Statement by Igor Novakovic

Chairman Hastings and Co-Chairman Wicker, Distinguished Members of the Committee, Senate and the House of Representatives,

Thank you for the opportunity to speak on this critical topic today.

Serbia is often praised as a regional, even world, leader in attracting foreign direct investment (FDI). In 2019, for example, it achieved the top spot on the Greenfield FDI Performance Index. Serbian experts tend to agree that its generous system of investment incentives is most likely the main reason for the increase of FDI and competitive advantage that Serbia has compared to the rest of the region. A relatively large share of the direct investment projects involving incentives, however, occurs when investors have already formed a firm opinion of making Serbia their preferred location. The issue of incentives thus mostly boils down to bilateral negotiations between an investor and Serbian authorities.

Following the 2008 economic crisis, Serbia established an FDI model based primarily on subsidies, at the cost of improving other aspects of its business environment. Investors who run their businesses with integrity typically consider the broader issues of political stability, the rule of law, democratic governance of local institutions, and market-oriented economy. Despite the ongoing process of EU integration, the rule of law and governance in Serbia have deteriorated. Therefore, it can be concluded that Serbia's strategy to attract FDI is not to improve its enabling environment.

The available data suggest that the subsidy model is not efficient either because its costs outweigh the benefits. In other words, similar results might have been achieved at a lower cost. Although employment has been on the rise and the GDP growth rate has remained modest, Serbia's economy does not stand out compared to the rest of the region – while the amount of subsidies it provides does. These facts suggest that while investors enjoy high returns on their investment, Serbia is not maximizing its incentives system and is missing out on the long-term benefits of foreign corporate presence, to say nothing of the sustainability of its subsidies.

There are no doubts that Serbia has raised its attractiveness to FDI, but not by improving the quality of the enabling environment. It does so by topping up the investment incentives it offers by making the investments easier and less costly through "regulatory incentives" that circumvent the democratic principles of transparency, oversight, and accountability in doing business.

Given the significance of the investments of “special importance” to the development of the Serbian economy and because of the problems that unfolded with similar investments in the past, our team decided to focus its analysis on investment incentives and how FDI in this category interacts with local governance. Though the investments of special importance were introduced to the Serbian legal framework only in 2015, investments of similar nature had existed for a long time: Gazprom’s privatization of Serbia’s oil industry in 2008 is one of the most notorious examples. And the Turkish Stream may become another.

Under the Investments Act, an investment can be deemed of special importance if it satisfies a combination of requirements primarily regarding the quality of investment, its amount (starting from EUR 5 million), and the number of jobs it will create. The law generally allows a broad interpretation of this category, and incentives to investments of special importance are rendered without a public call for bids. Their scrutiny is limited to an urgent procedure, which limits the space for a thorough examination of the proposed investment. Furthermore, they are treated with confidentiality. Investments realized on a basis of international agreements, which the Serbian government concludes with foreign states, become investments of special importance automatically. This is important because, according to the Serbian legal framework, all international agreements adopted by the parliament are above domestic law, including the Serbian constitution. This allows for the exclusion of domestic regulation from the scope of the agreement, giving the state and an investor the right to derogate from certain obligations, which may impair Serbia’s sovereignty or affect its legitimate development interests.

To strengthen the resilience to corrosive capital of public institutions responsible for investments of special importance, we reached out to the Council for Economic Development and the Development Agency of Serbia. The Agency is a public institution, which processes the applications for investment support and implements the decisions made on these applications by the Council. The Council is mostly composed of ministers (=secretaries), who are appointed by the government of Serbia. However, both institutions ignored our genuine interest in working with them, though it is commonly agreed that the design and realization of FDI incentives should be guided by policies available to the public, which contributes to building support for the government’s actions. This is true regardless of the placement of various policy and implementation responsibilities in this process.

Therefore, our analysis of these institutions draws primarily on information collected from secondary resources and primary data collected through surveys and interviews of several experts and clients, namely businesses that interacted with the two institutions. Interestingly, we concluded that 11 of the policies applicable to these institutions, which we examined, provided a solid framework for the prevention of corruption incentivized by corrosive capital. Nonetheless, they are not adequately implemented. As a result, governance gaps emerge. Despite the limitations of our study, we would like to offer the following observations.

First, Serbia should have one investment strategy uniformly implemented by all relevant public institutions. Investment incentives should reflect regional and sectoral developments and corresponding needs so that they do not interfere with each other and do not negatively impact competition. In addition to the investment strategy, investment incentive criteria must be clearly established to limit the space for their extensive interpretation and arbitrary decision-making by public and elected officials as well as abuses by investors, such as aggressive tax planning, transfer pricing, round-tripping, and of course, corruption or even criminal behavior such as money laundering.

Next, no FDI incentive strategy is likely to succeed unless the implementing public institutions have the necessary expertise to conduct a comprehensive cost-benefit analysis of proposed investments, negotiate, manage, monitor, and evaluate investment incentives, as well as the capacity to make decisions free from any pressures. Moreover, investment incentives should be open to thorough scrutiny by relevant policymakers and civil society. The Commission for the Control of State Aid should, therefore, participate in the examination of incentives for prospective investments of special importance before the final deals are sealed. The government of Serbia should give FDI incentives proper consideration as opposed to rubberstamping decisions by the Council with a limited representation of elected representatives, where the potential for external pressures is greater. Though the Council’s annual reports should be public, as prescribed by the law, they are not. Neither was the 2018 report provided to us following the freedom of information request we submitted.

Over the past year, the Western Balkans have continued to see signs of democratic backsliding, and the European Union’s recent retreat from the enlargement policy may lead to further deterioration. This situation allows malign foreign actors to enhance their presence in the region. Therefore, our continued focus on democratic and free-market values remains critical. Substantial reforms for greater transparency, oversight, accountability, and market-orientation of the system of investment incentives are needed in regard to these public institutions as well as the overall business environment in Serbia. That is the only way to boost the confidence of its citizens in democracy and prevent further brain drain.