioned facts, we must stress that financial reporting manipulation risks exist and that they are substantial. But more precise quantification of these risks can be performed only for individual companies. In our opinion, these risks do not receive enough attention and the same goes for the quality of financial reporting in general.

Conclusions

Despite existing privatization processes, public enterprises nonetheless continue to play an important role in national economies around the world. A number of research studies confirmed that public enterprises are less efficient than private companies, but we should not lose sight of the fact that many countries have managed to considerably enhance the performance of these enterprises. As regards the present situation in Serbia, improving performance of public enterprises should be seen as a top economic priority and, we believe, also as a political priority.

Due to a long delay in addressing accumulated problems in public enterprises, these problems have gradually become more pronounced, and their solving more challenging. Reform of public enterprises is no longer a matter of choice, but an urgent need without the possibility of further delay. From the macroeconomic perspective, public enterprises are perceived as one of the generators of public debt mainly as a result of the policy of providing state guarantees for their loans. Coverage of their substantial losses has directly or indirectly burdened the state budget. The same holds true for significant subsidies that have been granted to public enterprises either directly from the budget or indirectly, due to their failure to meet their obligations to other public enterprises. For all these reasons, the reform of public enterprises is considered as one of the prerequisites for restoring the health of public finance.

In order to successfully solve the problems of public enterprises, first of all, it is necessary to take into account inherited risks. Financial woes are so deep that they may undermine efforts aimed at tackling the problems in public enterprises. Illiquidity problem of public enterprises is so serious that it has a huge spillover effect on the liquidity of the entire Serbian economy. Debt of RSD 349.4 billion, liabilities of RSD 356.5 billion, loss of RSD 297.3, and a gap in net working capital of RSD 254 billion place an enormous burden on the economy. Moreover, due to negative cash flow from operations it is impossible to finance new capital investments in maintenance and expansion of capacities from internally generated sources, while relying exclusively on financing from borrowing is unsustainable. Continuous losses, negative return on equity, and negative financial leverage reveal an even bleaker picture of the performance of public enterprises. The situation might turn out to be much worse if we take into account the level of risk associated with low quality of information in financial statements.

Bearing in mind the importance of public enterprises and their huge financial problems, there is a need for a concerted effort to raise their financial performance to a higher level. This would require a wide range of carefully selected measures, such as full or partial privatization with

different dispersion of ownership, establishment of public-private partnerships, operational and financial restructuring, empowerment of some enterprises to access the capital markets and the like. A major step in the right direction should be a fundamental shift in the state's attitude toward public enterprises (to all, not just large ones), which will lay the basis for the improvement of corporate governance. To this end, it is necessary to increase the accountability of the state as an owner, to separate its ownership function from its regulatory function, to establish competent bodies that would monitor performance of public enterprises, to enable professionalization of management, to strengthen financial and fiscal discipline, to enhance transparency and to provide greater security to investors in mixed companies. Only if those conditions are met, we could expect an improvement in the performance of public enterprises.

A large burden of uncollected receivables, recognized and hidden losses, unfavorable pricing policy, high indebtedness, insolvency, workforce surpluses and similar problems affect in many different ways the performance of individual companies. Therefore, reform measures for individual public enterprises should be tailor-made and carefully selected. The strategy based on principle "grasp the large and let-go the small" can be effective in the short run, but it is certainly not sufficient. First of all, there is a need for a radical and comprehensive shift in the mindset and behavior of public enterprises irrespective of their size and whether their founder is the state, province or local government.

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POSVEĆENI VAMA I VAŠEM BIZNISU

*Jer smo više od 3,5 milijardi evra
investirali u razvoj domaće privrede.*

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GROWTH THROUGH INCREASE IN ACCESS TO FINANCE: RECOMMENDATIONS FOR SEE*

Rast kroz bolji pristup finansiranju – preporuke za JIE

Abstract

Since the impact of the global financial crisis of 2007/2008, and a subsequent impact of EU sovereign debt crisis of 2010, transition countries of South East Europe (SEE) have been in recession, stagnation or had very low growth rates. The debate on how to initiate growth in SEE is frequently focusing on austerity measures, attraction of FDI, structural reforms, fiscal policy stimulus or simplification of business procedures. This paper is focusing on a set of potential measures in the area of increasing access to finance for local small and medium-sized enterprises (SMEs) and other local companies capable of achieving competitive output in tradable part of gross domestic product (GDP). In other words, how to ease financing of endogenous entrepreneurs and help them evolve into competitive local, regional and eventually European companies? Analysis in this paper is focused on five important areas for better access to finance: non-performing loans (NPLs), collateral valuation, credit risk guarantees, nonbanking financial institutions (both credit institutions and securities institutions), and monetary policy and bank regulation and supervision. In all of these areas important improvements are possible.

Key words: *access to finance, endogenous growth, SMEs competitiveness, tradable GDP, SEE transition economies*

Sažetak

Od prvog udara globalne finansijske krize 2007/2008, kao i od narednog negativnog uticaja krize suverenog duga EU od 2010, zemlje Jugoistočne Evrope (JIE) u tranziciji nalaze se u recesiji, stagnaciji, ili na nivoima vrlo niskih stopa rasta. Debata o tome kako podstaći privredni rast u JIE uglavnom je fokusirana na mere štednje, privlačenje stranih direktnih investicija (SDI), strukturne reforme, subvencije i druge podsticaje iz budžeta i pojednostavljivanje administrativnih uslova poslovanja. Ovaj rad se fokusira na skup potencijalnih mera u oblasti jačanja i olakšavanja pristupa finansiranju za domaća mala i srednja preduzeća (MSP) i druga domaća preduzeća sposobna da budu konkurentna u delu razmenjivog dela bruto domaćeg proizvoda (BDP). Drugim rečima, kako olakšati finansiranje endogenih preduzetnika i pomoći im da izrastu u konkurentne lokalne, regionalne i konačno evropske kompanije? Analiza u ovom radu daje fokus na pet oblasti bitnih za poboljšavanje pristupa finansiranju: problematični krediti, procenjivanje kolaterala, garancije kreditnog rizika, nebankarske finansijske institucije (kako kreditne, tako i institucije HoV), i monetarna politika i regulacija i supervizija banaka. U svim ovim oblastima moguća su značajna unapređenja.

Ključne reči: *pristup finansiranju, endogeni rast, konkurentnost MSP, razmenjivi BDP, JIE zemlje u tranziciji*

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Introduction

Catching up of Central and Eastern European (CEE) and South Eastern European (SEE) countries with developed Europe was well underway in the years prior to the global crisis. It seemed that, with country-specific differences, the so-called convergence within Europe was working. Financial systems of new Europe countries were providing credit expansion, and macroeconomic position was on a path of inflation decrease and stabilization with relatively higher rates of economic growth and, on average, solid fiscal position. So, on average, things seemed to have been moving in an expected direction.

However, CEE countries on average proved to be doing better than SEE countries and it became clear that divergence was going on between these two groups of countries. Global financial crisis of 2007/2008 has revealed structural weaknesses of pre-crisis growth in SEE. Very often it was consumption-based and import-led growth model backed by inflow of capital and increase in debt. Growth of GDP was going on predominantly in non-tradable sectors, with current account deficits high, and competitiveness of local economies low. With unfolding of the crisis and sudden stop in inflows and FDI, it became obvious that many of the SEE countries are on a path of stagnation, high unemployment and increase in public debt. This unsustainable path needs to change, without delay.

Three broad mid-term goals of all of the governments in SEE wanting to create grounds for long-term growth, most probably are:

- Strengthening the capacity and independence of institutions;
- Increase in average level and quality of education;
- Increase in the level and quality of infrastructure.

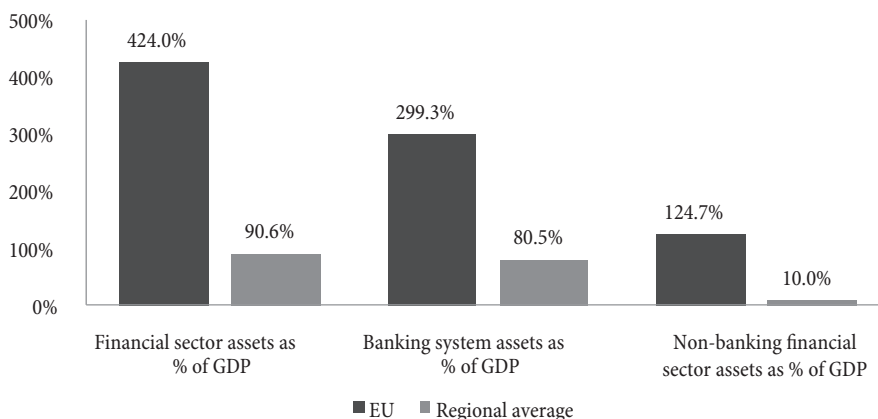
However, in the short run there is much that can be done as well. FDI cannot realistically be a predominant source of growth in SEE in a near future i.e. before substantial recovery in developed economies, most of all in Europe. Government investments are most probably limited in most SEE countries due to post-crisis fiscal restraints. Therefore, local private investments need to be considered as very important source of economic growth and new employment. Focus on this sector needs to be coherent in terms of simultaneously promoting entrepreneurship, substantially simplifying business operating standards, and increase in access to finance. This paper will deal in more detail with access to finance as one of the most important elements for every business environment, and especially important for endogenous growth.

Analyses will focus on five important areas for better access to finance: non-performing loans (NPLs), collateral valuation, credit risk guarantees, nonbanking financial institutions (both credit institutions and securities institutions), and monetary policy and bank supervision. In all of these areas important improvements are possible.

NPLs

Financial sector as a whole and its segments (banking and nonbanking sectors) are underdeveloped in SEE

Figure 1: SEE* Financial sector overview, comparison with EU, 2013



* Data is for Albania, BiH, Macedonia and Serbia (including Kosovo) Source: CREF Research

compared to the EU (Figure 1). There is obvious room for growth, but the activities in both sectors are stagnating in recent years.

Bank NPLs are relatively high and are burdening the banking sector in SEE (Figure 2). High NPLs are decreasing access to finance from banks throughout SEE. Most regulators are addressing this issue with stricter regulation in terms of loan loss provisioning and capital requirements. By doing so, they may decrease an immediate risk to financial stability, but that does not solve the problem of NPLs.

Banks themselves are also becoming more conservative in times of rising NPLs, low economic growth and strict regulation by the regulators.

High NPLs are decreasing access to finance by more requirements imposed to borrowers both by banks and the regulators. High NPLs are increasing the cost of financing for potential borrowers due to stricter regulation in terms of loan loss provisioning, capital requirements, etc. In addition, high NPLs are increasing the cost of financing for borrowers since average cost of financing for the banks with high NPLs increases as well.

Banks, as a rule, tend to prolong individual dealing with high NPLs, since that can sometimes as a result deteriorate their balance sheets or nominal market positions. However, increase in NPLs is also a self-fueling problem. More conservatism in bank business conduct due to high NPLs decreases credit growth and further deteriorates the ratio of NPLs to Total Loans. That makes a problem of NPLs relatively persistent and tends to postpone credit

growth and economic recovery, especially in bank-centric economic systems as are the ones in SEE.

That is a reason why high NPLs have to be taken very seriously both in terms of their negative financial stability impact, and in terms of their negative credit growth and economic recovery impact.

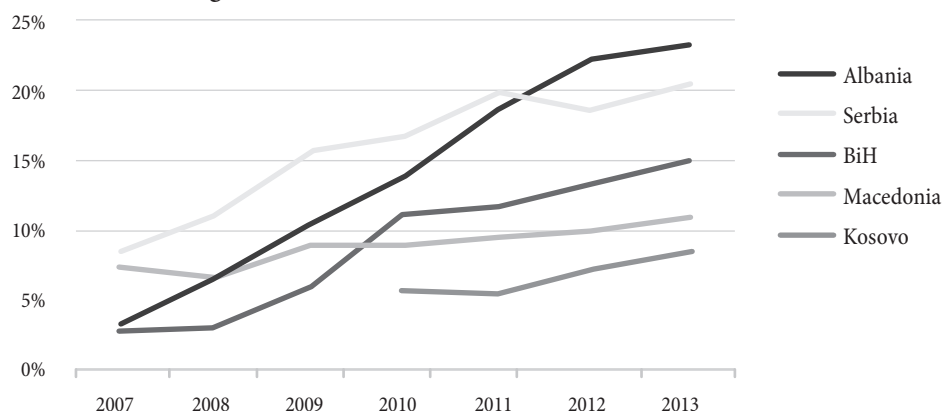
Dealing with this issue should be based on several principles:

- Centralized initiative conducted by central bank and ministry of finance, potentially in coordination with parent banks of local banks and their supervisors;
- Banks comprising dominant market share should commence NPLs cleansing in a same fiscal year;
- Regulatory and tax incentives for NPL decreasing procedures conducted by banks;
- No taxpayers' money involvement, i.e. private market solution for NPL problem;
- Involvement of private equity, distressed financing and other non-traditional institutions in the process;
- Credit biro keeps records of exposures until repayment, conversion into equity or other financial transformation that eliminates obligation of the borrower.

On these lines a specific NPL resolution plan could be formulated in cooperation between the banks, central bank and ministry of finance.

Substantial decrease of NPLs in banks would initiate credit growth and increase access to finance, both very much needed to increase economic activity and employment in SEE.

Figure 2: Bank NPLs to Total Loans 2007-2012 in SEE*



* Separate data is provided for Kosovo in line with United Nations Security Council Resolution 1244/99
Source: World Bank

Collateral valuation for lending purposes

Imprecise collateral valuation presents a very important issue for bank and even non-bank access to finance. There are several important aspects in which collateral valuation may hamper access to finance.

The first obvious possibility is that imprecise collateral valuation is recognized as an unacceptable risk for the bank and that potential borrower is denied when requesting a loan.

Second, is the situation in which the bank does not reject the client, but accepts him or her as a borrower of lower credit quality and therefore with a higher interest rate to pay. Higher interest rate deters borrowing and therefore lowers access to finance, but also increases the average interest rates of borrowers as well as the likelihood of loans becoming non-performing.

Third, the bank does not reject the client, but accepts him or her as a borrower and demands an additional credit risk mitigant (additional collateral, guarantee etc.). This increases the total cost of borrowing, again lowering access to finance and increasing the likelihood of a loan becoming non-performing.

Fourth, vague collateral valuation may lead to bank granting a loan but more conservatively imposing a lower loan-to-value (LTV) ratio. In this way, the bank achieves overcollateralization as a well-known method of reducing credit risk exposure, but decreases the total loan amount available on collateral, thereby reducing access to finance.

Fifth, without precise collateral valuation, the regulator may be more restrictive and therefore increase the cost of financing. Namely, if there is uncertainty about the loss in the event of a borrower's default because of imprecise collateral valuation, the regulator may impose higher required loan loss reserves (LLRs) on a bank for such a collateralized loan. These higher LLRs pose an additional cost to the bank and induce a rise in interest rates. Again, this lowers access to finance.

Sixth, another regulatory response to imprecise collateral valuation may be for a regulator to impose lower loan-to-value (LTV) for collateralized loans if they are to be treated as a lower-risk asset with lower-risk weights

when calculating risk-weighted assets (RWAs) and capital adequacy ratio (CAR). This potential measure again reduces the loan amount per pledged asset, decreasing access to finance.

Seventh, collateral overvaluation can have yet another negative impact. Namely, overvalued collateral may induce banks to keep the overvalued loan and its overvalued collateral in the bank books. This may artificially increase bank capitalization and bank profits, motivating further delay in the process of bank balance sheet cleansing, thereby delaying a supply of fresh loans. And this directly lowers access to finance.

Therefore, more precise collateral valuation in SEE could decrease or eliminate all of the mentioned weaknesses in collateralized lending and improve access to finance and growth prospects in SEE.

How to achieve this?

SEE countries need to develop collateral valuation standards in line with international standards in this area. For a well-functioning system of collateral valuation for lending purposes it is important to significantly improve the accuracy and quality of collateral valuations (especially real estate). There is an obvious need to establish trust and confidence in valuers and their valuations both among the lenders and borrowers, but also among the regulators and the general public. If we want to see a substantial and long-lasting increase in collateral valuation credibility and better access to finance as a result, it is important to achieve results in several important segments:

- Standards of valuers' professional practice and conduct;
- Competence of valuers;
- Licensing and supervision of valuers;
- Databases for precise valuations;
- Adequate regulatory treatment of collateralized lending.

More precise and credible collateral valuation for financing purposes can increase the credit quality of borrowers and, with adequate regulatory treatment of loans with precisely-valued collateral, may further decrease the cost of borrowing. Therefore, improved collateral valuation may increase both demand and supply of bank credits and support credit growth and economic recovery in SEE.

Credit risk guarantees for tradable SMEs

Public development programs in SEE have very often been compromised throughout transition period. However, some assistance is badly needed for SMEs and other companies in SEE tradable sector which are facing very serious challenges for growth:

- Strong EU and other foreign competition (China, etc.) in highly liberalized domestic markets;
- Relatively higher average cost of capital compared to their main competitors;
- Underdevelopment or nonexistence of brands¹;
- Real exchange rate increase in past fifteen years, making locally produced goods and services less competitive.

Therefore, if SEE is expected to grow, a form of public assistance is needed in order to help local competitive tradable sector GDP economy to grow. This assistance however needs to be on a new and much more effective basis. Old subsidies need to die off. New, effective, targeted support frameworks need to be established.

Despite some unfortunate experiences with public development funds and public credit risk guarantee schemes, these types of programs should not be abandoned.

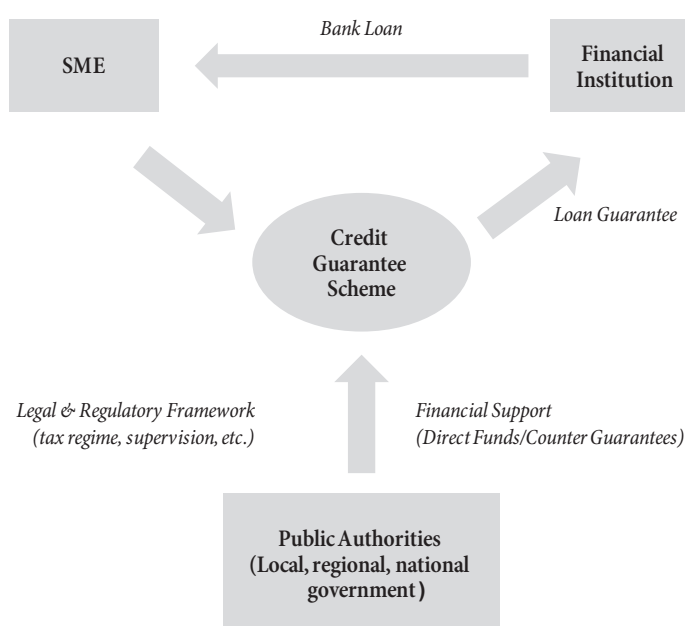
Rather, they should be reformulated in a way that they cost less, target better, and have a well-defined way out strategies (procedures that follow potential SME or other beneficiary default). They also need to be formulated in a way to minimize possibilities of moral hazard conduct of any form (corruption, political pressures, etc.).

Credit risk guarantees issued by the government or a government agency, may be one of the models with high potential to increase access to finance in SEE (see Figure 3). Credit risk guarantees should be issued only to tradable sector projects. With these guarantees, local tradable SMEs could regularly approach the bank and expect decrease in interest rates from three sources:

- Credit risk with a guarantee goes down, and so should the interest rate;
- Risk weight for this credit line goes down, so does the needed capital based on risk weighted assets – interest rate should go down;
- Loan loss provisions should go down even in case of default with a guarantee – interest rate should go down.

Credit risk guarantees have a vast international experience in implementation. If well-organized, it has been shown that these schemes can substantially decrease

Figure 3: Credit guarantee scheme example



Source: [11]

1 With some regionally established brands from the second part of 20th century being left to complete demise in unsuccessful privatizations

the cost of borrowing and enable viability to many projects and companies that would otherwise stay undeveloped. They can be treated as an indirect public support to SME development. Important is to limit this support to entities and projects in tradable sector of GDP. This would then contribute not only to economic growth and growth in employment, but also to the achievement of sustainable external macroeconomic balance i.e. from decrease in current account balance to long-term sustainable values. At the same time, that would also be a path to increasing national economy's competitiveness.

An important element of this new credit guarantee public support for SMEs should be a well-designed and effective post-default process that could include private equity, distressed financing and other non-traditional private institutions. The aim of the post-default process should be to minimize any taxpayers' loss in medium term. Therefore, this mechanism basically allows for government balance sheet borrowing with no immediate government costs, and minimal potential costs in the future.

Nonbanking financial institutions

Nonbanking financial institutions could be divided into two broad categories:

- Non-bank credit institutions are institutions that can provide credits but are not banks: microcredit institutions (MCIs), saving and loan associations (S&Ls), credit unions, etc.
- Securities markets and institutions: corporate bond markets, equity markets, institutional investors (insurance companies, money market funds, investment funds, private pension funds).

Improvements are possible in both areas.

Non-bank credit institutions should be introduced in order to increase competition on a supply side of credit markets and therefore provide better access to finance. There could be room for MCIs, S&Ls, credit unions, etc. These institutions might not often directly be involved in supplying loans to tradable sector SMEs, but can increase overall supply of loans in the market and ease access to finance for all potential borrowers.

However, it is important to introduce a good legal framework for these institutions and to provide adequate regulatory and supervisory capacity on national level prior to their introduction. Their emergence in an unregulated environment without adequate supervision in place in some transition countries has proven to have a negative effect on overall development and confidence in national financial system. Useful guidelines for proper regulation of these institutions could be to provide adequate answers to the following questions:

- Can they accept deposits from individuals? If yes, would there be an additional deposit insurance scheme for their deposits?
- How to constrain and/or eliminate financing with extremely high interest rates observed in some other countries?
- How to control moral hazard of borrowers (taking loans for one purpose and using it for a different purpose, etc.)?
- How to regulate the relationship between these institutions and commercial banks? Can these institutions be founded as subsidiaries of commercial banks?
- How to define the scope of their products, and how to avoid overlapping with products of commercial banks if the regulation is different?
- Can these institutions be included in an existing credit bureau system? If not, how to control the overall indebtedness of borrowers?
- How to define the scope of prudential supervision reporting of these institutions and to what authority?
- How to control the risk of some of these institutions supporting gray and/or illegal economy?

With careful consideration of this and other open issues for specific credit institutions, adequate regulation and supervision could be put in place and these institutions could contribute their potential fair share in improving overall access to finance.

Securities markets and institutions have been introduced twenty or so years ago with great expectations but with very slim results so far in SEE. They represent far less than normal, almost negligible portion, in overall gross fixed capital formation capacity of national financial systems

(Figure 1). To put it differently, this channel of financial system almost does not generate investments.

Why is that so?

Development of this financial market segment from the start has been undertaken without understanding the nature of this sector. We have been enacting laws, establishing asset management institutions, securities commissions, stock exchanges, forcing companies to trade on the exchange, etc. and still activity was there roughly only in a relatively brief post privatization period of time dominated with takeover activities. No real initial public offerings and sustainable depth in secondary trading of securities have evolved as an established practice in SEE financial markets. A top-down approach has been imposed in trying to develop this market sector, forgetting that only when the companies themselves realize the interest to regularly issue their securities these markets can start to grow.

Credibility, disclosure, competence, and institutional independence are core ingredients necessary for these markets to grow and to take their fair place and role in the overall development of financial systems in SEE countries.

The main problems of SEE securities markets are weak institutions, low disclosure, and a recent heritage of manipulative practices and investor rights abuse.

Major improvements in this area would be in:

- Strengthening institutional capacity in terms of independence, competence, and overall credibility (securities and exchange commission, stock exchange, association of auditors, association of accounting professionals, association of brokers and dealers, etc.);
- Better legal regulation of anti-manipulative practices and protection of investors' rights;
- Legal regulation and establishment of national rating agencies;
- Reevaluation of costs associated with securities issuance and trading, and putting in place a competitive overall fee structure attractive for trading in these markets.

Besides, the securities markets could and should be biased toward the needs of local economies, especially toward growth of SMEs by using the facilities of securities markets. There is no reason why even a startup company, especially with a credit risk guarantee (discussed in

the third part of the paper), could not approach these markets and use their financial capacity for its growth and development.

Monetary policy and banking regulation and supervision revisited

Monetary policy and banking supervision can sometimes limit access to finance. When countries are targeting an exchange rate officially or unofficially, one associated cost to that could be a relatively high reference rate of a central bank. This higher interest rate is sometimes there not to influence aggregate demand and bring down high inflation, but to support the local currency, prevent its depreciation, and provide relative exchange rate stability. This relatively higher interest rate may be hampering access to finance of all transactors in a financial system.

Reserve requirements as a monetary policy tool should be used in order to prevent excessive credit growth and aggregate demand. That is one of the ways to control the overall supply of money in the system. However, sometimes it can also be used for other non monetary policy purposes i.e. as a macroprudential policy tool. In times of recession and low inflation, these two applications of the same tool may become conflicting. By increasing reserve requirements, as a rule, there is a decrease in access to finance. Monetary policy stance would not call for that in times of disinflation or deflation. Therefore, if disinflationary and deflationary pressures persist in the financial system, it is wise to reassess existing reserve requirements. There is also a very sound reasoning for using reserve requirements as one of the countercyclical tools. Therefore, there is an additional impetus to reevaluate the reserve requirements, since in recession and low inflation they may be over excessive and unnecessarily hamper access to finance in times when it is badly needed for economic recovery.

Banking system that is burdened with NPLs, imprecise collateral valuations and FX risk is bound to have a significant regulatory burden in order to keep it relatively stable. At the same time it will be expensive and will not provide adequate access to finance to support growth and economic recovery. In such a situation,

borrowers will be unsatisfied because there is a high cost of borrowing. Bankers will not be satisfied because there will not be enough banking activities. Supervisors will not be satisfied since substantial risks are in the system that is controlled with heavy regulation. Government will not be satisfied in stagnant economy and low government revenues and the general public will not be satisfied since employment is not rising.

So dealing with these risks is very important for economic growth of a country. Eliminating or significantly decreasing the risks of NPLs, imprecise collateral valuation and FX exchange rate risks can substantially change the risk profile of a banking sector, and create an important opportunity for significant reduction in a cost of banking regulation without jeopardizing financial stability. And that would substantially increase access to finance.

In addition, Basel III should be implemented as soon as possible at least in some relatively important aspects. Such is an introduction of countercyclical capital buffers that could probably slightly ease financing in recession. Also, enhanced regulation of systemically important financial institutions (SiFIs) could possibly ease the burden for systemically unimportant financial institutions and improve access to finance. Dynamic provisioning could also be considered since its counter cyclicity should provide more access to finance in recession.

More effective supervision is also important for access to finance. Namely, if supervision is capable of more effective preventive actions, early detection of bank problems, and early intervention, then the regulatory burden on banks can be less heavy (costly) in any case, and that obviously improves access to finance. And improvements in this area are also possible.

Coming back to monetary policy again. It is futile and costly to proceed with a monetary policy framework without fulfillment of basic preconditions of its effective use. Namely, in the case of Serbia, inflation targeting without gradual but persistent increase in the use of local currency is producing costs without benefits, and is decreasing access to finance. In potential choice of alternative monetary regime, it is important to evaluate the capacity of every monetary model to eliminate or minimize inflationary expectations, eliminate or minimize

exchange rate movement expectations, and minimize FX risk on current exposures of: companies, households, and the government. The quality of monetary policy choice can substantially influence access to finance in every country.

Conclusions

Waiting for FDI and not doing enough for local endogenous development in SEE is not an option. Economies are stagnant and FDI is low and not foreseen in the near future in adequate volumes. It is important to improve the system in many areas to be more stimulating for local entrepreneurship and SME development. This can be a vital source of new employment and growth for SEE countries. This paper has focused on access to finance as an important part of an overall business environment. Current situation is that financial systems are underdeveloped in all SEE countries, and at the same time access to finance is low. That is a clear signal that substantial improvements should be made in many areas to improve access to finance. It is important to deal with basic risks that are hampering bank credit growth. This paper has focused on NPLs, collateral valuation and credit risk of local competitive SMEs and other companies. Besides banks and their credit growth, more can be done for access to finance both through securities markets, and non-bank credit institutions. Last but not least, adequate monetary policy, and regulation and supervision of banks and other financial institutions can have a very important positive impact on access to finance in SEE.

Reforms leading to substantial increase in access to finance could prove to be one of the most important reforms for SEE countries and their economic recovery.

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INNOVATION AND CREATIVE INDUSTRIES AS A BASIS FOR SERBIAN REINDUSTRIALISATION*

Inovativnost i kreativne industrije kao osnov
reindustrijalizacije u Srbiji

Abstract

A deep economic crisis affecting all the economies of South-Eastern Europe (SEE), including Serbia, has reignited the debate concerning the need for a new type of industrialization. While many other authors call for strong state intervention in select economic sectors, we strongly maintain that the best way to avoid the middle-income trap is to support the development of clusters and creative industries, buttressing innovation processes and the overall competitiveness of the economy. In this article, building upon the ongoing research on the importance of innovation and creative industries as key forces in the process of economic development, we analyse and shape policy recommendations, aiming to restore the growth of GDP_{pc} and gradually reduce the development gap in SEE region relative to developed countries. Serbia, specifically, needs to shift from the investment-driven stage of competitiveness to innovation-driven stage, by completing outstanding tasks from the factor-driven stage, especially relating to institutions and infrastructure development, and by focusing on innovation infrastructure. A favourable circumstance for Serbia and the SEE lies in their success in improving Global Innovation Rankings during the crisis; nonetheless, analyzed global reports also show weaknesses that need to be managed. In addition to supporting innovation policy and clusters, more comprehensive measures should be undertaken in improving the business-enabling environment, education (especially multidisciplinary approach) and access to finance.

Key words: *innovations, competitiveness, creative industries, reindustrialisation*

Sažetak

Duboka ekonomska kriza, koja je zahvatila privrede jugoistočne Evrope (JIE), uključujući Srbiju, ponovo je otvorila raspravu o potrebi za nekom novom vrstom industrijalizacije. Dok mnogi drugi autori pozivaju na državnu intervenciju u izabranim privrednim granama, mi se zalažemo za snažnu podršku razvoju klastera i kreativnih industrija, inovacionih procesa i sveukupne konkurentnosti zemlje, kao najbolji način da se izbegne zamka srednjeg nivoa razvoja. U ovom članku, nadovezujući se na aktuelna naučna istraživanja o značaju inovacija i kreativnih industrija kao motora ekonomskog razvoja, proučavamo i predlažemo mere javnih politika sa ciljem obnove rasta BDP_{pc} i postepenog smanjenja jaza razvoja u region JIE u odnosu na razvijene zemlje. Neophodno je da Srbija, koja se ovde posebno sagledava, dovrši nezavršene reforme iz stadijuma konkurentnosti vođene činocima proizvodnje, pogotovo kada se radi o institucijama i logističkoj infrastrukturi, a da istovremeno ojača inovacionu infrastrukturu kako bi prešla u stadijum konkurentnosti vođene inovacijama. Povoljna okolnost za Srbiju i JIE leži u poboljšanju ranga mereno Indeksom globalnih inovacija tokom krize, mada analizirani svetski izveštaji iz ove oblasti takođe ukazuju na slabosti koje treba prevazići. Pored podrške politika inovacija i klastera, sveobuhvatnije mere je potrebno sprovesti kako bi se unapredilo poslovno okruženje, obrazovni sistem (posebno višedisciplinarni pristup), kao i pristup finansiranju.

Ključne reči: *inovacije, konkurentnost, kreativne industrije, reindustrijalizacija*

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Introduction

A deep economic crisis affecting all the economies of South-Eastern Europe (SEE), including Serbia, has reignited the debate concerning the need for a new type of industrialisation, particularly to increase manufacturing. In shaping these processes, however, there are understandable differences with regard to key elements and policies to be implemented (see, for example [16], [48], and [40]). While other authors call for strong state intervention in select economic sectors, we strongly maintain that the best way to avoid the middle-income trap [25] is to support the development of clusters and creative industries, buttressing innovation processes [11] and the overall competitiveness of the economy [38], [38]. In this article, building upon the ongoing research on the importance of innovation and creative industries as key forces in the process of economic development, we analyze and shape policy recommendations, aiming to restore the growth of GDPpc and gradually reduce the development gap in SEE region relative to developed countries.

Role of innovation in economic development

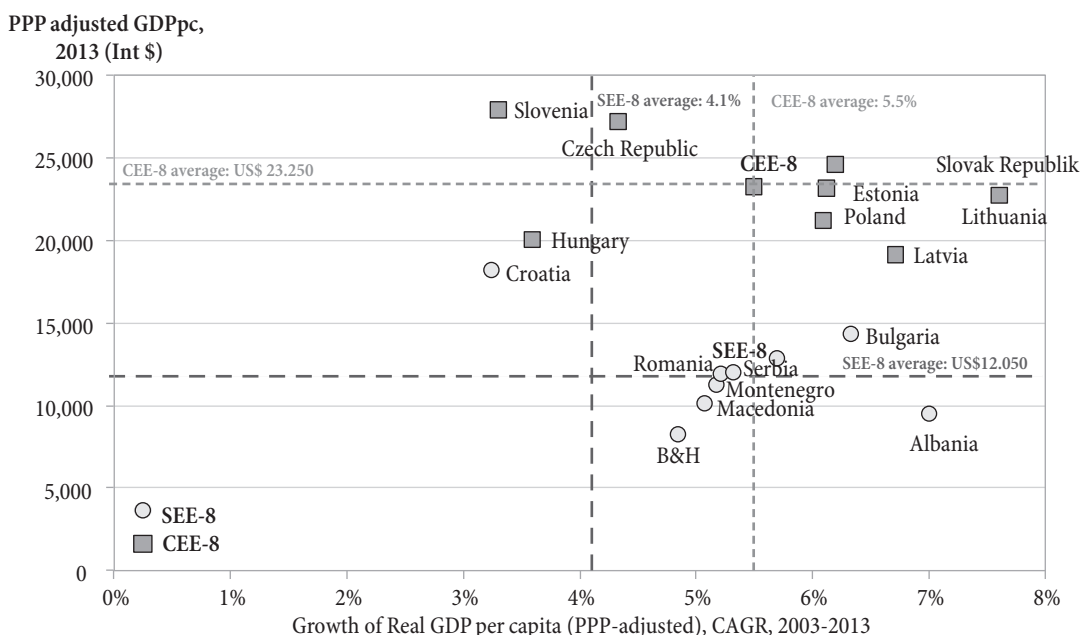
The current situation in the world economy is shown in Figure 1, illustrating the differences in character and rate

of prosperity among countries. The vertical axis shows the level of PPP adjusted to GDPpc in USD for 2013. The more developed the economy, the higher the level of prosperity. The horizontal axis shows the annual average growth rates of real GDP per capita (PPP-adjusted, CAGR) during the period 2003-2013. The greater the upward distance of the country from the origin of coordinates, the more developed the country, demonstrating higher growth rates and faster pace of development.

Figure 1 also reveals that countries with similar levels of GDPpc recorded very different growth rates during the period 2003-2013. In the case of Central European economies (CEE), they range from 3% to over 7%, while in the case of the South-Eastern European economies (SEE), they have a similar, though slightly reduced range from 3.5% to 6.5%.

Traditional economic theories fail to capture many of the underlying forces at work in today's global economy. While there is an understanding that competitiveness is the only means to achieve sustainable job growth and raise the standard of living, the real meaning of competitive advantage continues to puzzle economists. An explanation of significant differences among countries, illustrated in Figure 1, has been provided, among others, by Porter [31], by defining stages of national competitive development and identified policy imperatives. For every economy it is crucial

Figure 1: Prosperity performance



Source: Authors' recalculations based on IMF Database

to properly set the key transition points in the economic development process. Successful economic development is a process of successive upgrading. National business environment should foster increasingly sophisticated and productive ways of firm-level competition. *Porter* described this process as a sequence of stages, each with a different set of economic characteristics and challenges. Factor-driven economies are economies at lower levels of development, whose competitiveness is based on low-cost inputs (labour, natural endowments and alike). Competitive advantage in these economies is based exclusively on endowment of labour and natural resources. Investment-driven economies are economies at the medium level of development, whereby increasing productivity is a path to advance competitiveness. Dominant source of competitive advantage at investment-driven stage is efficiency in producing standard products and services. Innovation-driven economies are developed economies whose competitiveness is based on innovations, delivering products and processes with a unique value. Dominant source of competitive advantage at this stage is the ability to produce innovative products and services at global technology frontier; clusters become critical and firms compete with unique strategies. In essence, enhanced prosperity, i.e. GDPpc PPP, implies continuous improvement of competitiveness that can only be achieved by constant innovation, anticipating new dimensions of competitiveness. Therefore, it is essential to create a quality business environment that would encourage innovation, entrepreneurship and the development of small and medium-sized enterprises (SMEs).

According to *Rodrik* [35], [36], economic policies will be conditioned upon local constraints and opportunities, with each government reflecting on whether it is doing enough to support the expansion of capacity in sectors with greatest potential to absorb workers from the rest of the economy. *Vujovic* [49] shows that countries caught in the middle-income growth trap (MIGT) are unable to compete with low-income, low-wage economies in manufactured exports or with advanced economies in high-skill innovation goods. The root cause of the MIGT is failure to shift from lower middle (LMI) income to upper middle income (UMI) growth strategy. The former is designed to support supply-oriented capital accumulation and labour

relocation from agriculture to higher productivity industry, while the latter seeks to support skill (knowledge) intensive manufacturing activities (“moving up the value chain”) and business services. LMI strategies embrace diversification and simple export expansion, while UMI strategies foster specialisation and export growth based on innovations (new processes, new products, new markets) and highly educated labour force.

Porter [31] defines competitiveness based on productivity and focuses on the microeconomic foundations of competitive advantage that underpin productivity in nations, regions and clusters. *M. Delgado, C. Ketels, M. E. Porter* and *S. Stern* [10] define foundational competitiveness as the expected level of output per working-age individual that is supported by the overall quality of a country as a place to do business. Their competitive framework highlights three broad and interrelated determinants of competitiveness. Endowments, as a first determinant of competitiveness create only a foundation for prosperity, but true prosperity is created by productivity with which we use endowments. Second determinant of competitiveness, macroeconomic competitiveness consists of: (i) sound macroeconomic policy (monetary and fiscal policy) and (ii) human development and political institutions; this determinant sets only the potential for high productivity. The third determinant, microeconomic competitiveness, consists of (i) quality of the business environment (illustrated by “Porter’s diamond”), (ii) state of cluster development and (iii) sophistication of company operation and strategy, finally determine the level of productivity and sophistication of local competition. Level of productivity ultimately depends on improving the third determinant of competitiveness – microeconomic capabilities of the economy. Finally, it is not what a location competes in that determines its prosperity, but how productively it competes – how, not what.

Knowledge-based society and creative industries

Pointing to the significance of knowledge, innovations and creative industries in the contemporary economy, *Savic, Pitic* and *Trbovich* [40] discern their role in the development of the Serbian economy. They recall that

the important economic thinkers of the second half of the 20th century, specifically *Drucker* [13], [14], [15], *Bell* [5] and *Toffler* [43], [44], [45] advocated the position that the future of advanced economies would be closely related to the use of knowledge and information, maintaining that just as agrarian economies were once transformed by industrialisation, industrialised economies would be transformed by knowledge-based innovations. Successful transition into knowledge society is the utmost matter of development, which has strong economic, social and cultural dimensions [22], [1]. According to *Araya* [2], we are entering a new era in which the major raw materials are not coal and steel produced by machines, but creativity and products innovated by human imagination. Therefore, *Florida* [19] considers it crucial for society and politics to ensure the development of creative capacity, which is in essence possessed by all human beings. According to the *OECD* [28], knowledge has now become the key factor of production and growth, thus encouraging an increase in investments in high technologies, labour force education and an increase in productivity. Today, the highest share of value added in developed economies is not derived from the so-called material production, but from improvements in productivity and innovation. The *OECD* [28, p.12] has defined four types of knowledge: know-what, know-why, know-how and know-who.

In his analysis of major changes occurring in the modern world, *Florida* [19, p. 21] singles increasing human creativity as the key determinant of economic life. Creativity has become a value because the system has evolved in such a way that new technologies, new industries and new wealth are derived from it. The emergence of this creative era is based on the following three principles:

- Creativity is the essence of today's way of life and work – *Romer* [37, p. 9] says that major improvements in the standard of living, especially great competitive advantages on the market, are always derived from “*better recipes, not just more cooking*”;
- Creativity is multidimensional – it is not reduced to technological innovations or new business models; creativity is not kept in a box and taken out of it when needed; the multidimensionality of creativity permeates everything, thus reshaping the way we see

ourselves as economic and social actors, influencing our identity; and,

- Creativity is a social process (not an individualistic process), requiring appropriate organisational forms that encourage creativity; here *Florida* turns attention to the fact that life in the first half of the 20th century was characterized by the dominance of big and highly specialized bureaucratic organisations; this was also indicated by *Schumpeter* [41] when speaking about the “cold” effect of big organisations on creativity, which suffocated from great strength of capitalism and ultimately stemmed from entrepreneurs, who revolutionised the production structure.

Florida identified the new economic class – *working class* that will dominate the economic and cultural life of this century just as the working class dominated in the early 20th century and the service class over the past decades. Although the creative class is not so massive in numbers like the service class, it is an agent of growth and change in the economy and society. *Florida* [19, pp. 12-13] adds that American blue-collar and white-collar jobs have been turned collarless. Artists, musicians, scientists and other members of the creative class have traditionally determined their work hours and were dressed in relaxed and appropriate clothes while working in a stimulating environment. Collarless jobs today replace the traditional hierarchical system of control with new forms of self-management and new forms of motivation.

Florida [21] refers to the present economic era as a “Great Reset”, similar in scope and nature to the crises of the 1870s (the First Reset) and 1930s (the Second Reset), remarking that recovery will result not only in the accelerated rate of innovation and enhanced productivity, but also in the new sources of consumer demand that stem from significant shifts in lifestyles and a new geography. He argues that the current crisis is more than a financial or economic crisis and that it is an even deeper structural divide as the productive and innovative capacities of the emergent knowledge-based creative economies came smack up against the outmoded institutions, economic and social structures and geographic forms of the old industrial age. According to *Florida* [19, p. 67] the development of creative industries is conditioned by the

rise of the creative class consisting of individuals whose main economic functions are reflected in the creation of new ideas, new technologies and new creative contents. Using data from the 2006-2011 US Current Population Surveys, *Gabe, Florida* and *Mellander* [24] indicate that members of the creative class had a lower probability of being unemployed over this period than individuals in the service and working classes and that the impact of having a creative occupation became more beneficial in the two years following the recession.

Focusing on occupations provides particularly useful insights into the nature of work in times of crises. For example, people in jobs with more standardized work may be easier to replace than individuals with more advanced, less routine-oriented occupations [4]. As a result, we expect that working and service class jobs were more likely to be cut during the recession. Another explanation as to why members of the creative class might have fared better than individuals in service and working class occupations has to do with the nature of development that occurred alongside residential construction during the housing boom. In many places, housing growth during the early 2000s took place hand-in-hand with expanding retail and food-service-related employment. This pattern of development, referred to as a “great growth illusion” [21], is a false economy of sorts based on residential and commercial construction, expanding retail development and related service employment. *Gabe* and *Florida* [23] found that regions characterized by high shares of employment in retail and food service occupations, along with specialisations in construction, fared poorly during the recession. This means that, along with construction workers, individuals in retail and some service occupations – two large segments of the service class – might have been more adversely impacted by the recession than creative workers.

Potts [34] also states that creative industries are the main agent of economic modernisation. Advocating a new, evolutionary economic approach to creative industries, he makes a radical shift away from the hitherto dominant neoclassical model and offers the model of innovation dynamics and cultural co-evolution. In this model, the focus is placed on something that makes up the essence of creative industries, and he concludes that they have been

the agents of innovation processes in socio-cultural and economic systems. Therefore, the primary economic value of creative industries is not legacy or entertainment, but a deep affirmation and expansion of innovation during economic evolution. *Potts* [34, p. 152] also points to the importance of creative clusters and innovations, confirming *Porter’s* [29], [30] concept of linking agglomeration and innovation.

According to the management guru *Peter Drucker* [15], the basic economic resource in the era of knowledge-based economy is not capital, or natural resources, or labour, but education. Thus, in essence, he laid the foundation for knowledge-based economy. In *The Creative Economy*, *John Howkins* [26] argues that intellectual property is far more important today than “hard goods” and that creativity itself should be treated as a key commercialisation factor. At the same time, *Florida* [20] points out that the highest paid workers today are those who belong to the creative class. Just as factories were the key institutions in the industrial era, schools and universities are becoming the key institutions in the era of innovation. Shaped for some other times, contemporary universities function like parastatal institutions. Schools and universities must abandon their current position of isolated islands and evolve into cultural centres providing support to creativity and innovation.

Creative industries include a great number of micro-businesses and SMEs, as well as the largest corporate brands like Time Warner, BBC and the like. They need new public-private partnerships. The economic success of Silicon Valley and creative industries in London and a number of other large cities has always been accompanied by the significant involvement of universities and government agencies in the creation of an environment in which creative clusters can be developed. In this way creative industries also exert influence on the development of completely new social development models. In analyzing the development of creative industries after a decade of debate, *Flew* and *Cunningham* [18] conclude that creative industries are becoming increasingly important for economic well-being, while proponents suggest that human creativity is also an economic resource and that the industries of the 21st century will depend on the generation of knowledge through creativity and innovation.

The first industrial revolution began in Britain in the late 18th century with the mechanisation of the textile industry – craft production was replaced by machine production. The second industrial revolution began in America in the early 20th century with the assembly line, which ushered in the era of mass production. In describing the third industrial revolution, *The Economist* [42] points out that the factories of the future will enable competitive production in small lots and greater flexibility, coupled with a much lower input of labour, thanks to new materials and completely new processes, such as 3D printing, easy-to-use robots and collaborative manufacturing services available online. The shift from mass production towards individualized production is evident. Therefore, manufacturing firms are committed to introducing new and innovative products. Here we need to recall that in the United States, for example, the share of manufacturing in GDP is only 11%. At the same time, 68% of its expenditures accounts for R&D. In these processes there is a sharply increasing need for human capital with superb skills. An increasing number of goods will be sold on a service basis. Therefore, *Atkinson and Ezell* [3, pp. 182-184] emphasize that a new race for global economic advantage is well underway and that its winners will be those that are most innovative.

Supporting SME innovation capacity, especially in manufacturing, is the key component of the innovation strategies of most countries. Numerous countries have introduced expanded services with the aim of strengthening productivity, innovation and export capacity [17], including the use of innovation vouchers as SME support. These vouchers ranging in value from USD 5,000 to USD 30,000 enable SMEs to “buy” expertise from universities, national laboratories, or public research institutes. The intent is to provide an incentive to research institutes to be reactive to SME needs and encourage knowledge transfer, either as assistance to SMEs in addressing special technological challenges, or as assistance in the implementation of innovation systems. According to the Dutch Innovation Agency, this system has significantly spurred innovations – 8 out of 10 vouchers have produced the results that could not be possible without this programme. Since 2005, 80% of new R&D projects have been created in this Agency through

innovation vouchers. If innovation is the elixir that amplifies incomes and advances economic competitiveness, and if innovation policy is required for an even more potent elixir, *Atkinson and Ezell* [3, pp. 184-185] pose the question why India is still poor, why Japan cannot speed up its growth, why the United States is lagging behind in introducing digital platform technologies, why education systems are the same as 50 years ago, why some diseases, like cancer, have not yet been conquered, why recoverable energy is more expensive than coal and oil? They point to the fact that it took 24 years (1984-2008) for world GDP to double. As things stand now, global GDP will double until 2034, and to reach that level by 2026, it is necessary to increase competitiveness, that is, long-term productivity from 3.1% to 4.1%. Should the level of productivity be increased, the incomes of billions of people being trapped in the vicious circle of poverty will increase by factor of 5 in 41 years instead of 54.

In developing the concept of disruptive and sustaining innovation, *Christensen et al.* [8] point out that innovation has now become a dominant force in the processes of opening new markets to new entrants. A disruptive innovation, stemming from *Shumpeter's* school of creative destruction, is an innovation that helps create a new market and value network, and eventually disrupts the existing market and value network (over a few years or decades), replacing earlier technologies. The term is used in business and technology literature to describe innovations that improve products and services in the ways that the market does not expect (e.g. by creating different positions of consumers on new markets and lowering prices on existing markets). In contrast to a disruptive innovation, a sustaining innovation does not create new markets or value networks, but rather only evolves existing ones with better value, enabling firms to compete against each other's sustaining improvements. Sustaining innovations may be either “discontinuous” (i.e. “transformational” or “revolutionary”) or “continuous” (i.e. “evolutionary”). Three enablers of disruptive innovation are: (i) simplifying technology, (ii) business model innovation – which brings about simplified solutions for customers being interested in them (it always ranges from the value proposition – a product that helps customers do more effectively, conveniently and affordably jobs

that they have been trying to do, which requires people, technology, products, equipment, brands and cash in order to deliver the value proposition to target customers) and (iii) embedding this into a new value network (customers, distribution, suppliers). A disruptive (or empowering) innovation creates a base for new employment. A sustaining innovation is very significant but, due to its nature, does not generate new employment. Such innovations make a good product better. When customers buy the new product, they usually don't buy the old product. Toyota created the Prius, a phenomenal innovation product, and when it sells a Prius, the customer rarely buys a Camry, too. Consequently, sustained innovations are significant, but they do not create jobs.

Christensen [6] argues that successful companies often put too much emphasis on customers' current needs and fail to adopt new technologies or business models that meet their customers' unsatisfied or future needs. In his latest work, *Christensen* [7] places the focus on the outcome of innovation-based growth and categorizes innovations in the following way:

- (i) *Performance-improving innovations* replace old products with new and better models; since these innovations are in essence substitutive, they are characterized by the modest creation of new jobs; when customers buy the new product from this group, they will not buy the old product, too; in this case sustaining innovations are dominant and a good example is Toyota's model Prius (when the customer buys a Prius, he will not buy a Camry, too);
- (ii) *Efficiency innovations* enable the production and sale of goods and services to the same customers at lower prices; some of those innovations are so-called low-end disruptions and are related to the creation of new business models (Walmart was a low-end disrupter in retailing, Toyota's just-in-time production system represents process improvement); efficiency innovations play two important roles: (1) they increase productivity, which is essential for maintaining competitiveness, but has a painful effect – a decrease in the number of employed people, and (2) they free up capital for more productive uses; and

- (iii) *Market-creating innovations* deeply transform complicated and costly products so radically that they create a new class of consumers, or a new market (mainframe computers cost hundreds of thousands of dollars and were available to a small number of people; then, personal computers knocked down their price to USD 2,000 and made them available to millions of people in the developed world; a similar thing happened to smartphones whose price of USD 200 enabled billions of peoples throughout the world to dispose of computers; these innovations reduce costs with an increase in the volume of production and enable the innovator to reach new customers); as a rule, these innovations create new jobs, but require capital investments.

The essence of recent *Christensen's* message is that we need a mix of these types of innovations – capital freed up through an efficiency innovation should be invested in market-creating innovations. *Christensen* and *van Bever* [7] point to the phenomenon that we encounter today that firms do not invest in innovations that may spur growth despite the historically lowest interest rates and enormous amounts of cash. Reliance on old metrics based on the obsolete assumption that capital is a “scarce resource“ has been brought into question, because capital is not scarce today (over USD 1,600 billion in cash are now available in corporate balance sheets) and if companies wish to maximize their returns, they must change their behaviour and start the battle for talent. Recently, *Porter* and *Heppelmann* [32] have argued that there have been three waves of IT-driven competition, which radically reshaped competition in the past 50 years. The first wave of IT, during the 1960s and 1970s, automated individual activities in the value chain, ranging from order processing and bill paying to computer-aided design and manufacturing resource planning. The rise of the Internet unleashed the second wave of IT-driven transformation in the 1980s and 1990s. The Internet enabled coordination and integration across individual activities; with outside suppliers, channels, and customers; and across geography. It allowed firms, for example, to closely integrate globally distributed supply chains. These first two waves gave rise to huge productivity

gains and growth across the economy. While the value chain was transformed, products themselves were largely unaffected. Now, in the third wave, IT is becoming an integral part of the product itself. “Smart, connected products” – made possible by vast improvements in processing power, device miniaturisation and ubiquitous wireless connectivity – are expanding and transcending industry boundaries, disrupting value chains, altering industry structure, and raising a new set of strategic choices for competitors. This type of transformation will unleash a new and even greater wave of innovation, productivity gains and economic growth.

Innovation as a potential for growth in Serbia and the CEE/SEE region

The previous analysis, researching the work of the most relevant scholars, has deduced that innovation and creative industries play a key role in future economic development. It is now crucial to determine how Central and Eastern Europe (CEE) and Southeast Europe (SEE) as sub-regions, and specifically Serbia, stand in terms of innovation as potential for growth. For this purpose we will analyse the Global Innovation Index, Global Competitiveness Index and GDPpc PPP, and provide additional empirical data on the level of innovation and cluster development in Serbia.

According to *Savic, Pitic and Trbovich* [40], Serbia is currently at the investment-driven stage, conditioning further development upon new investments in increased productivity of goods and services. Although Serbia has entered the second stage of development, it has done so without a sufficiently developed infrastructure (roads,

railways, airports, ports and the like) or administrative infrastructure (weak rule of law, public administration, corruption, etc.), and with poor basic human capital. All this has contributed to a relatively low level of Serbia’s competitiveness, ranking as 94th of 144 countries in 2014. On the other hand, Serbia has achieved significant advantages in some competitiveness elements: elementary education, primary health care and part of telecommunications infrastructure. Therefore, Serbia should commit to resolutely completing the outstanding tasks from the previous stage, including development of logistic and administrative infrastructure, and focus on improving human capital quality. At the same time, it must strengthen the elements of competitiveness linked to innovation infrastructure (skills and innovations), which will enable it to shift to the most advanced innovation-driven stage of competitiveness in the future. In the skills segment, Serbia needs to further improve the quality of math and science education, to increase tertiary education enrolment, and to eliminate deficiencies in the overall quality of the educational system, and specifically the quality of management schools. In the innovations segment Serbia should further encourage the development of patents and enhance quality of scientific research institutions, while at the same time eliminating distinct weaknesses in university-industry R&D collaboration and country capacity to retain and to attract talent. Both the business sector and the government play a role in providing impetus to these processes.

As a general conclusion, based on the analysis of GCR rankings (see Table 1), it can be stated that, insofar as the macroeconomic determinant of competitiveness is

Table 1: Macroeconomic determinants of competitiveness (ranks)

	Macroeconomic competitiveness		HD&PI (former SIPI)		MFP	
	2008	2014	2008	2014	2008	2014
Serbia	74	91	75	87	75	116
B&H*	84	58	94	59	47	51
Romania	78	89	80	81	66	68
Bulgaria	81	78	87	94	56	41
Macedonia, FYR	70	69	75	62	48	48
Montenegro	50	50	51	54	47	52
Albania	88	76	87	83	90	79
Croatia	66	74	64	70	74	71
SEE	74	75	76	76	63	68

Note: Authors’ recalculations based on Porter et al. 2008. Rank versus 144 countries; * For B&H we used data for 2013
Source: *Global Competitiveness Report* [50], [52]

Table 2: Microeconomic determinants of competitiveness (ranks)

	Microeconomic competitiveness		NBE		SCOS	
	2008	2014	2008	2014	2008	2014
Serbia	88	106	85	102	106	129
B&H*	106	90	103	90	121	93
Romania	70	81	68	79	79	87
Bulgaria	80	85	75	81	102	98
Macedonia, FYR	88	66	85	62	103	80
Montenegro	72	71	69	69	85	85
Albania	100	86	98	88	108	86
Croatia	67	79	68	77	62	83
SEE	84	82	81	80	96	93

Note: Authors' recalculations based on Porter et al. 2008. Rank versus 144 countries; * For B&H we used data for 2013
Source: *Global Competitiveness Report* [50], [52]

concerned, Serbia and all SEE must act toward improving human development, rule of law and efficient political institutions - HD&EPI (former SIPI).

Since value is created only at the microeconomic level, we will further analyse the microeconomic determinant of competitiveness as the most important component. Table 2 shows the two key components of the microeconomic determinant of competitiveness – NBE (national business environment) and SCOS (sophistication of company operations and strategy). Data show that microeconomic determinant of competitiveness in Serbia to be at a lower level than the macroeconomic determinant. A key generator of the deterioration of microeconomic determinant of competitiveness, SCOS (Sophistication of company operations and strategy) which dropped from 106th in 2008 to 129th place in 2014. The second generator of the deterioration of microeconomic determinant is quality of NBE (national business environment) which dropped from 85th to 102nd place in the same period.

Additional analysis was devoted to NBE as the essence of microeconomic competitiveness (see Table 3). This analysis was carried out using the Porter's diamond on the basis of NGCI methodology (see Table 3). Within the Diamond, Serbia achieved the best ranks in terms of factor conditions and the lowest ranks in terms of supporting and related industries and demand conditions. These results are unsurprising and reflect the fact that competitiveness in Serbia primarily improved in the first two components of the Porter's diamond – factor conditions and the context for strategy and rivalry. In order to achieve a considerably higher competitiveness rank, Serbia should also significantly improve the other two components (supporting and related industries and demand conditions).

Consequently, it is strategically important that Serbia bases its reindustrialisation process on the strengthening of innovation, since the latter that provides a basis for shifting to the higher stage of competitiveness, as well as on the development of knowledge-intensive creative

Table 3: Porter's Diamond in SEE

	1. Factor conditions		2. Context for strategy and rivalry		3. Supporting and relating industries		4. Demand conditions	
	2008	2014	2008	2014	2008	2014	2008	2014
Serbia	77	90	95	117	100	122	89	127
B&H*	97	84	106	100	118	103	123	109
Romania	64	85	74	99	76	113	72	108
Bulgaria	73	73	78	89	82	92	71	52
Macedonia, FYR	75	71	97	85	105	95	100	118
Montenegro	68	60	64	71	93	101	65	64
Albania	96	80	92	68	119	122	110	54
Croatia	58	66	85	107	79	80	67	123
SEE	76	78	86	92	96	103	87	94

Note: Authors' recalculations based on Porter et al. 2008. Rank versus 142 countries; * For B&H we used data for 2013
Source: *Global Competitiveness Report* [50], [52]

industries that are deemed essential for accelerated GDP growth. To that end, Serbia must be intensively involved in processes described by *Porter* and *Kramer* [33] with regard to the emergence of new capitalism in which businesses fulfil their mission by creating shared value. According to *Porter* and *Kramer*, business at its best is an innovation that satisfies society’s needs and builds profitable enterprise, since these two twin goals represent the next competitive frontier for companies.

During the times of recession induced by the Global economic crisis, in the period from 2008 to 2014, SEE maintained their competitiveness rank (ranked at 80th place), while the score increased from 3.87 to 3.99. The region’s rank in terms of GDPpc ppp also remained unchanged (ranked at 80th place), with the average annual growth rate stood at 2.3%.

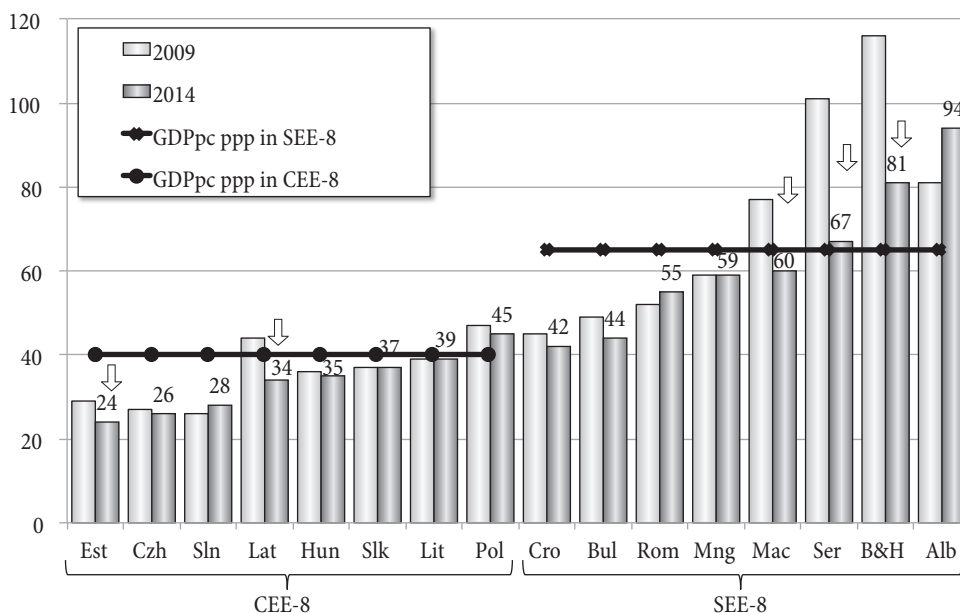
However, the competitiveness dynamics among the countries in the region exhibited substantial differences. The greatest improvement in competitiveness was recorded by B&H, Albania and Bulgaria, while the greatest deterioration was recorded by Croatia, Romania and Serbia.

Within the scope of Porter’s diamond analysis, in 2014 SEE established competitive advantages primarily in factor conditions (parts of administrative, communication and innovation infrastructure) and then in a certain elements of strategy and rivalry context. On the other hand,

there are distinct competitive disadvantages found in all four segments of Porter’s diamond: in factor conditions (especially in logistical infrastructure, part of administrative infrastructure, capital market infrastructure and part of innovation infrastructure), than in the strategy and rivalry context (primarily due to low intensity of local competition, extent of market dominance and insufficiently developed labour-employer relations), than in supporting related industries (primarily due to the low level of cluster development and low quality and quantity of local suppliers) and, finally, due to undeveloped demand conditions (primarily due to the low level of buyer sophistication).

The Global Innovation Index (GII, 2014) relies on two sub-indices – the Innovation Input Sub-Index and the Innovation Output Sub-Index and four overall measures: (i) the Innovation Input Sub-Index, which consists of five input pillars capturing elements of the national economy that enable innovative activities (institutions, human capital and research, infrastructure, market sophistication, and business sophistication); (ii) the Innovation Output Sub-Index based on innovative activities within the economy (knowledge and technology outputs and creative outputs); (iii) the overall GII score, which is the simple average of the Input and Output Sub-Indices, and (iv) the Innovation Efficiency Ratio, which is the ratio of the Output Sub-Index over the Input Sub-Index which shows how much

Figure 2: Global innovation index rankings



Source: Cornell University, INSEAD and WIPO, *The Global Innovation Index 2009/2010 and 2014* [9]

innovation output a given country is getting for its inputs. GII for 2014 includes 143 economies with 81 indicators, representing 92.9% of the world's population and 98.3% of the world's GDP (in current US dollars).

GII 2014 confirms the continued existence of global innovation divides. Despite the increased globalisation of R&D, the literature has noted that the actual production of high-quality scientific research papers over the last three decades is spiky and geographically concentrated in only a few centres of excellence. The world's leading cities for the production of scientific papers at the highest levels have remained essentially the same for the past three decades. The GII takes a more holistic view of innovation, which includes several factors other than R&D spending and scientific publications, but GII findings show that even with such a broader view, sharp divides in innovation results remain widespread.

Innovation leaders among the CEE (Central European Economies) are Estonia, the Czech Republic and Slovenia (see Figure 2). The leaders according to the GII level among the SEE are Croatia and Bulgaria. According to this indicator, when the financial crisis of 2008 began, Serbia was ranked 101st with only Bosnia and Herzegovina in the

region ranked below. Since then, Serbia has improved its ranking – in 2013 it was ranked 67th, but it was better only compared to Bosnia and Herzegovina and Albania in the region. Table 4 shows the rankings of these countries in terms of GDPpc PPP, GCI (Global Competitiveness Index) and GII. A country achieves a GDPpc PPP that reflects the level of its prosperity, that is, the standard of living (column 2). Column 3 shows GCI ranks. This index shows the level of productivity with which a country uses all available resources. The countries whose GCI rank is higher than the rank in terms of GDPpc PPP use their available resources in a more productive manner; they are more competitive and thus ensure a higher standard of living. Four out of the CEE countries are ranked better in terms of GCI than in terms of GDPpc PPP – Estonia, Lithuania, Poland and Latvia, while five of the SEE countries are also similarly ranked – Bulgaria, Romania, Montenegro, Macedonia and Serbia.

All CEE and SEE countries are ranked more highly in terms of innovation than in terms of GDPpc PPP. In addition, the positions of all countries (except Poland) are better in the GII than in the GCR. These data demonstrate that both the CEE and SEE countries have recognized the

Table 4: Competitiveness and innovations in Central and South-eastern Europe (ranks)

Country	GDPpcPPP 2013	GCI – rank in 2013	GII– rank in 2013	Relative GII position (2013 vs 2009/08)
CEE				
Estonia	45	29	24	+5
Czech Republic	37	37	26	+5
Slovenia	35	70	28	+8
Latvia	53	42	34	+26
Hungary	51	60	35	+12
Slovakia	41	75	37	-2
Lituania	47	41	39	+3
Poland	49	43	45	+11
Average CEE	45	50	34	
SEE				
Croatia	57	77	42	+20
Bulgaria	69	54	44	+30
Romania	74	63	55	+14
Montenegro	81	67	59	+12
FYR Macedonia	88	63	60	+29
Serbia	83	94	67	+25
B&H	100	87	81	+26
Albania	95	97	94	+27
Average SEE	81	75	63	

Note: calculated by authors

Source: *Global Competitiveness Report 2014-2015* [52], *The Global Innovation Index* [9]

importance of innovation in the process of improving competitiveness, and hence the standard of living. The last column in Table 4 points to relative changes in the GII during the crisis (2013 vs. 2008). During this period, all CEE countries except Slovakia improved their rankings. All SEE countries significantly improved their rankings: Bulgaria by 30 places, Macedonia by 29, Albania by 27, Bosnia and Herzegovina by 26, Serbia by 25, etc. These data demonstrate that, despite the impact of the 2008 Global economic crisis, the SEE as a whole succeeded in significantly improving innovation competence, partly due to the region's own efforts and partly due to lagging by other regions.

As for Serbia (see Table 5), the innovation strengths in 2013 included: (i) knowledge and technology output (especially scientific & technical articles – 5th place and ISO 9001 quality certification – 6th place, among 142 countries), (ii) innovation infrastructure (especially ISO 14001 environmental certificate – 9th place, ecological sustainability – 28th place) and (iii) human capital research. On the other hand, the crucial disadvantage of Serbia lies in the component of market sophistication, primarily due to the low intensity of local competition, low investments, trade and level of competition.

Insofar as relative innovation changes in Serbia in 2013 are concerned (relative to 2008, as the year when the Global economic crisis began), it can be observed that it moved up 25 places as measured by GII. In terms of innovation, Serbia improved its rank from 92nd to 67th place. Improvements were especially pronounced in the components of human capital and research, creative output and knowledge and technology output.

Clusters and creative industry development in Serbia

To this day, one cluster mapping study was conducted in Serbia using the European Cluster Observatory methodology that was initially developed by *Michael Porter*, focusing on employment distribution within 38 cluster categories (defined according to EU standards valid at the time of the study), though with noted limitations in employment statistics available in Serbia. The study, undertaken in 2009 by an EU-funded project, Support to Enterprise Competitiveness and Export Promotion (SECEP), found a) a high concentration of 11 cluster categories comprising various service industries in Serbia's three largest cities (Belgrade, Novi Sad and to a lesser extent Niš; Business Services; Communication and Equipment; Distribution Services; Education and Knowledge Creation; Entertainment; Financial Services; Hospitality and Tourism; Information Technology; Publishing and Printing; Sporting, Recreational and Children's Goods; and Transportation and Logistics), b) 14 clusters dispersed more widely across Serbia (Agricultural Products; Apparel; Biopharmaceuticals; Building Fixtures, Equipment and Services; Chemical Products; Construction Materials; Forest Products; Furniture; Heavy Construction Services; Lighting and Electrical Equipment; Metal Manufacturing; Plastics and Rubber; Processed Food; and Production Technology); and c) a number of cluster categories were insignificant in Serbia with low levels of employment and/or a small number of registered companies. (Aerospace; Analytical Instruments; Automotive Components; Fishing and Fishing Products; Footwear; Heavy Machinery; Jewellery and Precious Metals; Leather Products; Medical Devices;

Table 5: Innovations in Serbia (ranks)

	2013	2008	Relative change (2013 vs. 2008)
GI	67	92	+25
Institutions	69	94	+25
Human capital & research	59	120	+61
Infrastructure	53	81	+28
Market sophistication	134	59	-75
Business sophistication	83	104	+21
Knowledge & technology output	44	74	+30
Creative output	79	128	+49

Note: calculated by authors

Source: *GI (2008-9, 2014-15)* – Cornell University, INSEAD and WIPO [9], *The Global Innovation Index 2014* [52]

Oil and Gas Products and Services; Power Generation and Transmission; Textiles; and Tobacco) [27]. Since the study was conducted, service industries continue to dominate as cluster activities. Furthermore, an automotive components cluster (AC Cluster) has gained in significance due to market entry of a large automobile producer, Fiat, and positioned itself regionally, creating a SEE supplier database. Government assistance to clusters continues (usually grants distributed by Ministry in charge of economy and Regional development agencies), but it is more limited due to pending fiscal constraints (for instance, no grants were distributed in 2014), while donor assistance has subdued, with no ongoing EU projects in this area, one USAID grant in ICT as part of exit strategy, and a small cluster project funded by Danish government in Southeast Serbia. As a result, most clusters are poorly organized with low activity level. Notable exceptions are clusters in information and communication technologies – ICT (ICT Network, Vojvodina ICT Cluster, NICAT cluster, ICT Cluster of Central Serbia, ICT Hub Belgrade), apparel (FACTS), metals (Vojvodina Metal Cluster), tourism and, to an extent, furniture clusters, due to recognized value they provide to company members but also initial donor and government support. Film and engineering clusters (in form of Serbia Film Commission, and Association of Consulting Engineers in Serbia, respectively) have also been gaining increasing traction for similar reasons. Clusters in Serbia continue to require assistance to improve management, design and fund activities, and promote awareness on synergetic effects of clustering, not just at national but also at regional level.

Conclusions

Reindustrialisation in Serbia should be strongly focused on processes that buttress innovation, since this is the essential basis for shifting to the higher stage of competitive development. The strengthening of knowledge-intensive clusters of creative industries should provide a foundation for upgrading Serbian prosperity.

Synergetic effects could be achieved if SEE countries coordinate regional competitiveness more closely.

Stemming from our previous analysis, the following recommendations apply:

- (i) In the context of improving NBE it is necessary to strengthen regional infrastructure (logistical infrastructure, as well as energy, financial and research-educational infrastructure), remove trade and investment barriers, reduce market dominance and local monopolies and protect consumers;
- (ii) In the context of macroeconomic policies and access to finance, it is necessary to coordinate measures in financial markets and enhance investments by the European Investment Bank and the European Bank for Regional Development, as well as achieve full utilisation of new financial instruments within the Western Balkans Enterprise Development and Innovation Facility – EDIF, combined with national instruments such as the Innovation Fund of the Republic of Serbia and other regional funds such as the Small Enterprise Assistance Fund - SEAF; and,
- (iii) In the context of political institutions it is necessary to coordinate efforts on reducing corruption and strengthening regulatory bodies, while sharing best practices, improving dispute resolution mechanisms and economic statistics.

Clusters in Serbia, and in the region, require further support, which should be devised after further analysis including regional-level cluster and creative industries mapping. Specific cluster support should be combined with broader measures to improve the business-enabling environment, access to finance and education reform, teaching students and arts and humanities business and entrepreneurship, and enabling linkages among the traditional lines of industry to transform outputs into more value added outputs of creative industries.

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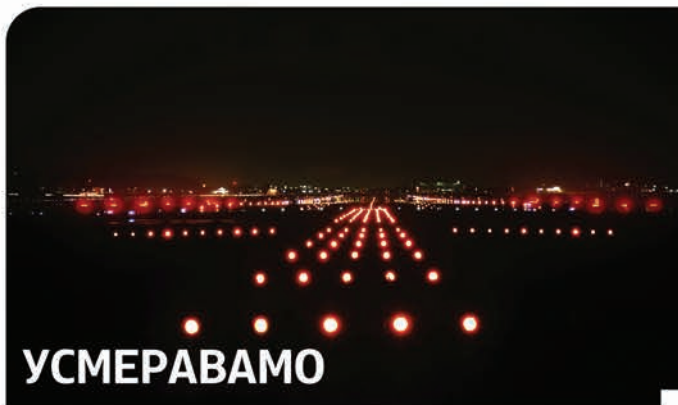
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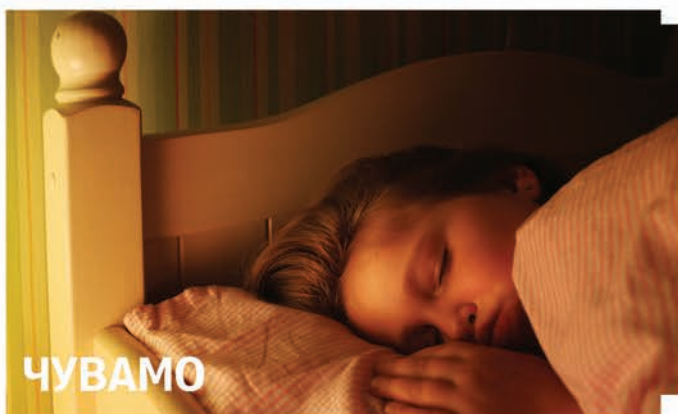
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PROSPECTS FOR THE APPLICATION OF NEW PUBLIC MANAGEMENT APPROACH TO THE SERBIAN PUBLIC ADMINISTRATION

Mogućnosti za primenu pristupa *New Public Management* u javnom sektoru u Srbiji

Abstract

The primary goal of this paper is to assess possibilities for the implementation of mechanisms characteristic of New Public Management into the Public Administration model in Serbia. Author firstly analyzed various approaches to Public Administration and compared experiences of different countries. After a brief overview of Public Administration legacy and tendencies in Serbia, author used findings from theoretical and comparative analysis to provide the proposal of new model.

Key words: *New Public Management, public administration reform, Serbia*

Sažetak

Osnovni cilj ovog rada je utvrđivanje mogućnosti primene mehanizama *New Public Management* pristupa u javnom sektoru (pretežno državna uprava) u slučaju Srbije. Autor je najpre izvršio analizu različitih pristupa u državnoj upravi i poređenje sa iskustvima drugih zemalja. Nakon kratkog pregleda razvoja i reforme javnog sektora u Srbiji, izložen je utisak o neophodnim promenama, kao i predlog novog modela javnog sektora u skladu sa nalazima teorijske i praktične analize.

Ključne reči: *New Public Management, reforma državne uprave, Srbija*

Introduction

Initial model of public administration (PA) implemented throughout the world in the 19th and 20th century was, both in terms of structure and processes, founded on bureaucratic organization as defined by Max Weber. The main characteristics of such a model were emphasis on accountability, procedures and top-down flow of initiatives. In the middle of the 1970s and the beginning of the 1980s a number of countries (predominantly members of OECD) began implementation of a new model in the light of economic turmoil. A set of goals to be achieved through the introduction of this model included above all: reorganizing structures and processes, focus on outcomes and results, improvements of personnel and financial management, and a strong emphasis on marketization of PA service provision. This approach was entitled the New Public Management (NPM).

Implementation of NPM was conducted differently in various countries depending on their PA legacy and socio-economic specifics, which led to the origination of several sub-models and a variety of partially exerted reforms.

The countries of Central and Eastern Europe (CEE) and South Eastern Europe (SEE) also implemented a certain number of NPM tools in the previous 20 years. This process

is still to be fully assessed in terms of effectiveness since it did not follow a continuous trend and had experienced substantial resistance in many occasions.

Serbia is characterized by many features inherent to the countries in mentioned regions. That is why it should also evaluate possibilities for the implementation of NPM. This should be, however, done with caution since not all tools of NPM are suitable for implementation in certain local settings. This is mostly the case with the introduction of market-oriented solutions. The goal of this paper is to assess the tools of NPM applicable in Serbia. Basis for this assessment are experiences of other countries combined with theoretical propositions and previous Serbian experiences.

In the first section several generic approaches to the public administration are presented. The focus is then put on the development and definition of NPM as well as on certain new models of PA. This is further elaborated in the second section which explains the main principles of NPM. The third section sums up several experiences regarding the implementation of certain NPM tools in different countries. Impressions gathered in this section are applied to the case of public administration in Serbia in the fourth section. A few recommendations as to the extent to which NPM should be implemented in Serbia are clearly stated. Conclusion summarizes the findings of the paper and gives potential trajectories for further research.

Short overview of public administration approaches

During the 1970s many developed Western countries encountered numerous problems regarding the efficiency, effectiveness and economical rationality of the existing concepts of public administration. This issue was closely connected to the features inherent to *Weberian bureaucracy* model that was predominant at the time.

The most vivid claim is the following "... the traditional bureaucratic structures that ushered in the industrialized economies of the 20th century may have been appropriate for that era but have reached a point of diminishing returns." [24]. In other words, fiscal burden incurred by massive and increasingly ineffective public

administration became too expensive to maintain. Moreover, the growing concern that the centralization of decision-making responsibilities tends to increase government's power and decrease its accountability to the population [12] was also a strong incentive for the significant change in this field.

Risks stemming from such a situation motivated authors in the field of public policy, administration and economics in general to assess the problems and offer an improved PA model as a solution. As a result, several theoretical models emerged. The ideas of Neo Taylorism, Public choice theory and Public entrepreneurship as well as key aspects of Principal-Agent theory and Transaction cost theory were used as the basis for the creation of various approaches that were jointly entitled New Public Management. Later on, Neo-Weberian and Public value approaches emerged from the need to deal with problems inherent to the application of New Public Management principles.

- *Neo Taylorism* (also referred to as Managerialism) stressed the need for changes in management of public administration as a system. The main fields of improvement should be the control of costs that arise in the process of public service provision, clear definition of personal responsibility for performances, and the incentivization system based on those practices [15].
- *Public choice theory* focuses on the political aspects of bureaucracy, perceiving its status as informationally monopolistic both towards politicians and the public. This theory implies that bureaucrats follow the rational goal of maximizing their utility in terms of increased power, status, patronage, etc., which leads to allocative inefficiency and oversupply of public services [23]. In order to avoid resource wastage it is suggested that more competition in the delivery of public services is introduced. Furthermore, privatization and contracting-out to private providers are outlined as a solution. In the end, information regarding the availability of alternatives to public services should be provided [15].
- *Public entrepreneurship* approach introduced the need for exceptional quality of public service,

empowerment of clients (citizens) and incentivization as the means for improvement of PA. Besides that, concepts of privatization and marketization are also outlined as solutions, which is quite similar to the ideas of Public choice theory. This approach insists on flexible (entrepreneurial) public management, i.e. the convergence of public and private managing practices [15].

- *Principal-Agent theory* emphasized the separation of provider and purchaser of public services. It was suggested that government should define standards and procedures according to which it should select private provider for certain public service. This approach emphasized higher efficiency of private entities in providing services [23].
- *Transaction cost economics* theory contributed to the debate with an idea that decision regarding which services are provided by PA itself and which are outsourced to private providers should be based on cost comparison [23].

The governments of the United States of America (Ronald Reagan's administration) and the United Kingdom (Margaret Thatcher's administration) pioneered the introduction of these concepts through the process of public administration reform.

Approach grounded in the aforementioned ideas and theories, further enhanced with concepts of modern economical and management theory is known as *New*

Public Management (NPM further on). The NPM is often regarded as “. . . the entire collection of tactics and strategies that seek to enhance the performance of the public sector. . .” [24].

The results of NPM, however, did not improve the performance of PA to the expected extent which is why concepts of Neo-Weberian State and Public value paradigm emerged as alternatives.

- *Neo-Weberian State* (NWS) approach builds on traditional bureaucratic model emphasizing the state-provided public service with focus on accountability. Only when sound PA system is built, flexibility and efficiency enhancements are introduced. In that sense, instead of implementing market-oriented solutions, the focus is on sophisticated control mechanisms. Flexibility should be exercised through consultation with external experts and as an additional measure rather than an alternate approach [26].
- *Public Value paradigm/Management* (PVM) encompasses three key components: services, outcomes and confidence in government. This reflects to PA in a way that the goal of public managers is to steer public services provision so that it results in outcomes beneficial to society as a whole thus improving the confidence in government [23]. Citizenry as a whole rather than individual citizen is a subject to services and outcomes of PA. Implementation of procedures that guarantee that collective preferences are adequately

Table 1: Differences between Weberian model, New Public Management, Neo-Weberian model and Public value management

Weberian characteristics	Characteristics of New Public Management	Neo-Weberian State characteristics	Public Value Management
Dominance of rule of law, focus on rules and policy systems	Inward focus on (private sector) management techniques	External orientation towards citizens needs	Relationships between key stakeholders
Central role for the bureaucracy in the policy making and implementation	Input and output control	Central role of professional managers	Multiple objectives are pursued including service outputs, satisfaction, outcomes, trust, and legitimacy
Unitary state	Fragmented state	Unitary state & collaboration	Collective preferences are expressed
Public service ethos	Competition and market	Public service ethos	Menu of alternatives selected pragmatically
Representative democracy as the legitimating element	Client empowerment through redress and market mechanisms	Supplementation of democracy with consultation and participation	Multiple accountability systems including citizens as overseers of government, customers as users and taxpayers as funders
Political administration split within public organizations	Political administration split within and between (agencification) organizations	Political-administration separation and emphasis on professionalization of the latter	Public managers use political approach and advocate for a value they create

Source: Adapted from [1] and [23]

met is the overarching goal. In order to achieve this, tools proposed by both NPM and NWS are used.

Differences between traditional Weberian, New Public Management, Neo-Weberian and Public Value Management approach are summarized in Table 1.

The key characteristics and principles of New Public Management

The overall goal of NPM is to create a PA system as small and efficient as possible. Such a system should follow strategic goals streamlined by corresponding action and project plans that would be subjected to performance control on a regular basis. Key performance indicators used with this regard should be effectively introduced to public managers/civil servants and aligned with the state budget. Competitive “mindset” would be established through the division of PA system to several subsystems (strategic business units) that would compete with each other in entrepreneurial way. Besides that, competition between public and private entities should be stimulated. System reformed in this way would perceive citizens both as highly dispersed stockholders (owners of the state) and customers (consumers of public services). Efficiency enhancement limited by the tradeoff between cost reduction and service quality should be taken into account for every assessment and action [19].

Having said that it is important to underline that NPM is a broad approach consisting of multiple concepts and theories rather than a single theory. Defining it with a set of principles comes more in handy than constructing a broad definition. It is often argued that there are as many sets of NPM principles as there are approaches to this model. However, there are some key elements that are common to the majority of approaches. Concise overview is given in Table 2.

Experiences of other countries

Different PA traditions

Depending on the PA systems introduced through their history, all countries have selected the most suitable approach of NPM. There are, however, certain groups of countries whose NPM approaches show substantial convergence to each other:

- United States, United Kingdom, Canada, New Zealand and Australia
- France, Spain, Italy and several other countries of (South)eastern Europe
- Germany, Switzerland and Austria
- Nordic countries (Sweden, Norway, Denmark, Finland) and Netherlands
- Countries of Central and (South) Eastern Europe (CEE/SEE, further on) including Serbia

Table 2: General principles of New Public Management

Category	Characteristics / objectives	Examples
Organizational restructuring	Delegation of responsibility Reduction of hierarchy Political and managerial Roles	City managers Holding structure
Management instruments	Output orientation Entrepreneurship Efficiency	Performance agreements Products Performance-related pay
Budgetary reforms	Closer to private sector financial instruments	Cost accounting Balance sheet Profit and loss statements
Participation	Involvement of the citizen	Neighborhood councils E-democracy
Customer orientation Quality management	Gain legitimacy in service delivery Re-engineering	One-stop shop Service level agreements E-government
Marketization Privatization	Reduction of public sector Efficiency gains through competition	Contracting out Public-private partnerships

Source: Adapted from [29]

The *first group* encompasses the countries traditionally regarded as prone to “market-type reforms” [6]. These countries have implemented the principles of NPM to the highest extent, especially in terms of marketization, privatization, and the perception of citizen as a customer [27].

The *second group* of countries is characterized by traditional Weberian bureaucracy model (imported from France) with particularly centralized provision of standardized services [21]. The NPM was not implemented to a high degree in those countries and the focus was primarily on (limited) marketization of service provision.

Countries of *German-speaking area* were the starting point for the Weberian model diffusion and certain principles and tools of NPM were implemented primarily as an incremental improvement of the traditional model with focus on: implementation of budgeting concept, decentralization of responsibility for resources [27] and enhancement of PA employee incentivization and flexibility [5].

PA in *Scandinavian countries* is characterized by intensive debate between public and private sector, extensive range of publicly funded and provided social services [6] and is also legalistic and accountability-driven in essence. NPM concepts regarding the verification of administrative performance and political decentralization [21] were in the focus of PA reform.

CEE/SEE countries (including Serbia) share the common history of centralized and highly specialized PA apparatus controlled by ruling political structures. However, it is important to point out that certain countries of this region maintained pre-communist, traditional bureaucratic PA system intact, which resulted in the persistence of important features such as accountability, considerable level of impartiality, and established procedures and processes.

Factors that affect the implementation of NPM principles

The analysis of PA reforms in mentioned countries led to important findings regarding the implementation of NPM concepts.

PA model legacy influences the introduction of tools in several ways. Firstly, the perception of PA in public and

inherited PA habits affect the (overall as much as internal) motivation for the introduction of changes. In countries that experienced historical periods of administrative apparatus being misused by dictatorships, the reputation of civil servants and the system as a whole is quite low. This was the case of Spain (Franco’s regime), Italy (Mussolini’s regime) and Greece. The same stands for systems that were historically characterized by high levels of corruption and low efficiency (Spain, Portugal). Systems with this burden are first expected to inherit democratic and meritocratic means of functioning before further changes are introduced [16]. Secondly, traditional PA mechanisms and values affect the cost-efficiency of implementing NPM tools. This is the case in France, where monitoring through key performance indicators was introduced with considerably low costs owing to the existence of so-called *policy tables* that were traditional feature of the system. [17].

The *difference between internally and externally-oriented NPM principles* in terms of results they provided is obvious. Internal reform measures encompassing the introduction of controlling, financial management and budgeting practices from private sector as well as the evaluation systems proved as generally successful in Germany, France [17], Netherlands [36] and even some countries that are characterized by dissatisfactory status quo in PA such as Italy. On the other hand, external reforms including privatization, outsourcing and quasi-competition-enhancing measures proved to achieve doubtful outcomes [16], [18]. Privatization of municipal utility companies proved to be particularly problematic. It is argued [17] that it substantially reduces the income of municipalities, therefore reducing their possibility to distribute it to the activities/projects of low financial viability but with high public value. Outsourcing also proved to be dubious in some cases because it included further subcontracting, thus complicating monitoring and diminishing service quality. Both initiatives often ended with remunicipalization.

Introduction of public agencies is effective only when precisely defined and monitored. The experience of the UK shows that inception of many agencies in a short time and with unclear performance indicators leads to several problems. Firstly, monitoring information is not aligned

and therefore hard to use for decision-making. Secondly, the possibility of underachievement and abolishment of agency is high [36]. Gradual introduction of these entities, as it was done in Netherlands [35], points to somewhat better outcomes. Firstly, it is possible to create a more concise (although still not effective enough) performance measurement system. Secondly, it is possible to track the common problems and therein enhance the implementation methodology. The experience of Netherlands shows that agencies on average provide satisfactory effects after 2-3 years upon establishment. Thirdly, a careful analysis that preceded implementation indicated that most suitable PA areas for agencification are inspectorates and implementation services.

Political setting is above all important in the sense of political support for reforms. Secondly, it is perceived that the type of concepts implemented highly depends on ruling ideology because it decisively defines the strategic orientation of reforms. In Greece [9] the scope and strategic direction of decentralization reforms were changed several times due to the changes of leftist and conservative parties in power. Another example is Denmark and Sweden where considerable convergence of introduced reforms was attributed to the similarity of ruling social-democratic parties. Differences in this case originated mainly from the differences in PA model legacy [6]. Thirdly, it is common that implementation of NPM reform principles heavily suffers from the government instability or atomized coalitions [16].

Implementation in pilot setting before introducing large-scale changes leads to establishment of logical connections between reform mechanisms. This is a trend specific to Scandinavian countries, Netherlands and countries of German-speaking area [6], [27], [36]. The example of Germany local municipalities shows that pilot initiative to decentralize responsibility for resources revealed the need for adjustments in budgeting. Responsibility for budget disposal was then combined with introduced possibility to use certain budget position as collateral for others. This further leads to the establishment of cost and performance accounting. In the end, the concept of financial controlling was implemented [27].

Suboptimally intensive decentralization of local self-government leads to the inception of local communities that are too small to commit all expected functions of PA. This problem was especially serious in Greece [9] where one reform wave ended with municipalities so small and power-deprived that their augmentation was the priority of next set of reforms.

Identifying the source of stakeholder motivation enables timely perception of implementation risks and ways to mitigate them. Thorough analysis of the process of new accounting policy implementation in municipalities of North-Rhein Westphalia in Germany [28] shows that different stakeholders show varying approaches to reforms. For civil servants in charge of implementing the change operationally, the greatest benefit is the know-how gained in the process. The perception that learned will be useful in further career development is key motivational factor for this layer of actors. Executives, on the other hand, are reluctant to introducing changes since they favor proven procedures and mechanisms to new solutions with uncertain effects. Their motivation is enhanced through communication of goals and inclusion in the process. Top management of PA body supposedly approves these efforts but in essence low level of related knowledge prevents them from showing concrete support. Communicating the strategic importance of reforms increases their motivation to take active part in process. If all three layers of actors are not equally motivated to participate changes would occur only on the operational level. The lack of involvement of executives and top management is perceived as crucial for straining from strategically aligned to purely technical inadequate implementation.

Problems regarding the NPM-oriented reforms in CEE/SEE countries have a lot in common. Areas that overlap most frequently are [9], [10], [13]: corruption, formation of legal state, preservation of human rights, low salaries in PA, anachronistic and irresponsive PA structure, doubtful recognition of PA stakeholder interests, notable resistance to reform. Transitional issues these countries encounter along with inherent institutional discontinuity make it difficult to precisely assess the effects of reforms. General impression is that these countries mostly implemented NPM concepts without overarching strategies and without

a firm existing PA structure. This resulted in a creation of rare “islands of success” in the majority of misaligned reforms [26].

Stated findings have several general implications for Serbia. *Firstly*, the introduction of NPM principles is highly country-dependent. *Secondly*, even so the most homogeneous region regarding the settings for implementation of NPM principles is the region of CEE/SEE mostly because of the common institutional discontinuity. *Thirdly*, too quick or too one-sided implementation of these principles leads to suboptimal results irrespective of how initially remedial they are perceived.

Besides these general impressions it could be argued that altogether these findings present a nice tool for assessing current state or potential introduction of reforms to the PA model in Serbia. If done so, they should be broadened by the assessment of solving the local-specific problems.

Empirical cases of NPM implementation

The most extensive evaluation of success in the PA reform process is present in the countries that pioneered this trend and subsequently went furthest both regarding scope and depth of changes. The following case studies present several possible outcomes.

1) *Outsourcing: National healthcare system (NHS) in the UK*

One of the most apparent examples of failures in the implementation of NPM principles is the *outsourcing of IT services* in the case of NHS in the UK. Initiative “Connecting for Health (CFH)”, which had a projected cost of GBP 12.5 billion was expected to deliver [18]:

- NHS care records service,
- Electronic booking,
- Electronic transmission of prescriptions,
- National network-IT infrastructure,
- Digital archive to replace film-based images, and
- Data collection and management system. However, there are numerous indications that CFH project was malfunctioned. Firstly, there is a reported disfunctionality of patient administration system (PAS). Moreover, elsewhere, twenty years of accurate immunization records were lost because of faulty software introduced in 2005. Consulting firms involved

in CFH (CSC (Computer Services Corporation), BT, Fujitsu, and Accenture) also happened to lack necessary experience in such a scalable project. After a series of failures and withdrawal of Accenture from the project, Fujitsu’s Head of Healthcare Consultancy stated: “What we are trying to do is run an enormous programme with the techniques that we are absolutely familiar with for running small projects, and it isn’t working. And it isn’t going to work” [18].

This example points to two important implications for Serbia. Firstly, projects of this scale should be outsourced to providers with renowned expertise and experience. Secondly, without the developed system for complex ex ante project assessment, large projects should not be undertaken. Thirdly, too sophisticated or revolutionary solutions can prove to be expensive failures, which is why pragmatic and rational alternatives should be chosen instead.

2) *Public-private partnerships: Mediation in Netherlands*

Although PPPs proved to have various effects, Sijtwende project in Netherlands had an atypical outcome. The starting point was over a sixty-year-long conflict between the municipality of Voorburg and the Ministry of Transport regarding the building of road track through Voorburg. However, a third party, the private consortium Sijtwende BV, showed itself to be a process manager by breaking through the barriers between mentioned public entities. It also turned out to be an exceptional project manager by developing a creative and innovative multifunctional land use plan. The private consortium Sijtwende BV proposed a ‘hollow levee’ solution, the Sijtwende Plan. This safeguarded the interests of the Ministry of Transport to build the road route and those of Voorburg that mainly were concerned about economic and environmental impact. In the end, plan resulted in a six meter high ‘hollow levee’ that is both soundproofed and landscaped. The concrete plan constituted of “... a two kilometer length of road most of which is in three lengths of hollow levee (measuring 1000 meters, 275 meters, and 375 meters respectively). Between the three covered sections there two junctions were planned. Covering the road in this way increases 22 hectares of land for housing and office building in the area to a functionally useable area of 27 hectares. This multiple

exploitation of the area provided financial compensation for the relatively expensive hollow levee version. About 700 new homes were planned to be built on either side. The plan also includes about 10 000 square meters of office space and the building of a recreational area, green space, and leisure facilities” [8].

Crucial conclusion that can be made for the case of Serbia is that besides regulated mechanisms or focus on planning and assessment, it is sometimes best to solve conflicts of interest simultaneously. Mediation should be taken over by the side with the highest interest in project success which therefore seeks the most adequate solution. However, sound legal framework must exist in order to prevent any “hidden agenda” that would destroy public value in the long term.

3) *Health system in France: Adverse effects*

Activity-based payment for medical services in France was implemented as a version of the US Diagnostic Related Groups (DRG). DRGs are predetermined reimbursement rates that reflect services that are actually delivered. Application of this mechanism replaced the former hospital financing model that depended on patient length of stay, local demographic factors such as population size, and the hospital bargaining power during fee negotiation with the central government. They incorporate some basic principles of NPM. Firstly, a split between financing, primarily from the government, and care provision by hospitals. Secondly, incentivization and competition for patients, as care providers’ income is directly related to patient volume [31].

Evaluation of French NPM reforms in the area of health services’ efficiency points to outcomes below expectations. It was argued that “... instead of improving or simplifying government execution, it appears that constant monitoring created additional risks and costs that remain largely unquantified. French hospitals hired ‘DRG coders’ instead of hiring physicians. The situation in medically underserved areas is even worse under NPM, as more public hospitals in close proximity to those areas do not support a sufficient patient pool. Furthermore, the closure of medical services that are too expensive to run such as cardiology, nephrology and emergency services in city centers occurs often. Discrepancies in hospital

payments, argued as the main reason for the adoption of DRG, have not disappeared, but were merely transferred from the central government to the patient who incurs a higher share of the cost. Despite a nationwide uniform DRG scale, daily fees, which are set by the hospital director, approved by the RHA, and paid for by the patient and his/her supplementary insurance, varies significantly. In a survey on medical cost in city based hospitals, procedure costs ranged from EUR 360 to EUR 2,230 for a similar medical condition with an average cost of EUR 817. Therefore, fees still do not reflect care intensity, but constitute an adjustment mechanism to balance the hospital budget. The public/private sector gap is rising. Private hospitals focus on the most profitable DRGs (including ambulatory care, elective surgery, and maternity care), leaving services with poor returns, for instance, organ transplantation or emergency services, which are more expensive to run, or welfare services (often, emergency rooms double up as shelters for the homeless), to the public sector. As for PPPs, particularly for the construction of hospitals, outcomes are clearly negative for the taxpayer. Early PPP evaluations point to inadequacies. In case of the largest hospital construction site in the city of Evry, a simulation for a 30 year public loan of EUR 344 million costs a total of EUR 757 million compared to the EUR 1.2 billion that were actually paid to the private operator. Unlike a private operator that contracts loans at higher rates or invests its own funds with an expected return on investment of 10% to 15%, public operators benefit from lower financing costs since they can borrow at preferential rates. These failures prompted the French government to adopt more stringent regulations to ensure that PPPs do not bankrupt municipalities” [31].

Three conclusions further applicable in the case of Serbia arise. Firstly, introducing marketization to healthcare turned out to be the cause of reduction in medical service offer and overall healthcare quality. Secondly, the shift of payment from central government to the patient proved to have increased the price discrepancy. Therefore, without sufficient legal and control capacities such radical changes should not be initiated. Thirdly, chosen PPP solutions in the area of hospital construction turned up to be more expensive but also more lucrative for private operators. This

also suggests that private operators may take advantage of PPP opportunity if contract or partnership relations are not carefully defined and properly legally reinforced.

Feasibility of application in Serbia

Previous sections of this paper introduced the idea of NPM, presented various conclusions on the basis of experience from other countries and gave an insight into three empirical cases. In order to apply these findings to the case of Serbia, the PA system legacy, reform experiences, and current PA model will be briefly presented.

Historical development of PA in Serbia

The first PA model established in Serbia at the beginning of 20th century contained elements of German, Austrian and French bureaucracy. In other words, it was a classical Weberian system based on legalistic principles, highly depersonalized, centralized and embodied in a strict vertical structure regarded as “the essential state institution” [4].

The majority of CEE/SEE countries have gone through the process of dismantling the existing institutions when (mostly communist) dictatorship regimes after the Second World War were established. Although communism was also the dominant ideology in Serbia/former Yugoslavia, existing PA structure was preserved. Enactment of legal texts (acts of parliament and governmental decrees) remained the primary role. Rigidity and low conformance also endured. These features are perhaps most adequately illustrated by the comment [4] that ruling structures found it more appropriate to change the constitution on the sign of political turmoil than to approach a PA reform. The role of service provider was introduced by the changes of legal framework in 1977. However, this was largely perceived as only formal solution with no evident application. Policy creation was not regarded as a task of PA. There were no notable changes to the system in the 1980s.

During and after the period of civil war in former Yugoslavia, administration suffered from problems that struck the society in general out of which emigration of qualified workforce was the most apparent. In addition to that a long lasting tradition of career advancement based on the seniority and professional reliability was substituted

by the criteria of political loyalty. Intensive centralization was also introduced as a reflection of regime’s political aspirations.

Brief overview of reform initiatives in the period 2000-2014

When political changes happened in 2000, government advocated thorough administration reform. Reform process by 2004, however, was characterized by the lack of overarching strategy. Because of that, although legislation was adopted at satisfactory pace, the reform implementation was omitted in most cases. Even when reform actions took place, they were misaligned and in most cases ended up as partly implemented initiatives. The overlap and lack of clarity in roles of the Ministry of State Administration and Local Self-Government, Agency for Public Administration Development and Civil Service Council were the main reasons for such result [34]. Suitable example of misaligned reform approach is the formation of large number of public agencies starting with 2000 even before they were regulated by corresponding law [34]. Functional reviews introduced in several ministries as a way to determine current status and define necessary changes did not receive wider political support. This initiative was labeled as donor-driven, highly politicized and further inhibited by poor communication of goals [20]. Chaotic reform initiatives in this period left Serbian PA as a centralized bureaucratic structure with insufficient flow and provision of information and poor capacity of conducting interorganizational initiatives. Government instability could be held responsible for much of the miscoordination [4].

The first Strategy of PA reform (Public Administration Reform, PAR) in Serbia was adopted in 2004. Key reform areas were organizational decentralization, fiscal decentralization, building a professional civil service, establishment of new organizational and management framework as a basis for rationalization, introduction of information technology (modernization), and introduction of public administration control mechanisms. Relation to the principles of NPM is obvious and comes from the orientation towards the EU-compatible reform course. The main disadvantage of this strategy was the lack of quantitative and financial

indicators [2]. This made it impossible to concisely assess the effects of introduced changes. In combination with the absence of implementation budgets it becomes apparent that measuring results of this strategy was provisory at best. Outcomes are in line with the following [2]:

- In the area of *rationalization*, several increases and decreases in the number of ministries happened, all related to the coalitional dynamics.
- *Public agencies* were legally defined but means for their supervision and basis for real independent functioning were not identified.
- *Capacity for policy creation and implementation* was not enhanced by the reforms and focus remained on the rule-obedient tasks.
- *Decentralization* efforts ended up with no clear effects. The main finding with this regard is that although central government is devolved to districts, public services are provided by parallel network of subordinated branches coordinated by each ministry.
- Although certain sources of income were assigned to local municipalities, *fiscal decentralization* was hindered by the fact that property mostly remained in state ownership. However, unlike some countries in the region such as Hungary and Greece it is argued that vast majority of municipalities have the capacity to exert given tasks.
- *Privatization* efforts did not take place in the sense of NPM. Only privatization of large public enterprises was a matter of discussion.
- In the field of *Civil Service* the reforms introduced evaluation system based on employee rating that was, however, vulnerable to biased assessment.
- Possibility for *external candidates* to be employed in executive places was also introduced.
- In the field of *PA's and general Government's openness* to citizens the institutions of Ombudsman and Commissioner for information of Public Importance were introduced.

Having in mind all those facts it is clear why it is argued that until 2008 the greatest progress was achieved in the field of legislation adoption [2]. The turbulences in coalition government once again proved to be one of the main reasons for such outcome.

In 2009 reforms focused on handling the effects of economic crisis through fiscal consolidation. Downsizing is chosen as a primary mechanism of reducing the fiscal burden. Instead of applying bottom-up approach based on the realistic resource requirements, the reorganization was defined in a top-down assessment that had cost reduction as a single goal. First step was the definition of austerity measure scope using required cost reduction as quantitative reference value. Determination of layoff scope was next on the agenda. Internal reorganization came as the last step in this process. It included the adjustment in number of employees in organizational units in accordance with provisory and unclear benchmarks [11]. In the end, the following could be concluded regarding this reform initiative of Serbian PA:

- Goals were short-term and exogenous in nature (reactive)
- Planning process was restricted to the achievement of a single goal
- Planning process was provisory and directive (top-down)
- Organizational restructuring was narrowed down to layoffs
- No formalized mechanism of monitoring was introduced

The initial Action plan for the implementation of PAR Strategy related to the timeframe 2004-2008. Since the effects of strategy were scarce in this period, a new action plan was adopted for the period 2009-2012, but suffered from the same set of problems. In the meanwhile, another change of government occurred leading to a short standstill in the application of strategic reform activities. It is, however, important to notice that further austerity measures including salary reduction in public sector were introduced during 2013 and 2014. The setting of those measures is quite similar to the one from 2009.

Findings from previous section are in line with the perceived [19] state of *strategic planning* in Serbian public administration. *Firstly*, there is no coherent framework that defines methods, principles and directions of strategic planning. Such practice of disintegrated strategy definition on the ministry level without adjustment efforts discards any intention to maintain strategic focus. *Secondly*, the

lack of resources to carry out a strategic planning process originates from insufficiently educated PA employees in the field of reference. The perception that it is just another working task with no additional incentive is also common. Furthermore, contracting foreign experts of questionable level of expertise as consultants often results in further strategic divergence. *Thirdly*, legal framework is also incomplete in the field of strategic planning. Deadlines and sanctions triggered by underperforming are not clearly defined nor are they a matter of serious assessment. This is also accompanied by the absence of useful action plans for strategy implementation. *In the end*, there is no alignment between planning and budgeting. Besides that, the fact that financial projections of public entities are submitted to the Ministry of Finance while their mid-term plans are submitted to the General Secretariat again indicates an illogical and divergent approach to planning and governance. It is obvious that strategic planning has no sense irrespective of its scale without systematic budgeting practice.

Current state of reforms, human resources, goal orientation and resulting PA model

The state of PA reform as reported in 2014 did not point to any radical improvements in comparison to earlier conclusions having that main problems remain [30]:

- The responsibility for policy making is still not clearly distributed among public entities
- Citizen-oriented approach is still absent except for several isolated cases
- Civil service status does not apply to all public employees including some that occupy key state functions
- Meritocracy is threatened by inadequate regulatory solutions that allow for discretion especially when senior positions and performance evaluation are in question
- Political responsibility for civil service, control of public expenditure incurred by PA and human resource management are situated in different public entities that are inadequately coordinated

Advancements in transparency, efficiency, and legislation harmonization in the field of public procurement

are regarded as the highest improvements in comparison to previous years.

Recent study of human resources in Serbian PA provided interesting outputs [32]:

- Although legalistic accountability remains dominant, the majority of employees have economic and management professional and/or educational background
- Average age of civil servants is lower than in Western and higher than in Eastern Europe, which could be attributed the outlined PA tradition that generally stands in between
- Employees indicate that reaching a career plateau after certain career level is common and frustrating
- Civil servants on the operational level show low levels of satisfaction due to lack of delegating
- The number of civil servants without experience in private sector is high

while the situation regarding strategic approach points to the following [32]:

- Management by objectives (MBO) is implemented to a limited extent
- Along with Hungarian, Serbian PA employees express the lowest familiarity with the implementation of strategic tools
- Centralization is high in the fields of budget allocation, policy design and policy implementation, and situated on the level of politically appointed management
- Technical skills of staff are not appreciated

A wide consensus exists among all levels of civil servants that there is a need for political support in order to resolve chronic problems of systemic centralization and far-reaching politicization.

The assessment of PA “evolution” and current state in Serbia indicates that the model of public administration has following features:

- In terms of *scope*, it is not entirely defined since current legislation accounts only for employees directly involved in administration irrespective of the fact that public healthcare, education, a number of public enterprises and utility enterprises constitute it.
- *Organizationally* it is a rigid, archaic model with many hierarchical levels that communicate through “legal

act exchange”. Even so, it is vulnerable to discretionary behavior and often circumvented because of the high influence of politically appointed staff since the decay of professional values in previous 25 years.

- In terms of *policy making* it is the uncoordinated system with small capacity, specialized for totally different tasks of legislation enactment.
- In terms of *policy implementation* Serbian PA is a mosaic of isolated initiatives without the built-in ex ante assessment mechanisms.
- *Decision-making* is centralized and accompanied by scarce delegation of tasks and responsibilities. This stands both for devolution to branches of central government and local self-governments.
- *Tools for performance measurement* are mostly absent along with awareness of their strategic importance.
- In terms of the *NPM principles introduction* Serbian PA model is in the initial phase characterized by small-scale impulsive implementation of certain structures and mechanisms (e.g. public agencies).

In general it can be claimed that preferable Weberian characteristics of Serbian PA model faded over the past 25 years further blurred by the chaotic partial implementation of certain NPM concepts.

Proposed steps towards the implementation of NPM principles and changes in PA model

In the process of proposing the new model experiences of other countries presented in the third section have been used as a reference case along with the recommendation of Serbian civil servants.

Regarding the *legacy of PA*, Serbia could have been regarded as a country with reasonably good starting point 25 years ago. However, as presented above, this is not the case anymore. Knowing that, the attention must be directed towards the mitigation of systemic flaws such as discretionary behavior and politicization. Besides that, legal accountability for public resources should be reintroduced as the core value. Another important step would be the communication of improvements to citizens and active request for feedback in order to regain their trust.

The example of public agencies testifies about inability to systematically introduce monitoring when

NPM tools are implemented. That is the reason why it is recommended to avoid changes that include *externally-oriented mechanisms* until capacities are improved.

The lack of control mechanisms both in the operational and implementation tasks of PA is proposed to be solved through the deployment of mandatory budgeting, i.e. *internal-oriented mechanisms*. Budgets would be used as means for subsequent performance assessment. In parallel to that, delegation of responsibilities and authority to lower levels of civil servants should take place. The starting point for this initiative should be the pilot projects in most developed public entities, organizational units or municipalities.

Existing *public agencies* should undergo a thorough reassessment with regards to the questions of: existence purposes, goal overlapping with organizational units within ministries/other public entities and applied control mechanisms. Agencies whose purpose ceased to exist or was proven to be misaddressed should be reassembled. In case of high goal overlapping with existing organizational units, goal fulfillment should be readmitted to ministry/other public entity. Agencies in which control mechanisms are absent or inadequate should implement locally-adapted version of proven foreign solutions.

Organizational changes should be based on the bottom-up assessment of available human and technical resources. Further on, resources should be reconfigured to the areas with higher priority goals and/or resource deficit. Radical dismantling of the strict hierarchical organization is not advised due to the fact that achieving stability of existing elements has the highest priority.

Motivation of key stakeholders is especially important having in mind problems of human resource management in Serbian PA. Appreciation of staff technical skills should be increased firstly through the legislatively defined delegation of responsibilities and authority to the operational levels. Further on, setting the line of communication between employee levels aside from the formal context would increase the mutual understanding. Regular meetings with rotating representatives of subordinated level would be a means for achieving this. Expected result is increased involvement of senior civil servants in reform processes. Professionalization of

senior level employees is also a solution to this problem. Knowing that currently Serbian PA has considerably low percentage of employees with business experience the beneficial spillover effect should also be taken into account. Affecting motivation of politically appointed PA layer should be achieved through the advocacy by senior public servants in line with findings of Public Value theory. This would, however, require education in the field of mediation and sales skills which would further enhance the need for stronger human resource management service.

Strategic tools and logic should be at first implemented in the area of policy making and implementation, especially regarding further PA reforms. Sectorial strategies should be aligned with the goals set by overarching state strategy. Each strategic initiative should be based on a planning process that is standardized through legislation. Implementation of initiatives is accompanied by budget which is further segmented to activities in the action plan. Only when motivational efforts and strategic logic are firmly imprinted in the PA system, could the tools such as management by objectives be properly introduced.

In the end, *political support* comes as the most important prerequisite for PA modernization. Every reform “wave” in Serbia was to a high extent affected by political situation. Experience proved that controllability of this factor was pretty low. However, the idea that public managers should advocate reform set out by Public Value theory could lead to a possible increase in controllability following the same algorithm as for stakeholder motivation.

In terms of overview in Table 1 the model based on all those recommendations has characteristics of Neo-Weberian State (NWS) as well as some features of Public Value Management (PVM). NWS ideas are necessary in order to remove the consequences of chaotic development that are obvious in the case of Serbian PA model. When advantages of robust and stabile structure are unlocked, (internally oriented) NPM principles can be successfully introduced. Features of PVM are maybe even more important in Serbian case since it emphasizes political approach by public managers which is a crucial skill for securing the political support.

Conclusion

The main goal of this paper was to determine which tools of New Public Management approach to Public Administration are applicable in the case of Serbia. Representation of these tools in the context of current PA model was supposed to point to the necessary improvements.

In order to gain the insight into currently available PA models at the beginning of the paper characteristics of Weberian bureaucracy as an initial model are outlined in brief. Further on, main features of Neo-Taylorism, Public choice theory, Public Entrepreneurship theory, Principal-Agent theory, and Transaction cost economics theory are presented since they all constitute the New Public Management approach. In the end, New Weberian State approach and Public Value Management were shortly assessed.

The lessons of assessed NPM implementation experiences have proven that some key factors that influence the introduction of these principals are: the legacy of PA model, difference between internally and externally-oriented NPM principles, introduction of public agencies, political setting, implementations in pilot setting before introducing large-scale changes, suboptimal intensive decentralization of local self-government and identifying the source of stakeholder motivation. Common problems regarding the NPM-oriented reforms in CEE/SEE countries are also briefly expressed. Three case studies depicting the detailed NPM implementation were presented.

Historical development of PA model in Serbia was shortly described. Afterwards, the reform trends and current status were presented with the emphasis on introduced changes, positive, and negative aspects. Overall conclusion was that current PA model is chaotic, with traditional advantages being archaic and “blurred” while introduced improvements are regarded as incomplete.

The assessment of possible application of NPM principles in such setting proved that certain (internally oriented) are more preferable than others. With regard to conclusions about implementation in other countries suggestions are made in order to reform the PA system. Newly proposed model proved to be similar to both NWS and PVM according to majority of characteristics.

In the end it should be noticed that the primary goal of this paper could be further broadened to empirical analysis of successful public entities, organizational units and/or municipalities. This would allow for more precise determination of best administrative practice in Serbia. Besides that, the field research that will result in proposing concrete performance measures for public agencies and/or other public entities would be a valuable extension to this paper.

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REGIONAL DRIVERS OF ECONOMIC GROWTH

Regionalni pokretači privrednog rasta

Entrepreneurship is a force that exploits other resources to satisfy market demand, an ability to create and build up something practically out of nothing. (Chouhan, 2012)

Abstract

Regional development of Serbia, after waves of recession, faced an additional challenge: a trend of increasing regional demographic regression, economic gap, etc. Entrepreneurs and SME sector are particularly hit hard by the economic crisis. But, in addition, in Serbia there are 1.2% rapidly growing enterprises (1,103, of which 160 gazelles) that boast growth potential (before the crisis, there were 3%). These are the drivers of regional economic growth.

The basic research results of the regional dynamic entrepreneurship: 1,103 dynamic enterprises (2009-2013) participated in the increase in business revenues of Serbia with 110.5% (these enterprises covered 10.5% of the loss of the remaining segment of economy), generated 1/3 of profit growth in the economy and created 10,000 new jobs in the economy. Regional driving forces of growth and development had, in a certain number of regions, an extremely important role in the change of economic structure, increase in employment, and improvement in competitive performances of local economic structures.

Economic recommendations presented in the paper go in two directions: firstly, it is vital to set up additional stimulating mechanisms for dynamic regional entrepreneurs in order to create conditions conducive to a faster growth of dynamic entrepreneurship in Serbia. Secondly, a way out of regional poverty will depend mostly on the building of institutions and affirmation of regional strategic planning.

Key words: *regional drivers of economic growth, dynamic entrepreneurship, regional strategic planning*

Sažetak

Regionalni razvoj Srbije se, nakon recesivnih talasa, suočio sa dodatnim izazovima: trend povećanja regionalne demografske regresije, ekonomski jaz, i dr. Preduzetnici i sektor MSP posebno su teško pogođeni ekonomskom krizom. Ali, i pored toga, u Srbiji postoji 1,2% brzorastućih preduzeća (1.103, od kojih su 160 gazele), koja imaju potencijal rasta (pre krize radilo je 3% brzorastućih preduzeća). To su regionalni pokretači privrednog rasta.

Istraživanje regionalnog dinamičkog preduzetništva pokazalo je da je 1.103 brzorastućih preduzeća učestvovalo u rastu poslovnog prihoda Srbije sa 110,5%, što znači da su ova preduzeća pokrivala i 10,5% gubitaka ostalog dela privrede, generisala 1/3 rasta dobiti u privredi i kreirala 10.000 novih radnih mesta u privredi. Regionalni pokretači rasta i razvoja su u jednom broju regiona odigrali izuzetno značajnu ulogu u promeni privredne strukture, povećanju zaposlenosti i poboljšanju konkurentskih performansi lokalnih privrednih struktura.

Ekonomске poruke u radu usmerene su u dva pravca: prvo, neophodno je kreirati dodatne podsticajne mehanizme preduzetnicima kako bi se stvorili uslovi za brži rast dinamičkog preduzetništva u Srbiji, i drugo, izlaz iz regionalnog siromaštva zavisice najviše od izgradnje institucija i afirmacije regionalnog strateškog planiranja.

Ključne reči: *regionalni pokretači privrednog rasta, dinamičko preduzetništvo, regionalno strateško planiranje*

Introduction

Social entrepreneurship is in the focus of competitive economy, it is the epicentre of the growth strategy “Europe 2020”. Social economy has been recognized as the priority of funding in the EU regional policy with about EUR 90 million allocated for the new instruments of the support to capital investment in the period 2014-2020. The primary goal of the EU is to facilitate the access to the private capital for social entrepreneurs.

Effects of the recession on EU entrepreneurship

- Added value of SMEs in EU-28 in 2013 was just 1% higher than in 2008.
 - Employment in 2013 was still 2.6% below the employment in 2008.
 - Micro companies suffered the greatest decline in the number of employed persons in the period 2008-2013.
 - Effects on SMEs vary significantly depending on which Member State they are in, sectors and size.
-

OECD is warning that entrepreneurship, small and medium enterprises and local development are confronted with increasing risks due to fewer and fewer financial incentives. Different attitude coming from financial institutions would contribute to the prevention of the collapse and employment increase. It is crucial that main preconditions are created, which, according to OECD, in the first place refers to the reduction of bureaucracy. Bureaucracy comprises about 3.5% of GNP, therefore if the bureaucracy was halved, GNP would increase by 1.5-2%.

Regional entrepreneurship presents an answer to the increasing problem of rising unemployment of the young. For example, in the Netherlands, where unemployment rate is the lowest in Europe, over 65% of young people start their work experience in social economic entities which prepare them for work and for the labour market, where they will be directed when they finish their education. “Schools and faculties should introduce social entrepreneurship in educational programs but as an activity as well. That would stimulate the capacity building of social entrepreneurs for managing their own economic activities,” *Marc Tarabella*, a member of European Parliament pointed out.

The fast-growing companies that boast growth potential (dynamic enterprises and gazelles) present

the propeller of development of any economy [5, p. 103]. Dynamic enterprises make use of their resources in a market environment most efficiently; they manage to raise employment continually, improve their balance positions, respond to market signals fast and, accordingly, make business decisions swiftly.

Encouraging the development of regional dynamic entrepreneurship is a development chance for Serbia. Primary tasks are to continually strive to create a stimulating environment and address key development problems of enterprises in the stage of growth and development [13].

The subject of the research is orientated to two directions: the testing of regional dynamic entrepreneurship in Serbia as a driving force of economic growth and the identifying of the key systemic determinants of the improvement in regional strategic planning and development management.

Trends and challenges of the regional development of Serbia

Regional transitional balance: The reflection of economic balance

Positive effects of the transitional economic balance (2001-2013) which reflect in the growth of the number of economic entities (45.9%), growth of the total revenue (48.9%) and growth of the profit (370.7%) of Serbian economy, have been in the shadow of perennial cumulative negative effects which reflect in the indebtedness (the growth of debt – 82.5%), insolvency, illiquidity and high losses (the growth of losses – 35.5%, cumulative losses – 14.5%), which present crucial limitations for the growth of productivity and competitiveness of Serbian economy (see Table 1).

One decade since the transition started, the Serbian economy is still operating unprofitably. In 2013 the negative financial result was EUR 265.7 million (EUR 1.3 billion in 2001; EUR 534.2 million in 2008). The loss (EUR 4.2 billion) is 6.7% bigger than the realized profit (EUR 3.9 billion) and it accounts for 12.2% of GDP.

Positive net financial result was made in 2006, 2007 and 2011 (see Figure 1), however, insufficiently dynamic structural reforms, which were additionally aggravated by the effects of global economic crisis, made it impossible

Table 1: The indicators of the economy of the Republic of Serbia from 2001 to 2013 (growth rates)

Indicator	2001=100		2008=100
	2001-2008	2001-2013	2008-2013
Number of enterprises	42.2	45.9	2.6
Employment	-17.8	-27.3	-11.6
Revenues	69.6	48.9	-12.2
Liabilities	61.6	82.5	12.9
Profit	370.1	370.7	0.1
Loss	45.2	35.5	-6.7
Cumulative loss	-18.7	14.5	40.7

Source: author's calculations

for the economy to get out of the zone of net loss-makers in the long run.

Operating of Serbian companies during the whole analysed period was burdened by high indebtedness and cumulative losses (see Table 2). Total liabilities in 2013 were two times bigger than at the beginning of the transitional period and exceed the capital value by 46.6% (in 2001 total liabilities accounted for 64.5% of the capital value), while cumulative loss accounts for 50.7% of the capital, 15.1 of structural points more than in 2001.

The high amount of cumulative losses (EUR 25.4 billion) affected the decrease of capital – the rate of the lost economic capital in 2013 was 39.1%. Cumulative losses per one employed person exceed many times the profit per one employed person and in the analysed years they have an upward trend.

Demographic regression

For many decades demographic trends have been posing the greatest developmental risk. Constantly negative population growth accelerated the process of demographic

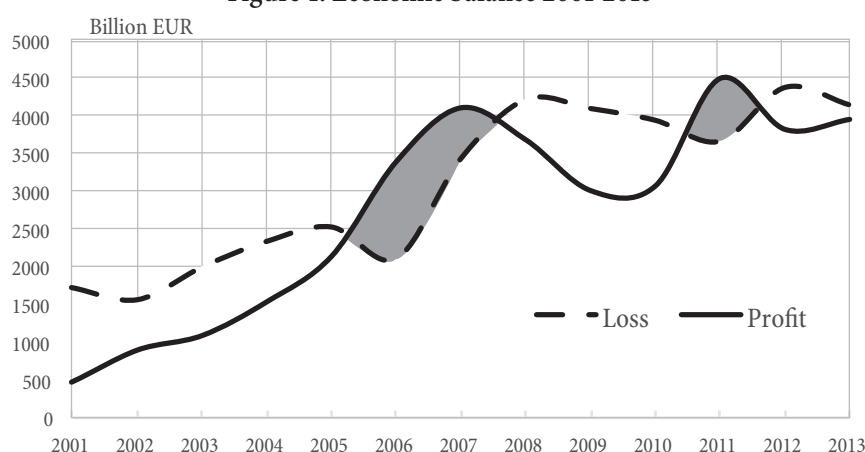
Table 2: Economic transition results 2001-2013

	2001	2008	2013
Cumulative loss/capital (%)	35.6	34.5	50.7
Capital loss rate (%)	34.0	27.8	39.1
Debt/equity (%)	64.5	124.3	146.6
Profit per employee EUR	340.2	3,277.5	3,977.7
Loss per employee EUR	1,261.2	3,752.8	4,244.9
Cumulative loss per employee EUR	9,007.0	15,013.1	25,608.6

Source: author's calculations

ageing, which represents the additional multi-dimensional developmental risk (see Figure 2). In the last few years the ratio between the young and the old has been 4 to 5, at the beginning of the transition, in 2002, the figures were almost the same. Demographic regression continued also in 2012 and 2013 when the decrease of population in Serbia was estimated at over 34,945 (see Figure 3); the regional aspect which is the most unfavourable is Vojvodina (the loss of almost 20,000 inhabitants) compared to central Serbia (a bit over 15,000). Migration flows heading to the capital city and other 23 cities with negative population growth greatly determine economic and social predispositions of municipalities and cities – educational as well as the potential of certain age, the level at which people are employed, economic and social structure. Human resources are particularly important in the process of planning of the economic growth [4]. The specific aspect of depopulation mirrors in extreme territorial asymmetry – concentration in cities and depopulation of the wider area.

Regression trends of natural and mechanical movement accelerated not only the volume, but also the structure of population – the process of ageing population in the period 2002-2011 increased from 40 to 42 years. On the

Figure 1: Economic balance 2001-2013

Source: author's calculations

other hand, the share of population younger than 15 has declined, from 15.7% to 14.3%, and the share of population older than 65 has increased from 16.5% to 17.4%. The ageing of population affects the changes in economic structure in the long term. *Coefficient of economic dependency* shows the increase in the number of people who are non-self-supporting, persons with personal incomes and the unemployed, showing the ratio between these categories and one employed person in all regions, except in Belgrade, South Backa region, and Srem region.

Transitional deepening of regional disparities

The causes of transitional growth of regional disparities are manifold – the lack of uniformity dating from the past, effects of privatization, lack of coordination between the sector and developmental policy, etc. The differences are to a great extent a product of regional specificities, particularly of the economic structure which determines the intensity of their adaptation to current economic and social changes [5].

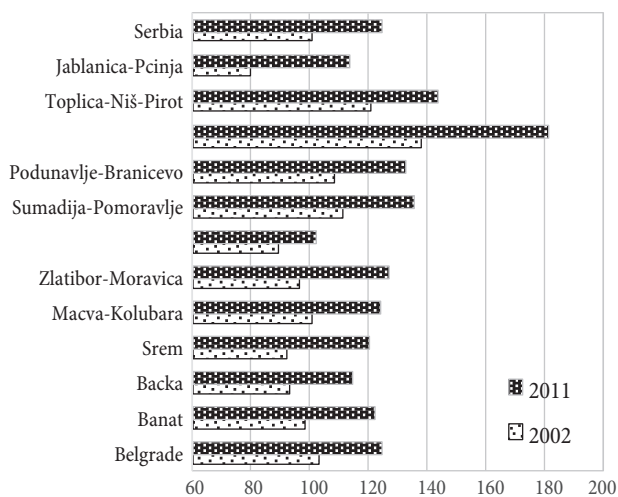
If we analyse regions (NUTS-2), the regions that contributed to GDP in Serbia in 2013 the most were (see Figure 4): Belgrade region which contributed with 39.8%, the region of Vojvodina with 27.5%, followed by Sumadija region and West Serbia with 18.8%, and the regions of South and East Serbia with 13.8%.

The analysis of regional GDP PPS of Serbia per capita, compared to EU-27 average, indicates that Belgrade region, as the most developed region of Serbia, had the index level

of 65% in 2009 and that in 2010 it dropped to 61%, while in 2012 it stayed at the same level (60%). The main cause of the decline, above all, is that in 2010 there was not only nominal decline of GDP PPS per capita in Belgrade region (from 15,216 PPS units per capita in 2009 to 14,811 PPS units in 2010), but also the average growth EU-27 of 4,3%.

There was 1.5 times less economic development in Belgrade region in 2009 than the regional average EU-27, and about 1.7 times less economic development in 2012. Vojvodina region was at approximate level of the average of Serbian regions in 2013, i.e. three times less than EU-27 average. It has to be stressed that the asymmetry between the regions is reflected in employment and unemployment – the Belgrade region has the share of 33% in the total employment of Serbia and the share of 14% in the total unemployment, the region of Vojvodina has the share of

Figure 2: The regional index of demographic aging



Source: author's calculations

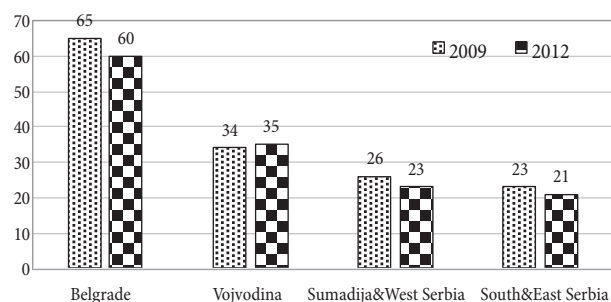
Figure 3: Depopulation 2002-2011



- A - Demographic extremely progressive area (>220.0) (municipalities)
- B - demographic stable area (100.0-219.9) (13)
- C - demographic weakened (regressive) area (70.0-99.9): (37)
- D - demographic the affected area (45.0-69.9): (37)
- E - demographic extremely vulnerable area (<44.9): (73)

Source: author's calculations

Figure 4: Regional GDP PPS p.c. NUTS-2 compared to the EU average



Source: author's calculations

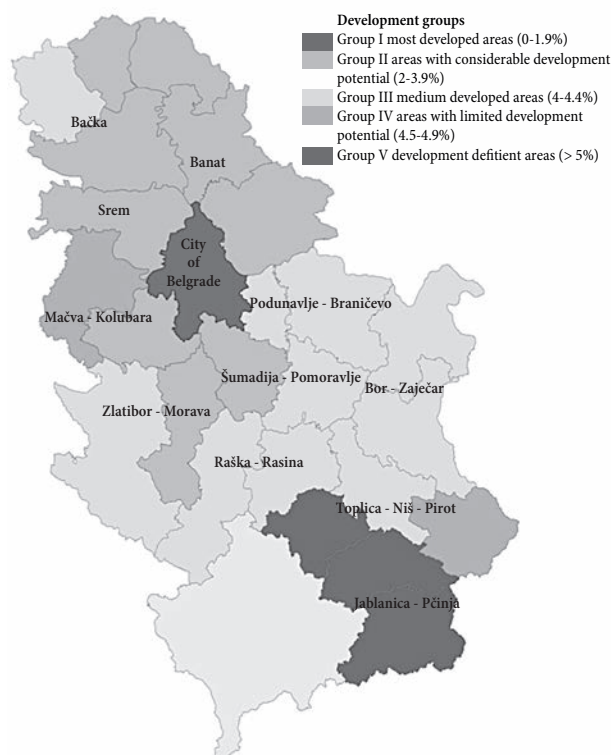
26% of both employment and unemployment. In the region of Sumadija and West Serbia almost 1/4 is employed, with the share of 1/3 in the number of unemployed of Serbia, while regions such as South Serbia and East Serbia have the share of 18% in the employment and the share of 26% in the unemployment.

Analysis of regional disparities at regional levels (NUTS-3) displays a real proportion of regional disparities in Serbia. Extreme values have slightly increased in the period 2006-2013 (see Table 3), that is the Index of Endangered Regions (IER)¹ indicates that the correlation between Belgrade and Toplica Region increased from 6.8:1 in 2006 to 7:1 in 2013, i.e. the City of Belgrade is seven times more developed than Toplica Region (see Figure 5). However, the value of IER recorded the decline for even 21 districts compared to 2011.

Serbian cities represent the driving force of regional development, but they have different intensities depending on the size, number of inhabitants, economic activities, and the level of development. In spite of the fact that the number of cities in Serbia has increased in the last decade, and that many municipalities received prerogatives of urban even regional centres, many indicators show that their role is insufficiently economic, social and developmental. Disparities within very cities are even more noticeable in the transitional period.

More than 50% of all economic activities of Serbia are done in the area of the City of Belgrade. As opposed to Belgrade there are 22 cities with 2.7 million of inhabitants, with 34% of companies doing their business activities

Figure 5: Index of Endangered Regions (IER)



Source: author's calculations

and 34% of the total number of employed people. The economy of 22 cities makes 34% of income, 37% of profit and has the share in the total loss of Serbian economy of 38%. Disproportions among 22 cities are the following:

- according to the number of companies 30:1 (Novi Sad : Zajecar);
- according to the number of employed 22:1 (Novi Sad : Zajecar);
- according to the total revenue 49:1 (Novi Sad : Zajecar);
- according to the profit 201:1 (Novi Sad : Zajecar);
- according to the loss 300:1 (Novi Sad : Novi Pazar).

From the aspect of developmental imbalance, the area of Belgrade stands out, being the most protruding point of the polarization and the most developed region of Serbia. Regional analysis of disparities at municipality level just confirms the thesis of the transitional pattern of the increase in regional differences, according to all representative indicators, showing that the number of municipalities which have the level of development below 50% of the Serbian average increases.

The correlation between the unemployment rate and the rate of underdevelopment in municipalities is very high, in accordance with that it reaches its maximum

¹ IER contains five developmental dimensions: economic, demographic, educational, infrastructural and environmental (where each dimension can be divided into a few representative indicators – altogether 13).

Table 3: IER – changes 2006-2013

Development group	Values scale	Number of districts (municipalities)		Changes 2006-2013
		2006	2013	
I group - the most developed area	0-1.9	City of Belgrade		without changes
II group - areas with significant development potential	2-3.9	8 (51)	9 (58)	<ul style="list-style-type: none"> • Srem and Central Banat District from III to II • West Backa District from II to III group
III group - medium developed areas	4.0-4.4	8 (49)	10 (57)	<ul style="list-style-type: none"> • Kolubara District from IV to III group • Nis District from II to III group
IV group - areas with limited development potential	4.5-4.9	5 (27)	2 (12)	<ul style="list-style-type: none"> • Raska, Rasina, Zajecar and Bor District from IV to III group • Pirot District from III to IV group
V group - development affected areas	>5.0	3 (17)	3 (17)	without changes

Source: author's calculations

values in municipalities which have had the status of underdeveloped for decades. The more underdeveloped an area is, the more obvious are inverse proportions between employment rates – the ratio of the employed to the unemployed is 100 to 40 in developed municipalities and cities, whereas in underdeveloped municipalities that ratio is over 250 of unemployed to 100 of employed (Zitoradja and Tutin). Out of 145 of municipalities in Serbia, in 58 the unemployment rate in 2013 was more than 50% of Serbian average, and if the marginal value is 20% over the average, then 83 municipalities had higher unemployment than the Serbian average. On the other hand, higher employment than the national average was achieved by 16 municipalities.

Regional driving forces of economic growth

Theoretical framework

The first systemic research into dynamic entrepreneurship had primarily been driven by the research done by *Edith Penrose* dealing with the theory of enterprise growth [17, p. 5], later named *theory of resources* (resource-based view of the firm). The theory of resources was rediscovered at the start of the last decade of the 20th century [19]. The core of the resource theory lies in the claim that a competitive advantage is acquired through resources that are valuable and scarce but that are hard to imitate and substitute.

Nonaka and *Sveiby* [16], [23] upgraded the resource theory with the proposed dynamic theory of organizational knowledge about creation through interactions of individuals. They argue that “*dynamic characteristics of knowledge are pivotal for managers*” [23, p. 344].

Basic researches into dynamic entrepreneurship show a high degree of correlation between growth factors and overall economic growth [7]. A usual division of growth factors is to motivation, (2) abilities, and (3) opportunities [22], while others suggest that growth of a company is primarily influenced by the following factors: (1) company's exterior and interior setting, (2) entrepreneur or entrepreneurial team itself, (3) innovativeness and realization of changes, (4) growth and strategic access, (5) business model and management system, (6) human resources, and (7) growth of financing [10], [21, p. 10].

Factors that have a crucial impact on the development of entrepreneurship can be covered by the term entrepreneurial-stimulating environment; the term refers both to factors in a broad sense of the word (socio-economic order that fosters or prohibits profit motives, cultural and religious aspects of a society and a general attitude to work, knowledge etc.) and individual elements which determine the behaviour and conduct of an entrepreneur and a company in an environment.

Entrepreneurial growth is influenced by many other factors in a specific social-economic system, such as the health care system, pensions, labour legislation, protection of knowledge and industrial property, the degree of professional attainment and the access to knowledge [9], protection of buyers and providers, regulation of the capital market, management of public companies, etc.

Over the past few decades some business researchers have devoted ever more time to the study of ecological factors that impact on the development of entrepreneurship and growth of companies and vice versa (the impact of a company's growth on living environment). *Gabe* [8] has

developed an empirical model that measures effects of an active environment policy on the growth of companies.

Numerous European researches have proved the link between the success of European gazelles and economic development [20, p. 65] by studying a set of stimulating measures: financial, fiscal, legal and other incentives for starting a business, attitude to entrepreneurship, tolerance of business failure, readiness to take a risk, an overall entrepreneurial climate, and favourable legislation for companies' growth.

Over the last decade the European Commission has repeatedly stressed that the business environment is no longer conducive to entrepreneurship development. The latest comprehensive analysis have shown that 85% of new jobs [6] can be attributed to the growth of micro, small and medium-sized enterprises, while the rate of employment growth in these enterprises is twice as high as in large enterprises [6].

Interdisciplinary treatment of entrepreneurship, as a socio-economic phenomenon [20, p. 63], is linking at least three basic approaches:

- (1) *the economic aspect*: from the macro-economic and socio-economic aspects we can establish, assess and measure the contribution of "entrepreneurship" to economic growth, employment, advanced stage of the country's economy, and the prosperity of the society. From the micro-economic point of view, we can establish the economic effects of individual entrepreneurial entities, their optimum size to achieve the expected return and balance the use of resources to achieve the maximum effects;
- (2) *the business-organisational aspect* helps us to assure the economic goals in an entrepreneurial organization – an enterprise – and administer and manage the business functions that are prerequisite for the specialization of entrepreneurship to achieve the economic and socio-economic goals;
- (3) *the aspect of entrepreneurial management and entrepreneurial behaviour* allows us to clarify, to a certain extent, what the entrepreneurial handling and conduct of the entrepreneur (or the entrepreneurial team, resp.) and the entrepreneurial organization should be like to be able to apply the

professional techniques and models developed by the business and organizational science and achieve economic, as well as non-economic goals as set by the entrepreneur and all other ones entering the organizational relationship.

Dynamic enterprises can be found in all developmental stages of an enterprise, not only in the so-called stage of growth. The long-term growth is related to, and depends on, the assertion of the leadership professionalization and the development of an entrepreneurial and managerial team, as well as on an advanced, professional organizational structure, tailored to the nature of the business. Underlying for the dynamic enterprise leadership is the understanding and awareness of the management techniques of a growing enterprise, which means that we cannot expect the most dynamic enterprises to be led by individual entrepreneurs, but by strong entrepreneurial and management teams, under the lead of an influential entrepreneur or an entrepreneurial manager, who must not necessarily be the founder of the enterprise.

Research and methodological framework

The research of company's growth is based on various methodological concepts, which include most representative indicators, such as: an increase in total or business income, gross value added, the number of employees, the market value of a company, market shares, the value of goods or service brands, company's assets, etc. The paper promotes an entirely new methodological concept of measuring the dynamic entrepreneurship in Serbia. Criteria and indicators result from a continual research into dynamic entrepreneurship in Serbia [10, p. 7]. The research is based on the quantitative analysis of growth of all the companies in Serbia during the recession period 2009-2013. The methodological framework for studying the dynamic entrepreneurship in 2009-2013 has been based on the following criteria that had to be met by rapidly growing companies:

- They had more than 2 employees in 2013 or more than one employee (this criterion refers to entrepreneurs);
- Their business income was higher than EUR 63,000 in 2013 (the border value represents average business income in economy);

- Their GVA (gross value added) per employee in 2013 on 2009 was larger than EUR 12,400 (the border value represents an average GVA per employee in the economy);
- Their enterprise worked continuously over the analysed period of 5 years;
- Their enterprise had at least the same number of employees in 2013 and higher GVA in 2013 compared to 2009;
- They created at least twice as high average growth of business income than created in the economy ($2 * 2.89\%$) over the period 2009-2013;
- The minimal cumulative profit was registered over the period 2009-2013;
- Enterprises are not in majority ownership of the state (over 50%) on December 31 2013;
- Enterprises dealing with the following activities have been excluded: L – Real estate; O – Public administration and defence, compulsory social insurance; S – Other services; T – Household activities with employers; various goods; U – extra-territorial organizations and institutions.

The listed criteria were met by 1,103 enterprises in Serbia in 2013, which equalled 1.2% of the total number of enterprises in Serbia.

The methodological process of ascertaining gazelles in Serbia was based on the well-known Birch's indicator² [2], which analyses changes to the number of the employed, gross value added, or their combination. The application of the Birch's indicator has helped differentiate 160 gazelles in Serbia, which is slightly more than 10% of dynamic enterprises.

Total economic growth in Serbia is generated by 1% of companies

During the period of economic recession 2009-2013 dynamic companies generated total economic growth in Serbia. In all other economies this number is between

3-5% by all companies, they have over average revenue and employment growth, they are the bearers of innovations and sustainable development. Each economy has to focus on such companies and encourage them, continuously creating conditions for their growth. Dynamic companies are for Serbia, based on the research done in the last ten years, driving forces of economic growth.

Comparative research of dynamic entrepreneurship in Serbia was done in two five-year periods: (a) period 2006-2010, and (b) 2009-2013. The main findings can be concisely put as follows:

During the period of recession 2009-2013 all economic performances were weakened [12], but the fast-growing companies kept the role of the driving force of the economic growth. The research singled out 1,103 dynamic companies (out of which 160 are gazelles – the most dynamic companies) which, during this period:

- had the share in the growth of Serbian economic revenue of 110.5%, which implies that these companies covered 10.5% of losses of the rest of the economy;
- generated three times bigger growth of gross value added in Serbia (the total economy in 2013 had smaller GVA than in 2009);
- generated 1/3 of growth in the economy;
- created 10,000 new jobs in the economy (2% of total employment in the economy), while in economy the employment declined by 78,000.

Total economic growth in the period 2009-2013 was made by 1,103 dynamic companies, i.e. 1.2% of all companies. The recession negatively affected extremely positive economic performance of fast-growing companies from the period 2006-2010, but dynamic companies kept showing positive performances and remained the driving force of economic growth and development in Serbia (see Figure 6).

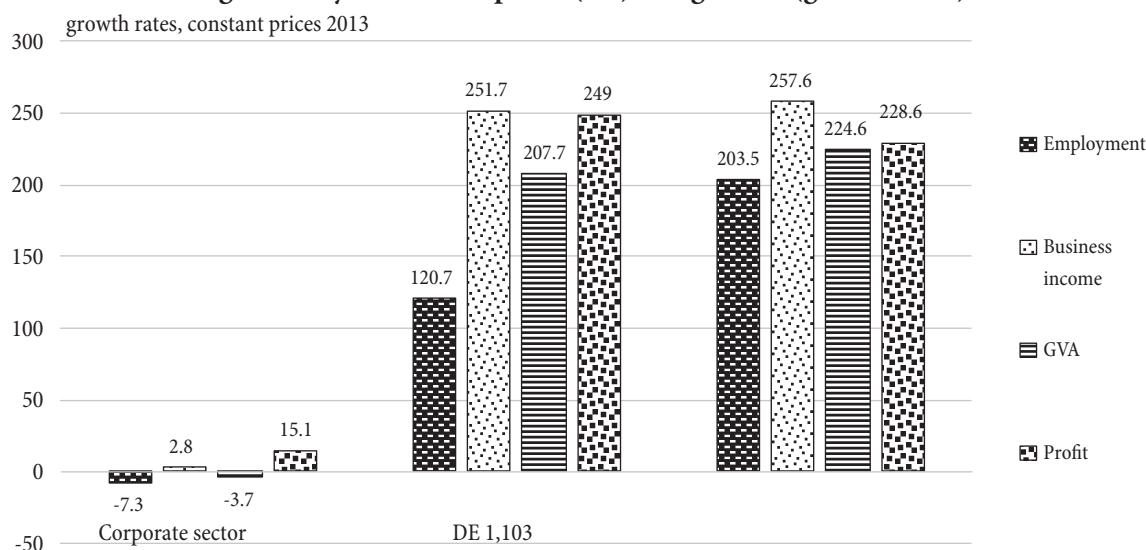
Sectoral structure of dynamic entrepreneurship

Dynamic enterprises increased their contribution to economic growth in all dimensions of research. According to all the relevant economic indicators, the impact of 1,103 dynamic enterprises over the period of five years has tripled despite recession tendencies:

2 The Birch's indicator aims to reduce the impact of a company's size on the growth indicator, and presents a combination of the proportional and absolute rise in employment:

$$m = (X_{it} - X_{i,t0}) * (X_{it} / X_{i,t0})$$

whereby X_{it} and $X_{i,t0}$ present the number of employees at the end and at the beginning of the period of reference.

Figure 6: Dynamic enterprises (DE) and gazelles (growth rates)

Source: author's calculations

- The share of employment rose from 0.8% to 2.0% (from 9,000 employees to 19,859);
- The share of business income rose from 1.3% to 4.3%;
- The share of the gross value added rose from 1.2% to 3.7%;
- Profit increased from 1.7% to 5.2%.

Dynamic enterprises have increased their contribution to economic growth in all dimensions of research (see Table 4). Development of the share of 160 Serbian gazelles within the corporate sector is faster than that of the share of dynamic enterprises – the largest contribution is that of lower unemployment and diminishment of social tensions (160 gazelles in 2009 employed 3,184 people, and in 2013 they had 9,665 employees).

The section structure shows that dynamic enterprises are concentrated in sectors of Trade (336 enterprises or 30%) and Manufacturing industry (201 enterprises or 18.2%). Negative developments in the sector of manufacturing industry are illustrated by all the indicators: shares in the number of employees, business income, and gross value added are down. Industrial dynamic entrepreneurs and industrial gazelles are to face even larger challenges than over the five years of reference.

Regional creators of economic growth

Regional distribution of dynamic companies and gazelles is in the shadow of economic concentration in the City of Belgrade and South Backa region (see Figure 7): out of 1,103

Table 4: Sectoral structure of DE

Sector	Number of companies	Employment		Business income		GVA		Profit	
		2009	2013	2009	2013	2009	2013	2009	2013
A Agriculture	4.9	3.7	3.9	6.2	6.0	4.5	4.0	7.6	5.3
B Mining	0.5	2.1	1.8	0.4	0.3	1.1	1.2	0.1	0.9
C Manufacturing	18.2	30.1	28.0	21.0	19.8	24.9	23.1	24.4	24.3
D Electrical energy	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1
E Water supply, etc.	2.1	2.3	1.9	1.6	2.1	2.1	2.3	2.4	3.0
F Construction	6.7	8.9	10.0	7.8	11.5	11.6	14.7	11.4	17.2
G Trade	30.5	22.1	22.4	47.3	45.1	26.1	23.6	36.4	27.5
H Traffic	15.5	13.1	12.1	8.6	7.7	13.3	12.1	5.5	7.8
I Accommodation and food services	0.7	2.6	3.0	0.5	0.6	1.3	1.8	0.3	1.6
J Information, etc	5.6	5.4	6.0	2.0	2.0	5.7	6.0	4.1	3.4
K Finance and insurance	0.4	0.1	0.1	0.0	0.0	0.1	0.1	0.1	0.1
M Professional, scientific act.	11.6	7.3	8.2	3.4	3.6	7.7	9.2	6.7	7.5
N Administrative and etc activities	2.6	1.8	2.2	1.0	1.1	1.4	1.6	0.9	0.9
Q Health and social work	0.3	0.2	0.2	0.1	0.1	0.1	0.2	0.1	0.2

Source: author's calculations

dynamic companies, 627 or 61.3%, are concentrated in these two areas. The trend of ever faster economic concentration is shown by all other indicators of dynamic companies, that is the reason why 54.3% of employed persons, 61.3% of business revenue, 60% of GVA and 60% of total profit were generated in 2013 in the City of Belgrade and South Backa region. Therefore, 60% of Serbian gazelles operate in this area.

Regional driving forces of growth and development had, in a certain number of regions, an extremely important role in the change of economic structure, increase in employment and improvement of competitive performance of local economic structures. The share of fast-growing companies in creating the economic growth in Macva region was 12.5%, and in Podunavlje region it was 4.3%. The weakest regional contribution to the economic growth in the previous period of recession was made in Pirot, Zajecar, Bor and Branicevo regions (less than 3% of total value added).

Institutional building of regional development

Strategic planning and regional development management

Global recession had an impact on the emphasised affirmation of strategic planning and development programming. Transitional period partially affirmed strategic development planning, above all, through numerous development strategies and policies. However, planning, as the main method of transformation of one system and cushioning of transitional blows (economic, social, regional, political),

did not play the key role in development (and regional development). It was not efficient enough in cushioning strong market blows of transformation of one system and the transfer to the market model of economic activities.

The lack of many resources will only increase the importance of planning as a developmental instrument. Probably the best possibilities for planning could be found in social management in the public sector. Positive impulses can also come from the process of ‘stimulating civil initiatives’. Strategic (developmental) planning is getting priority increasingly, as much for alleviating the negative effects of world economic crisis, as for the growth of the importance of environmental protection and sustainable planning, but also for the need of the government in charge of planning at various levels of the management and of the local units for higher certainty in the conditions of uncontrolled growth and its negative consequences. Strategic planning integrates economic and regional planning, including social and environmental component more and more. Regional developmental plans will have an integrating role, encompassing socio-economic development, its regional and environmental component. Naturally, a synthesis-based approach of regional sustainable development will have to meet most expectations. The concept of regional sustainable development cannot be realized without planning.

Efficient and successful national, regional and local development is unthinkable without the strategic planning. Efficient incentive policy (fiscal, monetary, state aid, etc.) should be based on the priorities of the regional development and local self-governments through the

Figure 7: Participation DE Belgrade and South Backa District



Source: author's calculations

process of strategic planning. The planning of regional and local economic development is a system-based process in which all persons involved, from private, public and non-governmental sector, work together with the aim of creating better conditions for economic growth and improvement of life quality for all citizens in a certain area.

The importance of regional level for regional development

The circumstances that have changed, when post-industrial society came into being, created the need for new strategies of regional policy. The economy which is more and more connected at regional level gets special attention. Special attention mirrors in the economy which is increasingly connected at the regional level. The importance of regions reflects in the strengthening of regional identity at both cultural and political levels.

Numerous factors have an impact on the regional level, as a result of such impact, this level becomes more and more important for the economic development. The change of perspective is based on understanding that economic development of regions is the basis for achieving national economic goals. Thus a state depends on both regional resources and their economic structure, which involves its social and cultural qualities. New circumstances of the improvement of regional development at regional level reflect in three interrelated subtypes: (1) endogenous, (2) cooperative and (3) polycentric regional development.

(1) *Endogenous regional development.* The greatest obstacle is reflected in significant differences at the regional development level, which is the consequence of the influence of the lack of harmonisation among sectoral policies on social events. A well-balanced and continuous development is economic development made to suit the environment, which leaves preserved natural resources to future generations, owing to sustainable social development. Endogenisation of regional development will be carried out particularly through the affirmation of regional centres that are of national importance, where regional development programs are prepared and regional institutions are established. This

requires 'hardware' infrastructure' (transport and communication connections, protection of the space), 'software' infrastructure (support to regional development agencies, preparation of developmental initiatives, assessment of the maintainability of the space, coordination between advisory activities, incubators, faculties) and adequate stimulation (such as financial stimulations, economic zones, certificates about the implementation of ancillary activities – training, consultations, etc.). Municipalities and rural areas should cooperate within the frame of regional development programs. As a rule, regional gravitational area includes more than 150,000 inhabitants. The development of national regional centres is of the primary importance for the regional development management and planning, since they represent regional development policy-makers. In the context of the European integration, the creation of small regions which do not have adequate regional centres, could negatively affect strategic interests of Serbia.

- (2) *Cooperative regional development.* Owing to the exchange of information, communication and coordination, the coordination should provide possible solutions for innovation, developmental problems [22, p. 5], and aspects of organizational behaviour [25]. Under these circumstances the lack of institutions at regional level reflects on inefficient preparedness for planning and program making, since these institutions in numerous cases are better and faster at the preparation of developmental programs which contain specificities of an area. Numerous aspirations for centralization cause the conflict of local interests, which in most cases damages both the state and municipalities.
- (3) *Policentricity – new leading principles for the implementation of well-balanced regional development.* The creation of integrated regional strategies by means of urban 'clusters' is connected to polycentric development in modern world, particularly in border-areas, and to the improvement of modern infrastructural integrations at interregional level

and strengthening of economic cooperation at regional level. For more even regional development, at the national level, it is important that economic development increases attractiveness of the whole region thus improving life quality. In spite of heterogeneity of an area and its size, the decentralised concept of network between cities whose structure of activities is compatible is something to aspire to.

The existence of strategic plans does not mean that regional and local economic development is managed according to the plan

Strategic planning of regional and local development has significantly evolved in the last few decades. Although there was not a single positive regulation in the Republic of Serbia which prescribed that cities and municipalities were obliged to prepare strategic development plans as well as particular perennial strategies for certain areas (education, employment, tourism, support to the young, investment attraction, development of social security services, sustainable development etc.), most local self-governments have at least one developmental strategy and certain municipalities have a whole set of different strategies which cover a good part of their original competences, and some even go further than that.

The results of a regional research imply that in the Republic of Serbia there are three types of municipalities:

- a) those which have a thorough development plan;
- b) those which have just some sectoral development plans (certain important areas);
- c) those municipalities which do not even have sectoral development plans.

A few handbooks of a good quality have been published in the last few years. Although they explain system-based approaches to the preparation of local strategies, establishment of a project cycle, the importance of integrated planning and harmonization of plans and activities from the strategies and action plans with the process of preparation and budget realization, the quality of local strategies is not at the highest level. Specific problem is that in the very process of implementation one does not have the impression that that priorities stressed in strategies become those projects for which one can apply and which

get external resources for financing and co-financing. The existence of development plans does not imply that the development is managed according to the plan. The main problem is the budget preparation without relying on any particular planning document and, as a result, municipalities very often do not act in accordance with plans. Deadlines in strategic documents and priorities are changed by individuals and their own will.

The most frequent practice of the application of the concept of strategic management reflects in the realization of sectoral plans. Accordingly, a comprehensive approach is not realized while segments which will develop according to the given model are chosen. These models are most often those which can currently be found in the focus of political decision-making (for example strategies for the young, action plans for the Roma education or residence, social security strategy, etc.).

Regional strategic development planning: Advantages and disadvantages

Regional strategic document presents the result of multi-sectoral planning process; however, this document is not the very aim, the primary aim is its efficient realization.

Regional strategic planning is a systematic process oriented to goals, cooperation and coordination.

The practice of strategic regional planning and local development plan stressed numerous advantages:

- Regions and local self-governments understood that regional planning is efficient instrument for implementing complex developmental processes;
- The established principle is that perspectives of regional and local strategic planning depend on interrelatedness and coordination of activities of numerous participants;
- New mechanisms of communication and cooperation through the formation of various institutional forms (coordination bodies, mixed working groups, operating bodies, various forms of partnerships) have been adopted;
- Regular monitoring and control of developmental activities through the system for monitoring by means of representative developmental indicators is applied;

- A greater number of participants in developmental decision-making get opportunity to participate;
- Regional and local strategic planning of the development presents an efficient frame for constructive and practical solutions for developmental problems.

On the other hand, some old as well as some new disadvantages and problems of strategic regional and local development planning have been pointed out:

- Regional strategic planning is extremely demanding and complex process which must be highly coordinated;
- The organization of the process of strategic regional planning requires significant financial resources;
- The necessary teamwork and communication process depend a lot on the culture of cooperation;
- It is getting more difficult to find experts with the ability to have strategic, analytical and methodological approach;
- Planning in crisis periods requires different analytical approach;
- If competences are not respected in developmental decision-making, successfulness of implementation is limited;
- Vertical developmental hierarchy in developmental processes in decision-making loses its strength – developmental activities are agreed on by more participants;
- The practice of strategic regional financial planning based on frequent auditing in the public sector reflects on the processes of making strategic documents which results in regional development strategies that are hard to implement;
- There is a lack of funds for the engagement of experts in developmental processes, therefore coordinators must rely on the existing resources;
- Developmental experts are not familiar with possible shortcomings of contemporary approaches to developmental planning, which as a result either causes opposite effects or just implies that the mere form is satisfied;
- The formalization of the planning process can cause opposite effects, which makes it impossible to recognize the specificities and development of social innovations.

Conclusion

“The relationship between inequality and growth is positive, the development process requires the presence of the initial disparity” [1, p. 15]

Growth factors of dynamic enterprises will ever more depend on the strategy for developing knowledge systems or knowledge spirals [15, p. 17], whereby learning happens within the company’s structure. *„The entrepreneurs provide a magical touch to an organization, whether in public or private or joint sector, in achieving speed, flexibility, innovativeness, and a strong sense of self-determination. They bring a new vision to the forefront of economic growth”* [3]. Entrepreneurs are not gamblers and they strive to reduce the risk to a minimum. A structured access to knowledge management and a strategic access to knowledge design through initiatives based on the mapping of critical knowledge will be increasingly needed [26, pp. 6-10].

Given their development potential of job creation, dynamic enterprises draw attention not only of economic scholars but also of economic policy creators who are aware of the fact that these enterprises can help diminish the rate of unemployment, and boost economic growth and development. Small and medium-sized enterprises are most propulsive enterprises, and over the last five years of the 20th century in the EU they created more jobs than the largest ones lost, whereby they saw the largest increase in income and profit [21, p. 53].

Research into regional dynamic entrepreneurship in Serbia has shown how much these enterprises have contributed to economic growth of Serbia: 1,103 dynamic enterprises in period 2009-2013 had the share in the growth of Serbian economic revenue of 110.5%, generated three times bigger growth of gross value added in Serbia, generated 1/3 of growth in the economy, and created 10,000 new jobs in the economy. Although the results are due to the recession, twice as weak as in the period 2006-2010, the fact is that regional dynamic entrepreneurs are the drivers of economic growth and development.

Regional driving forces of growth and development had, in a certain number of regions, an extremely important

role in the change of economic structure, increase in employment, and improvement of competitive performance of local economic structures.

Research results indicate that the acceleration of economic growth in Serbia should be sought in fostering dynamic entrepreneurship. It is necessary to create a supportive environment for the growth and development of dynamic entrepreneurship (unnecessary administering, tax burdens) and internationalization. It is necessary to promote confidence in entrepreneurship and in the institutions that would allow potential entrepreneurs to invest more easily.

Crucial precondition for faster development of the regional dynamic entrepreneurship is the institutional building and strategic regional development planning [4, pp. 342-343].

The effects of regional strategic development planning are as follows:

- It encourages reaching consensus on a common developmental direction, i.e. developmental priorities, by different participants;
- It affirms new ideas and improves the cooperation among interested parties;
- There is synergy effect among activities which are carried out by different participants in the process;
- It helps to solve antagonisms among different participants;
- It creates the atmosphere of positive expectations;
- It encourages the competitiveness of developmental ideas;
- Partnership and communication process create the feeling of ownership over the strategic document;
- It improves decision-making through the orientation towards the solving of crucial development problems;
- It brings strategic planning into connection with the budgetary process;
- It focuses on efficiency, results and achievements;
- It stimulates the use of new resources in a more efficient, coherent and transparent manner;
- It focuses its resources on key priorities.

The measures for the improvement of regional strategic development planning include:

- Defining the methodology (precise guidelines) for strategic planning and regional development management;
- Giving more precise guidelines of “partnership” and “consultations” process;
- Consultative process has many dimensions; the successfulness of the process depends on the communication culture of a certain society, on the skills of coordinators and facilitators, as well as on previous results of the success or failure of consultative processes. It should be clarified how citizens can get involved in developmental processes. Classic public discussions in the process of regional planning have shown that citizens are often involved at the very end when they cannot have any influence on the content. Consultations should be planned in advance;
- What is least known is in connection with the vertical functioning of the institutional frame. New legal solutions must clearly and precisely prescribe institutional competence of all participants in the process of regional development planning;
- Regular auditing of analytical bases is necessary for the sake of monitoring of regional development strategies on the basis of defined indicators;
- It is necessary to harmonize regional and spatial planning development;
- Although SWOT analysis is a good tool, it is necessary to use alternative analytical tools;
- A very reliable methodological tool in the form of a tree of problems and aims, which is based on inductive and deductive analysis as well as on cause-and-effect relations, should be used in the methodological procedure while determining hierarchies of goals, priorities and measures;
- Terminology of strategic planning should be consistent with the terminology of strategic documents in EU;
- Regional Action plans should contain financial plans for three years.

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- Koliko zadirete u srž njihovog poslovanja?
- Koji su parametri koje potencijalni klijent mora da zadovolji kako biste otpočeli uspešnu saradnju?



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NEW STRATEGIC CYCLE IN THE SERBIAN TRADE AND TOURISM DEVELOPMENT

Novi strategijski ciklus u razvoju trgovine i turizma
Srbije

Abstract

Trade and tourism, as significant areas of the service sector in Serbia are entering a new development cycle. In fact, in commerce as well as in tourism, previously adopted strategic documents expire. This creates a need to provide new development strategies for the coming development period in order to coordinate and guide the efforts of the public and private sectors. In both cases, a similar set of questions arises: what has been achieved that was planned in the previously adopted strategies, what is still very relevant and whether it is necessary to make radical shifts or only purifying, complement and update of the existing strategic documents is acceptable. The macroeconomic environment is not favorable neither for tourism nor commerce. However, at least when it comes to tourism, global trends suggest the continual growth of demand for tourist services so it can be expected from Serbian tourism to grab some effects of this global positive trend. This paper specifically examines unrealized projects in both areas and investigates the causes of these failures. The aim is to give some recommendations in conclusion. One option is a possible change of attitude, if the strategic goals were wrong. Another possibility is to change the ways of solving problems and the realization of the project, if the attitudes remain the same, but the way of implementation proved to be ineffective. In the conclusion, it was argued that, so far used strategic documents were basically correct and that the new document should bring updated suggestions on how to start and develop tourism and trade in Serbia more successfully, in the future.

Key words: *trade, tourism, strategy, development, development policy, state intervention*

Sažetak

Trgovina i turizam, kao noseće grane uslužnog sektora u Srbiji, ulaze u novi razvojni ciklus. Naime, i u trgovini i u turizmu ističe važnost prethodno usvojenim strateškim dokumentima. Tako se stvara potreba da se za naredni razvojni period obezbedi nova strategija razvoja koja će koordinirati i usmeravati napore javnog i privatnog sektora. U oba slučaja se postavlja sličan set pitanja: šta je ostvareno od planova iz prethodno usvojenih strategija, šta je još uvek aktuelno i da li su potrebni radikalni zaokreti ili samo pročišćavanje, dopuna i ažuriranje strategijskih dokumenata koji su do sada bili u upotrebi. Makroekonomsko okruženje ne ide na ruku ni turizmu niti trgovini. Ipak, bar kada je reč o turizmu, globalni trendovi ukazuju na kontinualni rast tražnje za turističkim uslugama pa se i od srpskog turizma može očekivati da iskoristi deo tih globalnih povoljnih kretanja. Ovaj tekst posebno ispituje nerealizovane projekte u oba područja i istražuje uzroke ovih neuspeha. Cilj je da se u zaključku dođe do preporuka. Jedna mogućnost je eventualna promena stava, ukoliko su se strateška opredeljenja bila pogrešna. Druga mogućnost je promena načina rešavanja problema odnosno realizacije projekta, ukoliko su opredeljenja ostala ista, ali se postojeći način implementacije pokazao kao nedelotvoran. U samom zaključku je iznet stav da su do sada korišćeni strateški dokumenti u osnovi bili ispravni i da novi dokumenti treba da donesu u sebi ažurirane predloge kako da se započeti razvoj i turizma i trgovine u Srbiji mnogo uspešnije nastavi u narednom periodu.

Ključne reči: *trgovina, turizam, strategija, razvoj, razvojna politika, državna intervencija*

Serbian trade and tourism economic environment

Serbia is a small economy and very vulnerable to the impacts of the global market. In particular, it is *under the strong impact of the European economic trends. In the Serbian foreign trade exchange*, European countries participation is very high as can be seen from the brief review in Table 1.

Table 1: Foreign trade exchange between Serbia and European countries

	Participation in %		Import export ratio	
	2013	2014	2013	2014
Participation in export	93	95	82	81
Participation in import	81	85		

Source: [19, p. 53]

Over 80% of total imported goods in Serbia are coming from European countries. Export dependence on the European market is even higher. This suggests that the development of export sales channels for the Serbian goods is very limited and directed toward neighboring countries and the countries in which they were inherited from the ex-Yugoslavia. Sales channels in distant countries, due to the cost of their maintenance, were abandoned. Now, weak Serbian economy does not have the capacity to open new channels on distant markets. This result is high dependence of Serbian economy of European economies and the inability to diversify. Aggravating circumstance is that Serbian companies have not developed connections even with all European countries. Actually, the main part of the foreign trade exchange is focused on the countries of the European Union (mostly to the geographically closer ones), then the countries of the Central and Eastern Europe region (surroundings) and the Russian Federation. Therefore, it is useful to monitor trends in these trade zones in order to understand their future impact on the Serbian economy.

Global macroeconomic trends are not encouraging concerning the prospects of Serbian economy, particularly trade and tourism. Modest growth of the global economy is projected for 2015-2016 compared with 2014, on the level of 3.1% and 3.4%, respectively. However, the growth will not be equal in the regions worldwide. It is expected that growth of the economic output will be only 1.7-

2.1% in the EU, then 1.2-2.0% in the Central and Eastern Europe, and 0.5-1.2% in Russian Federation. Serbia is making the majority of the foreign trade exchange with these countries and also, majority of the foreign tourists are coming from these countries. It is obvious from the presented projections that these countries will have slower growth of the economic output comparing with the global average of 3.6-3.9% [21, p. 7]. Serbian companies and government cannot expect the foreign trade exchange with these countries to increase spontaneously, as well as it is not expected to record more tourist arrivals made by their citizens. Such results could be achieved only after strong and successful marketing efforts.

One of the most important and globally existing problems in modern economy is the unemployment. Very high unemployment rate is projected for European economies in 2015 (11.3%), and the expectations for 2016 are not much better. In addition, high unemployment rate is accompanied by a fall in the percent of the working age population in the total population. The only one country is not faced with the unemployment, and that is Germany (4.9% in July, 2014). Totally opposite situation is in some other countries, facing extremely high unemployment rate (Greece – 27%, Spain 24.7%). Furthermore, in some countries there is high level of unemployed young people (Spain – 53%, Italy – 44%, Portugal – 35% in September 2014) [21, p. 13]. Unemployment has already affected the number of tourists from Italy, who are not growing anymore in Serbian arrivals. The erosion of the purchasing power will also restrict exports to these countries, which may adversely affect the Serbian industry (for example, the Fiat Automobile export). The decline in purchasing power will have same effect on the arrivals of foreign tourists in Serbia, which will be reflected through shorter stays, the demand for cheaper arrangements and again with high level expectations, based on experiences in other destinations.

World Economic Forum's panel of experts in Davos in 2015, ranking the most important trends in 2015, gave two highest ranks to growing income inequality and economic growth without employment growth. Although the rising gap between rich and poor does not affect Europe so severely as other parts of the world, it

is still present in the Mediterranean countries and the countries that surround Serbia. In situations like this, middle class is suffering, and this middle class actually is the target market for Serbian industry and tourism. In addition, the trend of productivity growth has negative effect on employment, causing that economic growth does not initiate employment growth and the growth of final demand, but possibly only increase in investment demand.

The light at the end of the tunnel in which the European economy entered 2008 can, maybe, bring a new policy of the European Central Bank, which announces the implementation of the so-called quantitative easing. Euro zone monetary authorities are injecting fresh money into the economy, trying to discourage the current behavior of investors, natural for unstable conditions, to invest in liquid and safe securities, such as money deposits. It is expected that a controlled inflation, while the benchmark interest rate is close to zero, simulates a new equilibrium negative interest, natural for a crisis and “move forward” the money in other investments. It is assumed that new investments will stimulate the economy and its growth. The success of the operation depends on the successful delivery of the so-called “helicopter money” to the citizens or state institutions who are inclined to spend it. However, there are serious doubts that the money will still be retained in the layer of institutional investors, which, in this case, could opt for other relatively safe and liquid investments (foreign currencies, government securities), instead of the equity in economic projects [1]. So, for the sake of uncertain expectations, this relief is not so sure and need to be proven.

Macroeconomic trends in the Serbian economy are even less favorable than those in Europe and are further exacerbated in 2014 and 2015 due to the floods of March 2014. The estimated decline in Serbian GDP in 2014 was about 2% and it is estimated that the decline in 2015 will be around 0.5%. However, analysts have found that the downward trend in Serbian economic activity would be present even without the negative impacts of natural disasters in March 2014. If floods effect were excluded, the decline is estimated at 1.7% for 2014 and 0.8% for 2015. Very disturbing is significant decline in investments that were not recovered during 2014, which may cause the

delay of the economic recovery in 2015 and 2016. Based on these expectations, there will be no significant increase in purchasing power of domestic demand neither in the retail nor in domestic tourism services.

Summarizing these trends, it can be concluded that the Serbian companies will have to make business on the international market in worse circumstances than before. If it is known that companies are exhausted, the economy is in poor condition and the budget cannot cover all existing needs, it is clear that it will not be easy to find a solution. And, the solution obviously will be in raising the competitiveness of domestic offer in order to conquer the markets that is economically weak and uncertain in the future, thus less ready for spending. To find the best ways how to conquer such a market, it is necessary to have a good plan and a list of implementing activities derived from this plan, ranked by urgency and possibility to be implemented.

Serbian government has such plans, i.e. strategies for trade and tourism, but both of them are in the final phase of its lifetime. The existing tourism development strategy in its name carries the limit “... by 2015” [8]. This formal as well as substantive reasons stemming from the changed circumstances from 2005, when the existing strategy was created, impose the need for updating. It is enough to just to mention the fact that the hospitality sector in Serbia has completely restructured from 2005. Some new tourist centers have emerged (Stara Planina, Tornik Zlatibor), and some already existing but at the time ruined tourism products, such as business (conference) tourism, have experienced a renaissance.

The strategy of trade development is in similar phase, although it was adopted somewhat later, in 2009. However, trade in Serbia has witnessed some critical changes. There have been some major takeovers of companies. In one case, sequence of acquisitions has brought independent companies Mercator Serbia, Tus, Rodic and Idea within a sole ownership. In the other case, major food retailer Maxi was acquired by one of the leading international retailers, Delhaize. In addition, some large distributors entered the market and spread their activities upwards. The most prominent is the Atlantic group which acquired Droga Kolinska Stark system (along with the Grand kafa division). All of these changes in the domestic market, as

well as those in closer and wider environment, indicate that it is time to review and update the strategic objectives of further trade development in Serbia.

Text that follows contains the analysis of the existing level of validity and reach of the existing strategies in these two areas. The conclusion will outline some basic directions and the framework for the new strategic initiatives. Before anything else, it will be answered to the key question: *Do we need really new master plans for the trade and tourism development in the Republic of Serbia or some amendments and updates of existing documents will serve the purpose?*

Recent experiences in adopting trade development strategy in the Republic of Serbia

Critical analysis of the transitional process in the Republic of Serbia has led to a sequence of conclusions related mainly to numerous tries and errors accompanied with some open or hidden resistance in the modern trade and modern market development. The sequence of occurrences fully confirmed the hypothesis of the authors of this paper, announced long ago, that building of modern market and modern trade is one of the most difficult problems in the process of transition. Intentionally, it is emphasized “market and trade” because these categories are mutually dependent. It is known that there is no modern market without modern trade, and vice versa. But despite this knowledge, nobody could even imagine that so evident and strong opposition to the development of modern market economy would exist in period of more than 30 years. The optimism that modern market and economy would be developed constantly declines and it probably would disappear by this moment if there is no decisive commitment to joining the European Union. This process requests creation of market institutional framework that will be appropriate to the standards of the EU market. In other words, today’s optimism is primarily based on “homework” that Serbian authorities receive in the process of joining the European Union. The fact is that given “tasks” are largely related to crucial institutional prerequisites for the effective integration of Serbia into the system of European Union single market.

Exposed notes, perhaps, sound confusing and unnecessary to the reader, but to the authors of this

paper cause some relief and wake up certain optimism and motivation to engage in a discussion related to the creation of new or amend existing Master plan of Trade Development in the Republic of Serbia. Until 2000 the trade in Serbia developed spontaneously and without meaningful and consistent trade policy. The shift was made at the beginning of 2000 with great optimism and expectation that in a relatively short period of time key tasks in economic transition would be implemented in order to build a modern market structure. Foothold was given by the first strategy and policy of trade development, done in 2003. Unfortunately, despite clear commitments, mentioned in the Strategy adopted, processes in practice went spontaneously and with enormous problems in ownership transformation. Numerous visible and invisible individual interests also existed, not aimed at building modern market economy, and the modern trade.

A significant shift occurred in April 2008 when the Stabilization and Association Agreement between the European Union and the Republic of Serbia was signed. With this agreement, the Republic of Serbia committed to harmonize its legislation with the *acquis*, including the domain of market development and policy as priority. Some of these areas are: protection of competition, state aid control, intellectual property rights, public procurement, standardization, and consumer protection. All this gave rise to the Government of the Republic of Serbia to adopt a new Strategy of Trade Development in the Republic of Serbia by 2012, until the end of January 2009. It should be noted that this is the first time in the history that the Strategy of Trade Development, as an official document, was adopted by the Government of the Republic of Serbia.

The conditions in which the adopted strategy of trade development was designed, still were favorable providing plenty of optimism for the consideration about the future course of overall economic growth and development, including trade. There was a general consensus that Serbia until 2012 will be fully ready to join the European Union. On that platform, key projections of economic development were carried out, along with the projections of trade sector key indicators and trade network development. Unfortunately, given forecasts were not realized since the global and local economic crisis gained momentum and still

is strongly present in Serbian economy. Nevertheless, the adopted Strategy resolved the dilemma whether to build a modern trade and modern market in the Republic or not. In principle yes, but as will be seen later, in practice, no.

Are the key orientations set out in the Strategy questionable?

The key orientations set out in the Strategy for the Development of Trade from 2009 are not in dispute and still are fully valid. Starting point, still valid, was that Serbia has not yet emerged from the process of transition towards full and functional market economy. It was pointed out that the Republic of Serbia too slowly builds modern market structure. That was the platform to define clearly key strategic decisions. These decisions stem from the need to build such a market structure that will enable more intensive and effective competition between trading actors.

All proposals in the Strategy were on the straight line of building a modern market economy and modern trade. The focus was on faster integration into the European Union framework. It was pointed out that trade sector should play a key role in this process of Serbian economy integration in the economy of the European Union. The basic orientation, still fully valid, referred to the fact that the entire trade sector should be market-driven and indirect state intervention can only be directed to support and not to weakening of the free market and free trade.

Taking into account all exposed, the key commitments set out in the Strategy have been gaining on its agenda, given the even greater national consensus on Serbia's accession to the European Union. These are the following commitments:

- The need to build such a trade structure and network that will enable intense competition in the Serbian market;
- Encouraging more intensive internationalization of trade activities, fitting trade network in the European and global trends;
- Protecting the interests of consumers, manufacturers and other stakeholders through appropriate development of market-oriented trade;

- Full consumer protection on the Serbian market;
- Supporting SME development as well as the entrepreneurship in trade sector;
- Intensifying the development of e-commerce and other means of multi-channel marketing; and
- Harmonization of the legal framework regulating the market and trade with the EU legal framework.

As can be seen, exposed commitments are not disputed. On the contrary, today it is more than obvious that all solutions in the strategy and policy of trade should fully be in accordance with the solutions that exist in the single market of the European Union.

To what extent Strategy for Trade Development in Serbia is implemented?

It has passed five years from the creation of Strategy and it is rightly today, to raise the question: To what extent suggested solutions are implemented? There is no doubt that the key effects were expressed in the process of creating a national consensus about the construction of a modern market economy, and the modern trade consequently. Conviction about the importance of trade in the overall economic and social development is maturing. Commerce is increasingly becoming a key engine of market economy development. The institutions of the European Union are fully aware of this interrelationship, emphasizing the role of the retail sector for the efficient functioning of the single market and the overall economic development. Thus, for example, official record of the Commission of the European Union is pointing out that “the retail sector (is) driver for growth, competitiveness and jobs in Europe and plays a key role in reaching the goals of the EU 2020 strategy.” Then, it states the following: “The retail sector is the pillar of the European economy.” It is particularly significant that “Retail services act as a link between a multitude of upstream and downstream markets, making it a key player in the European economy [4, p. 3].”

Similar processes are also manifested in the Serbian market. It is certain that the role of trade in the overall economic and social development strengthens. During the crisis, trade sector proved to be one of the vital parts

of the Serbian economy [7, p. 16]¹. As a result, the share of trade in gross domestic product and in total employment rises. Along with that, the processes of concentration, computerization and modernization of trade are evident. New trading formats are emerging, encouraging the development of new forms of competition in the market of Serbia.

Solutions exposed in Strategy fully support the unique treatment of internal and external trade. The authors of this paper repeatedly emphasized the need for an integrated treatment of internal and external trade. Hence, it should be noted that three years ago a single Ministry of Trade was formed, combining internal and foreign trade. The role of this Ministry should certainly be stronger in the future development, maintaining capability to cope with the increasing complexity of total trade sector activities.

The main contribution of the Strategy should definitely be in the development of legal framework regulating market and trade. Thanks to the Strategy to great extent, Ministry actively approached to the process of drafting numerous laws, bylaws and other acts that regulate the field of market and trade. These regulations largely were prepared according to the solutions in the single market of the European Union in this domain. Hence, it was not surprising that by the authorities of the EU gave a lot of favorable reviews related to the adopted legislation in the field of market and trade.

It is to be noted that the adoption of the Strategy initiated adoption of the following acts: Law on General Product Safety, 2009 (Official Gazette of RS, 41/2009); The Law on Electronic Commerce (Official Gazette of RS, 41/2009); Law on Protection of Competition (Official Gazette of RS, 51/2009); Law on Trade (Official Gazette of RS, 53/2010); Law on Consumer Protection (Official Gazette of RS, 73/2010); Law on Market Surveillance (Official Gazette of RS, 92/2011); Law on Amendments to the Law on Foreign Trade (Official Gazette of RS, 2011); Law on Monetary Obligations Settlement Deadlines in Commercial Transactions (Official Gazette of RS, 119/2012); Law on Amendments to the Law on Trade (Official Gazette of RS,

10/2013); Law on Amendments to the Law on Protection of Competition (Official Gazette of RS, 95/2013); Law on Amendments to the Law on Electronic Commerce (Official Gazette of RS, 95/2013); The Law on Brokerage in Selling and Leasing of real estate (Official Gazette of RS, 95/2013); Law on Commodity Reserves (Official Gazette of RS, 104/2013); Law on Consumer Protection (Official Gazette of RS, 62/2014). In the pipeline, there are: Law on Commodity Exchanges, Law on Advertising; Law on Services; and Law on Lobbying.

The list enclosed clearly indicates strong activity in recent period resulting in numerous laws which regulate market behavior from various aspects. Also, numerous updating acts containing amendments may be noted, indicating intensive changes not only in Serbian but also in EU trade sector.

What is not implemented from the Strategy of Trade Development in Serbia?

The adoption of the Strategy analyzed, among the other things, created a higher awareness level of the increasingly important role that trade plays in the overall economic and social development. It was necessary to make a turn in the treatment of modern trade and its growing role in the economy. Starting point in the process of Strategy creation were modern market trends, which may be encapsulated in a phrase "trade revolution". The effects of trade revolution manifest in all segments of the economy and the markets. The fact is that the current market is becoming increasingly a complex mosaic of networked relationships between different trading partners [18]. Rigid boundaries among subjects dealing with production, trade and consumption are fading away. Trade is increasingly becoming an active factor in the development of production. At the same time, with the intensive development of marketing activities, it is taking an active role in the creation of new value to consumers [9], [14].

This was the platform for further development of the proposals in the Strategy. Hence, naturally emerges the question if the proposals created were widely accepted by professional and political circles. Unfortunately, the answer to this question is essentially negative. This

¹ Number of employees projected, based on permanent growth of the number of employees during the whole period of crisis in trade, in 2020 compared with 2009 is 150.8 thousand, or 43.5%, being the biggest projected growth in the number of employees in the service sector.

estimate is based on widely present public opinion that trade plays minor and supporting role in economic and social development instead of very active one [16]. As an illustrative case it is just to remind of easily announced decision that retail and distributive margins on some food products will be frozen, by the end of 2011. Or, to remind of permanent orientation to avoid small and medium sized retail and wholesale enterprises when planning government financial instruments for support to new employment, self-employment, investments, etc. Still, there is no single vision on the national level how distributive and retail sectors should look like, which cause “slowly drifting away” from expected development. The statements, like this one that “the trade develops at the expense of the agricultural and industrial sector” are of particular concern. It is obvious that if the trade was better developed, the impact on agriculture and manufacturing sector would be only positive.

In given environment and under the pressure of overwhelming global economic crisis, the implementation of proposed “distributive trade sector management model”, as the mentioned Strategy set out, absolutely failed. Proposed management model was designed in order to facilitate the balance between corporate and public policy, contributing to the distributive trade sector sustainable growth [10]. Essentially, it is all about the balance between liberal and restrictive policy of trade companies growth. Particularly, it is important to understand the weight of balanced growth of new trade institutions, which is the key policy area that EU Commission for single market development is dealing with [13].

Unfortunately, two completely opposite policies have been recognized in Serbia, and none of them respected suggested solutions. On the one hand, the requirements for restrictive trade practices and restrictive trade development were easily accepted. In rude way, it has manifested in the case of direct state interference in wholesale and retail margin rates of food products. On the other hand, extremely liberal policy was demonstrated regarding the development of trade and particularly retail network. It is enough in this regard to consider the spontaneous development and location of big box retailers and shopping centers in major urban areas in Serbia, especially in Belgrade.

Experiences from the developed market economies assure us that there were no successful efforts in order to resolve satisfaction of the individual needs through state intervention instead of market mechanism. Furthermore, distributive trade sector development experiences in different economies showed that state government cannot minimize the costs of trade and transactions, influencing the efficiency of the whole chain of relationships between manufacturers and consumers. Direct state intervention in trade sector is redundant in developed markets, gives counterproductive effects, deforming the market relations and overall functioning of the market mechanism. It is commonly adopted fact that efficient relationship management in trade sector can be regulated primarily by market mechanism and competition among actors competing for the customers. So, dilemma “market or state intervention” is basically, false. Existing Strategy fully affirms the statement that the state intervention that is thought-out and rich in content, is necessary not to replace the market but in order to support its functioning in the interests of the consumers and the whole society.

An active role of the state administration dealing with the development of trade and market is important in order to establish balance between public and corporate policy. In other words, the relevant state authorities dealing with markets and trade should have a “proactive” role in their development. This applies primarily to the ministry responsible for trade, which must have a proactive rather than passive (observing) role in the development of trade network, the current market trends and the level of competition in the market. The precondition for acting, certainly is development of an appropriate information system [11].

National Bureau of Statistics and Informatics created a distinct project on this topic for the Ministry of Trade [12]. The project considered all methodological issues in the process of building an adequate information system covering the whole commerce. The methodology for new research has been, also, established and new solutions in order to provide continual monitoring of key market and financial indicators on wholesale and retail trade were proposed. Foothold in all of this is given in the first Trade Law (Official Gazette of RS 53/2010.), where it is envisaged

that the obligation to commercial entities to submit data electronically to the Centre for Development of Trade under the Ministry of trade.

Unfortunately, subsequent amendments the Law on Trade erased it all. As a result, we now have the complete devastation of a database on trade sector of the economy. In particular, there are no data on the structure of retail and wholesale network, as well as on the structure of the prices and margin rates in wholesale and retail trade. Particularly disturbing is the fact that there is no accurate insight in the retail market and its structure. In the absence of these key performance indicators, there is lack of adequate analytical basis for the adoption of key macro-economic decisions. Simply, it is not possible to make neither exact effects of on budget income, nor the size of the gray market that are present at all stages of marketing channels and in all commodity groups.

Furthermore, it is of particular concern that an adequate control of the implementation of the requirements for trade in goods and services, which is specially elaborated in Law on Trade (Official Gazette RS, 53/2010). Therefore, should not be surprising that today we are witnessing excessive flows in gray market and illegal relations between entities in the market. In particular, there are almost no sanctions for non-registered dealing with the trade in goods and services, as well as skillfully maneuvering and disregard of legal provisions regarding trade formats.

As a result of these and related failures to implement the proposed solutions, there is no adequate information data base for managing the development of trade and trade networks in the Republic of Serbia. And, just to add in order to avoid any confusion that the authors of this paper are not in favor of administration in the process of trade network development. On the contrary, it is a proactive influence in the process of development that will function as a support to more intensive competition in the market.

Evaluation of the current level of trade development in Serbia

The development of trade and trade networks in the past period proceeded in directions predicted in the Strategy. The processes of modernization, concentration,

computerization and internationalization in the development of trade and trade networks were manifested. The fact is, however, that in spite of the results achieved, still some significant structural problems at the macro and micro levels of trade development exist. It should be noted the following structural problems:

- Fragmentation and low level of concentration, consolidation and integration of wholesale and retail trade, on average, with a widening gap between small and large through disproportionate and rapid enlarging of certain entities;
- Excessive development of wholesale compared to the retail trade sector;
- Fragmentation of trade network and big number of retail outlets, as well as their inadequate dispersion and development in certain market areas of the Republic of Serbia;
- Absence of the trade formats that could, to a significant extent, improve competition in the market, such as “Cash and Carry” centers in wholesale trade or discounts in retail trade;
- Insufficient level of electronic commerce development;
- Vulnerable position of small retail companies and entrepreneurs and the absence of any public assistance or support in their development.

The gap between big retail chains, distributive giants and big-box formats, on one side, and small companies and stores on the other, is increasing, thanks to the explained conditions and structural problems.

Concluding remarks and key proposals for further work on the Strategy for the Development of Trade

Based on the above presented, the authors of this paper do not see the need to prepare a completely new strategy for the trade development. Instead, it is more adequate to propose paper complement to existing Strategy for the Development of Trade of the Republic of Serbia. In this regard, there is a need to obtain one concise document with the appropriate amendments. That kind of document would be aimed to fully and in more details specifically strengthen present solutions and commitments in order

to develop modern and market-oriented trade. It should be trade that will be the real “engine” in the process of linking the economy of the Republic of Serbia with the single market of the European Union. The amendments to the existing strategy should answer the following key questions:

- How to develop management model and statistical basis so that ministry in charge of trade can run an active policy and implement concrete measures in the process of modern market and trade structure development?
- How to establish and in what areas, the balance between corporate and public policy in the process of sustainable trade development?
- Which areas of the existing legal framework, covering the process of modern market and trade structure, should be improved and planned in details, particularly having in mind segments of the competition, consumer protection and the development of SME trade sector?
- How to support and which measures to use in order to develop trade formats enabling the modern trade structure development and the increase in the competition level in the market?
- Which measures to use in order to develop e-commerce and other multi-channel marketing initiatives?
- How to provide efficient monitoring of the market in order to support competition and gray market suppression?

In addition to proposals for the improvement of the public sector in charge of trade issues, amendments need to contain proposals for the other stakeholders, involved in the implementation of the Strategy. This particularly refers to consumers, improvement of the organizations that protect the rights of consumers and articulate their interests. Besides consumers, we refer to the entities that directly operate in the trade sector. The update of Strategy need to answer the question of how to organize direct actors in trade to enable their active participation and influence to support strongly trade profession and its role in development of production and the overall process of creating new value for consumers. Actually, the creation of a new understanding of the contemporary role of trade

in the overall economic and social development needs to be supported.

Global industry performance/trends in tourism

Over the past 60 years the tourism industry recorded significant growth and diversification, proving its image of one of the most growing economic sectors in the world. In accordance with the statistics, constant international arrivals have shown uninterrupted growth from 25 million in 1950 to 278 million in 1980, 528 million in 1995, up to 1,138 billion in 2014. Despite global economy restrictions, international tourism demand exceeded expectations, with additional 51 million international tourists travelling around the world in 2014, which proved the growth of 4.7% year-on-year. It is expected that the market share of emerging economies, grown from 30% in 1980 to 47% in 2013, will reach 57% in 2030.

In accordance with the UNWTO forecasts it is expected that international tourist arrivals will grow by 3.3% and in 2030 will reach 1.8 billion [22]. Interesting observation regards travel trends shift between new (emerging) destinations and the developed ones. It is expected that, within the period starting from 2010 up to 2030, new destinations will record the increase of 4.4%, while international arrivals to developed destinations will grow by the half of that rate. Tourism has developed in global phenomenon – one of the most significant market sectors and social activities of modern times; this sector has proven growth of 5% in the world GDP, and every 11th of employees is working in tourism. Globally, tourism is growing by the rate higher than of GDP, doubling created jobs within the 10-15 years period [15]. Tourism is the main export sector for many countries – developed, as well as developing ones. Undoubtedly, there is prominent link between tourism and economic growth and tourism is the important part of the new economic growth in the period of stronger influence of unproductive sector [17]. Progress of this sector is especially expected within next 20 years. At the same time, these will be years when tourism will be the engine of the economic growth, investments, overall social progress, and sustainability of environment. For this achievement, it is obvious that tourism gains priority

in development of national economy policies, fostering competitive and responsible business models and practices as well as promotion of public-private partnership.

As defined in the World Tourism Organization (UNWTO) *White Paper*, tourism development should address both short-term market challenges and long-term sustainable development imperatives. This fundamental need represents two basic priority pillars of tourism development – competitiveness and sustainability, while additional ones are: positioning tourism's contribution to economic growth, inclusive social development, and environmental sustainability on the national and international agenda. In this sense particular importance have UNWTO activities with the UN Environment Programme in the post Rio+20 period [24], namely in the coordination process of the *10-Year Framework of Programmes on Sustainable Consumption and Production (10YFP)*, considering that tourism is among the five global economy initial programmes, then definition process of the *Aims of the post-2015 Sustainable Development Goals (SDGs)* [23], under the auspices of the UN General Assembly, as well as promotion of links between tourism and culture, tourism and security (through the Committee on Protection of Critical Tourism Infrastructure in order to implement the Strategy for support fight against terrorism), raising awareness about the most common illicit goods and services that tourists might be exposed to while travelling, fighting against trafficking in persons etc.

The key topics considered at the global level as considerable for enhancement of the overall, global tourism program and turnover are as follows: travel facilitation (activities refer to visa procedure facilitation), taxation (advocate for intelligent taxation, raising awareness of the need to evaluate the economic impact of the raise or introduction of new taxes on tourism industry achievements; an econometric model was created to assess the impact of changes in fiscal policies in tourism [24]. The focus is also on the following topics: connectivity and accessibility (considering that half of all international tourists arrive to their destinations by air, there is a prominent need for closer coordination between tourism and aviation policies), innovation and application of new technologies (new distribution channels, new tourist infrastructure, new

business models), mitigation (of programmes for seniors, young people, people with special needs). The global tourism market is diversifying further in accordance with different life styles and patterns of behavior, i.e. changes in the demographic structure. The average number of trips per year increases, so as a number of reasons for tourist trips.

The key results of the Tourism Development Strategy 2005-2015

Tourism Development Strategy (Official Gazette of RS, No 91/06) determined the strategic development goals for Serbian tourism, as well as measures for their implementation. Expected global results of the implementation of the Strategy are as follows: rise in Serbian tourism competitiveness, increase in foreign exchange earnings, rise in domestic tourism turnover, increase in the number of international tourists, as well as increase in employment through tourism in order to transform Serbia into a competitive tourist destination.

In a year when expires the current, first Tourism Development Strategy of the Republic of Serbia, for the first 11 months Serbian tourism recorded a growth of foreign exchange earnings of 9%, amounting to RSD 1,017 million and showing a real chance to be a record year (RSD 1,052 million in 2013), drop in domestic tourists arrivals of 9% in comparison with 2013 and permanent increase in international tourists arrivals (increase of 12% in comparison to 2013) [20]. During the previous decade demand structure of the tourism product of Serbia was significantly changed: share of international tourists arrivals increased from 23.3% in 2006 to almost 47% in 2014, in regard to total arrivals structure, from 15.4% to 35% in a total number of overnights structure.

The current Tourism Development Strategy has already defined key tourism products, as well as recommendations for their development (city breaks, round trips, business tourism, health tourism, mountain and lake tourism, nautical tourism, events, conferences and other events, rural tourism and special interests), five tourism clusters (Belgrade, Vojvodina, Kosovo, Western and Eastern Serbia), provided an analysis and guidelines for improving the competitiveness of Serbia as a tourist destination.

Some products recorded significant results: owing to an active approach of the Congress Bureau of Serbia since its establishment, Serbia moved from 72nd in the world among *Top 50* and in 2014 ranks as 41st among the destinations for congress tourism with a total of 66 organized congresses; Belgrade and Novi Sad recorded a permanent increase in the number of tourists, especially foreign, different manifestations of cultural, tourist and economic character (estimates are about 1,200 of them per year) have become recognizable tourist product/brand of Serbia, some of which have important international significance (Guča Festival, EXIT, Beer Fest). After assessing the identified tourism products of Serbia and in accordance with development potential, *mountain tourism* is defined as a product with the highest rank in priority to the development of tourism in Serbia. In this sense, the public sector has in the previous period invested significant resources in the modernization and development of the ski resort Kopaonik, but also in the development of new ski centers: Tornik in Zlatibor and Stara Planina. One of the first measures and recommendations in the Action Plan was the modernization of accommodation, mainly in hotel capacities and change in their structure. In 2005 the 2&3 star hotels (32% and 33%, respectively) dominated, while in February 2015, in the Republic of Serbia there are 33% with 3 stars and 27% with 4 stars, out of 328 hotels. Besides, 25% of these hotels were built in the last 5 years. In comparison to 2005, the share of hotel rooms with global and regional hotel brands in the total number of hotel rooms increases (*Radisson Blu, Crowne Plaza, The Luxury Collection – Starwood, Falkeinsteiner, Holiday Inn, Best Western, Hyatt*), and according to recent announcements, the opening of the *Courtyard by Marriot* is expected by the end of 2015 and of the first hotel of the *Hilton Chain* in 2016. The result of a strategic partnership with Etihad is the launch of a new national airline “Air Serbia” which has connected Belgrade and Serbia to 39 destinations in 29 countries and an additional 20 popular destinations around the world through “code share” partnerships with leading airlines. Investment and modernization of the airport *Nikola Tesla* in Belgrade, as well as the introduction of low-cost companies, have resulted in a record number of passengers

in its history, 4.6 million, which is a European record in terms of growth in the amount of 32% per annum. If it is known that foreign direct investment has a significant role in the development of tourism around the world [3], the project “Belgrade Waterfront”, in addition to the overall economic importance, should further position our capital city in terms of tourism as one of the most attractive destinations in this part of Europe.

The system of benefits (for instance: proposed a lower rate of VAT) and incentives for the development occupy an important place in the action plan of existing Strategy. In a recent time period, the state has committed significant investment in tourism and public infrastructure, tourism signalization, promotion and education projects (see Table 2).

Table 2: Investments through a system of incentives: subsidies + NIP (2006-2013)

Cluster	No. of Projects	Total in RSD
Belgrade	10	166,221,571
A.P. Vojvodina	49	954,313,786
Eastern Serbia	115	3,244,401,959
Western Serbia	96	2,337,350,390
Other projects from NIP	12	1,252,570,299 + EUR 410,000
TOTAL	304	7,954,858,005 + EUR 410,000

Source: Work Report of the Sector for Tourism, August 2013, Ministry of Finance and Economy

In accordance with the system of incentives for the most part was completed the following:

- Rehabilitation projects of collapsed urban parts;
- *Greenfield projects* – river (freshwater) marinas and *breakthrough projects* of destinations development;
- Projects related to the environmental protection;
- Projects related to culture – protection of historical monuments and cultural heritage as well as the arrangement of the urban centers and city parks.

Also, in accordance with the Investment projects through a system of incentives mostly was invested in projects: Stara Planina, Palic, Zlatibor – Zlatar, Iron Gate, Divcibare, Fruska Gora, Upper Danube, Sokobanja, Stig – Kucajske planine – Beljanica, Archeological site Felix Romuliana, Lepenski Vir, Golubac, and then in the projects: Kopaonik, Lower Danube, Mokra Gora, Vrnjacka Banja and more. Beside subsidies, lower VAT rates for categorized accommodation capacities, also a

system of loans for small and medium-sized enterprises were introduced in order to improve the quality of tourist offer, with a *grace* period of one year (*brownfield*) and 2 years (*greenfield*) investments, with the repayment period of 5, i.e. 7 years, respectively, and an interest rate of 1% per annum. Finally, the Government of the Republic of Serbia in October 2014 introduced visa facilitation for holders of passports with valid Schengen, American and British entrant visas, which is of a great importance for the development of regional tourism products and joint appearance in third, especially overseas markets.

On the other hand, although the number of cruise ships and foreign tourists on cruise ships that dock in Serbia is growing (in 2014 is approximately 64,000 passengers), it can be said that the Cruise tourism (nautica) recorded the expected results. Underdeveloped infrastructure (marinas, docks, fuel supply) and disordered banks significantly influenced the development of this product; in 2015, Belgrade or any other Serbian cities, were not the starting point for line ships and cruise ships. It was not recognized by the private capital as a challenge and a good investment. What to say about the incredible potential that Serbia has in spa, i.e. medical tourism? Due to unresolved property relations, litigations and undefined priorities, undefined strategy for rehabilitation and disease prevention, rejection of privatization process and strategic partnerships, also in 2015, spas have remained at the potential level equal to past decades, with a tendency to stagnation in terms of tourist arrivals and overnight stays, despite the fact that spas, after Belgrade, are the most visited tourist destinations in Serbia (386,345 tourists in 2014).

The concept of Destination Management Organizations, of a public and/or private character, was not implemented, although they were supposed to represent a kind of catalyst for initiating and implementing the priorities of destination development and establishment of a comprehensive value chain. Arrival of international companies, primarily international hotel chains should have a strong positive impact on improving the quality of the existing human resources, but also on developments in the labor market in the hospitality and tourism industry in general. Serbia has failed to establish a system of experience and completed products, positioned and ready to be introduced in the global market. Consequently,

it was not fully established recognizable tourist image of Serbia as an attractive, safe, new, and undiscovered tourist destination. One gets the impression that, among other issues, due to insufficient investment in marketing and tourism promotion, Serbia failed in the previous period to sufficiently commercialize existing tourism offer and realize the full effect in regard to returns from tourism and employment. Also, there was not enough progress in the development of main, planned investment projects (*greenfield*); one of the few examples is the construction of the ski center and mountain resort in Stara Planina.

Framework for defining new strategic development

Despite the continuous increase in arrivals, mainly of foreign tourists and, consequently, foreign exchange earnings from tourism in the past, forecasts and recommendations of the current Tourism Development Strategy of the Republic of Serbia have not been fully realized. According to the Strategy, the basic development control model of Serbian tourism is based on strong coordination role of the state (privatization, major new investment), including the establishment of the National development agency for tourism as a leading organization that will deal with the implementation of the Strategy, while being a promoter of investment projects for private and public sector (The National Tourism Development Corporation was founded in July 2009, in the framework of the IPA 2007 project, based on the provisions of the Law on Tourism "Support to implementation of Tourism development strategy". After three years, Corporation entered the liquidation process, as part of measures of rationalization of state agencies and institution of the Government of the Republic of Serbia). This was influenced by both objective (global financial crisis and budgetary constraints) and subjective circumstances (incomplete development of basic infrastructure: Corridors 10 and 11, undeveloped nautical infrastructure along the corridor 7, incomplete or canceled privatization of hotel and tourism enterprises, unresolved property questions in spas, etc.).

Regarding tourism, it seems that in 2015 Serbia still faces the same or similar choice or dilemma, just as in 2005: on the one hand, uncoordinated and slower way of

tourism development that is, based on offer and demand market principles, largely dependent on the development of other economic sectors and the overall social situation in the country. On the other hand, tourism development is coordinated, integrated, based on the plans and principles of sustainable development still in the current Strategy proclaimed by the state of which will bring together all stakeholders of the public and private sector in order to implement the defined goals. With this in mind, we can say that valid tourism strategy provides a good basis for defining and/or redefining the new strategic directions of the development of Serbian tourism.

The necessity of making new Tourism Development Strategy which will define clear objectives, measures and expected results in the short, medium and long term is not in question, but the new strategy document should not be lengthy and descriptive, but concise and concrete with a precise action plan. Also, it is necessary to consistently include the findings and recommendations of several important documents that have been delivered and adopted in the meantime: *The Danube Strategy, Strategy for Sustainable Development of the Carpathians, Program of development of sustainable rural tourism in Serbia*. We should not ignore the basic recommendations arising from the project “Support implementation of tourism development strategy”, EU IPA 2007 project, which was publicly named “revision of strategy,” though it was not a defined objective.

Recently presented “Territorial marketing strategy – Danube Serbia Region” provided the important input that indicates three possible focuses: 1. Cost management strategies (low tax rates, low cost of land, low regulatory barriers), 2. The strategy of differentiation (the uniqueness of resources and costs in a specific location is highlighted which will in a global context affect the investments decisions), and 3. Segmentation strategy (targeting market niches and operation through the development and maintenance of relationships, by the application of specialized knowledge and custom support tools). Strategically set goals are: creating awareness of the Danube region in Serbia and its resources, ensuring high quality level of offered mix of products and services, and focus on market segments with the highest potentials. “The place where the Danube meets Balkans”[2] – is the

slogan for an internationally famous region for its quality products, a dynamic and stimulating environment that fosters creativity, knowledge and understanding for the business development; which creates the benefit for their community through sustainable growth and development mechanisms presenting a vision of the Danube region in Serbia [5] which has to be implemented in the new strategic document in view of its importance and potential.

In defining the future directions of development of Serbian tourism in the next decade, we should also bear in mind the framework and development trends of the World Tourism Organization of the United Nations defined in the documents *Tourism 2020 Vision* (trends and forecasting on the state of the global tourism market in the first 20 years of the third millennium) and *Tourism Towards 2030*, which provides for further growth in the number of international arrivals, but at a moderate rate, a lower rate elasticity of travel in relation to changes in the level of GDP, an increase of transport costs and others. Long-term growth of tourism by the year 2030 will be based on sustainable and inclusive development. With regard to its European orientation, in defining strategic orientations Serbia should take into account the Europe 2020 strategy, which was created as a result of the global challenges faced by the EU, and especially the economic empowerment of certain emerging countries, reorganization of global finance, climate changes and limited resources. Identified priorities include: intelligent growth (economy based on knowledge and innovation), sustainable growth (economy that consumes resources efficiently, environmentally focused and competitive) and integrative growth (economy, which has a high rate of employment and social and territorial integrity) [6].

In the study “*Development potentials of Serbia in the tourism and travel industry from 2011 to 2023*” World Travel and Tourism Council (WTTC) identified seven key areas in order to strengthen its position in the international tourism market [25]:

- Strategic Value of Travel & Tourism (Encourage and proactively plan stakeholder engagement in long term tourism planning and implementation);
- Long Term Planning & Research (Collect and strategically use accurate and relevant data to measure

- and monitor domestic travel and international tourism arrivals as well as tourism's economic and employment impact across the economy);
- Co-ordinated Branding, Promotion and Marketing (Invest in countrywide and tourism-specific branding and promotion);
- Infrastructure Development (Prioritize the maintenance and upgrade of core infrastructure);
- Transparent Business Environment (Simplify and enable a business-friendly environment);
- Unique Product Differentiation and Development (Make the tourism offer a uniquely Serbian experience);
- Investment in Human Resources & Education (Professionalize the industry by establishing leading-edge vocational training).

Key recommendations for further activities in the new Tourism Development Strategy

Recognizing the key international trends (financial, technological, innovation) and recommendations, set forth in the aforementioned international papers, the new tourism development strategy, starting with the guidelines and recommendations of the current Strategy and the Law on Tourism, which in Article 7 defines precisely the basic elements of a strategy, among others, should:

- Define the model of growth and the key drivers, the role and place of the state/public sector in the growth and development of tourism;
- Contain measures and proposals that should improve the work efficiency, but also the impact of the National Council for the development of tourism, as tourism will be finally bring into focus of national economy policies, and identify what measures should be taken to achieve greater synergy of tourism with other sectors: finance (system of fiscal and monetary stimulus), culture, environment protection, planning and construction, education and others;
- Similar to the trade, tourism development strategy should contain clear measures for improvement of managerial skills and information base of the Ministry in charge of tourism in order to build the necessary

- capacity for the creation of development policies and an adequate regulatory framework in tourism;
- Identify the key measures and proposals for the tourism products competitiveness increase, which should result not only in an increase in revenues from tourism, but also in new investments and, consequently, new jobs – it is necessary that the public sector has a concrete development plan, guidance and a framework; after the adoption of Strategy by the Government of the Republic of Serbia, it will represent a solid basis in the coming years for budget funds planning, which would be achieved through national consensus;
- Provide clear guidance and propose measures for further improvement in the institutional framework, but also for organizational promotion of work concepts and activities of all *stake-holders* and the introduction of the destination management organizations concept, as the concept of comprehensive value chain management on the territory of Serbia;
- Identify the key measures to combat the gray economy;
- Harmonize and improve consumer protection in accordance with European practices and legislation,
- Define the priorities and measures to improve the quality of human resources in tourism;
- Contain an action plan with precise measures, holders of activities and deadlines for their implementation.

Such a master plan for tourism development, simply and convenient, seeks for national consensus of many participants. It appears that it is possible at this stage. Positive trends provide basis for optimism and energy of the private sector. Difficulties, known from the previous period, are sufficient challenge to motivate actors to finally resolve the long-existing problems. The adoption of a new strategic document, as a guideline for the future work of the private and public sectors, is expected.

Conclusion

Taking into account both sectors, trade and tourism, the validity of the medium-term development strategic documents, adopted by the Government of the Republic of Serbia, expires. Analyzing the position of both sectors of

the economy, it can be shown that trade and tourism in the previous period recorded qualitative, and even, in the case of tourism, quantitative progress. This progress has been achieved, to a large extent, thanks to the guidelines derived from the previously adopted strategic documents. Primarily, state authorities in both areas, significantly improved the legal framework regulating the business operations, protection of competition and consumer protection. Improvement of the legal environment, accompanied by economic optimism of the first decade of the 21st century initiated, to some extent, the arrival of new players in the market of Serbia who built modern facilities and brought with them new technologies. Of course, some opportunities were exploited, but many of them were missed, partly because the governmental bodies were slow to implement the necessary changes and partly because of inadequate instruments for the implementation. Summarizing the situation in both Serbian economic sectors in the beginning of 2015, it is possible to conclude that further planned activities of state bodies are required. The role of the state should be to direct activities towards fostering further development of market economic conditions. National authorities will have positive impact only if they respect the two principles. The first is to work on the improvement in the market environment (and not to replace it) by using the interventions that are public, visible to everyone and limited in time. The second is that interventions can only refer to accelerate some of the changes that the market normally initiate, but slower, except in the case of protection of competition and consumer protection. The best guide to planning a new development cycle is in the documentation and rules of the European Union. The task of the creators of the new strategy is to link the solutions that have been implemented on the basis of previous strategies and to design activities for the new five (ten)-year-period. For such activities, the best approach is to update, extrapolate and amend previously adopted strategic documents.

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PUBLIC SECTOR RESTRUCTURING ON THE MUNICIPAL LEVEL: THE CASE OF CITY OF BELGRADE

Restrukturiranje javnog sektora na nivou gradske uprave na primeru Grada Beograda

Abstract

As at 2013 year-end the City of Belgrade had a 20.25% budget deficit, an inefficient City Administration and an overweight public sector that generated a total financial loss almost EUR 24 million. In just one year, through the implementation of reforms that involved institutional, organizational and financial restructuring, the City halved the budget deficit, and the public sector which previously generated a loss was transformed into a public sector that generates a profit, in the amount of EUR 8.5 million.

The essence to the restructuring process is reflected in the clear division between the function of the founder and the function of management. The founder, City of Belgrade, starts doing the basic function of the founder, which is continuously controlling and monitoring the operations of public companies. The management of public companies was given two key goals: improving the efficiency of business operations and a continued improvement in the quality of the services provided by the public company. Many public companies do not have the fundamental goal of making a profit but rather providing services of public interest in the business activity they are in charge of. By establishing an economic goal also, the public companies, regardless of their fundamental goal and purpose for which they were founded, also have to take into account economic parameters or, in other words, operating efficiently.

Key words: *restructuring, budget deficit, public utility companies, City of Belgrade*

Sažetak

Na kraju 2013. godine budžetski deficit Grada Beograda iznosio je 20,25%, dok su neefikasna gradska administracija i glomazni javni sektor uticali na to da ukupni finansijski gubici dostignu skoro 24 miliona evra. Za samo godinu dana, zahvaljujući sprovedenim reformama koje su bazirale na institucionalnom, organizacionom i finansijskom restrukturiranju, gradska uprava uspela je da prepolovi budžetski deficit i da javni sektor, koji je u prethodnom periodu konstantno beležio gubitke, transformiše u profitabilan javni sektor čija je ukupna dobit iznosila 8,5 miliona evra.

Od ključnog značaja za proces reformisanja je uspostavljanje jasne podele između osnivačke i upravljačke funkcije. Kao osnivač, Grad Beograd najzad počinje da obavlja osnovnu funkciju osnivača, a to je kontrola i monitoring poslovanja javnih preduzeća. Uprava javnih preduzeća treba da bude usmerena na realizaciju dva ključna cilja: veća efikasnost poslovanja i stalno unapređenje kvaliteta usluga javnih preduzeća. Mnoga javna preduzeća gube iz vida da je njihov fundamentalni cilj stvaranje profita i zadovoljavaju se ulogom isporučioća usluga od javnog interesa u segmentu za koji su zadužena. Orijehtacija javnih preduzeća ka ekonomskom cilju, bez obzira na njihovu osnovnu delatnost i svrhu osnivanja, znači da će takođe morati da vode računa o ekonomskim parametrima, odnosno, da posluju efikasno.

Ključne reči: *restrukturiranje, deficit budžeta, javna komunalna preduzeća, Grad Beograd*

Introduction

Optimization of the functioning of the public sector is crucial for the proper functioning of social environment which it serves. In the case of the Republic of Serbia such examples are particularly significant for two reasons. First, because efficiency of the public sector is the problem at the state level, and by further addressing it, economic environment would be significantly improved, obstacles for prompt and quality performing of public affairs would be removed, but it would also reduce social costs of insufficient effectiveness of the system. Second, because there is quite a strong belief that the public sector is, by definition, inefficient, that it generates losses, as well as that the subjects in its ownership cannot carry out their target function with the achievement of positive financial effects.

Same observations can be applied to the City of Belgrade (hereinafter referred to as: CoB). In this paper is, therefore, shown great progress in terms of positive effects of restructuring public sector of CoB that has been achieved in the previous year. The first segment of the paper contains a summary of the undertaken systemic and operational measures in the field of restructuring. The second part of the paper represents the presentation of the financial effects of restructuring public sector of CoB as a whole. The third part consists of the review of effects apportioned on individual public companies (hereinafter referred to as: the PC) and limited liability companies (further on: the LLC) in the ownership of CoB.

Literature review

There is strong degree of agreement in the empirical literature about the low efficiency of the public sector, both absolutely and in comparison to the private sector. The vast majority of researches indicate that the public spending must be substantially lower [8], [13], [14], [15].

The empirical results differentiate in terms of the prevailing sources and factors of unsatisfactory level of efficiency. *Roubini* and *Sachs* [11], [12] analysis performed on OECD countries demonstrated that extensive spending and high budget deficits are highly correlated with fragmented and weak governments. Similarly, *Borge et*

al. [5] provide evidence that high fiscal capacity and high degree of party fragmentation lead to low public sector efficiency. *Von Hagen* [16] findings are in line with the previous, demonstrating strong relationship between low deficits and strict budgetary procedures in US states and EU members. *Bartel* and *Harrison* [4] provide evidence that public sector inefficiency in terms of soft budget constraint and the level of competitiveness is primarily due to agency-type problems. *Alfonso et al.* [1], [2] find that the efficiency of the public sector depends on factors that influence the ability of the private agents to protect their resources from public claims, on the monitoring capacity of public and private agents, and on international constraints.

Besides the prevailing agreement on the public sector efficiency problem, in literature there is ongoing debate on the optimal solution, i.e. whether reforms could effectively substitute the privatization [6], [7] [9],[10]. *Borge et al.* [5] indicate that the organization and financing of the specific services are politically determined, and that restructuring that may improve efficiency is often politically controversial. *Alfonso et al.* [1] point to the importance of transferring many non-core activities to the private sector. In his paper, *Bangura* [3] explains four main reform fields, namely, fiscal stability, managerial efficiency, capacity building, and public accountability.

Restructuring measures for the City of Belgrade's public sector

At the end of 2013 the financial situation at the CoB budget was the following:

- Total liabilities at CoB level amounted to EUR 1,118,716,459
- Due and unpaid liabilities towards direct and indirect budget beneficiaries in the amount of RSD 14 billion (approximately EUR 120 million)
- The budget deficit of 20.25%

The situation is followed by the two general lack: a. massive and inefficient public sector, b. a lack of basic control and monitoring mechanisms by the founder.

The basic problem is that, in the previous period, CoB did not execute its role of the founder, in the domain of

control and monitoring of operations of public companies. In order to resolve the above mentioned problem, CoB first and primary measure was to establish mechanisms for the exercise of these activities. Large number of systemic and operational activities and measures that were conducted, in order to restructure the public sector, can be divided into three groups: institutional, organizational, and financial.

Institutional restructuring

Within the institutional restructuring, CoB has taken several measures. Within the CoB Administration, the powers of the Pricing Administration have been expanded, so as to continuously monitor the work of public companies. The position of the Assistant to the Mayor for public and public utility companies has been established. So-called Project Managers monitoring individually each company have been introduced. At a weekly level data providing insight into the work of companies (general data, financial data, as well as open issues - current problems in companies' operations) were collected and systematized, in order to prepare consolidation business plan, primarily through costs reduction and revenues increase, and all in order to increase the efficiency of CoB companies. So far, shortened *due diligence* had been conducted for all companies, and on that bases, consolidation business plans for all public and public-utility companies have been prepared and are now under execution.

Described measures set up the CoB Administration's proactive approach and demonstrated an example of the management within the administration. In addition, a system of continued control and monitoring is established, providing, at the same time, needed support of the founder to public companies. Now, there is a continuing presence of the founders to the extent that founder is entitled to, with regards to exercising its functions, i.e. control and supervision of the public companies operations.

Also, Internal Audit and Budget Inspection functions have been separated from CoB Administration, and were given the position of independent institutions. Unlike other sectors of CoB Administration that experienced the reduction in the number of the employees, those two institutions had an increase of the employees' number in

the past year. The goal is to strengthen them in human resources, so as to be able to perform assigned functions in full capacity.

By the Decision on the Establishment and the Operations and the Section for Centralized Public Procurement and Control of the Procurement Process, the process of centralization of the public procurement for certain goods and services was launched (goods: office supplies, equipment for the hygiene maintenance and hygiene paper, foods, vehicles, energy sources, computers and computer equipment, furniture and services: cleaning facilities, physical-technical security, maintenance of computers and computer equipment, printing services, disinfection, fumigation and pest control services), that will lead to significant savings within the public companies spending and prevent abuses. Director of the Public Procurement Office of Republic of Serbia said on 14th November 2014, that the greatest individual saving had been made by the City Administration of CoB, which managed to save RSD 1.3 billion in the first semester, i.e. spent 62% less than in 2013 for public procurement.

In addition to formal fulfillment of the public procurement procedure and executing centralized public procurement by the Public Procurement Agency, CoB established a dedicated organizational unit, within the Budget Inspection, that is analyzing the substantive need for certain procurement. No public company may undertake any public procurement prior to notifying subject unit, explaining in parallel the need for such procurement. Special attention is being paid to unifying public procurement in order to launch an open procedure and to eliminate procurements of small value and procurements via Purchase Order, where the possibility of an abuse is much more expressed. By applying these measures, as well as the principles, in their business policies, public companies Ada Ciganlija, Tasmajdan and Funeral Services managed to consolidate during this year and not to be on the list of the companies subsidized by the new budget.

Also, in accordance with the amendments to the Labour Law (Official Gazette of RS No. 24/05, 61/05, 54/09, 32/13 and 75/14), negotiations the with representative Unions were initiated in order to adopt new Special Collective Agreement for public companies in communal

and housing/ activities in Belgrade. In line with the Law prescribed time frame, a Special Collective Agreement at the level of CoB was signed, as well as the individual collective agreements at the level of each company. For the first time, all public and public - utility companies whose founder is CoB have signed individual collective labor agreements. This sets a true example of establishing social dialog, as well as harmonization around minimum of common values that are necessary, especially in the moment of implementation of the reform process. New collective agreement protects the rights of employees, as well as conditions on the work and union gathering, but at the same time it acknowledges CoB difficult economic situation.

Organizational restructuring

Basic characteristics, i.e. the shortcomings of the organizational structure and job positions' systematization, which CoB new management faced in public communal system, are:

1. Unreasonably large dispersion, namely broad organizational structure with a large number of sectors and other organizational units within the sectoral structures in the largest number of public companies (PC) and public-utility companies (PUC).
2. As a consequence of previously mentioned, there is a large number of managerial staff (at all organizational units' levels - deputies, assistants, coordinators) at the expense of operational job positions, where, if observed in percentage terms, the number of managerial staff in relation to total number of employees ranged from 3% to even 53% of the total number of employees (which means that in some companies there were managers supervising a small number of employees, or that some managers did not have any subordinate employees).
3. In a large number of companies positions of advisors and assistants to director are present. Such positions were usually the result of creating a position for a particular person, instead of having a real need for fulfilling a position with a suitable employee.

4. Lack of a normative basis for determining working effects, as well as the system for control over the need for work force and performed tasks.

As a reaction to existing situation, i.e. to the abovementioned irregularities, the new management of CoB launched an initiative to adopt new Rules and Regulations on the Organization and the Job Positions Systematization, at the level of all PC and PUC. CoB, as the founder of PC and PUC, provided the instructions, that should primarily result in the compliance of the new organizational structure and job positions systematization with the new Labour Law, as well as in rationalization of the organizational structures and job positions systematizations, taking into account that the implementation of the City's instructions should not jeopardize organizational functionality of each PC and PUC.

Instructions provided by CoB reflect in the following:

1. Introduction of the obligation for the PC and PUC to comply their Rules and Regulations on the Organization and Job Positions Systematization with the provisions of the new Labour Law, by the 26th November 2014 (note: committees for supervision, established by CoB, confirmed that all companies carried out harmonization by the given deadline);
2. Implementation of the unified content of the new Rules and Regulations on the Organization and the Job Positions Systematization;
3. Analysis of the existing organizational structures and identification of the shortcomings, i.e. opportunities to execute rationalization;
4. Creating of the new, more shallow and immediate organizational structure, which will, without disruption of organizational functionality, contribute to more efficient utilization of the resources.

Management of CoB narrowed the frame for deepening the organizational structures in PC and PUC, through unified instructions, such as: unifying titles of the organizational units (Sector as the biggest organizational unit, Division or Section, and at the end – Department, as the lowest organizational unit), defining the minimum number of officers that can make the smallest organizational unit (recommendation was minimum 5 employees).

Also, in co-operation with the companies' management, the analysis was carried out regarding the sectoral dispersion of the organizational scheme, resulting in recommendations for the unification or cancelation of certain departments. In this way, horizontal rationalization was carried out, but at the same time operational functionality of the operation was maintained.

Previously stated has resulted in reduction in the number of managerial staff, i.e. their deployment on the operational level, thereby contributing to having a greater number of available officers, on one hand, and having savings through lower salaries, on the other hand. Concrete measures to achieve this goal were the following:

- Abolition of advisers, coordinators and assistants to director positions in all PC and PUC.
- In 2015 CoB, as the founder, plans to introduce Financial Management and Control function (FMC) in all PC and PUC, and thus be ready to welcome opening of the Chapter 32. Implementation of Financial Management and Control also includes setting of the normative for each business operation, by which real needs for human resources will be identified and proper system of control over set goals and conducted tasks will be possible. Only with the implementation of FMC we will have realistic information on how much the applied organizational scheme and systematization are adequate, and in accordance with it further rationalization will be conducted in order to improve the efficiency of the PC and PUC business operations.

In accordance with the previously said, CoB instructions are to place, in the organizational sense, under the directors' office, organizational units that are of special importance for control of business operations. The organization units are as follows:

1. Internal Audit Section,
2. Control over Public Procurement Section,
3. Quality Control Section, and
4. IT Sector.

The implementation of the above mentioned instruction is on-going in all the PC and PUC, where the CoB, as the founder, is continuously conducting supervisory function over this process.

Financial restructuring

The financial restructuring process has been carried out using the following initiatives:

First, it was recommended that the companies change their way of financing costs for engaging task force under the contract (personnel services through private companies), and to directly engage workers. The example for the said is the City Sanitation which used to, in the previous period, engage a part of its work force – 700 workers, through private companies (staff leasing). All of these workers are now engaged directly by signing contracts with the company.

Second, after detailed review and analysis of the practice of paying subsidized prices for utility services, abuses by subsidized users were detected. Based on that, the Decision on amendment of the Decision on Setting Categories of Users Who Pay Subsidized Prices for Communal Services was adopted, which resulted in reform of users' categories and made savings amounting to RSD 90 million on monthly level.

Third, external legal services were abolished, which resulted in yearly savings of RSD 33 million. Namely, in 2013, public companies paid to external law firms RSD 33 million for services provided, while at the same time all these companies have, in their systematizations and organizational schemes, department for legal services, while CoB has City Prosecutors' Office.

Fourth, all the vehicles that had been identified as surplus, 263 cars, were sold. Projection of the savings only on fuel costs, insurance, registration and spare parts, on annual level, gave the amount of around RSD 108 million. At the auction, held on 7th June 2014, 54 cars were sold, while the amount received, RSD 11,605,648.00 was transferred to the account for the help to population of flooded areas. The cars that were not sold were given for use to institutions of general social interest: health care centers, emergency assistance, social institutions, municipalities that were harmed by the floods and similar.

Fifth, spokesperson and consulting services, on which public companies spent RSD 110 million in previous year, were terminated.

Sixth, for the first time, the Mayor's Office, in cooperation with the Secretariat for Finance, Internal Audit

Section, Budget Inspection Section, relevant secretariats, Pricing Administration and public companies, worked on detailed planning of the Business Program for 2015. The main goal that was set for the forthcoming year was to increase the efficiency of the business operations, on one hand, and to increase quality of the communal services, on the other. The goal is for companies to rationalize their costs, so as to utilize those savings to increased number of activities – improving services (more parks being taken care of, cleaner streets, increased number of connections to water supply and sewer networks and similar).

Effects of the restructuring measures on the City of Belgrade’s public sector

The effects of restructuring process could be analyzed by following total revenues, net financial results and number of employees.

A/Total revenues

The trend of revenue movements is slightly negative, and is the consequence of the fact that CoB decreased budget giving and the subsidies to public companies in the last year. The fact is that in almost all companies the high growth rate of net profit is present, which points to doubled positive effect of measures taken. First, reduced grants and subventions to public companies by CoB were achieved. Second, profit of public companies was increased. It is also important to note that a significant number of companies that used to record losses are now reporting

net profit. The conclusion is that in the previous year management has been significantly improved.

The average rate of revenues’ growth, for the whole system of Public Companies and Limited Liability Companies founded by CoB, is negative and amounts to 7.1%, while the growth rate of the net profit is 151.2%, meaning that the system moved from the zone of loss amounting to RSD -1,820,076,555.00 (in 2013) to the profit zone, which amounts to RSD 954,285,474.00 as of end of 2014.

Business result of PUC ‘District Heating Plants of Belgrade’ largely generates the positive result on the total level because they had an increase of close to RSD 3 billion in comparison to 2013 (see the Figure 2), which also significantly contributes to covering of losses of Urban Public Transportation ‘Belgrade’ and other 3 companies that are operating with negative result.

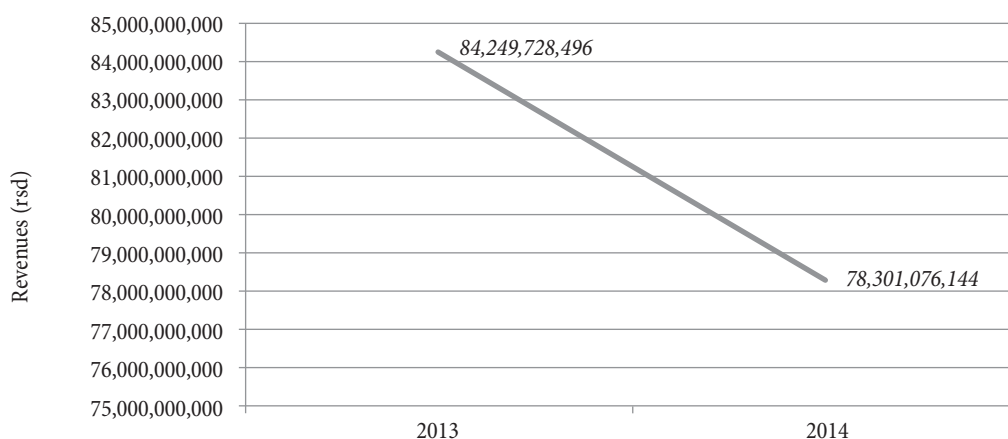
The trend of total revenues’ movement is shown in Figure 1 and Figure 2.

B/Net profit and number of employees

According to shown data, the system of PC and LLC operated positively and achieved net profit growth of RSD 2,774,362,029.00 (from negative result in the amount of RSD -1,820,076,555.00 the system achieved positive values of RSD 954,285,474.00). The effects of such positive results will be materialized through distribution of net profit in favor of CoB budget during 2015.

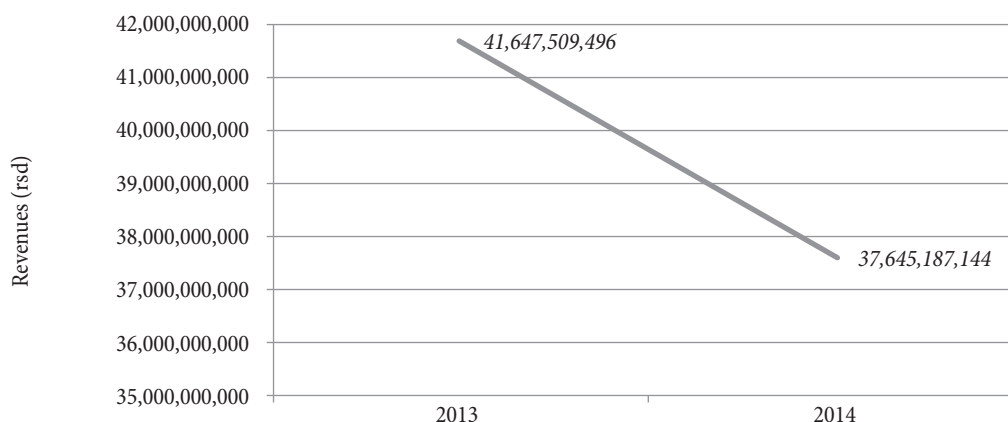
If we exclude the system’s two largest companies, outperformers in positive and negative results, i.e. PUC

Figure 1: The trend of changes in revenues from PCs and LLCs founded by the City (in RSD)



Source: Author’s calculations on the basis of the City Administration data

Figure 2: The trend of changes in revenues from PCs and LLCs founded by CoB, excluding PUC ‘District Heating Plants of Belgrade’ and UPTB



Source: Author’s calculations on the basis of the City Administration data

‘District Heating Plants of Belgrade’ (DHPB) and Urban Public Transportation Belgrade (UPTB), the remaining system’s PC and LLC achieved the growth of net profit in the amount of RSD 1,730,336,029.00, i.e. net result of the remaining companies is moved from the loss of RSD -866,156,555.00 to the increase in the amount of RSD 864,179,474.00, which is the result of increased business efficiency (rationalization of costs and other measures of business-financial consolidation).

In the system of PC and LLC, there is a trend of employees’ reduction, by 329 persons, which represents a decrease of 2.2% (this is a natural outflow of employees).

Number of persons engaged by temporary and occasional labor contracts in 2014 was reduced by 677 persons or 22.6%. Within the framework of the measures for business-financial consolidation companies had an

obligation to reduce the number of persons engaged on temporary and occasional basis.

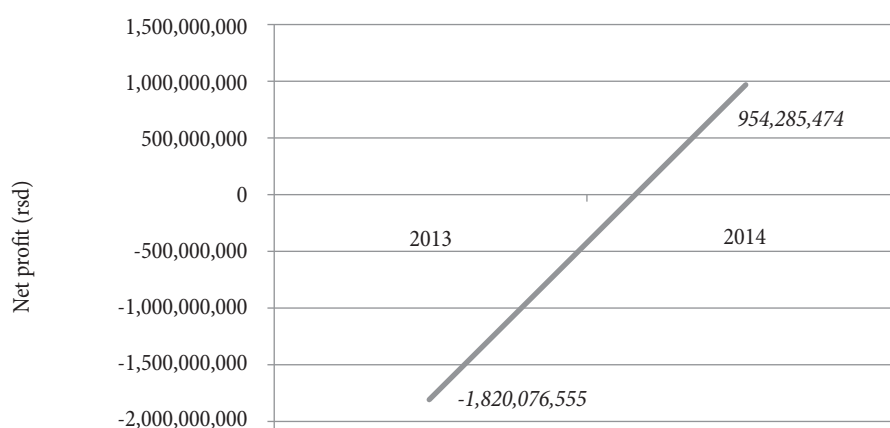
The dynamics of monitored categories is shown in Figures 3, 4, and 5.

Comparative review of net profit by years is given in Figures 6, 7, and 8.

The overall results

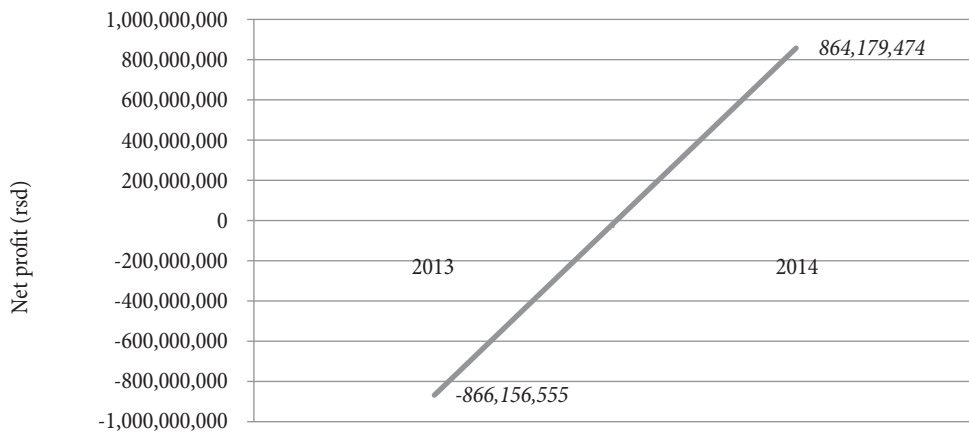
By observing the data presented in the previous segments of this paper, it is noticeable, even given the opposite general belief, that public companies and limited liabilities companies founded by CoB, can operate with profit, if optimizing adjustments are applied. Table 1 distinctively illustrates this claim, but also provides a comprehensive picture of the effects of the changes implemented in the previous year.

Figure 3: Net profit by PCs and LLCs founded by CoB (in RSD)



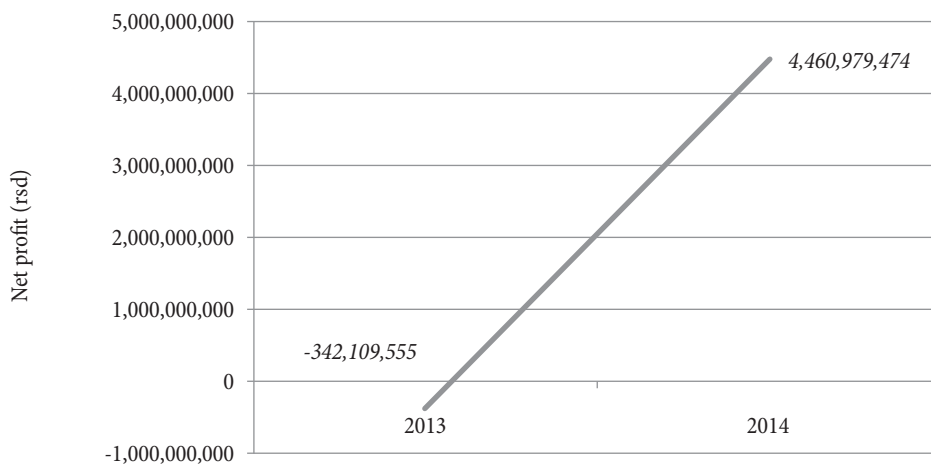
Source: Author’s calculations on the basis of the City Administration data

Figure 4: Net profit by PCs and LLCs, founded by CoB, excluding DHPB and UTSB



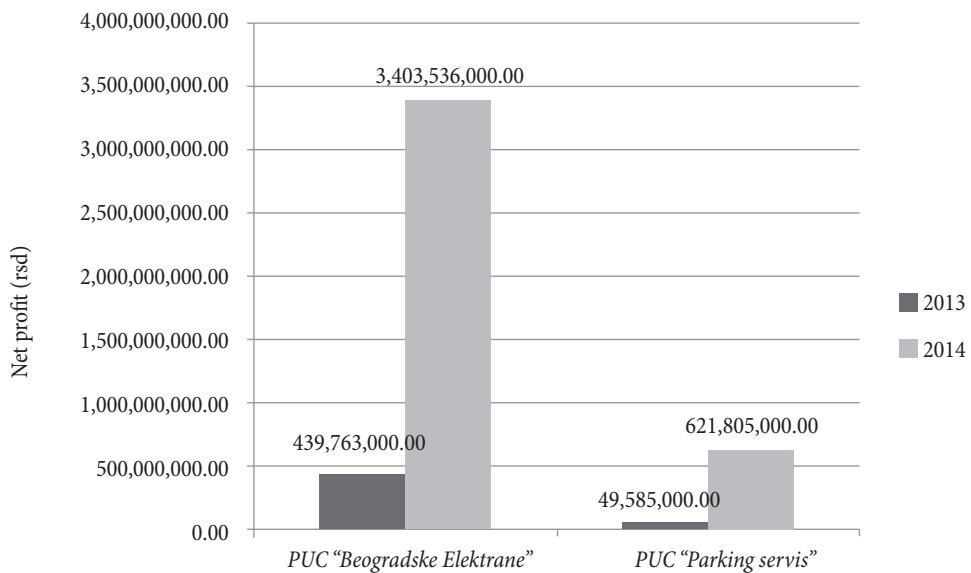
Source: Author's calculations on the basis of the City Administration data

Figure 5: Net profit by PC and LLC, founded by CoB, excluding UTSB and SC (in RSD)



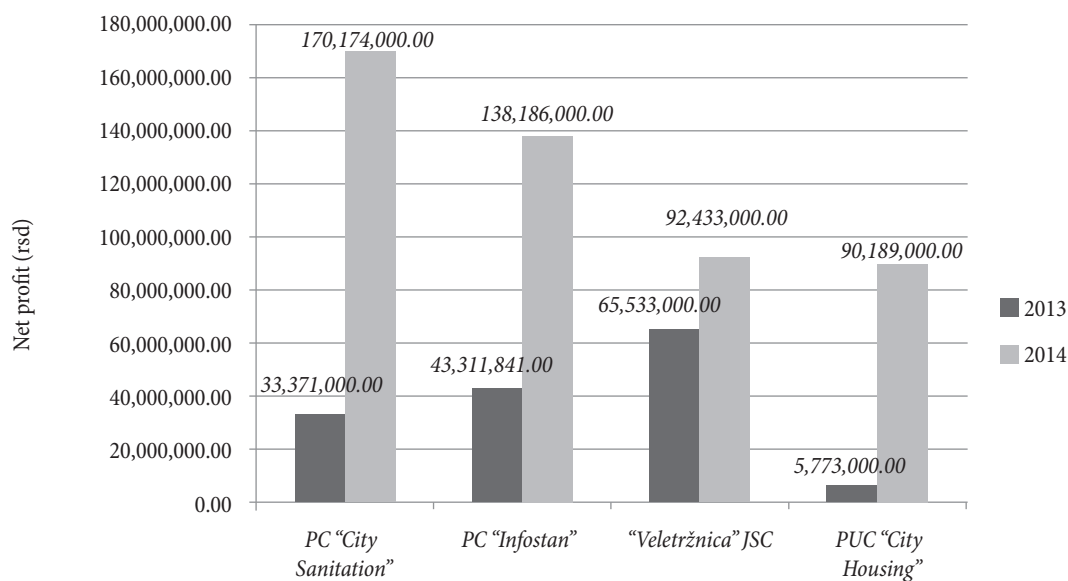
Source: Author's calculations on the basis of the City Administration data

Figure 6: Companies whose net profit exceeds RSD 500 million



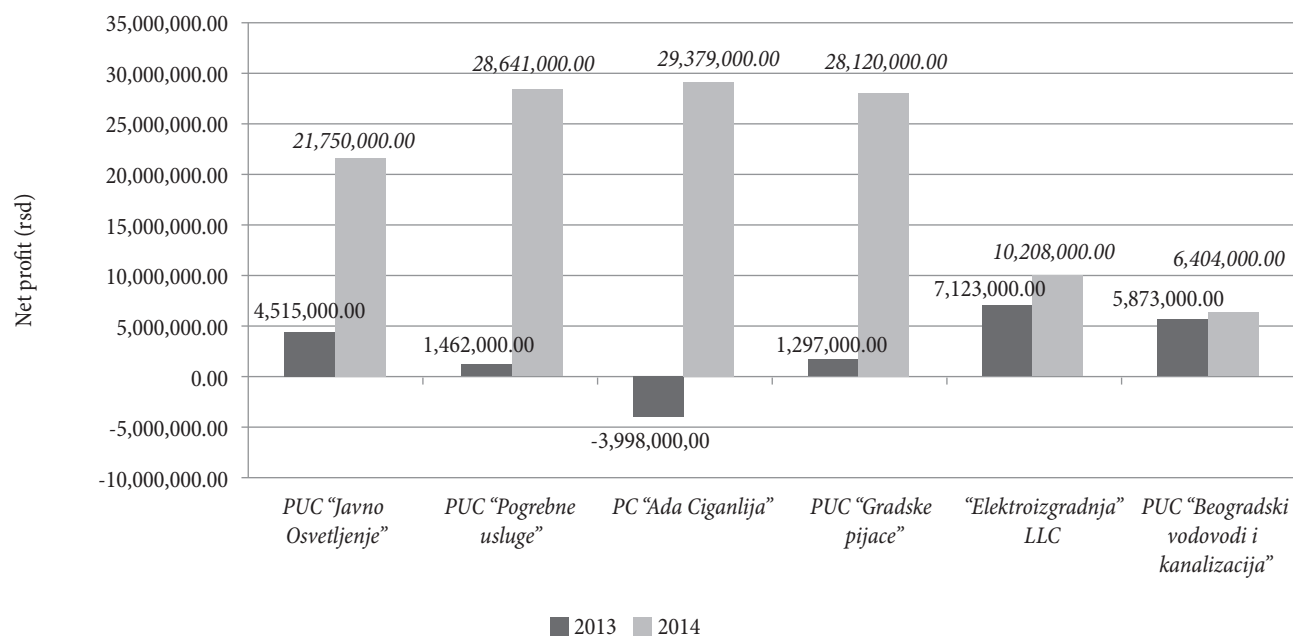
Source: Author's calculations on the basis of the City Administration data

Figure 7: Companies whose net profit ranges from RSD 50 to 200 million



Source: Author's calculations on the basis of the City Administration data

Figure 8: Companies whose net profit ranges from RSD 5 to 20 million



Source: Author's calculations on the basis of the City Administration data

Table 1: The overall display of the effects of restructuring the public sector of CoB

Order	Name of the company	Net profit				Number of employees in personnel records				THE TOTAL REVENUE				Revenue growth rate 2014/2013
		Realized in 2013	EUR	Assessment of the achievement at the end of 2014	EUR	Net profit growth rate 2014/2013	Number of employees in 2013	Number of employees in 2014	Change in the number of employed	Revenues in 2013	EUR	Assessment of the achievement at the end 2014	EUR	
1	PUC "District Heating Plants of Belgrade"	439,763,000.00	3,835,964.27	3,403,536,000.00	28,186,890.32	673.9%	2,208	2,130	78	28,816,473,000.00	251,360,303.06	237,540,888.57	-0.5%	
2	PUC "Parking service"	49,585,000.00	432,519.99	621,805,000.00	5,149,570.72	1154.0%	657	647	10	2,507,637,000.00	21,873,613.62	21,565,049.45	3.8%	
3	PC "City Sanitation	33,371,000.00	276,088.53	170,174,000.00	1,409,425.21	409.9%	1,826	1,768	58	5,466,577,000.00	47,683,852.62	47,146,325.97	By 4.1%	
4	PUC "Infostan"	43,311,841.00	377,800.49	138,186,000.00	1,144,407.94	219.0%	162	163	-1	2,147,427,000.00	18,731,574.18	10,161,078.07	-42.9%	
5	Veletřnica AD	65,533,000.00	571,631.19	92,433,000.00	765,497.66	41.0%	42	44	-2	265,401,000.00	2,315,039.59	2,364,551.56	7.6%	
6	PUC "City Housing"	5,773,000.00	50,356.72	90,189,000.00	746,968.69	872.7%	220	223	-3	2,294,817,000.00	20,017,227.53	17,478,461.50	-8.0%	
7	PUC "Public Lighting"	4,515,000.00	39,383.44	21,750,000.00	180,139.14	381.7%	173	169	-4	856,041,000.00	7,467,073.61	6,273,008.12	-11.5%	
8	PUC "Funeral Services"	1,462,000.00	12,752.73	28,641,000.00	237,194.71	1859.0%	457	436	21	1,708,930,000.00	14,906,652.97	14,404,147.78	1.8%	
9	PC "Ada Ciganlija"	-3,998,000.00	-34,873.75	29,379,000.00	243,324.49	805.3%	34	63	-29	247,983,000.00	2,163,105.87	2,088,433.10	By 1.7%	
10	PUC "Belgrade City Markets"	1,297,000.00	11,313.47	28,120,000.00	232,871.69	2068.0%	206	205	1	1,003,513,000.00	8,753,442.23	8,184,795.06	-1.5%	
11	Elektroizgradnja doo	7,123,000.00	62,132.50	10,208,000.00	84,539.07	43.3%	172	165	7	919,332,000.00	8,019,148.29	7,114,474.75	-6.6%	
12	PUC "Belgrade water supply and sewerage"	5,873,000.00	51,229.00	6,404,110.00	53,036.59	9.0%	2,473	2,434	39	8,723,119,000.00	76,090,014.05	75,105,969.03	4.0%	
13	PC "Belgrade Fortress"	895,000.00	7,806.91	2,479,000.00	20,528.32	176.98%	18	18	0	79,528,000.00	693,706.76	842,218.85	27.9%	
14	PC "Beogradvođe"	-129,358,000.00	-1,128,363.84	1,113,000.00	9,217.48	100.9%	171	165	6	346,294,496.00	3,020,657.30	4,121,735.27	43.7%	
15	PC "Belgrade Land Development Public Agency" (surplus/deficit)	0.00	0.00	0.00	0.00	0.0%	288	296	-8	8,355,529,000.00	72,883,600.35	62,526,449.52	-9.6%	
16	PC "Urban Planning Institute"	-87,125,000.00	-759,973.87	-47,054,000.00	-389,684.71	46.0%	144	144	0	151,115,000.00	1,318,145.78	1,628,023.11	30.1%	
17	PUC "Beograd put"	-804,449,000.00	-7,017,046.97	-125,577,636.00	-1,040,066.55	84.6%	1,292	1,247	45	2,734,684,000.00	23,854,098.97	2,711,999.86	-88.0%	
18	PUC "Belgrade City Parks"	37,144,000.00	323,999.65	31,519,000.00	261,005.29		1,243	1,204	39	2,114,039,000.00	18,440,337.36	17,191,933.01	-1.8%	
19	Beo Zoo	8,991,000.00	78,426.69	1,419,000.00	11,751.66		49	42	7	136,900,000.00	1,194,151.19	1,093,227.35	-3.6%	
20	Kombank Arena	11,501,604.00	100,326.18	1,249,000.00	10,343.78		39	39	0	639,279,000.00	5,576,302.25	2,262,447.11	-57.3%	
	Total PC and LLC (with the net profits)	-308,791,555.00	-2,693,526.68	4,505,972,474.00	37,048,147.01	87.60	11,874	11,603	271	69,514,618,496.00	606,362,047.59	541,770,245.06	-5.9%	

№	Name of the company	Net profit				Number of employees in personnel records				THE TOTAL REVENUE				
		Realized in 2013	EUR	Assessment of the achievement at the end of 2014	EUR	Net profit growth rate 2014/2013	Number of employees in 2013	Number of employees in 2014	Change in the number of employed	Revenues in 2013	EUR	Assessment of the achievement at the end 2014	EUR	Revenue growth rate 2014/2013
21	UTC "Beograd"	-1,393,683,000.00	-12,156,816.74	-3,313,430,000.00	-27,442,686.76	113.8%	5,862	5,769	-93	13,785,746,000.00	120,250,292.00	11,968,921,000.00	99,129,708.46	-13.2%
22	PC "Sava Center"	-84,284,000.00	-735,192.39	-193,264,000.00	-1,600,544.60	188.5%	131	123	8	519,842,000.00	4,534,477.30	528,083,000.00	4,373,398.02	1.6 Times zoom %
23	JRDP "Studio B"	-33,486,000.00	-292,091.65	-29,729,000.00	-246,782.51	151.2%	242	222	20	361,991,000.00	3,157,574.75	345,671,000.00	2,862,725.87	-4.5%
24	PC "Hippodrome Belgrade"	168,000.00	1,465.43	-15,264,000.00	-126,411.09	150.2%	16	16	0	67,531,000.00	589,059.34	36,073,000.00	298,743.92	-46.6%
	Total PC (with negative result)	-1,511,285,000.00	-13,182,635.35	-3,551,687,000.00	-29,331,762.03		6,251	6,130,000	121	14,735,110,000.00	128,531,403.38	12,878,748,000.00	106,657,269.76	-12.6%
	Total PC and LLC	-1,820,076,555.00	-15,876,162.03	954,285,474.00	7,716,384.99		18,125	17,733	392	84,249,728,496.00	734,893,450.97	78,296,909,144.00	648,427,514.82	-7.1%
25	SRC Tasmajdan	-34,190,000.00	-298,232.50	30,246,000.00	250,486.75	188.5%	140	110	30	301,182,000.00	2,627,150.06	259,860,000.00	2,152,069.29	-13.7%
26	SRC Pionirski grad	-199,000.00	-1,735.84	-6,909,000.00	-57,217.91	14.4%	13	13	0	31,456,000.00	274,384.37	29,293,000.00	242,594.34	-6.9%
27	City Center for physical culture - DIF	-13,819,000.00	-120,540.36	-16,680,000.00	-138,137.90	113.8%	48	42	6	83,924,000.00	732,032.19	71,050,000.00	588,411.16	-15.3%
	Total sport centers	-48,208,000.00	-420,508.70	6,657,000.00	55,130.94		201	165	36	416,562,000.00	3,633,586.61	360,203,000.00	2,983,074.79	-13.5%
	Total PC and LLC and sport centers	-1,868,284,555.00	-16,296,670.73	960,942,474.00	7,771,515.92		18,326	17,898	428	84,666,290,496.00	738,527,037.59	78,657,112,144.00	651,410,589.61	-7.1%
15	Pharmacy Belgrade (surplus/deficit)	1,706,096,000.00	14,881,932.56	1,951,011,000.00	16,158,779.19	14.4%	1,077	1,023	-54	10,642,182,000.00	92,829,614.98	9,174,482,000.00	75,985,439.79	-13.8%
29	VU "Veterina Beograd"	123,183,000.00	1,074,500.55	14,249,000.00	118,013.91	14.4%	208	201	7	557,868,000.00	4,866,170.46	399,746,000.00	3,310,556.04	-28.3%
30	Tourist Organization of Belgrade (surplus/deficit)	-327,000.00	2,707.85	895,000.00	7,113.28	0.0	36	36	0	108,618,000.00	947,452.99	115,950,000.00	960,168.93	Are 6.5%
31	Institute for Biocides and Environmental Medicine	0.00	0.00	0.00	0.00	0.0	51	53	-2	86,853,451.51	757,605.20	352,910,000.00	2,922,676.73	306.3%
32	City Institute for expertise	188,000.00	1,639.89	-32,835,000.00	-271,927.94	6.4%	82	70	12	149,800,000.00	1,306,675.30	115,668,000.00	957,921.77	-22.8%
	Total institutions and institutes	1,829,665,475.48	15,959,804.26	1,933,320,000.00	16,122,577.43		1,454	1,386	68	11,545,321,451.51	100,707,518.89	10,158,456,000.00	84,128,766.39	-12.0%
	In T O T A L:	-38,619,079.52	-336,866.47	2,894,262,474.00	23,971,032.35	7569.6%	19,780	19,284	496	96,211,611,947.51	839,234,556.48	88,815,568,144.00	735,539,356.00	-7.7%

Source: Author's calculations on the basis of the City Administration data

Conclusive remarks

The key to the public sector reform, which was executed by the management of CoB in the previous year, is based on a clear segregation between the function of the founder and the management function. The founder, CoB, took over its basic function, which is to continuously control and monitor the operations of the public companies.

When it comes to management function, two basic goals were set: to increase business efficiency and to constantly improve quality of services provided by public companies. Through the principle of efficient operations it is being insisted on economic postulates of rational and optimal operations. Through the principle of permanent improvement of service quality, public function is being protected as well as the activity for which the public company was founded in the first place. For many of the public companies earning profit is not even the main goal, but conducting public function for which they have been established for. The point is to appreciate economic postulates in the regular business, but not at the expense of service quality. By introducing both of these principles, mechanisms for corrective actions are established.

The three key areas of reform of the public sector in Belgrade were characterized by: institutional, organizational and financial restructuring.

The example of Belgrade shows that the consolidation of State finances must start at the level where the costs are incurred, i.e. at the level of local government. The example of Belgrade also shows that the reform of the public sector does not have to be politically controversial as *Alfonso et al.* [1] concluded. The proof of this is in the signing of the collective contract with the representative syndicates at the City level as well as the public companies level.

In accordance with the consulted literature, the example of the reforms of the public sector showed that the outsourcing of certain services had negative effects on the income of the companies. The elimination of outsourcing and the taking over of these services by public companies lead to a reduction in costs for the following two reasons: 1) the workers who were already on the payroll and surplus to requirements were engaged in work and

2) it prevented corruption, considering these contracts had a very high value.

By applying the above principles, CoB public sector managed, in only one year, to come, from the phase of generating, at the consolidated level, the minus of RSD 1.8 billion, to the phase of producing profit of almost RSD 1 billion. This positive difference is not the result of the revenue side growth and rapid increase of the communal services, but to against, it is primarily the result of abolishing unnecessary expenses.

Reform of the public sector is characterized by, and for the first time in modern history, reduction in the number of employees. It has proven that with the responsible approach, the public sector does not have to be, by automatism, polygon for “political employment”.

Last year, 2013, was marked by the process of business-financial consolidation at the level of CoB budget, as well as the level of public and public-utility companies. Given the fact that the budget deficit was halved, that CoB did not enter into new debts, and that the public companies came from minus phase to the phase of positive operations, the conditions are now set to mark this 2015th year as the year of investments. Stable financial system at the City level, as well as at the level of each company, is a good base for introduction of a process of public-private partnership that will be one of basic methods and models for attracting investors. Belgrade identified possible areas of cooperation, offered already elaborated projects and is currently in the process of drafting internal procedures that should work out all legal acts with the aim to efficiently implement this process. Belgrade will be the pioneer in realization of this model of attracting the investors, paving the road for other local self-governments and the Republic as well. Our goal is to have the year 2015 as the year marked with investments, where public-private partnership will be one of the key models.

In order to seriously prepare for attracting investors, Belgrade has prepared ‘Guide for Investors’, where in one place it sublimed all potentials Belgrade has, with clear specification of all projects that already exist. The Guide identified three main pillars for attracting investors: the process of public - private partnership, green field investment and the privatization process.

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Siniša Mali

is the Mayor of Belgrade, leads a city of 1.7 million people where he has initiated a vast financial reconsolidation program to achieve sustainable fiscal stabilization. Siniša has served as Special Economic Advisor to the Prime Minister of Serbia. He was a financial advisor in private practice specializing in transactional work in M&A, financial advisory, restructuring and business consolidations. In 2001, he was the Assistant Minister for Privatization, and the Director of Tender Privatizations. Previously he worked at Deloitte Central Europe and Credit Suisse First Boston in the Mergers & Acquisitions Group in NY. The Mayor is a graduate of the University of Belgrade, in Economics. He completed his MBA with honors in Finance at Washington University, St. Louis, Missouri. In 2013, he obtained his PhD at the Faculty of Organizational Sciences of Belgrade. He has served on various boards at Fiat Serbia, Komercijalna Banka, Air Serbia, and the Clinical Hospital Centers. Currently, he is a President of the Air Serbia Supervisory Board. Siniša is happily married and is a father of three children.



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was born on January 8, 1979. He finished the postgraduate studies at the Faculty of Economics in Belgrade, earning a Master's degree in Business and Financial Management. Currently, he is working on his doctoral thesis, researching "Inflation targeting: advantages, disadvantages and application in Serbia." Before having accepted the position of the Deputy Mayor, he was the Head of Administration for Prices, of the City of Belgrade. He has more than ten years of work experience. He worked on many national and international projects as a manager or as a team member, applying the various kinds of internationally recognized methodologies. He has published several papers in relevant scientific journals. He excelled his financial skills, while working at "EKI Audit" company, by completing the audit of over thirty financial reports, and by developing numerous business and financial Due Diligence reports. Borko expanded his interest at the Institute of Economics to macroeconomics, specializing in monitoring and analysis of macroeconomic indicators, as well as creating applied macroeconomic and feasibility studies, development strategies etc. As one of the best students of the Faculty of Economics, Borko gained his first work experience, with the Ministry of Economy. Later on, he confirmed the qualifications to work in the state administration, by passing the state exam. Borko is fluent in English.



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THE ROLE OF ECONOMIC PLANNING IN PUBLIC SECTOR: PRINCIPLES, EVIDENCE AND LESSONS FOR SERBIA IN THE CONTEXT OF EU INTEGRATION*

Uloga ekonomskog planiranja u javnom sektoru
– principi, praksa i poruke za Srbiju u kontekstu
evropskih integracija

Abstract

The aim of this paper is to provide an overview of the current situation in the area of policy planning in Serbia based on some basic principles in the field of national level economic planning and evidence-based policy making. Current abundance of individual strategies on national level adopted by the Government of Serbia is definitely a reflection of a strong need for development planning in order to deal with all reform challenges ahead which should be addressed with thoughtful policy agenda. There is a room for improvement in the following areas: (a) introduction of a systemic approach linking sector level strategies to the roof long-term development plan, (b) strengthening of the analytical support to planning, (c) linking phases of policy making to include monitoring and evaluation phase, (d) linking the annual cycle of planning and budgeting into a single process, with a harmonized methodology, which also covers planning of non-legislative activities such as public investment, and (e) legitimizing policy concept or concept document as a policy document that can be presented to the Government. The paper is structured as follows: first we try to depict main principles of government planning, we secondly present the role of evidence-based policy making, following by the overview of the current situation in terms of policy making in Serbia. Finally, in the concluding section, we propose the main axes of possible further improvement in the present setting and its alignment with best practices.

Key words: *development planning, evidence-based policy making, policy coordination, strategic documents*

Sažetak

Cilj ovog članka je da pruži pregled stanja u oblasti planiranja politika u Srbiji na bazi osnovnih principa u polju ekonomskog planiranja i utvrđivanja politika na osnovu činjenica. Postojeća situacija u kojoj postoji mnoštvo nacionalnih strategija usvojenih od strane Vlade Republike Srbije izvesno predstavlja rezultat snažne potrebe za razvojnim planiranjem u cilju sprovođenja svih reformskih izazova sa kojima se suočava Republika Srbija, a kojima treba pristupiti sa promišljenim setom javnih politika. Postoji prostor za unapređenje u sledećim oblastima: (a) postavljanje sistemskog pristupa kojim bi se povezale sektorske strategije sa jednim krovnim dugoročnim razvojnim planom, (b) unapređenje analitičke podrške planiranju politika, (c) povezivanje različitih faza donošenja javnih politika u smislu uključivanja faza praćenja i evaluacije, (d) povezivanje godišnjeg ciklusa planiranja i pripreme budžeta u jedinstven proces sa jedinstvenom metodologijom, koji uključuje i planiranje neregulatornih aktivnosti kao što su javne investicije, (e) zvanično uvođenje predloga politike ili koncepta kao dokumenta javne politike o kojem je moguće odlučivanje od strane Vlade. Članak je organizovan na sledeći način: najpre su opisani glavni principi planiranja od strane Vlade, zatim je objašnjena uloga izrade javnih politika zasnovanih na činjenicama, nakon čega sledi pregled tekućeg stanja u oblasti donošenja javnih politika u Srbiji. Na kraju, u poslednjem odeljku, date su preporuke za moguće unapređenje sadašnjeg stanja u skladu sa vodećim principima u ovoj oblasti.

Ključne reči: *razvojno planiranje, izrada javnih politika zasnovanih na činjenicama, koordinacija javnih politika, strateška dokumenta*

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The role of planning in organizations: Main elements and underlying principles

The role of planning is widely recognized as an important governance instrument in both corporate and public organizations around the world. In large corporations, planning and budgeting represent a main steering and management tool for continuous monitoring of performance, assessing the main internal and external challenges and opportunities, evaluating risks to achieve planned level of profit and output, as well as reacting accordingly to changes on the market by adjusting plan and its assumptions. Apart from being a management tool, plan also serves as an important communication and coordination tool in large systems as many dislocated internal actors need to align their activities to common goals. For that purpose, it is of crucial importance to continuously exchange information bottom-up and top-down along the planning process.

Planning is an ongoing process. It starts from evaluation of performance from previous period, following by setting or revising the goals that are already set up, formulation of the planning assumptions which result from data analysis of both external and internal factors relevant for the goals, and definition of plan of activities. The next phase consists of implementation and monitoring,

which leads to the new cycle of planning as one planning period ends and a new one starts (see Figure 1).

Planning in public sector is a main tool for articulating public policy. The fundamental aim of development plans until today has always been to ensure that economic growth and social development continue in a sustainable manner. In this respect, increasing competitiveness, rise in employment, human and regional development, strengthening social protection and solidarity, and increasing quality and efficiency of public service have usually been in central attention of all development plans. Hence, depending on the evolution of political economy mainstream, different importance, position and methods were associated with plan and planning across different periods of time and countries. While it was used in centrally-planned socialist economies to allocate all or majority of resources, it is also present and popular in free-market societies. Since the 1980s and rise of neoclassical liberal economic theories, the New Public Management approach has brought along a new order in which the private sector has had a more effective role in economy. Plan has changed scope and methods but remained an important tool in public management. Planning of aggregates and planning based on deterministic, heavy and detailed calculations have lost popularity. These were criticized for ignoring absorptive

Figure 1: Planning process flow



Source: Authors

capacities, institutional constraints, spatial diversity, interpersonal and intersectoral distribution problems.

The concept of strategic planning saw a simultaneous rise in both academic and business world coupled with liberal views in economic thinking and greater reliance on market mechanism in distribution of wealth. Under the New Public Management approach, the public sector is expected to develop guiding strategies for the policies to be followed. The accent is more on the utilization of market mechanisms and planning becomes less deterministic and more indicative in the form of main targets. Though not initially linked to economic development, business management oriented research has developed theories and tools on strategic management that found applications in planning on the national level. A notable contribution is the work of *Michael Porter* [14] with the Porter's diamond – concept extending the notion of competitiveness of a firm to that of a nation. Meanwhile, economic geography and urban economics become in vogue after seminal contributions of *Krugman* [8].

Since the last global economic crisis, industrial policy is getting more attention by developed countries' policy makers [18], [1]. National level economic planning is gaining popularity accordingly. The globalization is however adding an additional level of complexity to planning and national-level industrial policy as individual countries are less sovereign to introduce autonomously some broad level measures which can have supranational consequences due to economic integration or these measures and measures of other countries' economic policies may appear to be on a collision course. Moreover, it gets much more difficult in the environment of globalized economy to base a plan on sound assumptions as global economy is much less predictable. Finally, there is much more need for coordination of national economic policies. An example of economic policy coordination is the so-called European semester – an annual cycle of economic policy coordination in the EU based on common targets set by the roof strategy Europe 2020.

The basic classification of plans according to time coverage includes long-term, medium-term and short-term plans. Usually, long-term plans are rather general and of a broader scope with less details serving as a vision and

basis for medium-term and short-term plans. Another distinction is made between centralized plans covering usually a national level and all sectors against more narrow level of coverage being regional, local or sector specific. Depending on shareholders' participation in preparation of a plan, it can be democratic i.e. participatory or non-participatory. According to powers of the plan, one can distinguish mandatory plan (for the public sector) and/or indicative plan (for the private sector) [20]. Additionally, plans could be classified as original policy documents where specific policy is outlined *versus* derived documents representing a set of policy decisions in a specific area or by specific nature. In the second case, plan is rather an informative document serving for policy coordination or monitoring and reporting.

Apart from successful examples of experiences of national development planning in countries like South Korea along last 40 years¹, national level economic planning was exercised and still represents an important source of evidence-based policy making in developed market economies in Western Europe such as the Netherlands, France or Norway. The Central Planning Bureau is an independent Dutch government agency founded in 1947 by Nobel laureate *Jan Tinbergen*, a pioneer of economic planning.

Evidence-based policy making

The process of policy making ('policy cycle') consists of five 'phases': policy planning (initiation), policy analysis and development (formulation) of public policy, preparation of public policy documents, decision making, and implementation, monitoring, evaluation and reporting. Coordination, consultations and data gathering are not separate phases, but rather processes that should be conducted during the whole of policy cycle. It includes

1 South Korea has been developing its economy into one of the most competitive economies in the world on basis of five-year national development plans for more than 30 years. After the Asian financial crisis in the mid-90s, it was decided to start drafting and implementing fiscal plans, instead of national development plans. These processes have been supported by extremely developed IT systems for integral planning and budgeting, making the check of spent money and its effectiveness transparent and in a real time mode. In South Korea, one ministry is responsible for planning and budgeting.

analysis of the existing situation; definition of the problem, its causes and consequences; setting objectives, results to be achieved and appropriate measures to achieve the results; identification of options; *ex-ante* impact assessment of identified options; decision making – selection of the preferred option; policy formulation and choice of policy instruments; implementation, monitoring, evaluation or *ex-post* impact assessment (using the results of monitoring), and reporting.

Good policy analysis is a critical precondition for effective policy making in the public administration [5]. When done well, policy analysis can have multiple beneficial effects, including: facilitating the adoption of more effective policies by identifying and systematically comparing potential solutions against specific clear goals (criteria based on country's specific circumstances), identifying the lowest-cost solutions and saving taxpayers' money, advancing public interest and preventing private interests from hijacking the process by thoroughly analyzing the problem and proposed solutions, and justifying the solutions based on explicit criteria and specified goals. This ensures that the decision making process is less vulnerable to corruption and more conducive to advancing public interest.

According to *Weimer and Vining* [19], functions of policy analysis include: (1) developing policy proposals to address public policy problems; (2) serving as focal points for coordinating policy analysis in specific program areas across government; (3) providing research for an oversight and evaluation of policies in program areas; and (4) supplying urgent and timely policy and evaluation information to decision makers.

Great efforts and resources are needed to introduce an effective evidence-based policy into the policy cycle. There are numerous challenges regarding the improvement of evidence-based policies in the public administration, including: (a) the presence of electoral cycles whereas priorities for analysis may, and usually do, change when the structure of a government changes; (b) irregular communication between governments and research institutes and think thanks; (c) absence of good preconditions and resources (time, human, financial and other resources) for analysis [13]. Despite that, there are

many ways of introducing different analysis tools into public administration, ensuring evidence-based policy making. One of the policy analysis tools specific to all EU countries, and many other countries across the world, is impact assessment. Impact assessment is a technique that should be used before an actual public policy measure is taken in order to explore the existing problems in a specific area, solutions, and the anticipated social, economic and/or environmental impacts of the possible solution set. The focus of the impact assessment might be a public policy or piece of legislation, forecasting potential impacts as part of the planning, design and approval of a public policy or legislation. An integral part of each impact assessment should be the assessment of fiscal impacts (impacts on the state budget) of analyzed public policy measures. Besides the *ex-ante* impact assessment, there is also *ex-post* impact assessment, focusing on the evaluation of real impacts achieved by the implementation of a public policy or legislation. Of course, in order to introduce impact assessment into the public administration, it is necessary to ensure both political and expert support and appropriate resources and capacity.

At the bare minimum, it is possible to use different external resources of data and information in order to ensure that decisions in the public sector are made on the basis of sound evidence and objective analysis (analysis produced by different think thanks and other non-governmental organizations, institutes and bureaus which are budgetary users, etc.).

Current setting in terms of policy planning in Serbia

This section presents an overview of planning practices in Serbian state administration, with an eye on the principles and purpose of planning from a development and management perspective developed in the previous section, as well as the role of analysis in decision making process linked with planning in public sector.

The history of planning by the Serbian government dates back to the former Federal Republic of Yugoslavia when the government was planning centrally performing overall distribution of income almost without market mechanism.

Starting from early 1952, centralized planning in SFR Yugoslavia was replaced by a more flexible system based on the planning which used only global targets [6, p. 10]. The administration of the Federal Republic of Yugoslavia relied on specialized institutes for economic planning that had an important position within the Government institutions on both federal level and individual state level administration. Special attention was given to the coordination of policies across federal republics on the one hand, and a central state level, on the other. Despite the fact that since the 1960s state planning in Yugoslavia was evidently undergoing crisis [6], the developed planning and analytical infrastructure is generally considered to have been a beneficial contribution to the decision making process. This infrastructure, which included economic modeling, served in particular as a reliable base of information about the economic flows. With dissolution of the federal state during the 1990s, many policy planning institutions and processes were debased. As a result, to this date analytical jobs and/or units are not systemically recognized within the Serbian public administration. This leads to a loss of the systemic link between policy decision making and analytical inputs from both within the public administration and from a network of public research institutes in social sciences. This reminiscent, and to a certain extent legislative, obstacle furthermore frustrates the development of both the government analytical capacity necessary for policy development and evaluation, and an institutionalized approach to cooperation between decision makers and science and academic institutions [7].

Existing policy planning mechanisms

The current structure and content of planning and strategic documents demonstrate a lack of a systemic approach. Policy planning documents can be considered as documents outlining specific public policies. In Serbia, a strategy is a typical document fulfilling this purpose. Policy planning on the other hand is executed through “derived” planning documents with the primary aim of providing an integrated information base on specific policy area or to serve for monitoring and reporting purpose. The latter is provided by a working plan such as Annual

Working Plan of the Government or National Programme of Adoption of the *Acquis Communautaire*.

As outlined by Lončar [9], from 2000 onwards, there have been several initiatives aiming at setting up a unique and coherent strategic planning framework in Serbia. Meanwhile, the absence of a unique system of planning documents – prepared and decided upon in a decentralized manner – as well as a single overarching development strategy (‘roof strategy’), each ministry has developed a multitude strategic planning documents without much consideration of whether their goals are aligned with the medium and long term goals of the state, or indeed with the strategic goals of other ministries [9]. This results in many instances of contradictory or mutually colluding goals. Moreover, no overarching long-term strategy, providing for a long-term vision of development of society and economy, as well as for reconciliation between main tradeoffs among naturally conflicting priorities, has been prepared, even though the Constitution of the Republic of Serbia includes a provision prescribing that the National Assembly adopts both a spatial² and development plan.

As a result of these divergent planning mechanisms, and a lack of the top-down approach in a form of an overarching strategic document, there are around 120 actually valid strategies that have been prepared by different public administration bodies and adopted by the Government of the Republic of Serbia. Only a third of these strategies are followed by the preparation of the action plan for its implementation and roughly a fifth of the strategies incorporate estimates of financial resources required for their implementation [15]. It is estimated that the implementation of these strategies, would cost approximately 45% of GDP.³ Moreover, there is no systemic procedure for monitoring and evaluation of the implementation of strategies and many of goals remain unrealistic and result in materialization in a form of regulations or other policy instruments. Indeed, findings from the largest survey of senior public sector

2 The spatial plan has been adopted in 2010 in the form of the Law on Spatial Plan of the Republic of Serbia, including planning period of 10 years (until 2020) [10].

3 Estimation made by the Public Policy Secretariat of the Republic of Serbia, 2014.

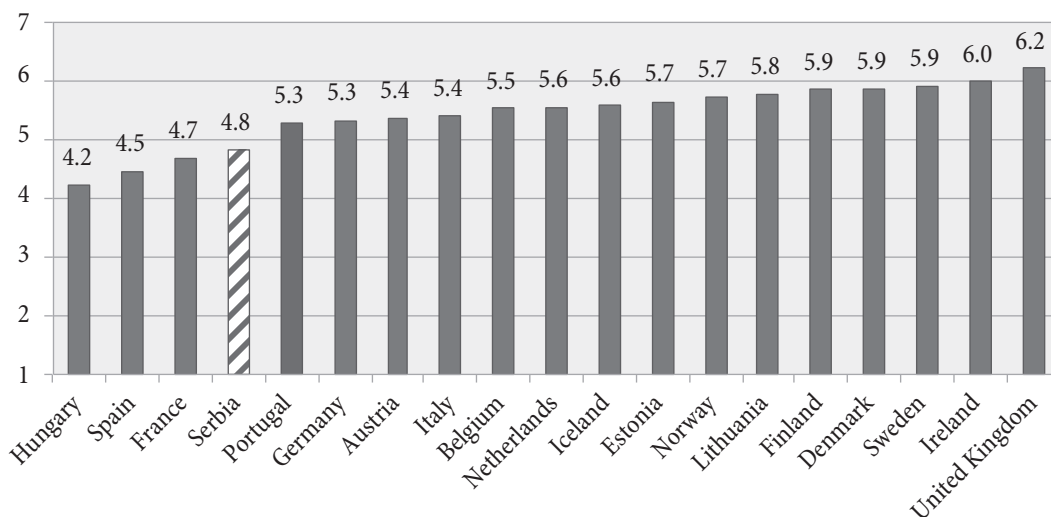
executives in Europe (COCOPS⁴) indicate that the actual extent to which strategic planning has been implemented (as a *management tool*) in Serbian central government administration is comparatively low: a finding strikingly at odds with the proliferate number of adopted strategies (see Figure 2).

Such outcomes are however understandable when one considers that in Serbia, both policy content and policy proposal documents (e.g. policy concepts or concept documents), are presented in the form of strategies. This practice can to a large extent be ascribed to legislative obstacles. As the Serbian Law on Government [3] prescribes that Government adopts regulations, rules of procedure, decisions, conclusions, budget memorandum and strategies, and no documents which one would classify as policy concept⁵ suitable for decision in an early stage of conceptualization of a specific policy. Because the adoption of such policy documents is an integral part of the policy making process, many have been presented in the form of a strategy leading to an overabundance of individual strategies, many of which do not meet a minimum form

and contents which a representative strategic document should include, the most important of which in this context are clearly defined and measurable goals and targets crucial for policy evaluation and monitoring.

Strategies in Serbia are therefore very often *de facto* often understood as policy concepts where a strategic vision and primary goals are designed, while the implementation of specific strategic goals are foreseen in accompanying action plans. However, there are no clear links between these documents and the decentralized systems for policy planning derived from them such as the Annual Government Working Plan and National Programme for the Adoption of the *Acquis Communautaire*. Both documents are primarily focused on legislative activities (drafting and adoption of different laws, strategies, action plans, programs, etc.) planned for a certain timeframe. While the National Programme for the Adoption of the *Acquis Communautaire* is monitored by the Serbian Office for European integration⁶, there is no built in process for reporting and monitoring related to the Annual Government Working Plan and significant overlaps exist.

Figure 2: Use of strategic planning by senior executives in European public administrations



Question: To what extent are the following instruments used in your organisation? Strategic/ Business Planning, 1 "Not at all", ... 7 "To a large extent"
 Source: Authors' calculations on the integrated COCOPS database

4 The COCOPS survey, financed under the European Union's Seventh Framework Programme under grant agreement No. 266887 (Project CO-COPS) financed under covers the responses of 9,300 senior level executives in European public administrations. The Serbian sample is based on a full census of central government executives, with 1,367 responses (for more information on COCOPS Serbia see [17] and the full COCOPS survey see [4]).

5 Policy concepts are also called: concept documents, white papers or green papers across different countries.

6 Realization rate for 2013, for example, was approximately about 50% [16].

Another challenge is that policy planning in the Republic of Serbia has not been linked to the processes of fiscal planning despite the fact that, according to the Law on Budget System [11], public administration bodies⁷ are obliged to switch from line budget preparation to creation of program budget since 2015. There is no central document outlining the mid-term plan of each institution which would serve as a catalytic point for linking policy contents designed in strategies into institution level activities in the specific period of time. Moreover, this type of document is usually used for managing the goals of specific organizational units. In addition, there are many challenges in the area of public investment in all phases including evaluation of economic effects, planning and monitoring of realization. This is furthermore reflected in low level of realization of contracted investments which are secured through funding from international development loans [2].

The last is reflected in the fact that calendars of the policy, fiscal and financial planning are not mutually coordinated.⁸ Also, different terminology provided in the methodologies for preparing of working plan and program budget makes it harder for the civil servants to provide all the inputs for both processes, making them complicated and time-consuming for the public administration.

The origin of policy content and the relevance of government analytical capacity

It can be expected that great majority of policy and planning initiatives in Serbia arise from a need to comply with market-based mechanisms, *Acquis Communautaire* and other EU rules and standards. Very often in countries at this stage of development, the World Bank acts as a kind of 'bank of knowledge' on development policy solutions, while initiatives related to macroeconomic and fiscal stability are primarily put forward by the International

Monetary Fund. In addition, some policy initiatives come also from different think tanks, trade unions, chambers of commerce and other non-governmental bodies, etc.

For instance, in addition to the challenges regarding strategic planning identified in the preceding, the planning framework is further complicated because planning initiatives are driven by procedures established by the European Commission (EC). Specifically, in the process of EU integration, the EC very often suggests drafting and adopting different plans, strategies and programmes aiming to assure consistent policy planning in a certain area. Namely, EC has recently requested that candidate countries maintain plans for social and economic reforms by, for example, drafting documents such as Economic Reform Programme including a list of structural reforms in designated policy areas (e.g. infrastructure, human capital) and Employment and Social Policy Reform Programme. For these documents, a monitoring and reporting process is foreseen with a special role for the European Commission. Such conditions are generally considered beneficial, not only to Serbia's harmonization efforts with the EU, but also to its internal development efforts. Considering the lack of monitoring, planning and coordination capacities however, such additional demands in practice sprain an already overstretched part of the state administration.

Hence, while the positive influence that international and non-governmental organizations exert on the policy development and implementation cannot be overstated, there is arguably a strong need to further enable the Serbian administration to address development challenges and specifics of the local economic and social issues, which include but are not limited to (1) high fiscal deficits, (2) the need to comply with EU *Acquis Communautaire* and strict standards in terms of state aid, competition and scope of intervention into free markets, (3) significant structural imbalances reflecting in low level of export to GDP (20%) and high level of trade deficit (15%) in pair with high unemployment rate even before the crisis (12%) as well as today (20%). Such intertwined and overarching challenges can only be addressed by leveraging all available administrative and political capacity, which in its turn can best be supported by

⁷ According to the Law on Public Administration [12], public administration bodies include line ministries and their accompanied directorates, administrations and inspectorates, special organizations and Government services.

⁸ Public administration bodies are obliged to prepare inputs for the preparation of the budget first, and after that – inputs for the annual government working plan.

analytical, monitoring and evaluation units embedded within the state apparatus. Such units are potentially best placed to understand not only the local context, but also the constraints faced by state actors tasked with policy planning and implementation.

Conclusion and policy recommendations

Strategic planning can, similarly to private corporations, represent a powerful performance management tool within public administrations. Economic components of such plans also provide stable inputs for private sector business planning, and stimulate it to align itself with long term strategy of the state. Successful development and implementation of strategic plans however depend critically on the presence of solid support systems, in the form of monitoring, coordination, and analytical capacities. Moreover, for these support systems to be effective, they need to be anchored within an overarching strategic plan against which subordinate strategic plans are tested.

In Serbia, the dissolution of the federal government of former Yugoslavia during the 1990s has led to a loss of significant analytical and coordinating capacity, as well as links with research institutions and academia, an issue furthermore compounded by the contextual factors such as isolation and brain drain. At present, the rebuilding of these capacities is hampered by the legislative barriers such as the lack of analytical government positions.

On the demand side, the lack of a clear distinction between policy concepts and strategies has resulted in a proliferation of the latter, with policy concepts often being presented as strategies in order to be able to obtain the required legitimacy through adoption by the government. As these ersatz strategies are fed into strategic plans such as Annual Working Plan of the Government or National Programme of Adoption of the *Acquis Communautaire*, all the while lacking clear and measurable targets of proper strategies, the evaluation, monitoring and alignment of all the competing strategic plans become much harder.

One can therefore conclude that the current challenges in the implementation of strategic planning can to a certain extent be addressed through including policy concepts as separate instances of policy documents in the Serbian

Law on Government. This will both reduce the number of strategic goals to be implemented, and potentially increase their rate of implementation. Such efforts would also provide the necessary legitimacy to policy documents. Finally, the introduction of an overarching 'roof' strategy, would facilitate the standardization of typology of strategic planning, thereby reducing both coordination efforts and improve monitoring and evaluation.

Through simultaneously (1) increasing government analytical capacities, (2) clearly distinguishing strategies from policy concepts and (3) standardization of the typologies and methodologies *via* the introduction of an overarching strategy, Serbia will be able to further direct its strategic planning and monitoring efforts to address the complex challenges it faces today and in the foreseeable future.

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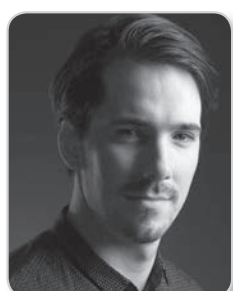
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