



TOP 10 ECONOMIC MISCONCEPTIONS IN SERBIA

Top 10 Economic Misconceptions in Serbia

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For the publisher:

Miloš Nikolić

Author of texts:

Mihailo Gajić

Proofreading:

Dajana Marinković

Graphic design:

Uroš Eleković

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Top 10 Economic Misconceptions in Serbia

Preface by the Publisher

Presented here is Libek's latest issue of Top 10 Economic Misconceptions in Serbia. This publication is part of our broader efforts in the fight against economic populism in Serbia. After publishing a collection of texts "Abuse of the People 1" and "Abuse of the People 2" dealing with the roots, nature and various forms of populism, both in Serbia and in other countries, the new publication deals exclusively with economic misconceptions.

Economic Misconceptions are the Most Expensive Type of Misconception

The particularity of economic misconceptions is reflected in the fact that they are embedded in public policies that determine the direction in which societies move. Having this in mind, economic misconceptions, because of bad economic results, create costs that are passed onto the whole society. Costs of economic misconceptions are often unpredictable, deferred and hidden. The outcomes of economic misconceptions are often difficult to straighten out and leave serious consequences. For example, political games with salaries and pensions, although in the short term they can benefit citizens, in the long run, they can cause damage to the whole society, even to those who have felt the short-term benefits.

Customs, which in the short term can protect some companies from competition, will also negatively affect the business of those companies in the long run. Printing money or using foreign exchange reserves as an anaesthetic in a crisis can only lead the citizens down a very harmful path with incalculable costs. By indicating the wrongful premises on which the devastating conclusions of economic misconceptions are based, we want with this publication, first and foremost, to point out the harmfulness of political proposals that in their core have economic misconceptions.

State Power is an Essential Prerequisite for Economic Misconceptions

The economic misconceptions we have dealt with in this publication have included, to a greater or lesser, but certainly significant extent the involvement of the state in the economic life of Serbia. This interventionism exceeds the usual limits of the actions of successful and developed states of liberal democracy that should be exemplary for Serbia.

One could say that economic misconceptions are cousins to political misconceptions – misconceptions about good intentions, about honest and professional public governance of public resources, about the exchange as a lesser or greater conflict in which we⁹ must win, about some sectors (such as agriculture) that allegedly possesses these magical qualities to initiate economic growth.

Political misconceptions with all their layers tend to be reinforced by economic misconceptions as a driving force.

Political and economic misconceptions survive to a great extent because the fundamental construction of independent institutions and the rule of law in Serbia is still lacking.

The Most Important Lesson of Economic Misconceptions

Often it is wrongly assumed that omniscient regulators of impeccable moral reputation will be employed to implement political solutions empowered by economic misconceptions. With unplanned and unpredictable costs, the possibility of misuse is increased – economic misconceptions are often fertile soil for irresponsibility and corruption.

It eludes us that in politics the consequences of policies are more important than the intentions of politicians, that the expertise is of secondary importance, if the experience of some practice is opposing political proposals. We as a society have even a harder time learning the most important lesson of economic misconceptions – because we all have to learn about misconceptions since we are the ones who are sooner or later paying the cost – both those who have

accepted such misconceptions and those who have warned about the danger of those misconceptions.

Contribution of Associates

In the process of preparing and processing the materials for this publication, our Advisory Group made an exceptional contribution. This group, which met once a month for one year since October 2017 was composed of our most renowned experts, professors, journalists, business people, and representatives of civil society. We are using this opportunity to thank these true friends of Libek for their efforts and contribution.

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Miloš Nikolić
President of Libek

1. The Myth of Public Consumption

If the state starts spending more and increasing salaries and pensions, it will increase consumption, which will lead to economic growth.

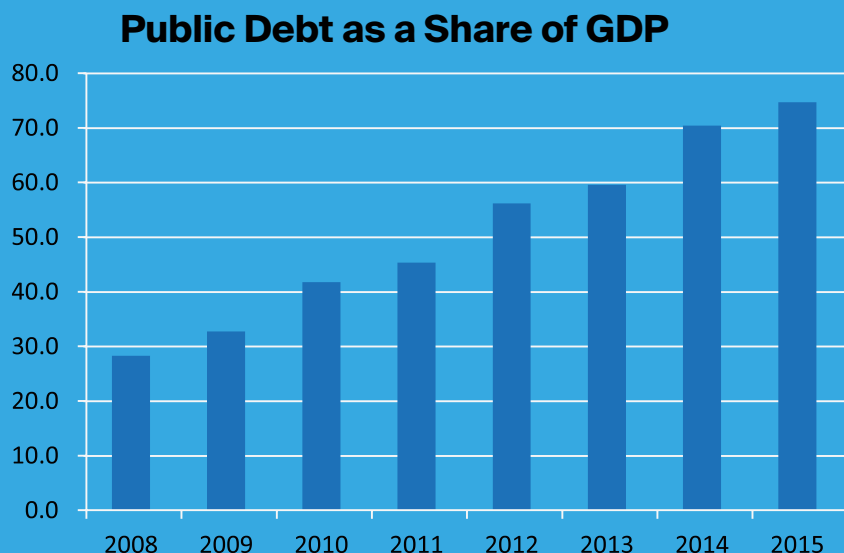
Since the level of public spending in Serbia is already disproportionally high for a country at this level of income, this policy requires the increase of taxes or the creation of budget deficits. This policy is particularly inappropriate for Serbia, because it has already led to the explosion of public debt and has diverted public spending from productive spending for capital investment to current consumption. All this did not lead to economic growth.

STATE SPENDING INCREASES DEMAND AND FACILITATES GROWTH

The myth of increasing government spending as an instrument for achieving economic growth is based on the simplified presentation of the Keynesian School of Macroeconomics. According to this understanding, if there is a recession, it is a consequence of insufficiently aggregated demand, which must be increased in order for the economy to return to the path of growth. In the event of insufficient private consumption, state spending becomes important, so that it will replace this shortcoming.

However, this applies only under certain conditions, which are not fulfilled in Serbia. The most important condition is high fiscal multipliers (which measures

how the increase in public spending increased economic activity). In the case of Serbia, multipliers are low, there are no correct estimates for our country, but for other neighbouring transition countries, there is an estimate that multipliers are only as high as 0.3, which is very low. This means that for every dinar of additional public spending, the economic growth amounts to only 0.30 dinars. This is predicted by economic theory, because Serbia is a small, open economy. Consequently, a large part of consumption must end up abroad due to imports of consumer goods, from food and clothing to vehicles and equipment. Since the equation for GDP calculation uses net exports (exports are increasing, and imports are reducing GDP), thus the economic growth is exported to the countries from which we import, while the debt to finance this policy remains in Serbia. Instead of economic growth and, consequently, new employment and tax revenues, by applying the policy of increasing public spending, economic growth was low and public debt exploded, and threatened to cause a fiscal crisis.



Source: National Bank of Serbia

Economic Growth

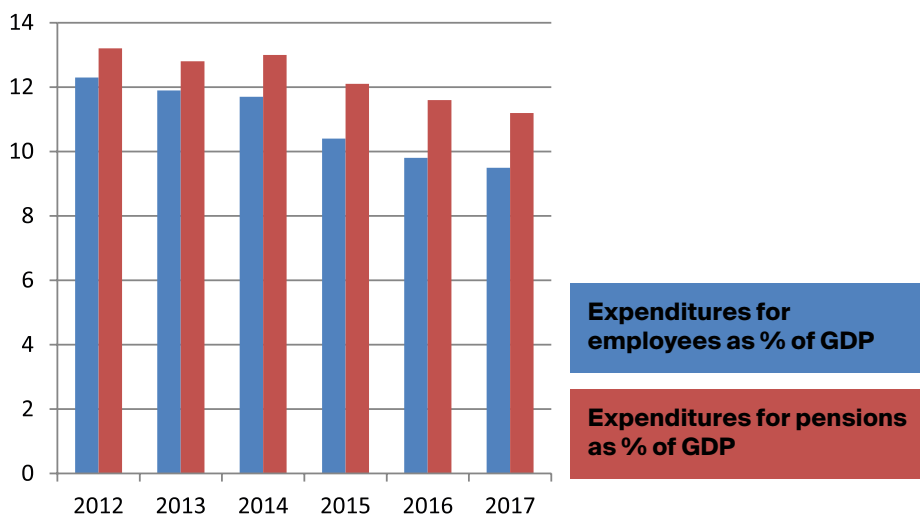


Source: National Bank of Serbia

STATE SPENDING ON SALARIES AND PENSIONS

The spending on salaries and pensions in Serbia has been reduced by a decision to reduce salaries and pensions in 2014. Salaries and pensions are now closer to a level that the Serbian economy can finance. It is necessary that they remain at this level, which means that there is space for increasing salaries and pensions, but in such a way that they grow in line with inflation (in order to preserve purchasing power) and grow in line with economic growth, so that their amount will remain sustainable. Their level, however, should be the consequence of economic growth, not its cause.

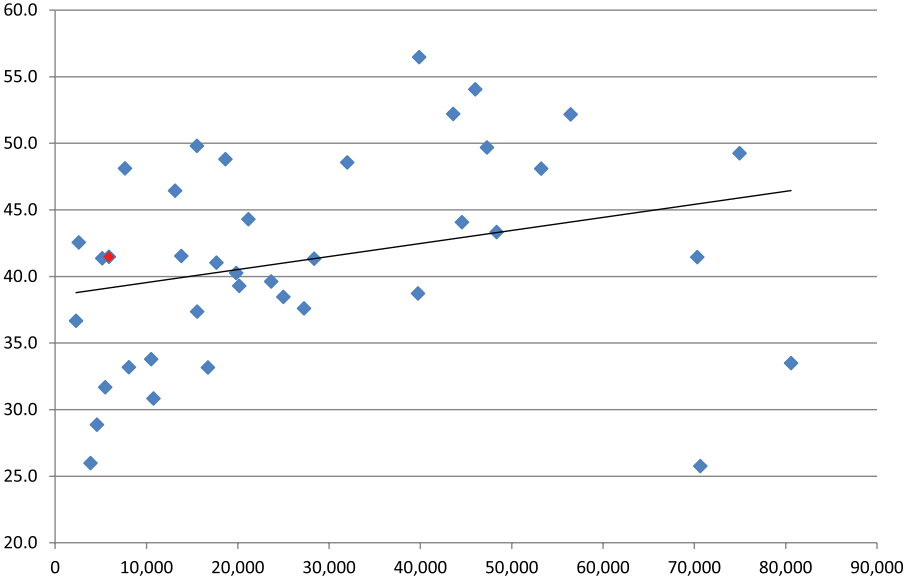
Salaries in the Public Sector and Pensions as %



Source: Ministry of Finance

In addition, public spending in Serbia is excessive, bearing in mind the level of development. Countries with a lower level of development have a lower level of public spending, and as their level of income increases, their level of public spending increases. Serbia, like most of the other countries of the former Yugoslavia, is deviating from this trend, with high of public spending despite its low income.

GDP level and level of public spending



Source: IMF, WEO.

Is the overall level of public spending important? If too much money is taken from the economy and citizens by means of tax, they are left with less money for savings and investments, without which there is no economic growth. There is public spending that is fostering and that is not fostering economic growth:

capital investments, for example, in the construction of infrastructure, such as roads or gas pipelines, increase economic growth as they encourage private investment. Spending for education (primary and secondary schools, faculties) for the creation of human capital due to acquiring knowledge and skills can also positively influence growth (provided, of course, that schools are of good quality). Public spending on current consumption, such as salaries, pensions and subsidies, on the other hand, has no positive impact on economic growth.

IF THE INCREASE OF SALARIES AND PENSIONS DOES NOT LEAD TO GROWTH, WHAT THEN?

Salaries and pensions are an important aspect of Serbia's public finances: individually they make up about half of the total public expenditures. Salaries of public sector employees should reflect a fair compensation for their efforts and commitment. On the other hand, this should be reconciled with the fact that the money for salaries in the public sector is taken from people who are also working hard to earn their salaries in the private sector. Pensions constitute the basic income of the vast majority of the population in old age, who were previously forced to pay social insurance contributions during the entirety of their working lives.

Because of all this, the level of salaries and pensions should not be the decision of politicians who will change them because of political support, but as a consequence of rules known in advance. The argument that this will make everything better for everyone because their increase will lead to economic growth especially is not true and has bad consequences. With a still very high public debt, and rising costs for pensions due to demographic change, any playing around with increases of these expenditures is highly irresponsible and can lead to a crisis in public finances and poses a risk to all citizens, including those¹⁷ who are getting a pay rise or pension increase.

2. The Myth of State Enterprises

State-owned enterprises can be as successful as private enterprises. In their operation they create new jobs and serve as an instrument of economic development for the country.

This myth offers a seemingly effective response to low economic growth, low investment and high unemployment in Serbia: state capitalism. It is based on the argument that management efficiency is not a matter of ownership, but management, and that therefore state enterprises can operate equally as well as private companies, it is only necessary to bring in the right people to manage.

The myth about the efficiency of state-owned enterprises leads to the support of policies that go against the privatization of the remaining state-owned enterprises, and support the protection of state-owned enterprises from domestic and foreign competition, higher public investment and state interference in economic activities.

ISOLATED CASES OF SUCCESSFUL MANAGEMENT DO NOT PROVE THE RULE

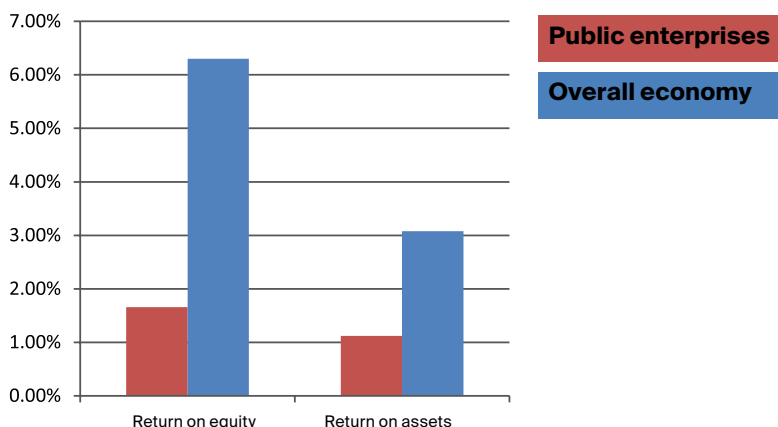
The myth about the efficiency of state-owned enterprises is based on the view that any management can be efficient or inefficient, and therefore the status of the equity does not have any impact on it. Here one can see the trap of inductive conclusion: it is just as possible to come across a successful state-owned enterprise, as it is easy to find examples of unsuccessful private companies. Observing isolated cases, however, does not necessarily indicate the correct conclusion. Instead, we have to look at the broader picture, that is, the whole set of state and private companies.

When you put things in this way, the picture becomes clearer: on average, private companies are significantly more efficient than those in state ownership.

PROBLEMS OF STATE ENTERPRISES IN SERBIA

This situation is easily visible in Serbia as well, since the media have dealt with the problem of state-owned enterprises for a long time. These companies have too many employees, employees often have significantly higher salaries than the average for the jobs they perform, and there is also a problem of party influence and nepotism in employment and fixing of tenders. In addition, the company's resources are used to finance political parties and personal wealth through corrupt public procurement, but also to exert influence on the media through advertising policy and the purchase of media services.

State-owned enterprises often have inadequate pricing and tolerance of losses or non-payment policies, due to which their incomes are insufficient for the necessary investments, while an additional problem is their inadequate business strategy, resulting in failed investments or in the implementation of poor business strategies. Because of this, state-owned enterprises are on average significantly less effective than privately owned companies, as shown by the data.



Source: Business Registers Agency

Even those state-owned companies that are considered to be very successful, because they have high incomes and profits, often lag behind their competition from the private sector.

Efficiency of selected telecommunication companies	Telenor	Telekom
Profit, in billions RSD	8,9	14,7
Number of employees	791	12,032
Return on equity	51.7%	19.7%
Return on assets	18.9%	5.7%

Source: Business Registers Agency

STATE ENTERPRISES AND POLITICAL PARTY MANAGEMENT

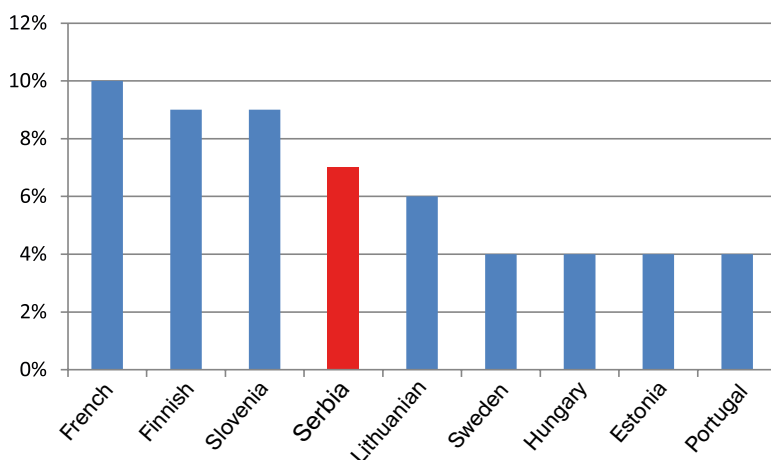
Why do state-owned companies display the above-mentioned weaknesses that affect their business? First of all, the process of setting up and controlling the management is inadequate, which is directly related to ownership. This process is governed by political parties, which are not guided by public interest, but by narrow political party interest. Thus, public enterprises become political party prey, and as their resources are important for financing political parties (through public procurements and recruitment of political party staff), this is a very important issue for the ruling parties, so the issue of the management of large public enterprises is part of the coalition agreement. The political parties are trying to place at the head of state enterprises loyal political party soldiers and not professional managers. That is why it is not surprising that the directors of state-owned enterprises are members and even high-ranking officials of political parties or, according to media reports, that they are in close friendship or nepotistic relations with political party leaders.

ARE THERE TOO MANY OR TOO FEW STATE-OWNED ENTERPRISES?

Opponents of privatization say that everything was sold out and that there are too few state-owned enterprises. However, when looking at comparable data from European countries, only Slovenia, France and Finland have as a percentage more employees

in state-owned enterprises than Serbia. In addition to local utilities enterprises (water supply, sewage, garbage collection, public transport) and public enterprises at the national level (Post of Serbia, Electrical Power Company of Serbia, Railways, EMS) there are also companies in the restructuring and privatization process (Resavica, Politika) as well as enterprises under majority state ownership (Telekom Serbia, Dunav Insurance Company, Postal Savings Bank) or companies in which the state holds a minority but significant share package (Komercijalna banka, NIS).

Share of state-owned enterprises at the central government level as a share of total employment



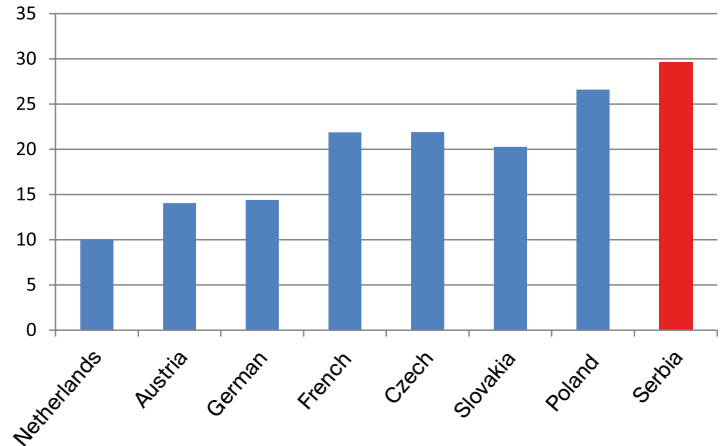
Source: State-Owned Enterprises in the EU, 2016

THE NECESSARY ENVIRONMENT FOR STATE-OWNED ENTERPRISES DOES NOT EXIST IN SERBIA

In what environment is there a greater chance for efficient state-owned enterprises? This exists in an environment that destimulates the described behaviour. These are the countries in which state ownership in the economy is rather an exception than a rule, so it is easier to control such cases. Frequently cited examples in the media about successful state-owned en-

terprises are actually those under minority state ownership and not under majority state ownership (e.g. A1, former Austrian Telekom, or Deutsche Post). Also, for the control of state-owned enterprises, freedom of the press is important to report on abusive practices. We would have never known about the rental of machinery in the open pit mine Kolubara that was in operation for more than 24 hours a day, were it not for the TV show Insider.

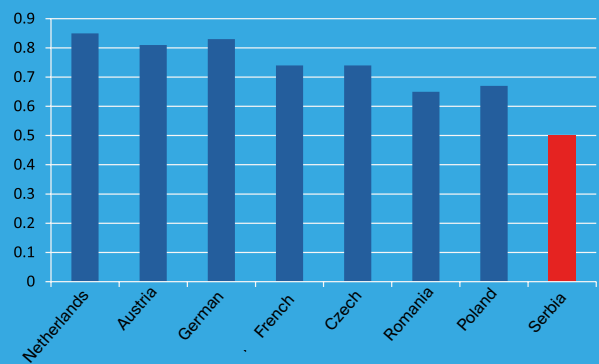
Freedom of the press in selected countries



Source: Freedomhouse, Freedom of the Press 2017

In addition to the freedom of the press, important factors are the rule of law, the level of corruption and the effectiveness of the state administration. The higher the degree of the rule of law, this means that laws are being implemented, the greater the chance for the management to be free from political party control in making business decisions.

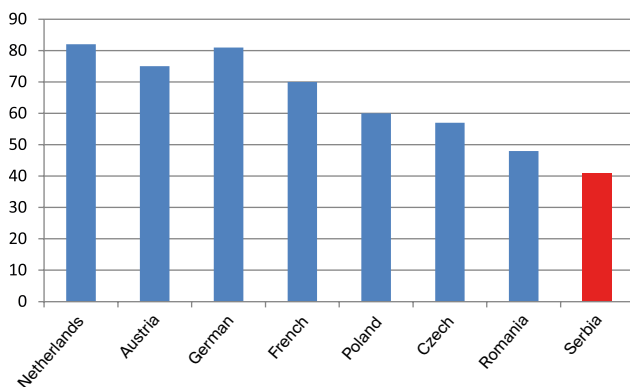
The level of the rule of law in selected countries



Source: World Justice Project, Rule of Law Index 2017.

The level of corruption is equally important - in a society where corruption is endemic, such as Serbia, the chances for setting up an adequate management and for non-involvement of political parties in the management of the enterprise, as well as bleeding out money for financing political campaigns are pretty slim.

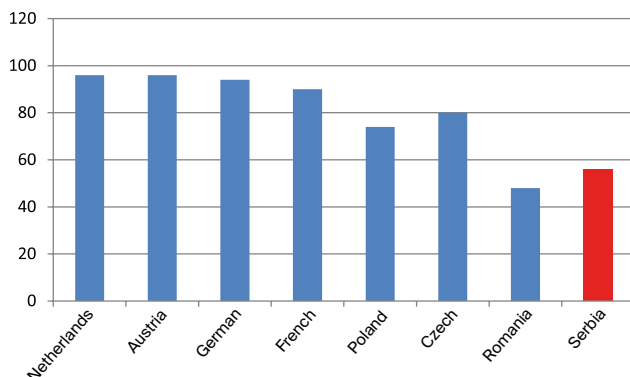
Level of corruption in selected countries



Source: Transparency International, Corruption Perception Index 2017.

The effectiveness of the administration is also important - state administration should formulate adequate rules and regulations, and then take care of their implementation. Only a professional and independent state administration can control the operations of state-owned enterprises.

Quality of administration in selected countries



Source: World Government Indicators, Government Effectiveness 2015.

IF NO STATE-OWNED ENTERPRISES, THEN WHAT?

As the data show, in Serbia, the political environment is such that it does not meet the minimum preconditions for the emergence of a successful state-owned enterprise. Data on the performance of the economy show this clearly. Instead of putting hopes into economic growth, we are placing new jobs and increase in salaries in state-owned enterprises. It is necessary to focus on creating the preconditions for private sector growth. The state has important roles to perform - judiciary, army, police, infrastructure, education, social policy - but playing the role of an entrepreneur with other people's money is not part of state authority.

State-owned enterprises operating on the market (Telekom, Dunav Insurance, Komercijalna Banka) should be privatized in a transparent and fair procedure. Local utility enterprises should be left to local governments to deal with. Possible solutions are public-private partnerships and management contracts with the private sector. For Republic public enterprises, there is an entire range of solutions - minority or majority privatization (through tenders or market presentation), professional management contracts, but above all with the liberalization of the market in order to enable competition that will facilitate the protection of consumers by reducing prices and increasing the quality of services. A particularly sensitive issue are the network industries (distribution of gas, electricity, rail infrastructure) due to the characteristics of natural monopoly (the existence of competition is inefficient, due to high fixed, and low marginal costs), which can be solved by regulation.

3. The Myth of State-Owned Banks

The state should own at least some domestic banks in order to foster investment and economic growth; state-owned banks are more interested in doing business within the domestic economy than with foreign private banks and can finance those projects that private banks would not otherwise finance.

This myth boils all problems of the Serbian economy down to the business activity of banks. Since they insufficiently finance the economy and have high interest rates, this limits economic growth. The myth of state-owned banks leads to the support for public policies that will go towards state control over the banking sector that would go beyond regulation, either through state-owned participation in a commercial bank, or by incorporating a specialized development bank.

LOW LEVEL OF INVESTMENT AND HIGH BUSINESS RISK

The myth of the necessity of state-owned banks relies on some accurate observations.

1. The investment level in Serbia is lower than in other comparable countries.
2. The lack of funding has been present for years as one of the obstacles to development, especially in small and medium-sized enterprises.

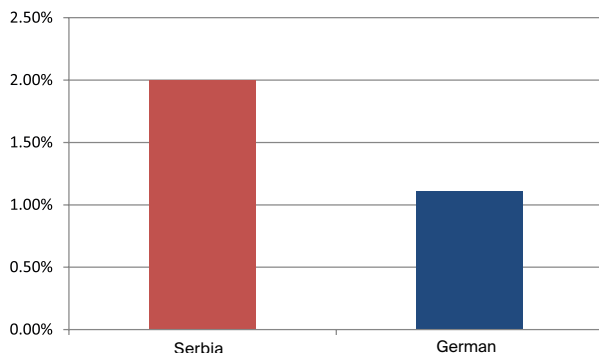
Ranking of access to financing are among the factors that have the highest negative impact on business in Serbia

Year	Ranking
2010	3
2011	4
2012	3
2013	3
2014	3
2015	2
2016	1
2017	4
2018	2

Source: Global Competitiveness Report, World Economic Forum.

3. Interest rates in Serbia are higher than in other European countries. This probably has implications for the investment potential of small enterprises. However, this is not a consequence of the fact that state-owned banks operate in Germany, and in Serbia private banks, but of the level of collection risk.

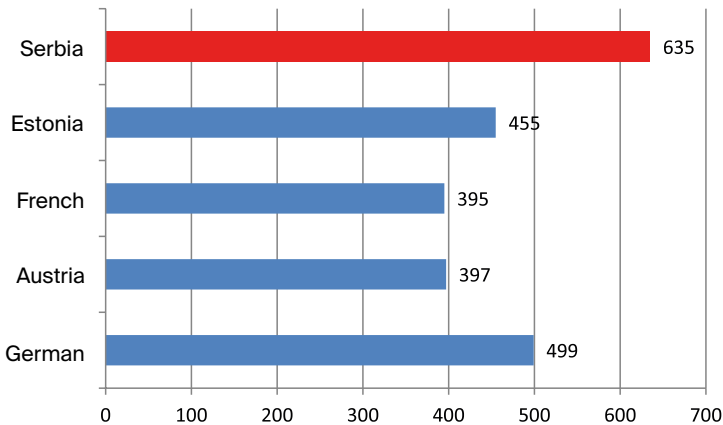
Interest rates on newly approved loans to businesses in euros



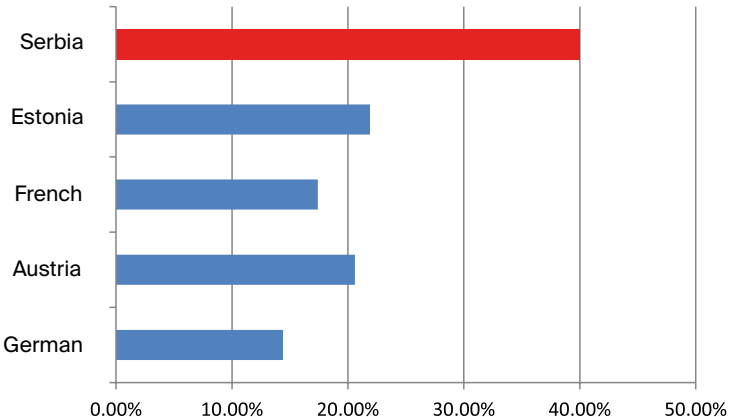
Source: European Central Bank and National Bank of Serbia

As the risk of doing business for banks is higher in Serbia than in Germany, since the collection of receivables is often significantly more difficult and more insecure, the higher risk of doing business must be reflected in a higher interest rate. If foreign banks would not be able to charge higher interest rates for their business than at home, they would not even invest their capital in Serbia, so all potential investment would have to come from domestic savings, which are at a low level. This would lead to the interest rates being far higher than today.

Duration of court proceedings in days



Court proceedings costs as part of receivables

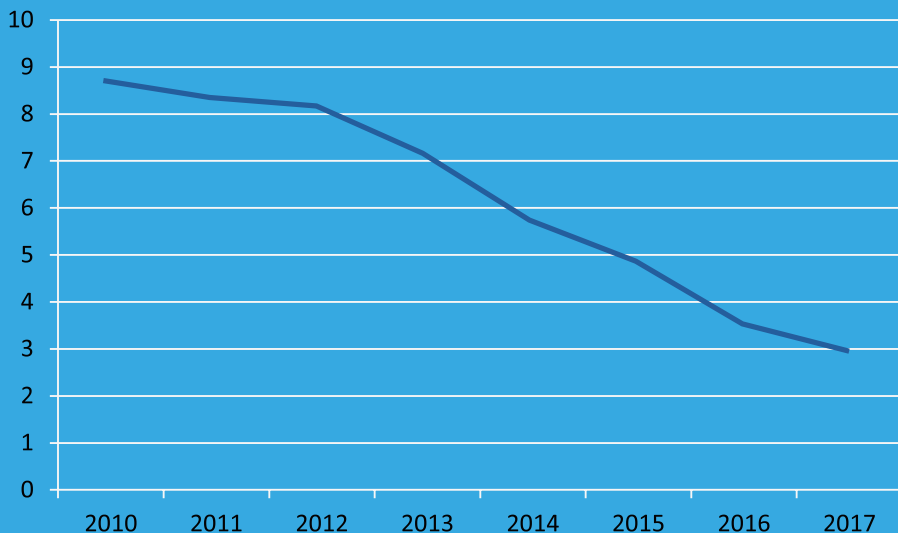


Source: World Bank, Doing Business 2018.

POLITICAL INFLUENCE AND CORRUPTION

In addition, interest rates are at a historical minimum due to the monetary policy of the European Central Bank. This spilled over to Serbia, where interest rates in banks are much lower than a few years ago. Therefore, if the interest rate is a problem, they are now at least significantly lower.

Interest rates on loans to companies indexed in euros



Source: National Bank of Serbia

The management of state banks faces the same problems as management in other state-owned enterprises, which are: political influence on operational decision-making, corruption and siphoning off of money for financing political parties, poor quality and unprofessional management. As a result, state-owned banks cannot conduct good lending policy: because of these

factors they often grant loans to those who are better connected with political parties in power, instead of those who can repay these loans, and as collateral, they take assets whose value is shown as much higher than it really is. Because of this, state-owned banks in Serbia have a very bad business history.

HOW IS THE SITUATION IN OUR STATE-OWNED BANKS?

Not only had state-owned banks gone bust during the 1990s, for which there is a justification in hyperinflation and international sanctions, but a number of state banks failed in 2012 also. The Development Bank of Vojvodina, Privredna banka Beograd, Srpska banka and Agrobanka are the only banks that went bankrupt in Serbia following the wave of privatization of the banking sector – these banks have one common characteristic, that the state was the single majority shareholder in all of them, so that it had a decisive influence on their business policy. Just these 4 bankrupt banks have caused damages to taxpayers in the amount of around EUR 800 million, because their state-guaranteed savings deposits have gone bust.

Currently in state ownership are the Postal Savings Bank (Poštanska Štedionica), Serbian Bank (Srpska banka) (reactivated following a capital increase), Komercijalna banka and Jubmes banka. How come these banks did not fail? The Postal Savings Bank was specialized for payment operations and not for lending to the economy, while in Komercijalna Banka, the Republic of Serbia, although it is the largest single shareholder, still has a counterweight in international financial institutions, such as the International Finance Corporation (IFC) and the European Bank for

Reconstruction and Development (EBRD), therefore, it could not influence the business policy of the bank to such an extent.

FUND FOR THE DEVELOPMENT OF MISCONCEPTIONS

If there are strong arguments claiming that the state's participation in commercial banking is unnecessary or counterproductive, what about a specialized Development Bank? It could provide funding to ventures that commercial banks would not do - investments in economically destroyed areas, in particular strategic industries and start-ups who have no business history or assets that they can offer as collateral.

The Republic of Serbia already has a specialized financial institution for these purposes - the Development Fund. This Fund was established already with the privatization of Telekom, but its performance is very bad due to the above-mentioned weaknesses in the state administration: one particular report of the Council for the fight against corruption dating from the year 2014 points out the political influence on the loan allocation process, which is why these funds were often allocated to individuals and large companies (often in state ownership) who were close to the ruling political parties.

IF NOT STATE-OWNED BANKS, THEN WHAT?

Instead of the state being directly involved in banking, it should deal with provision of the regulatory framework and respecting property rights and contracts. In a system where courts operate quickly and impartially, which makes it easy to collect debts, the risk of doing business in the country would be reduced and thus the risk premiums, which would be significantly lower than the interest rates. In the case of a specialized development bank, if the experience so far is an indicator, the same as in the case of state-owned commercial banks, only those who are politically well connected will have bene-³¹fits, while the overall costs will be paid by the private sector, to whom this policy originally intended to provide help.

4. The Myth of Subsidies as an Economic Development Instrument

In order to increase the volume of investments and thus accelerate economic growth and create more new jobs, it is necessary to attract private investments by giving subsidies from the state budget.

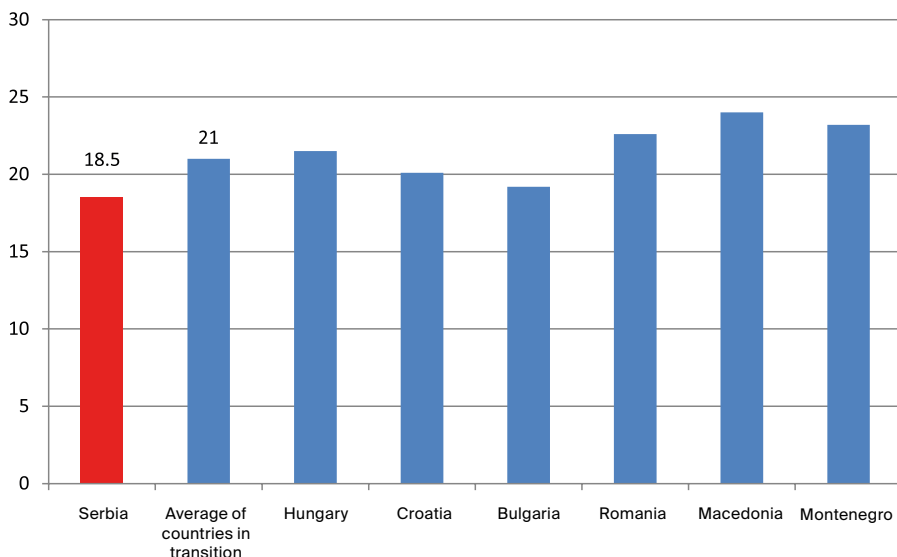
In order for state-owned enterprises to be able to continue their business operations, they need subsidies; this preserves the existing jobs and develops the economy.

The myth of the necessity of subsidies to increase investments offers a quick and easy solution to slow economic growth and unemployment. The myth of subsidies as an instrument for development and job creation creates support for public policies by which the state, through subsidies, but also through indirect benefits (such as tax exemption) attracts, but also streamlines investments in politically-selected regions or industries. Bearing in mind that subsidy programs are non-transparent and often kept secret because contracts were never published, it provides ample space for various forms of misuse and trading with political influence.

MUST WE HAVE SUBSIDIES BECAUSE OF LOW INVESTMENTS?

The myth of subsidies is based on some true beliefs. Above all, on the fact that the level of investment in Serbia is significantly lower than in comparable countries.

Share of investments in % of GDP in selected countries



Source: IMF, World Economic Outlook.

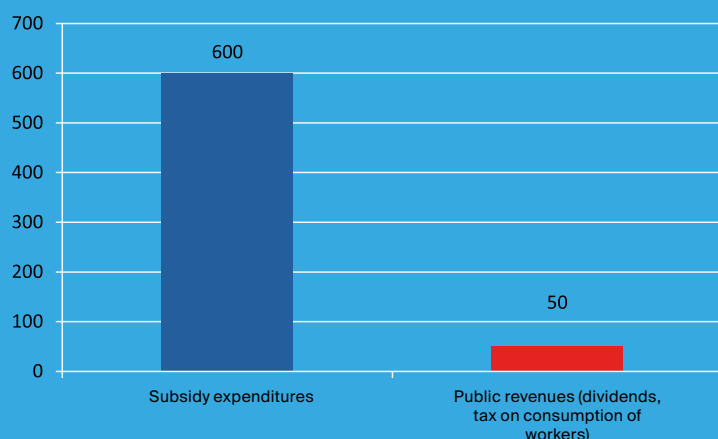
However, the myth of subsidies is also based on the incorrect premise that state money is free of charge, i.e. that it appears from nowhere, which of course is untrue. If the claim that a sum of 10,000 euros, when given to an entrepreneur, creates one single job, then the same claim must be true that one job is lost when the same amount of money is taken away from the entrepreneur. In order for the money to be distributed through the state budget, first it must be taken away from the economy, first the money is taken away from it, then it is given back to it. Thus, the economy is being returned to its earlier state, reduced by the costs of the subsidy program itself³³ (officials, paperwork and lost time), so the economy is in fact in a worse position than before the subsidy program.

The problem lies in the fact that the losses of the subsidy program are not easily visible, while the profits are easily noticeable, because everybody can see a newly built factory and the people employed in it, but they are both geographically and temporally concentrated. On the other hand, the losses of such policies are spread all over the territory of the country - the hairdresser in Bor, the panel beater in Užice, the farmer in Kula, the boiler manufacturer in Pećinci (who due to the amount of taxes could not expand their businesses and create new jobs or had to sack somebody) are invisible.

IS THE INVESTMENT RETURNED AND HOW?

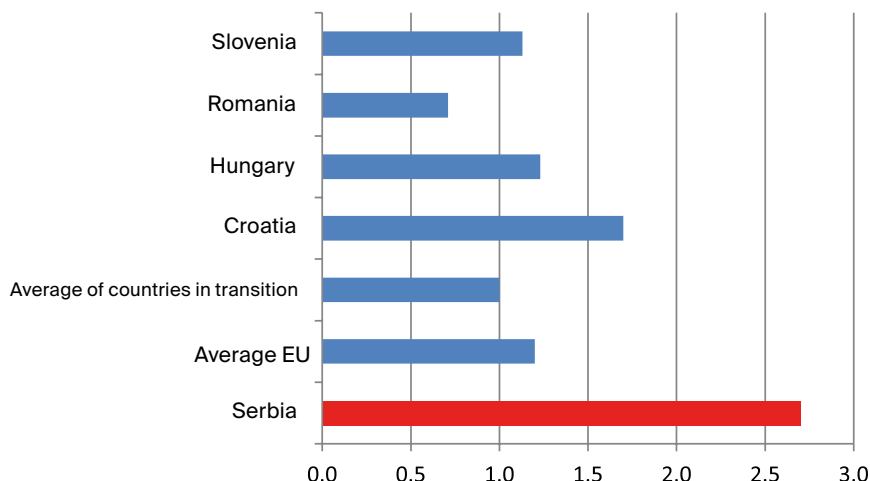
The argument that all subsidies can be quickly and easily returned through future public revenues from taxes and contributions is refuted by the fact that these companies are often exempted from paying taxes and contributions for a number of years. For example, Fiat Automobiles Serbia (FAS) in Kragujevac was exempted from paying all taxes and social contributions on workers' salaries (they were actually paid, but reimbursed at the end of the year), and profit tax and various smaller local taxes and fees.

Assessment of the ratio of provided subsidies and public revenues in the case of the company Fiat Automobiles Serbia



If subsidies were a good economic policy, all countries would use them abundantly. Besides the fact that, to a certain extent, subsidies are present also in other countries, Serbia is by volume the largest provider of subsidies in Europe. On average, Serbia gives about 3 times more subsidies than other former transition countries.

Subsidies level as % of GDP

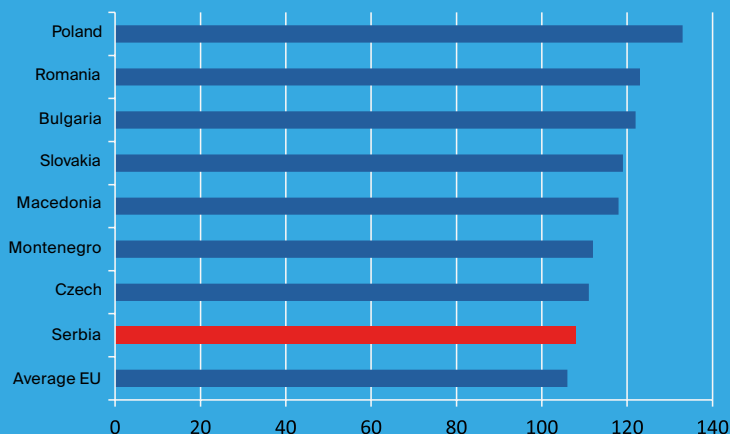


Source: Eurostat, Ministry of Finance.

One should not forget the distribution aspect of investment subsidies: in them, the money goes from the poor to the rich, that is, from the taxpayers of Serbia to the owners of subject companies, some of which have an annual turnover that exceeds the total gross domestic product of Serbia.

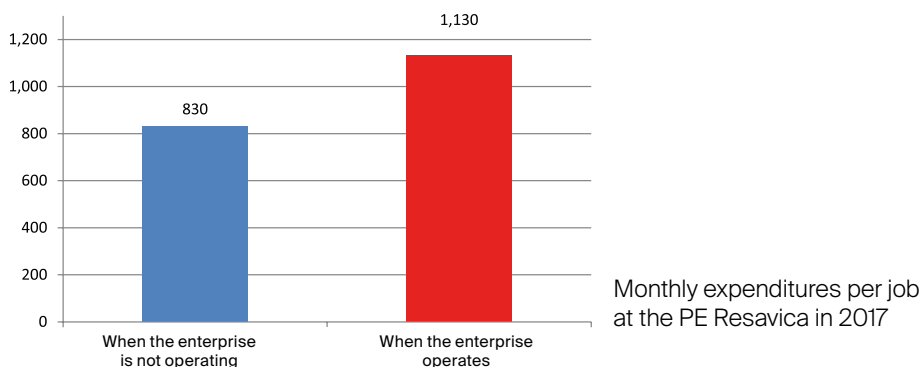
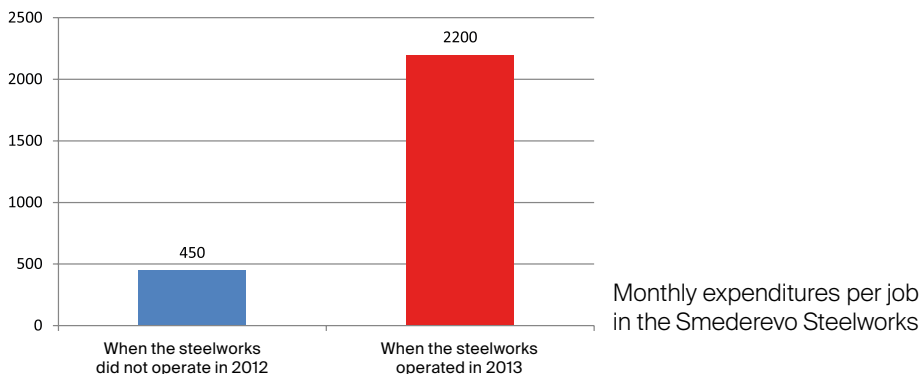
Despite such extensive use of subsidies, Serbia is a country that has recorded one of the lowest levels of economic growth in the past decade. Serbia has only in 2016 reached its per capita income level from before the crisis in 2008, which means that almost a full decade has passed without growth. On the other hand, other countries have experienced a significantly higher growth.

Cumulative economic growth 2008-2017, Index 2008 = 100



Source: IMF, WEO.

A particular issue are subsidies for state-owned enterprises, which are closely related to state management of these enterprises. Since such enterprises operate inefficiently - they have an excessive number of employees with often higher than average salaries (for example, unskilled workers in EPS Distribucija (Electric Power Company, Distribution Division) have higher salaries than teachers in schools, and those with secondary education almost twice the salary), they tolerate non-payment of services, network losses, they have low prices that do not cover all production costs, permanent issues of poor management and low investments - they often cannot cover all of their operating expenditures from the operating income, so they rely on state subsidies. Some of these companies are so inefficient that they cannot even earn enough money to pay the salaries to their employees. In extreme cases, it is even cheaper for workers to receive salaries without producing anything



WHAT ARE THE SUBSIDIES?

Entrepreneurial ventures thrive there where the business environment is good - where the courts function efficiently, where it is easy to collect receivables, where private property is safe. The subsidies should be abolished for the current operations of state-owned enterprises, and the solution for their business should be sought on a case by case basis: to introduce professional management, a minority or majority private shareholder, to close it down, if there are no interested parties, etc. State subsidies should be kept only in the event of the construction and maintenance of the necessary infrastructure in the network industries (e.g. rail³⁷ traffic, electrical power distribution). The subsidies for attracting foreign direct investments should also be completely abolished.

5. The Myth of Customs

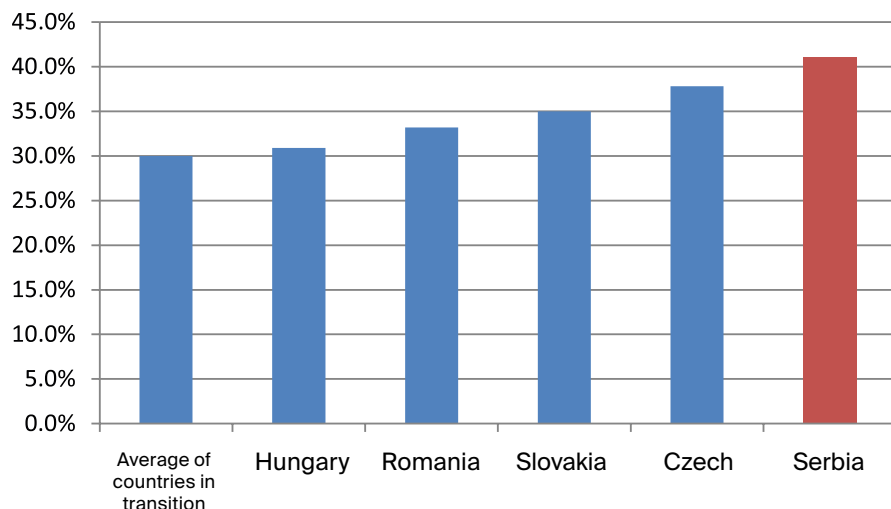
Customs are a necessary instrument for protecting domestic industries against competition from abroad. By introducing high customs duties on imports, there will be an increase in domestic industrial production, economic growth and new jobs will be created.

The myth of customs as a suitable instrument for industrialization offers a seemingly easy and sustainable solution for the poor state of the domestic industry. This myth is based on the view that state officials are able to successfully evaluate the development opportunities of different industries and to choose to protect those with high growth potential. This myth also ignores comparative advantages in the economy.

Such a policy of protecting selected industries against competition from abroad is called an import subsidy. The myth of customs as an adequate economic development instrument leads to support for public policy makers who advocate the introduction of discriminatory import customs on all or selected industrial products into Serbia, or to make imports difficult through non-customs barriers or quota restrictions.

The level of industrial production in Serbia is lower than it was before the transition, despite the growth of this sector that followed the economic and democratic changes in 2000. Industry in Serbia, however, does not perform lower in GDP than is the case in comparable countries, in particular in comparison with more successful transition countries.

Participation of industry in creating GDP



Source: CIA Factbook.

THE ECONOMY HAS NOT COLLAPSED BECAUSE OF TRADE LIBERALIZATION

The main reason for the collapse of the industry in Serbia was not the trade liberalization that came after 2000, but due to the bad state of the whole economy, and consequently of industry, due to the wars during the break-up of Yugoslavia: the economy in Serbia experienced many years of sanctions, plus the collapse of the common Yugoslav market as well as the large market of the former USSR, to which, until then, it had a privileged access compared with other non-socialist countries.

The lost decade in transition meant that there were no direct foreign investments, that were present in other transition countries, and thus there was no technology transfer. How important this technology transfer is can be seen in the fact that the Zastava Car Factory in Kragujevac had in 1989 over 50,000 employees, but that the same factory in 2017 employed only 2,400 workers (with another 1,000 employees in automotive component parts manufacturers), because it uses new technology, including robots in the production.

The argument that customs are a good policy for the development of the industry is based on the view that these trade barriers will ensure the domestic market for domestic producers. However, as it has been shown so far, this policy will not lead to economic development: would the domestic companies be competitive to foreign companies by prices and quality of their products, they would already produce not only for the domestic market but also for exports. Consequently, the domestic industry, isolated from the world by customs, would become uncompetitive, because there is no need to adapt to competitive pressure.

CUSTOMS PROTECTION HAS A SERIOUS PRICE

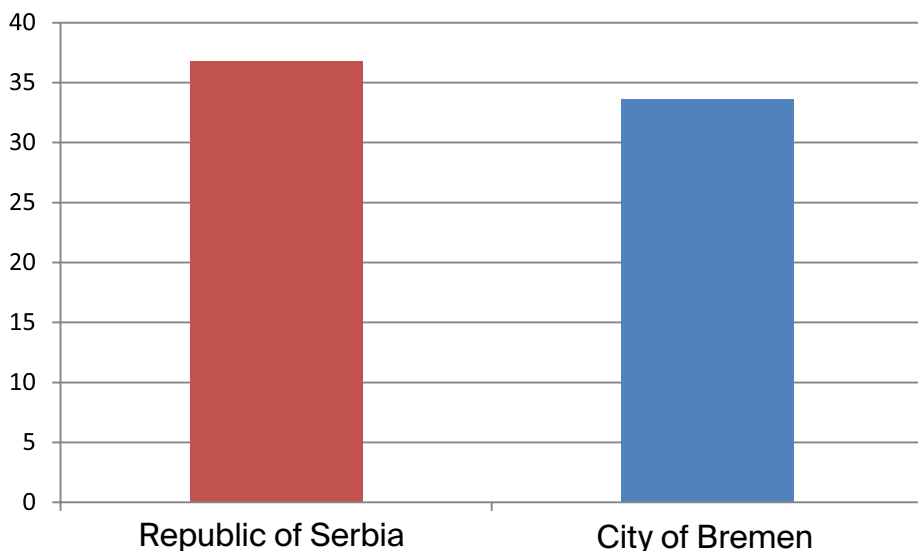
Another important problem is that this customs protection will lead to the price increase of protected products. It is true that the producers will therefore have higher revenues, but the fact is ignored that these revenues did not appear out of the blue, but from the pockets of domestic consumers. All the higher revenues of the producers are equal to the decrease of income of consumers, therefore at the level of the economy there is no creation of new values, but only distribution from one area to another. This will have a negative impact on other industries, as consumers now have a lower available income than before and therefore reduce consumption of other products.

Anecdotal examples of some countries that have applied import substitution in some industries as evidence that such a policy produces good results is not adequate. Primarily because only successful examples of countries that have implemented this policy are mentioned (Japan, South Korea, Taiwan), while there are also a large number of other countries that have applied (or still apply) this policy without having had positive results (e.g. India and Russia). In order to have a true view of the

results of the import substitution policy, it is necessary to observe its application in all countries and then to draw conclusions.

A particular problem in the implementation of this policy is the small capacity of the Serbian market. Serbia is a country with a small population (only 7,000,000) with low purchasing power (with a GDP of only \$ 5,000 per capita). The entire annual GDP of Serbia is close to the GDP of the German city of Bremen, which has fewer than 700,000 inhabitants. As a result, it is difficult to imagine that such a shallow domestic market can lead to rational production of industrial products. If a high customs duty on imports of mobile phones would be introduced, would it really result in the opening of a mobile smartphone factory somewhere in Serbia?

GDP of Serbia and GDP of the city of Bremen

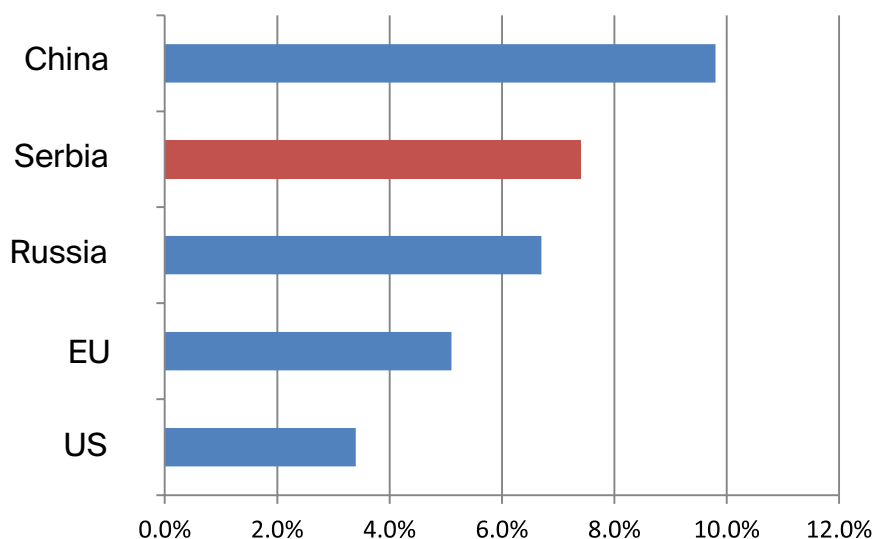


Source: National Bank of Serbia and Wikipedia.

Customs duties on imports to Serbia are relatively low. Also, trade agreements have been signed with the largest trading partners,⁴¹ with the European Union, the Russian Federation, Turkey and the countries of the region within the CEFTA agreement, which provide

duty-free or preferential customs treatment of goods coming from these countries (and accordingly, goods exported from Serbs to them). However, Serbia is still one of the few countries that are not members of the World Trade Organization, within Europe, together with Bosnia and Herzegovina and Belarus, while members of this international organization that support free trade are almost all other countries of the world, including China and Russian Federation. Hence, there is still room for import duties to be reduced.

Average applied customs duty rates



Source: World Trade Organization.

In the event of a change in trade policy and the increase of customs duties, this can very easily lead to a change in the policy of trading partners that will be affected by these measures, which will endanger Serbian exports. Such a policy would certainly trigger a sharp reaction from the European Union whose countries conduct a common trade policy, as well as stop the further EU accession process.

IF CUSTOMS DUTIES ARE A MYTH, THEN WHAT?

Customs duties and other import restrictions do not lead to the development of industry, economic growth and job creation, but to economic ossification and redistribution of income. In order for the industry to be able to develop in Serbia, a good business environment is required to enable this, and not a protection from foreign competition. The answer to the question about what, where, how and for whom they can produce can only be given by entrepreneurs who assume the risk of doing business, and not by civil servants sitting in their offices. In today's modern, integrated and globalized economy, any trade restrictions will yield only poor results. The best example of such a policy is China, which has been closed to the world for decades, to open up to it, which resulted in economic prosperity.

6. The Myth of Trade Deficit

A trade deficit is a bad thing and has a negative impact on the Serbian economy; In foreign trade, Serbia must make a trade surplus, so it can develop.

A trade surplus is often presented to the public as a positive and desirable outcome, in contrast to a trade deficit that is viewed as a negative, unwanted outcome. This myth is based on a deep lack of understanding of trade and considers trade as a behaviour resulting in a zero-sum: One man's loss is another man's gain; In trade there is always one party that is gaining and one party that is losing. The myth of trade deficit leads to the support for public policies based on import substitution (customs duties, quantitative restrictions) and the prevention of further liberalization of foreign trade (membership in the World Trade Organization) and subsidies for the protection of domestic enterprises. These policies do not result in the growth of the economy and living standard, but on the contrary, lead to a reduction in the prosperity of the inhabitants of the whole country, at the expense of a small number of workers in the protected industries.

FREE TRADE DOES NOT FUNCTION AS A WAR

Trade is a positive transaction – a win-win situation for both parties; It is completely irrelevant whether the trade takes place within the same political community or between the residents of two different ones. The exchange is always taking place between individuals or businesses, not the countries themselves. Consequently, a trade surplus or deficit by itself has no negative or positive characteristics. The surplus or

deficit are only accounting statements of the factual situation in all trade transactions between residents of a country with foreign countries. As soon as all of these transactions have occurred with the free will of those who have completed them, we can claim that they have contributed to the increase in the welfare of all parties, since no one would like to voluntarily partake in a transaction in which he would lose money.

The trade deficit in Serbia is viewed as the cause of some deeper problem: It is generally thought that the imports are so high because we do not produce enough ourselves. Therefore, if we did not import something, we would have to produce it in our country, which would create new jobs, increase the salaries and lead to economic growth.

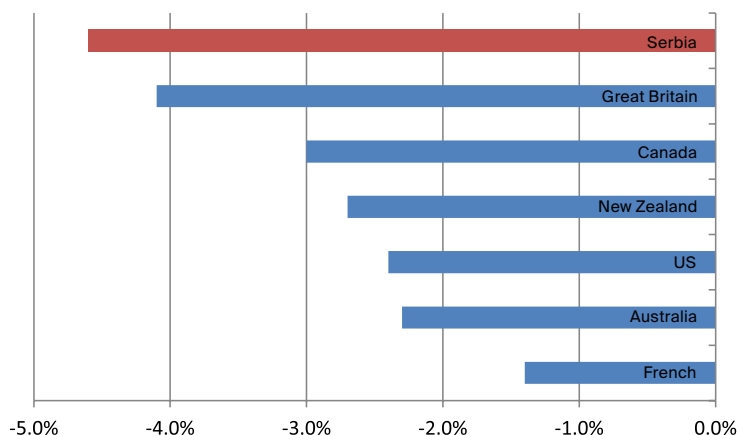
ADVANTAGES AND RESTRICTIONS OF INTERNATIONAL TRADE

This attitude that promotes the economic growth policy by substitution of imports ignores the absolute and comparative advantages and benefits of specialization in trade. Try not to buy bananas from abroad but plant them yourself in Serbia and you will see the importance of absolute advantages in international trade. Also, do not buy bread in the bakery, but rather sow wheat, mill it into flour, then make the dough and bake it in the oven and you will appreciate the magic of comparative trade advantages.

Reducing the trade deficit will not lead to a growth in prosperity but will have the opposite effect. If the import of some goods is restricted, they will become more expensive. It may even be produced in Serbia, but this production will be inefficient in relation to foreign competition (otherwise it would have been produced in Serbia from the very beginning, and no help would be needed), so the product itself would be of lesser quality or more expensive. The consumer would have to pay for such a product more money than if it was in free trade. These effects will be greater if it is not a simple consumer product, but a production input in some industry with a higher degree of added value: The customs duty on imports of powdered milk did not increase the production of domestic milk but has limited the production of domestic chocolates and candy that use powdered milk as a raw mate-

rial. Thus, the domestic confectionery industry was less competitive than the production from abroad, so that this policy has not only reduced, but even increased the trade deficit (since domestic confectionery was more expensive, it has encouraged imports and made exports more difficult). The trade deficit is not a sign of an uncompetitive domestic economy and a low standard of living. The United States, like most other developed countries, has for years or decades had trade deficits, but the quality of life in them is high and continues to improve.

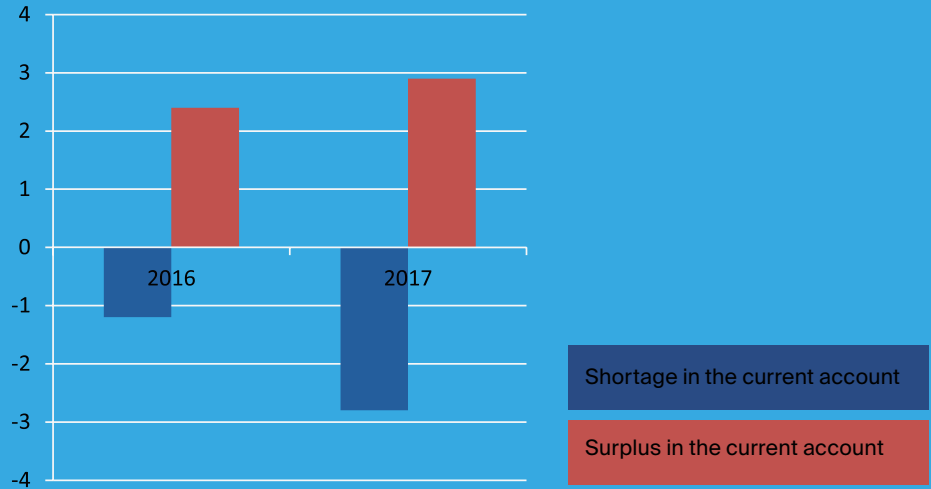
Trade balance of selected developed countries, in % of GDP in 2017



Source: International Monetary Fund, World Economic Outlook database.

Also, the trade deficit is not a cause, but a consequence. Balance of payments consists of current (trade) and capital account. While the current account records movements of goods and services, the capital account records the movement of capital, in the form of foreign direct or portfolio investments and foreign loans. Bearing in mind that the balance of payments is conceived as a dual bookkeeping system, each asset or receivable has its own liability, i.e. the countries who have a deficit in the current account always have a surplus in the capital account, and vice versa.

Balance of payments of Serbia, in billions of USD



Source: International Monetary Fund, Balance of Payments Statistics.

IF ONE SHOULD NOT PLAY WITH THE TRADE DEFICIT, WHAT THEN?

Any trade restriction aimed at the reduction of the trade deficit will not produce a positive economic impact. Protectionist measures are making the products more expensive, whose market is “protected” and this will affect all industries that use them in their production, therefore they will produce less and export them. Because of the higher price, consumers will also consume less. Instead of instruments that limit trade in order to reduce the trade deficit, it is necessary to create preconditions for the domestic economy to grow and develop. This will allow domestic companies to compete on foreign markets, and naturally the increase⁴⁷ of exports will occur. However, if the domestic business environment is bad, no measures will lead to an increase in exports.

7. The Myth of Agriculture

Agriculture is a development opportunity for faster development of Serbia's economy. The development of agriculture will result in the increase of income and the catching up the level of development of other European countries.

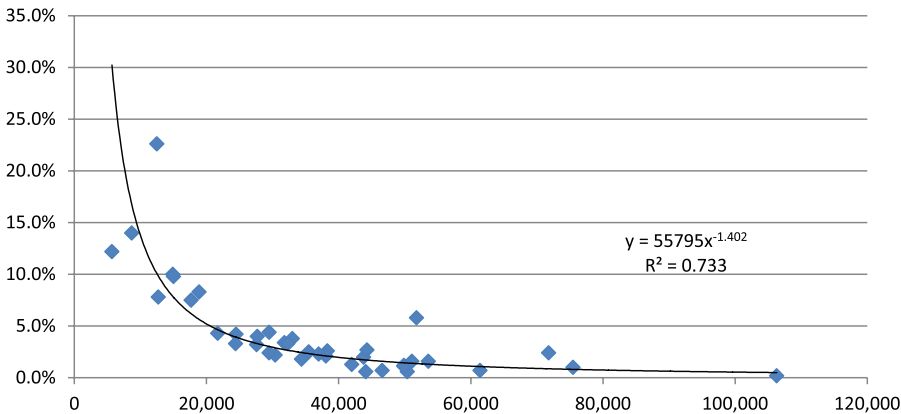
This myth provides an easy and quick solution to the problems in the Serbian economy, offering a magical solution for its growth, which is the development of agriculture. Agriculture in Serbia is seemingly successful and provides a strong basis for achieving the level of income of developed countries. In the opinion of the supporters of this myth, its development will create new jobs, increase salaries and exports. The myth of agriculture leads to the support of certain public policies that are aimed at fostering the development of agriculture. They are mainly based on:

1. Increasing subsidies for agricultural production,
2. Investments in increase of irrigation,
3. Creation of state purchasing centers that would guarantee the purchase and price of agricultural products,
4. Policy of protecting domestic farmers against competition from imports in order to create space for domestic agricultural production.

A STRONG VILLAGE DOES NOT NECESSARILY MEAN THAT THE ECONOMY IS STRONG

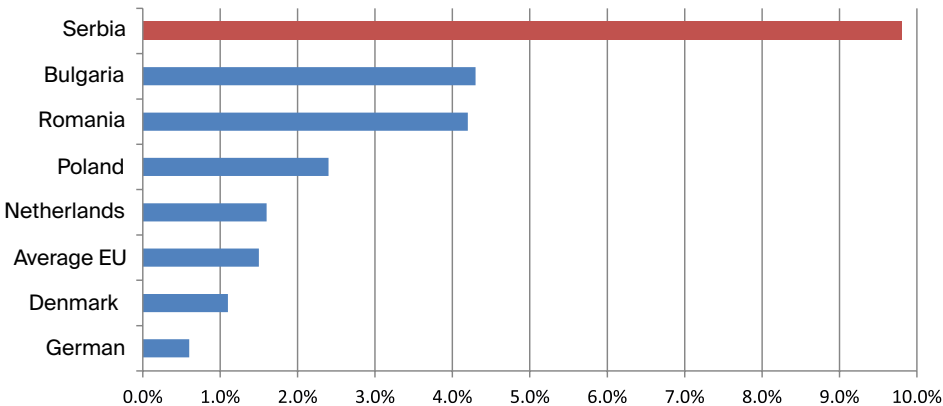
The economic argumentation of the myth of agriculture as a development opportunity is based on the view that growth generated by the development of agriculture is sufficient for a significant enough increase in income. This claim can be easily empirically verified - it is only necessary to find an agricultural country with a high income level. Unfortunately, the situation is completely the opposite: Countries where agriculture makes up a high proportion of income (measured by GDP level) have a significantly lower level of development.

Income level and share of agriculture in the GDP



Source: IMF and World Bank

Share of agriculture in the creation of the GDP in selected countries



Source: World Bank

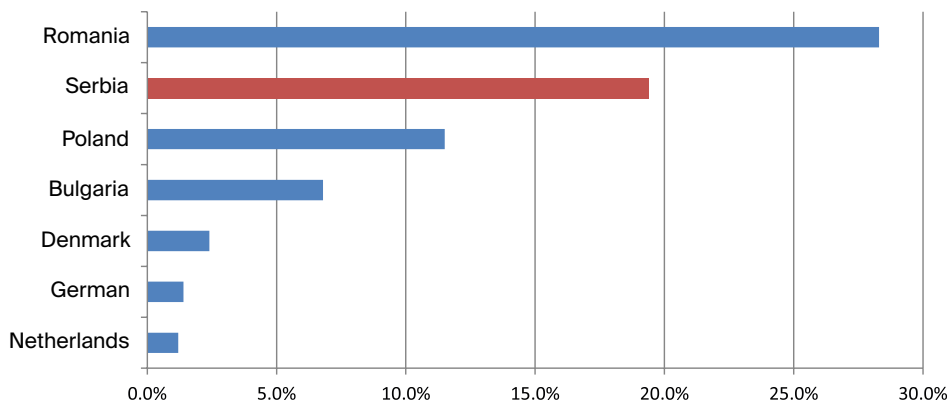
Developed countries owe their income level, above all, to industries and services, and not to agriculture, in which only a small part of the workforce is active and which accounts for only a small share of GDP. In fact, as the countries developed, an increasing number of workers went from agriculture to other economic sectors, first industry and then services.

SENTIMENTAL ASSOCIATIONS VERSUS CONTEMPORARY INNOVATIONS

In addition to the economic argumentation itself, the myth is based also on the sentimental view of agriculture, not as a modern economic activity in which modern technical measures are applied aimed at increasing the yields, but as an activity that is organically linked to the country and identity. In addition to that, an important segment is personal family history - the majority of the Serbian population lived in villages until the Second World War. The emotional connection with the village has survived the move to the city, because at least one part of the family has stayed in the village to work the land. That is why agriculture invokes the memories of summer holidays spent with grandparents in the countryside, and not of what it in reality is - a business of producing food for the purpose of generating profit.

Such positions can be nicely illustrated by the recent opinion research of students' views in Serbia (Libek 2018), where 63% of respondents consider agriculture as a development opportunity, whereby this generation has grown up on the Internet and on mobile phones.

Participation of agriculture in employment in selected countries

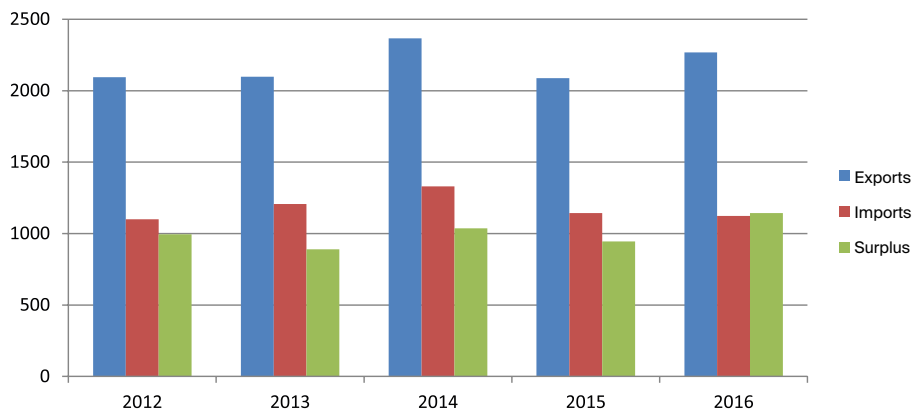


Source: CIA Factbook.

IS A SURPLUS IN THE AGRICULTURAL SECTOR SUFFICIENT TO INITIATE THE DEVELOPMENT?

Also, it is often considered that Serbia abounds with comparative advantage in agricultural production - a large number of inhabitants still live in the countryside, and the soil is fertile. There is also a tradition of agricultural production and the processing industry. The industry has failed to recover in the aftermath of the transition processes - a large number of former factories were closed down and a large number of workers lost their jobs due to reduced production, but also due to technological progress and increased use of machines. At the same time, the agricultural sector is one of the few sectors in Serbia that continuously register a surplus in international trade.

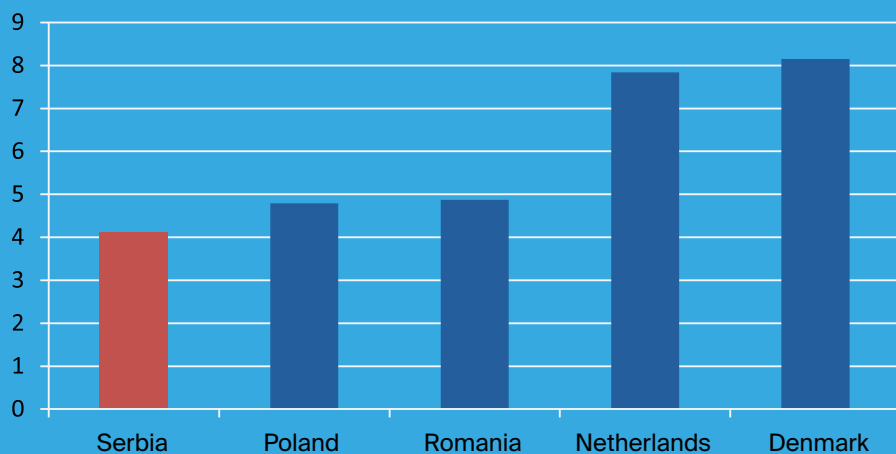
Trade of agricultural products, in millions of USD



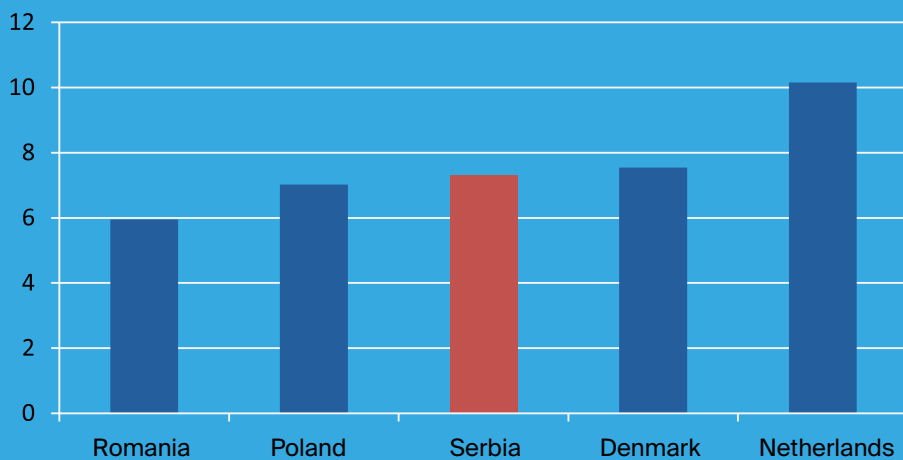
Source: The Statistical Office of the Republic of Serbia.

This surplus is yet another argument for claims that agriculture is an opportunity for development. However, this surplus is not based on the strong effect of Serbian agriculture, but on the low level of import of agricultural products due to the low purchasing power of the population. If more citizens would have higher incomes, and if more expensive agricultural products would be imported in Serbia, as is the case with other European countries, such as tropical fruits, Italian and French cheeses and cured meat products and alcoholic beverages, this surplus would have quickly melted. Therefore, it is much better to compare the performance of Serbian agriculture with yield per hectare. Unfortunately, this data shows that Serbian agriculture is also in this parameter significantly lagging behind developed European countries.

Wheat

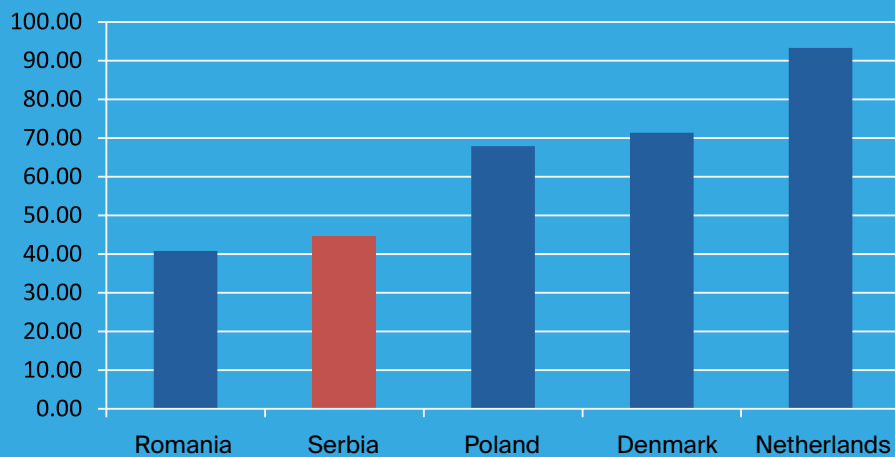


Maize



Source: Eurostat.

Sugar beet



Izvor: Eurostat.

IF IT IS A MYTH THAT AGRICULTURE IS A CHANCE FOR ECONOMIC DEVELOPMENT, THEN WHAT?

Agriculture is an important segment of the Serbian economy and commands a significant share in employment (both formal and informal) and GDP creation. Agriculture in Serbia, however, is not at the level of developed European countries and it is significantly lagging behind the solutions being applied there. Modern agriculture is increasingly based on the application of new technological solutions and highly specialized know-how.

Agriculture in Serbia certainly has room for progress and development, but this sector by itself cannot lead to the increase of income and the achievement of the standard of developed countries. As shown by the example of developed countries, this is possible only through the development of industry and services. In order to achieve this, it is necessary to create a business environment that will encourage entrepreneurial initiatives in all sectors.

8. The Myth of Printing Money

Printing money, also known as “monetary expansion”, can provide funds for investment and development projects, or the missing funds can be provided from existing foreign exchange reserves.

Printing money or using foreign exchange reserves provides an easy solution for the problem of lack of funds for development projects and investments. The money is there, the supporters of this myth claim, and should be used instead of just lying there in the form of securities or in bank accounts, or it should simply be printed. This myth leads to the support of public policies that involve state investments and enterprises, or development funds (through which these funds would be placed in the economy or projects for financing would be selected).

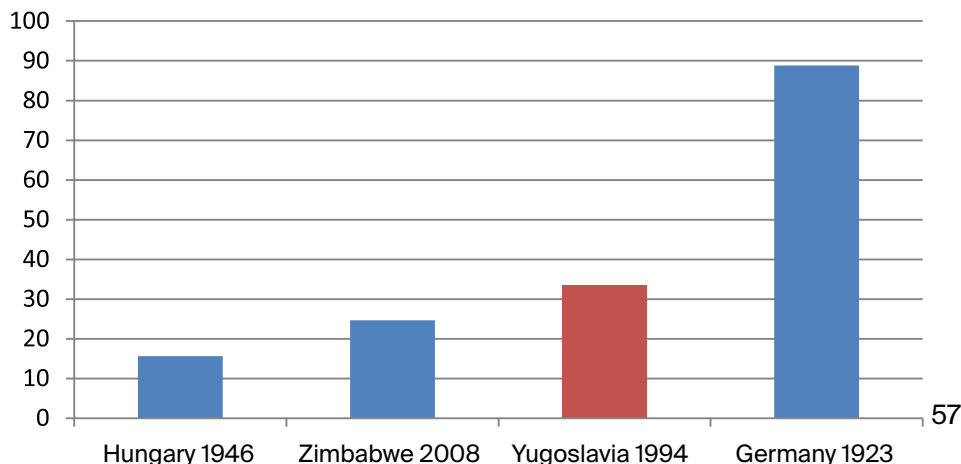
PRINTING MONEY GENERATES INFLATION

Arguments on printing money as an instrument that would provide investment funds ignore the link between the amount of money in circulation and the price level. As Milton Friedman, who won the Nobel Prize for his research in the area of monetary policy said: Inflation is always and everywhere a monetary phenomenon. Inflation, therefore, is not a natural disaster, which occurred due to some force majeure, but a direct consequence of monetary policy. In other words, the increase in the amount of money in circulation (created by the loose monetary policy or direct printing of money) will lead to inflation, i.e. to a general price increase.

Inflation will have very negative economic consequences. General price increase will reduce the purchasing power of all, both individuals and businesses. It is destimulating to savings, because money will be worth less in the future than today. It also makes the redistribution of assets from creditors to debtors, as they now repaying their debts that, although they are in the nominal amount the same, their amounts are in real terms impaired. Inflation carries very real costs to the economy, creating insecurity and eliminating the possibility of entrepreneurial calculations of the profitability of entrepreneurial projects. During 1993, the Federal Republic of Yugoslavia (FRY) experienced one of the highest recorded hyperinflations in the history of the world: with a daily inflation of 64%, the prices doubled every 1.4 days, while the total inflation rate amounted to 31.3 million percent. If inflation does not have any negative economic consequences, this age would not be remembered as a period of poverty and shortages, but of richness and abundance.

The highest recorded hyperinflation in the world

Number of hours required for the prices to double

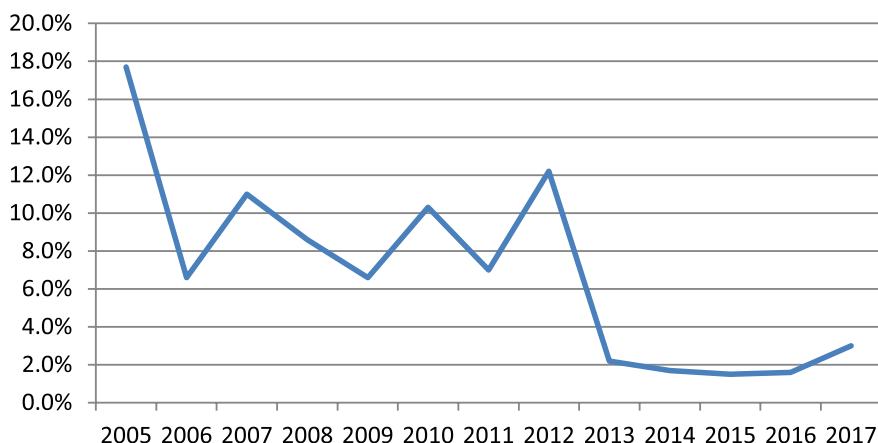


Source: Wikipedia.

Due to this historical experience, people switched to using foreign currency – the German mark, then the euro – since they preserved their purchasing power. Today, a quarter of a century since the hyperinflation, the dinar is the means of payment for most people in Serbia just because the legal regulations require it, while prices, salaries and other expenditures are calculated in euros.

Unfortunately, Serbia even after this has no experience of low and stable inflation. Only in the recent few years has the inflation been stable and low.

Annual inflation rate

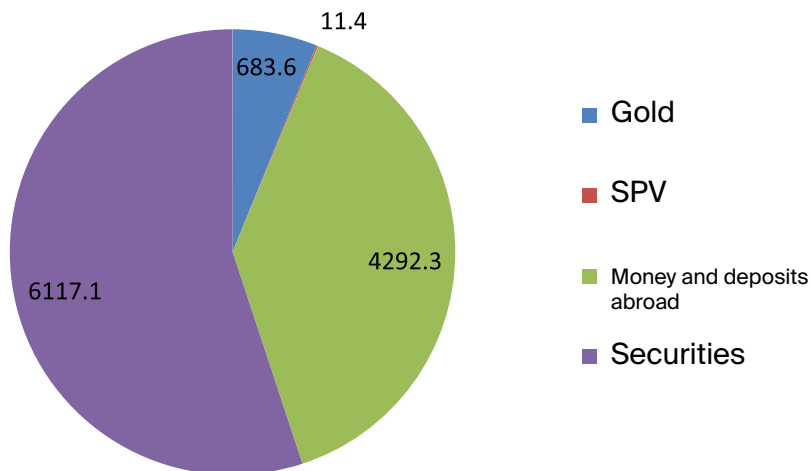


Source: National Bank of Serbia

USE OF FOREIGN RESERVES DISTURBS THE EXCHANGE RATE OF THE DINAR – A THREAT TO THE EXPORTS AND POTENTIAL FOR INFLATION

Komplementarna politika jeste korišćenje deviznih rezervi. Ovakav potez ne zahteva štampanje dinara koji bi se puštali u promet i koristili za finansiranje investicija, već korišćenje već postojećih deviznih sredstava. Devizne rezerve su devizna potraživanja koja su pod kontrolom Narodne banke Srbije (monetarno zlato, specijalna prava vučenja kod MMF-a, ali pre svega hartije od vrednosti denominovane u stranoj valuti). Uloga deviznih rezervi je da po potrebi posluže za nesmetanu ekonomsku saradnju sa inostranstvom: za uvoz su potrebne devize, kao i za vraćanje inostranih kredita.

Level of foreign exchange, in millions of euros, 30th June 2018



Source: National Bank of Serbia.

If the foreign exchange reserves were to be used for investments and other development programs, this would have an impact on the exchange rate. The dinar is located in a dirty managed exchange rate system - which means that the National Bank is actively buying and selling foreign exchange but does not defend a certain level of the exchange rate, as in a fixed exchange rate, but only prevents excessive oscillations. So, the exchange rate can rise and fall, due to supply and demand for dinars and foreign exchange. In the event of a rise in the quantity of foreign exchange (originating from foreign exchange reserves), and with the same quantity of dinar, the value of the dinar in relation to the euro will rise. This scenario will have negative consequences for exports from Serbia, because in real terms it will become more expensive, while imports will be cheaper.

In order to preserve the value of the exchange rate, the National Bank may intervene in the market by increasing the quantity of dinars. As long as the rise of the dinar is accompanied by the rise of foreign exchange, the exchange rate will remain unchanged. This would avoid negative consequences for exports. However, this increased quantity of dinars will lead us to the scenario from the beginning of the story: it will generate inflation.

IF THE PRINTING OF MONEY AND THE SPENDING OF FOREIGN EXCHANGE RESERVES IS NOT A SOLUTION, THEN WHAT IS?

Macroeconomic stability, as well as price stability, is very important for the economic development of the country. Only with growth we can have higher salaries and a better standard of living. In the case of high inflation, entrepreneurial tax calculation is impossible, savings are melting, and the economy faces serious difficulties. If salaries and pensions are not accompanying the general price increases, this leads to a drop in living standards. That's why we should not play with fire – in order not to burn our fingers, as it was already the case before.

The policy of spending foreign exchange reserves for something other than their basic purpose of facilitating unhindered economic relations with foreign countries would be a dangerous signal to domestic and foreign entrepreneurs that on the domestic market the generally accepted rules of conduct were suspended, which would increase uncertainty for doing business.

As a result, there would be even less investment, and the interest rates would increase even more. For Serbia, it is best to conduct a neutral monetary policy that will allow inflation to be low and predictable.

9. The Myth of Economic Cooperation with Russia as an Unused Potential

Economic co-operation with the Russian Federation is an unused opportunity for economic development through increase of exports of Serbian products to the Russian market, and the attraction of Russian investment.

The myth about economic development relying on co-operation with the Russian Federation offers easy answers, which are based on several false assumptions. One of them is that the Russian market is large and rich, and unusually open to products from Serbia, and while Serbia refuses to use these economic opportunities and wants to cooperate with the Western countries, to which it has nothing to offer or which they do not even want to cooperate with Serbia.

FRIENDLY RELATIONS WITH RUSSIA DO NOT NECESSARILY NEED TO HAVE ANY CONNECTION WITH ECONOMIC COOPERATION

In addition to several poorly-placed economic arguments, this thesis rests primarily on the foreign policy orientation of the advocates themselves. Despite the fact, that they do not necessarily have to be against the membership of Serbia in the European Union, such views are common among them. The conclusion of the significance of Russia as a great world military and political power with which we have (at least in theory) good political relations, is transferred onto the economic sphere. Russia is seen from this perspective as a great power that will help Serbia in its fight for its territorial integrity in relation to the status of Kosovo and Metohija, and as the only one who is

able to counter the interests and resources of the United States in the Balkans. Such preconceptions are the source of the views on the need for greater economic cooperation with Russia and the increase of exports to the Russian market.

Three things are important for the volume of trade between countries:

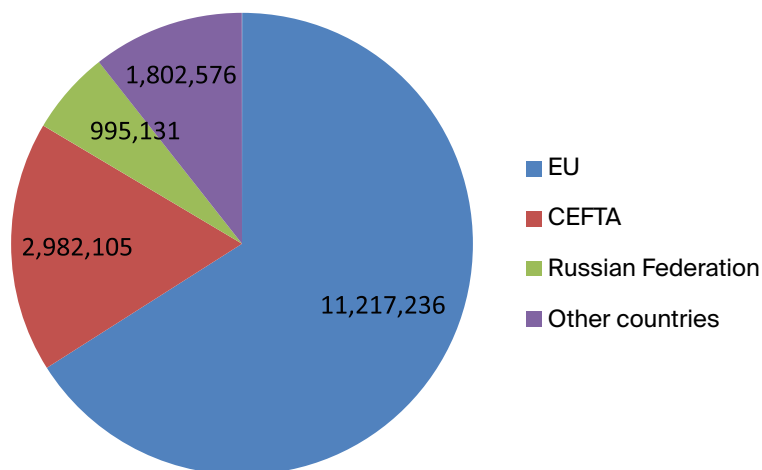
1. Size of the market,
2. Geographical distance, and
3. Complementarity of the economies.

When we look closely at these parameters, we can conclude that a large increase in exports of products from Serbia to the Russian market is highly unlikely.

THE STRENGTH OF THE RUSSIAN ECONOMY DOES NOT REFLECT THE SIZE OF RUSSIAN TERRITORY

The largest export markets for Serbian products are the countries of the European Union and CEFTA. Among the most important ones are Germany, Italy, Bosnia and Herzegovina and Montenegro.

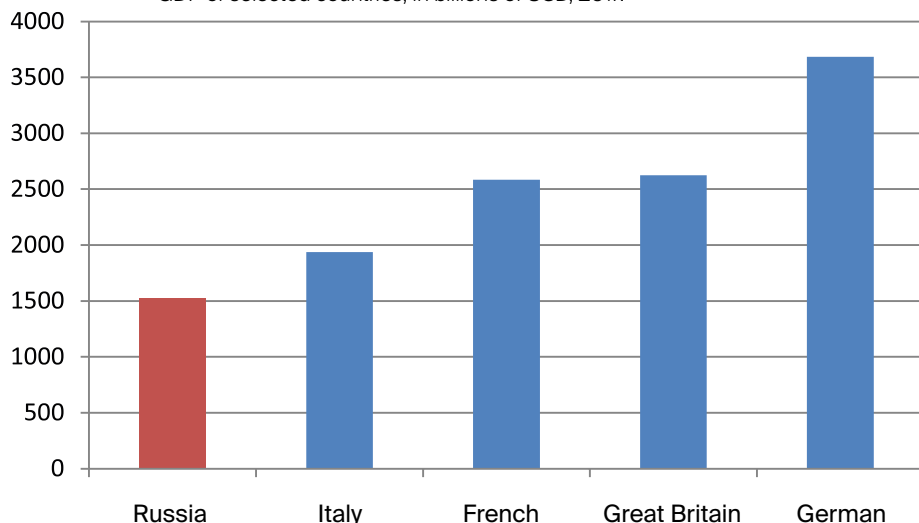
Export destination of Serbian goods, in millions of USD



Source: The Statistical Office of the Republic of Serbia.

The Russian market is not particularly big. The Russian Federation is the country with the largest land surface in the world, but its economy is smaller than that of all major European economies taken individually. Even several smaller European countries taken together, such as the Netherlands and Belgium, have a larger economy than that of Russia.

GDP of selected countries, in billions of USD, 2017.



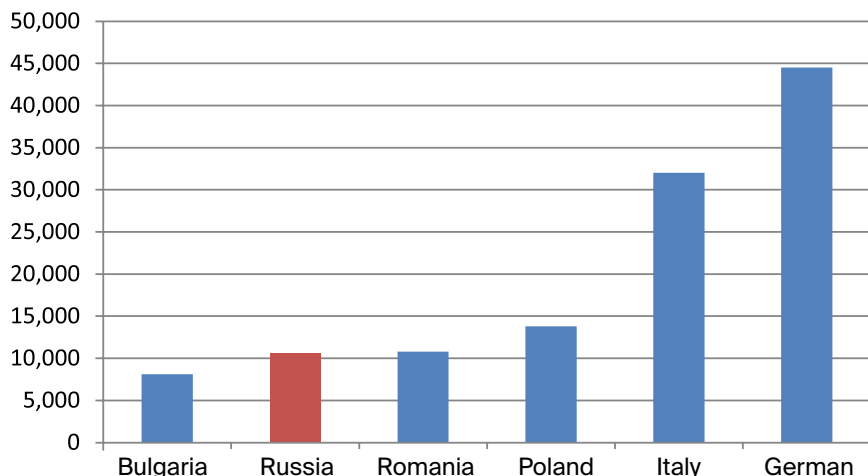
Source: IMF, World Economic Outlook.

When looking at the size of an economy, one can look at the nominal amount of GDP or GDP in relation to the parity of purchasing power. The parity of purchasing power is a better representation of the difference in the income of the population due to the fact that the prices of products in poorer societies are lower than in developed societies, and vice versa. However, in the case, in which when the size of the Russian economy is seen as a potential for the growth of Serbian exports, it is better to look at the nominal amount of GDP, since the import of Serbian products would have to be paid in foreign currencies (dollars or euros) according to the fixed foreign exchange rate.

In addition to the size of the entire economy, another important piece of information is the level of income

of the population, which is best expressed as the amount of GDP per capita. The higher the income, the more the population will have available to buy products from abroad. For example, India's economy is big, but it's a level of income shows that it's still a poor country. Looking at the level of income in Russia, it is striking that it is considerably higher than in Serbia, but Russia is still far behind the European countries.

BDP per capita odabranih zemalja, u tekućim dolarima

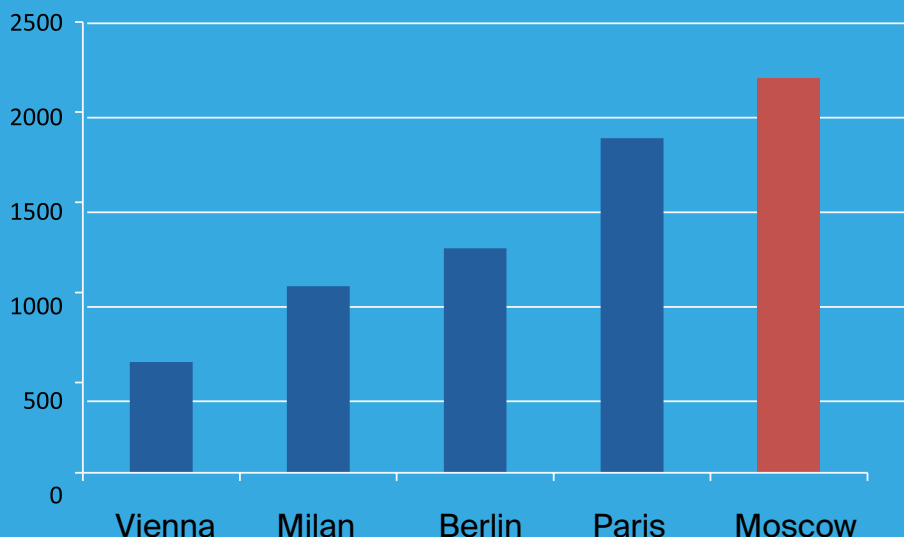


Izvor: MMF, World Economic Outlook.

GEOGRAPHICAL DISTANCE CREATES ADDITIONAL TRANSPORT COST

Geographical distance has a negative impact on trade: the farther apart two countries are, the more burdensome transport costs will be for the trade between them. The Russian market is significantly farther away from Serbia than the market of the countries of the European Union (with some of whom Serbia also shares a border). This certainly has consequences on the cost of transportation for Serbian exports. In addition, a large geographic area, such as that of Russia, has further consequences for transport: Vladivostok is almost as far away from Serbia as Japan.

Distance between Belgrade and selected cities, in km



Source: Wikipedia

THE COMPLIANCE AND OPENNESS OF THE RUSSIAN ECONOMY

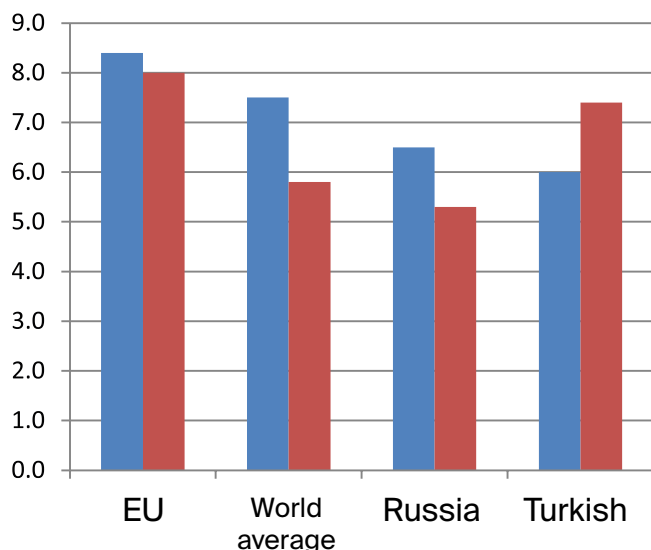
The complementarity between the Serbian and Russian economies is not great enough to justify great hopes for exports to the Russian market. Complementarity of economies implies that they produce at different technological levels: for example, if an economy produces foodstuffs and the other pharmaceutical products, they will spontaneously trade with medicines and foodstuffs to a greater extent than with other countries that also produce these products.

Herein lies a very important issue: intra-industrial trading or inclusion in global supply chains. Today's globalized production of multinational companies implies that the product is no longer produced or assembled in one place, but that raw materials and se-

mi-finished products are produced around the world, and then transported to the place where the next stage of processing takes place. For example, in the automotive industry, the engine is manufactured in one country, the gearbox and ball bearings in another, cables in a third country, etc. Unfortunately, Serbia and Russia are not sufficiently involved in these global supply chains to have an impact on their international trade.

Customs and non-customs barriers to trade also affect the level of trade. The more present they are, the more restricting an impact they will have on trade. When looking at data on the level of freedom of international trade measured, by the level of customs duties and the presence of non-customs barriers, the Russian market is somewhat more closed than the EU market, which has repercussions for Serbian products.

Level of trade barriers (1-10, 1 more barriers, 10 less barriers)



Customs barriers

Non-customs barriers

The free trade agreement with the Russian Federation (later expanded to the Eurasian Union, which besides Russia includes Kazakhstan, Belarus, Armenia, and Kyrgyzstan) provides preferential treatment of Serbian goods in relation to third countries, but this advantage was significantly reduced by Russia's entry into the World Trade Organization in 2012, when the customs barriers were lowered to other countries.

IF NOT THE INCREASE OF EXPORTS TO RUSSIA, THEN WHAT?

Economic exchange with Russia is important and beneficial for both countries. However, due to the above-mentioned limitations, it is not at all surprising why Serbian exports to the near but underdeveloped Bosnia and Herzegovina are higher than exports to the large, but far-off Russian Federation. Even if there is a significant increase in exports from Serbia to the Russian market, it still won't be able to reach the same importance for our economy as having economic ties with the countries of the European Union.

In order to increase exports to any foreign market, it is necessary to create local conditions for the domestic economy to be successful and productive, so that it can compete abroad. No player will play in an international league if he has to run with tied legs on a domestic court.

10. The Myth of the Pension Fund

The pension fund was robbed, and because of this, the pensions are low and there is a deficit in the fund. The PIO fund (Pension and Disability Insurance Fund) deserves to have its seized property returned to it and should be prudently managed.

The most visible problems with pensions in Serbia are the low level of pensions and the high level of expenditures from the state budget required to finance these pensions. It is not possible to finance the system only from the contributions paid out of salaries.

The myth of the destruction of the PIO fund by seizing and spending its assets gives an easy answer to the cause of this problem, as well as a magical solution. Such a myth fuels the support for public policies that are moving towards increasing the expenditures for pensions without realizing the real economic possibilities of the state to finance them in the long run, but it also prevents a real public debate on the problems that arise in the current pension insurance system in Serbia and on possible reforms.

THE PENSION FUND IS ACTUALLY NO FUND AT ALL

The myth of the abundant assets of the pension fund originates from its very name: Pension and Disability Insurance Fund. This creates the impression that the fund really has assets (or that it has had them), and that pensions are paid out of the return on equity. However, the PIO fund in Serbia (formerly Yugoslavia) never had such a system - it was conceived as a flow-through system: insured employees pay contributions, from which current pensions are immediately paid. This system is also called the current financing of payments - Pay As You Go.

The exact determination of how much contributions will be charged and how much shall be paid as pensions is not easy: at the beginning, when the pension system was young, there were few pensioners and a lot of insured, there were years in which sporadic surpluses occurred. In those years, the PIO had slightly more revenues than expenditures. These funds were invested in some investment projects in the framework of the then socialist system at the time: a large number of spas and medical centers, and even the Sava Center were built with these funds. These surpluses, however, were sporadic and not very high. Most of these entities were subsequently transferred from the PIO fund to the state, bearing in mind that the state has at the same time guaranteed pensions, not only in words, but also with funds from the budget. In the privatization process, 10% of the shares were allocated to the Fund, but this was never organized as an active portfolio to be managed, but as the companies were sold, state agencies have transferred to the PIO fund the money it has received for its shares package.

THE VALUE OF ASSETS OF THE PIO FUND IS ONLY A DROP IN THE SEA

The current estimated value of the PIO fund's assets is around 500 million euros. However, having in mind that the hole in the Pension and Disability Insurance Fund for pension payments amount to approximately 1.7 billion euros per annum, this is only a drop in the sea and cannot affect the change in image of the pension system. It is highly unlikely that these assets would generate very high revenues given that the PIO fund has no experience in active asset management, adding to the existing weaknesses in governmental management, that are visible in state-owned enterprises, banks, etc.

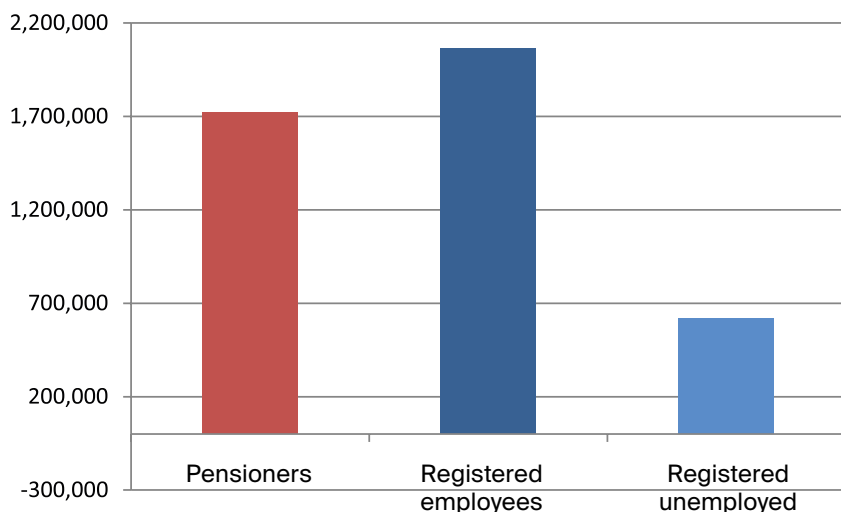
Even the granting of state-owned assets to the PIO fund will not⁷¹ be able to ease this problem, because there are simply no such assets. Even if these assets would yield a high return of 10% per

annum, in order to eliminate transfers from the budget for the payment of pensions, it is necessary that these assets be worth about 20 billion euros, and to pay all pensions about 40 billion euros (more than the annual GDP).

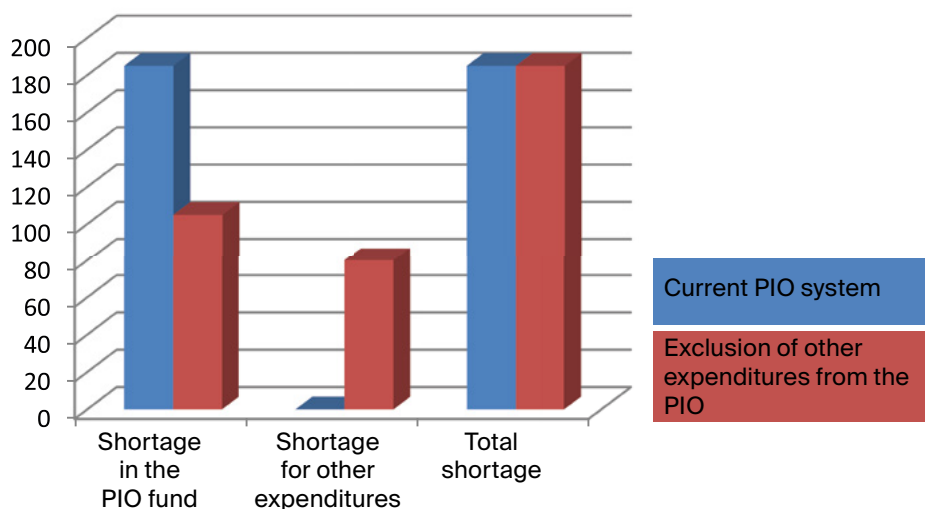
IMBALANCE BETWEEN THE NUMBER OF EMPLOYEES AND NUMBER OF PENSIONERS

Since the pension system is based on current contribution payments, the ratio of the number of employees and the number of pensioners is very important. With the current amount of contributions and the ratio of pensions to salaries (one average pension is about half the average salary), in order for the pensions to be paid out smoothly, it is necessary to have at least twice the number of insureds than pensioners, which has not been the case for a long time. The

Ratio of pensioners, employees and unemployed during 2017

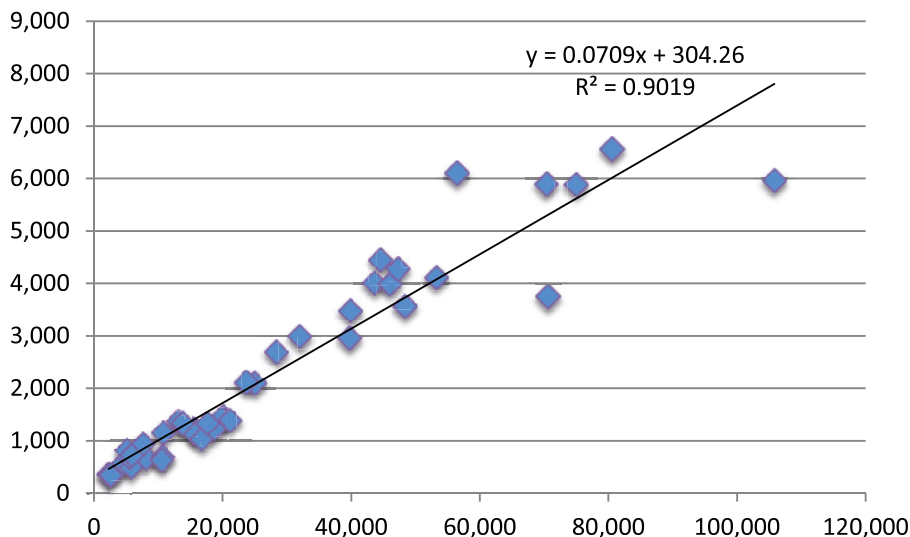


responsibility for this lies in the low level of activity in the labor market (in Serbia, the number of people working or actively looking for jobs is lower than in the developed countries of the EU), a high unemployment rate and a high rate of emigration from the country. However, the primary problem is demographic trends, above all a low birth rate, which is a characteristic of all European countries. With these parameters, in order for the system to be in balance, every married couple should have around five children. Since the total fertility rate (TFR) in Serbia is around 1.5, we can see how far we are from this ideal situation.



Moreover, other things besides direct pensions are also financed from the PIO fund in Serbia: benefits for external care and assistance, health care for pensioners, etc. As a result, net expenditure for pensions is slightly lower than the total pension fund's expenditure, and the deficit would still be significantly lower if it was relieved of these expenditures. However, these expenditures would be transferred onto other state funds - health care for pensioners onto the RFZO, fees for external care and assistance onto the social welfare budget, etc. Consequently, although the deficit of the PIO fund would be lower, the overall deficit of the state would remain the same.⁷³

The connection between the level of GDP and the average salary



The level of pensions is one of the numerous issues where everyone would agree that pensions in Serbia are relatively low and that it would be good if they could be higher. However, it is necessary first of all to bear in mind whether it is possible to increase these expenditures and to finance them. Since pensions are funded by contributions, they are low because salaries in Serbia are low. The general level of salaries is dominantly determined by the productivity of the economy, i.e. the level of economic development, and since Serbia is among the poorest countries in Europe, this situation should not be surprising.

IF THERE ARE NO FUND ASSETS, THEN WHAT?

The name of the PIO should be changed from fund to account. This would make it clear that there is no easy and quick solution for the problem of the pension system in the country. Instead of discretionary decisions by politicians who can, at their discretion and for political reasons, decide whose pension should be reduced or increased, it is necessary in this respect to return to the systemic approach: the increase of pensions should be in line with some general rule that depends on objective circumstances. The best solution is the so called Swiss formula: to adjust pensions with economic possibilities, taking into account the general price increases (in order to preserve purchasing power) and economic growth (in order to gradually increase purchasing power).

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