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INSTITUTIONS AS A FACTOR OF ECONOMIC GROWTH AND DEVELOPMENT: THE CASE OF SERBIA

This paper focuses on the analysis of the key aspects regarding the development level, quality and efficiency of economic institutions in Serbia and their influence on the economic growth and development of the country. The comparative analysis of institutional infrastructure in Serbia and other former Yugoslav republics, as well as the movement of per capita income in the mentioned countries results in a more realistic assessment of the quality of institutions in Serbia and facilitates the derivation of a conclusion on their interaction with economic growth and development dynamics.

Keywords: *institutions, institutional infrastructure, economic growth, economic development.*
JEL Classification: B52, F43, F63, O11, O43.

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ІНСТИТУТИ ЯК ФАКТОР ЕКОНОМІЧНОГО РОСТУ ТА РОЗВИТКУ: ЗА ДАНИМИ СЕРБІЇ

У статті проаналізовано ключові чинники розвитку, якості та ефективності економічних інститутів у Сербії, а також їх вплив на економічний розвиток країни. Порівняльний аналіз інституціональної інфраструктури Сербії та інших республік колишньої Югославії у співвідношенні до динаміки змін доходів досліджуваних країн на душу населення дозволив провести об'єктивне оцінювання якості інституціонального розвитку Сербії та його впливу на економічне зростання та динаміку розвитку.

Ключові слова: *інститути, інституціональна інфраструктура, економічне зростання, економічний розвиток.*
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ИНСТИТУТЫ КАК ФАКТОР ЭКОНОМИЧЕСКОГО РОСТА И РАЗВИТИЯ: ПО ДАННЫМ СЕРБИИ

В статье проанализированы ключевые факторы развития, качества и эффективности экономических институтов в Сербии, а также их влияние на экономическое развитие страны. Сравнительный анализ институциональной инфраструктуры Сербии и других республик бывшей Югославии в соотношении к динамике изменений доходов исследуемых стран на душу населения позволил провести объективное оценивание качества институционального развития Сербии и его влияния на экономический рост и динамику развития.

Ключевые слова: *институты, институциональная инфраструктура, экономический рост, экономическое развитие.*

Introduction

The research of the economic growth and development includes the examination of all relevant issues of these fundamental elements of every economic system, which means that the economy must be considered in a broader perspective comparing to the established views of the traditional economic science. The analysis of the above elements is central in the context of the overall social system, which involves the relations between economic and non-economic factors. Non-economic factors imply, among other things, an organizational system and rules under which a partic-

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ular economy operates, since economic efficiency, personal motivation and initiative are determined by the applicable rules. Thus, it is important to give the answer to the question: which particular institutional characteristics, due to their impact on the effectiveness of the market system, determine economic success?

This paper analyzes the system of economic institutions in Serbia, with the aim of emphasizing the importance of building a consistent, high quality and efficient institutions, given that the economy itself represents the institutional system within which the market operates. In this respect, the hypothesis that developed institutional infrastructure is necessary for the achievement of steady growth and development will be tested, since an inadequate institutional framework definitely leads to economic lagging of a country. The methodological procedure of a comparative analysis was used to determine the correlation between institutional development and economic growth and development, as well as to compare the level of development of basic institutions and GDP per capita movement in Serbia and other former Yugoslav republics.

1. A survey of the relevant research

Institutional environment, as a set of formal and informal institutions, decisively influences the successful functioning of the economy; therefore, institutions have an undeniable role in initiating economic growth and sustainable economic development. Namely, if institutional environment provides favorable conditions for economic agents, particularly those that affect the level of investment in physical and human capital, technology and organization of production, then it is evident that institutions make an important factor of economic growth. At the same time, the quality of institutions determines the intensity and spread of technological progress, which increases the efficiency of investments, directs the potentials in terms of economic growth of a country and improves other economic elements, such as the allocation of resources.

Following North (1990) institutions, as humanly devised constraints that shape human interaction, by reducing the level of uncertainty create conditions for the formation of stable structures of human exchange. Depending on how the particular structure evolves, it shapes the direction of economic trends towards growth, stagnation or decline. Rodrik (2000) warns that in an environment of underdeveloped institutions, economy is not able to achieve lasting development results. When consistent institutions are established and when they function effectively, macroeconomic policies and other incentives related to economic growth may be relatively easy to implement, and this results in better economic outputs.

The influence of institutions on the economic incentive structure is very important. According to North (1990) this is a significant role of institutions, given that incentives are a key determinant of economic success of each and every economic entity, as well as the economy itself. Acemoglu, Johnson and Robinson (2005) point out that economic institutions determine the incentives of and the constraints on economic actors, thus shaping the economic outcomes. By creating appropriate incentives of economic actors and conditions that make their behavior predictable, institutions enable the effects of their actions to become more easily anticipated. At the same time, by influencing the transaction and production costs, institutions affect the profitability of economic arrangements. Therefore, the explanation for differences in performance levels, as well as for the long lasting periods of stagnation or decline of economic well-being of particular societies, are most commonly found in the differences in the nature and quality of institutions.

In terms of analyzing the institutional factors of economic growth and development, the protection of property rights and enforcement of contracts are especially emphasized. Acemoglu, Johnson and Robinson (2005) consider that economic institutions encourage economic growth under the following circumstances: when they allocate power to the groups with interests in property rights enforcement; when they create effective constraints on power-holders; when there are relatively few rents to be captured by those in power. On the other hand, in terms of their regulative role, institutions influence economic growth by enforcing norms and rules of behavior on economic entities, specifying and diversifying property rights and affecting the reduction of transaction costs and efficient resource allocation (Radygin and Entov, 2008).

Furubotn and Pejovich (1972), Cutter (1998) and other authors point to the dominant impact of the property rights structure on the outputs of an economy. This influence stems from the fact that ownership represents an institution in its own right which regulates the right of choice regarding the utilization of limited resources. Radygin and Entov (2005) argue that the significance of a clear determination and effective protection of property rights is reflected in the fact that owners of production factors are willing to invest only if they believe in the sanctity of their rights over these factors. Owners understand this as the granting of established rights, and, at the same time, the prohibition to others to interfere in the exercise of their rights. Therefore, ownership relations are defined as the system of exclusivity in terms of access to material and non-material resources in society, which means that exclusively the owner collects all positive results of his/her activity, but at the same time he/she is the only risk bearer of possible negative results. This is a key element underlying the motivation that determines the efficiency of business operations, because it ensures efficient allocation of resources, which is a condition of the overall economic efficiency and which thereby stimulates economic growth and development.

Since property rights are a crucial determinant of a rational allocation of resources, it is only logical that a consistent institutional regulation of property rights makes a key pillar of the transition process. According to Kuter (1998) one cannot count on the increase in investments in production, economy modernization and, accordingly, the transition from depression to economic growth, unless the ownership rights are clearly defined, i.e. until the situation of "undermined" ownership rights is overcome – which is typical for the majority of transition economies.

Another important precondition for establishing an enabling business environment is full and effective protection of contractual rights. North (1990) suggests that the inability of societies to ensure efficient enforcement of contracts is the most important source of stagnation and underdevelopment, considering the fact that adequate business environment for effective and efficient functioning of economic agents and the economy as a whole cannot be established under such conditions. Hence, it is only when property rights and enforcement of contracts are regulated in a consistent manner, that the incentive conditions for investors can be created, because the adequate protection and granting of property rights and contractual relationships are the critical preconditions for more intensive investments, which are, again, a condition of dynamic growth and development. On the other hand, the lack of security regarding property and contract rights introduces the possibility of arbitrary interpretation of norms, which makes a fertile ground for corruption and crime. In this way investors get discouraged, making it impossible to raise the level of economic dynamics and opening of new jobs, without which there is no economic growth and development.

The manner in which property rights are regulated also influences the level of development of market mechanisms, especially financial markets. Rodrik (2008) suggests that the efficiency of investment utilization depends on the differences in the quality of national financial systems. In addition, development of financial markets has a positive effect on competition, which is a crucial factor in improving business environment and promoting economic growth. On the other hand, the weakness of market structure generates investment crisis and therefore economic growth is impossible unless such crisis is surpassed.

With reference to the research of economic growth, significant attention is paid to the quality of social infrastructure, as social stability makes an important condition for the stability of institutions. In particular, the countries that are characterized by a high degree of social stability, under the same other conditions, have more developed and stable institutions and thus better prospects for economic growth. In this context, Easterly, Ritzan and Woolcock (2006) consider the degree of social unity, i.e. social cohesion, a key factor in the development of efficient institutions. Considering that the implementation of institutional reforms is determined by the level of social stability, the positive correlation between social infrastructure and the level of per capita income is only logical.

2. Indicators for state of institutions and economic growth in Serbia

The analysis of the development, quality and efficiency of the institutional framework of an economic system is generally based on the following indicators: the protection of property rights; legal safety and certainty; efficiency of state and its share in GDP; indicators of economic freedom; corruption perception index; as well as other relevant indices. Bearing in mind the strong causal link between better institutions and better development results, as pointed out by Acemoglu, Johnson and Robinson (2005), the establishment of quality institutions and, above all, the protection of property rights and contractual relations, is one of the main preoccupations of economic policy-makers and creators of economic system in each country. Furthermore, in terms of assessing the level of competitiveness of an economy, the institutional quality indicators are considered as the key indicators. In light of the aforementioned facts, the Government of the Republic of Serbia adopted the National Strategy for Economic Development of Serbia 2006–2012, which, inter alia, emphasizes the necessity for improving key indicators of institutional environment.

The first pillar of the Global Competitiveness Index (GCI) – public institutions – is used for the assessment of institutional quality and institutional effectiveness in Serbia. At the time when the aforementioned National Strategy for Economic Development of Serbia 2006–2012 was drafted, according to the public institutions index, Serbia was on the 99th place on the list with the score of 3.37, and in 2012, when the strategy should have been fully implemented, Serbia found itself on the 130th place, with the score of 3.16. Instead of the expected improvement, the condition of public institutions deteriorated as a result of many unsolved problems faced by public administration, inadequately defined and insufficiently protected property rights, low levels of legal bodies' independence, burden of government regulation etc. Thus, much desired institutional environment that would be favorable for greater economic efficiency and triggering of economic growth was not achieved. The comparative analysis of the Global Competitiveness Index (GCI) and state institutions showed that the value of GCI and the values referring to state of institutions were relatively constant, however, the ranking of Serbian public institutions continuously deteriorated, therefore Serbia got the worst ranking among the neighboring countries. The outline of the movements in competitiveness index and the Serbian public institutions index in the period 2007–2012 is given in Table 1.

Table 1. **Indicators of the Competitiveness Index and Serbian institutions in the period 2007–2012**

Year	Competitiveness Index		Public institutions	
	Rank	Score	Rank	Score
2007	91	3.78	99	3.37
2008	85	3.90	108	3.40
2009	93	3.77	110	3.24
2010	96	3.80	120	3.20
2011	95	3.88	121	3.15
2012	95	3.87	130	3.16

Source: The Global Competitiveness Report (the 2008-2012 editions).

The values of the indicators relevant for assessing the quality and effectiveness of the institutional framework in Serbia, such as the protection of property rights, legal bodies' independence and contract enforcement, transparency of government policy-making, the level of organized crime, are well below the overall average of the same indicators for other countries in transition. According to the key indicators referring to the quality of institutions, in terms of the neighboring countries, only Bosnia and Herzegovina had poorer rankings than Serbia and even this was the case only until 2010. Table 2 shows the values of particular indicators whose ranks and scores illustrate the state of institutions in Serbia in the period 2008–2012.

Table 2. **State of Serbian institutions in the period 2008–2012**

Indicator	2008		2009		2010		2011		2012	
	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score
Property rights	108	3.6	111	3.4	122	3.2	126	3.1	130	3.1
Intellectual property protection	105	2.8	101	2.8	111	2.6	107	2.7	116	2.8
Legal bodies independence	106	3.0	110	2.8	124	2.5	128	2.4	129	2.4
Burden of government regulation	132	1.9	129	2.2	131	2.2	134	2.3	136	2.4
Transparency of government policymaking	82	3.9	86	4.0	97	4.0	102	3.9	111	3.8
Organized crime	97	4.5	109	4.2	111	4.3	107	4.3	118	4.1

Source: The Global Competitiveness Report (editions 2008-2012).

Movement of the key indicators referring to the state of institutions in Serbia in the observed period shows a continuous decline. According to the Global Competitiveness Report (GCR) 2011–2012, Serbia has the lowest ranking among former Yugoslav republics. The analysis of subindicators under the pillar public institutions in Serbia shows that such unfavorable situation is particularly evident regarding the definition and protection of property rights, intellectual property protection, legal independence, the burden of state regulation and the presence of organized crime, although other subindicators did not received favorable scores either.

A significant indicator of the institutional environment in which economic activities take place is the state of economic freedom, which is one of the most important development factors. Higher level of economic freedom, especially the part that relates to the improvement of legal bodies independence and certainty and granting of property rights, market openness, free exchange and free disposal of assets, make an important precondition for successful performance of economic activities, thereby enhancing economic growth and development. On the other hand, a low level of economic freedom is primarily a result of inadequate institutional framework of an economic system.

The Cumulative Economic Freedom Index integrates the indicators on the status of the following components of both economic system and economic policy: business freedom; trade freedom; fiscal freedom, government spending; monetary freedom; investment freedom; financial freedom; property rights; freedom from corruption; labour freedom.

Serbia's economic freedom score in 2012 was 58.6, putting its economy on the 94th place in the 2012 Index (out of 179 ranked countries). Thus, Serbia is ranked among the mostly unfree economies. Table 3 provides an overview of the scores of individual components (i.e., economic measurements) of the 2012 HF's Index of Economic Freedom for Serbia.

Table 3. **2012 HF's Index of Economic Freedom for Serbia**

Index Components	Score	Rank
Index of economic freedom	58.0	98
Business freedom	56.5	128
Trade freedom	77.9	87
Fiscal freedom	84.1	52
Government spending	39.3	140
Monetary freedom	68.0	153
Investment freedom	60.0	64
Financial freedom	50.0	72
Property rights	40.0	72
Freedom from corruption	35.0	80
Index of economic freedom	68.7	62

Source: 2012 Index of Economic Freedom.

If we look at the components of the 2012 Index of Economic Freedom for Serbia, we can see that Serbia got slightly better scores for the components: fiscal freedom, monetary freedom and trade freedom, while it recorded the lowest scores in terms of freedom from corruption (35.0) and the protection of property rights (40.0). These scores are the result of the lack of legal bodies independence, which is also the reason why the system is corrupted and inefficient. When it comes to protecting the rights of ownership, it is evident that the legal framework is significantly improved; however, the enforcement of the relevant laws and regulations is still unsatisfactory. Due to the high share of government spending in GDP and government's control of prices, the component of government spending also received unsatisfactory score.

Table 4. **State of Institutions in Serbia and in other former Yugoslav republics in the period 2007–2012**

Country	2007	2008	2009	2010	2011	2012
Slovenia	44	49	46	50	55	58
Croatia	65	74	85	86	90	98
Serbia	99	108	110	120	121	130
Bosnia and Herzegovina	113	123	128	126	109	85
Montenegro	78	59	52	45	42	44
FYR Macedonia	102	90	83	80	81	78

Source: The Global Competitiveness Report (the 2007-2012 editions).

Realistic position on the quality of institutions in Serbia can be formed on the basis of the comparison between the state of institutions and movements of GDP per capita in Serbia and in other former Yugoslav republics in the period 2007–2012, according to the data provided by the Global Competitiveness Report. Table 4 shows the data on this.

Table 5 demonstrates the movement of GDP per capita in Serbia and other former Yugoslav republics in the period 2007–2011.

Table 5. **GDP per capita in former the Yugoslav republics (in USD)**

Country	2007	2008	2009	2010	2011
Bosnia and Herzegovina	3,721.1	4,625.4	4,279.0	4,319.0	4,618.0
Croatia	11,576.0	15,268.1	14,243.0	13,720.0	14,457.0
FYR Macedonia	3,659.0	4,656.6	4,482.0	4,431.0	5,016.0
Montenegro	4,088.3	6,509.0	7,300.0	6,589.0	7,317.0
Slovenia	22,932.7	27,148.6	24,417.0	23,706.0	24,533.0
Serbia	5,595.9	6,718.9	5,809.0	5,233.0	6,081.0

Source: The Global Competitiveness Report (the 2008-2012 editions).

A comparative analysis of the key indicators of the state institutions and the achieved GDP per capita in Serbia and other former Yugoslav republics in the period 2007–2012 points to their mutual dependence. Based on the indicators of institutional quality, Serbia is on the 130 place out of 144 countries ranked in the 2012 Global Competitiveness Report, which clearly shows that Serbia has the poorest ranking among the former Yugoslav republics. If we focus on the 4 former Yugoslav republics, namely, Bosnia and Herzegovina, FYR Macedonia, Montenegro and Serbia that have the lowest GDP per capita, we can also see that the slowest growth rate of GDP per capita is recorded in Serbia. Furthermore, in the observed five-year period, GDP per capita increased in Bosnia and Herzegovina for $ 897, in FYR Macedonia for $ 1,387 in Montenegro for $ 3,230, and in Serbia for rather modest $ 486. It is also important to mention the advance of these countries in terms of state institutions development. During 2007–2012 Montenegro made a progress and climbed up the list from the 78th to the 44th place, FYR Macedonia – from the 102th place to the 78th, Bosnia and Herzegovina – from the 113th to the 85th, while Serbia managed to fall from the 99th place to the 130th. This analysis confirmed the existence of a positive correlation between the development of key institutions and the dynamics of economic growth. The position that inadequate institutions and policies cannot produce the desired growth proved right. In this way, the hypothesis that the institutions have a crucial impact on business environment (which determines the economic performance of economic entities) and enhances economic growth and development was confirmed.

The research shows that the differences in the development levels between the countries under study are largely the result of differences in the development of quality of their institutions, and the causes of economic backwardness could be traced back to the inadequate institutional framework within which economic activities are taking place. Namely, if property rights are not properly regulated in a country and if the protection of both property and contractual rights are not granted by its legal system, then the economy of such country cannot be efficient and is unable to produce the necessary growth and development.

3. Factors of efficiency of institutions in Serbia

Bearing in mind that incomplete and dysfunctional institutional system in Serbia represents a serious obstacle to the development, the essential task that this country has to get down to is to create an enabling institutional environment and grant its successful functioning in order to achieve the successful long-term and short-term economic dynamics, as a precondition for sustainable economic development.

Various forms of limitations, such as those that result from insufficiently developed market and failures of the government, threaten the stability and efficiency of the economic system and reduce its appropriateness. This study takes into account the government failures manifested through higher business risks both at the micro- and macrolevels. Microrisks are manifested through companies facing weak protection of property rights, high corruption and high taxes. Macrolevel risks are the result of the unfavorable financial situation of the country, as well as the present monetary and fiscal instability. Institutional environment characterized by the abovementioned conditions does not attract investors since their property rights are not protected. Indeed, when transactions are not guaranteed and when there is no freedom in terms of property rights transfer, the market is not able to stimulate dynamic growth and development.

The empirical data show that the components relevant for assessing the quality and effectiveness of the institutional framework in Serbia, such as the protection of property rights and their free transfer, as well as enforcement of contracts, which are the basic institutions of the market system, are below the regional averages and those of other transition countries in the world. Differences between countries in terms of security of property rights are the result of the nature of national laws and the efficiency of the judiciary system. In order to maximize economic effects, it is necessary to adopt adequate laws and regulations which will support the achievement of the desired economic results. Furthermore, the judiciary system should be independent and function effectively and impartially. When a state fails to establish the rule of law, the absence of adequate protection and enforcement of contracts and property rights, economic entities will turn to rent seeking instead of seeking profit.

Inadequate protection of property rights by the state is one of the most serious issues related to microrisks. Among more specific problems of property rights is the issue of restitution, which is one of the basic legal principles that grants the rights pertaining to the continuity of ownership. However, inadequate protection of property rights was also identified related to the irregularities in privatization, in which the Commercial Court was involved regardless the fact that this institution should provide legal certainty in this area.

Given that the security of property rights is one of the most important factors of successful development of economic activities, determining the dynamics of growth and development of a country, this research considers the issue of property rights in Serbia as very important. Furthermore, the incompleteness of the process of ownership transformation is also taken into account. The ownership transformation, mainly the privatization of state and public property, should result in the establishment of the ownership structure that is the basis for market system. The aim of this complex and comprehensive process is not questionable, however the manner of its implementation is. Namely, the privatization of the state and public ownership in Serbia took place in the environment of inefficient regulatory institutions, which were supposed to protect social objectives and long-term social and economic interests. However, the privatization process generated property owners, rather that entrepreneurs and thus establishing the economic system dominated by monopolies instead of competitive companies. Such concept of privatization resulted in the deindustrialization of the country. One of the reasons for this is the lack of effective and independent judicial system, which underpins the system of property rights and facilitates the enforcement of contracts and property rights.

A key task for Serbia is to establish a high quality and efficient institutional infrastructure, which would allow the allocation and use of resources to be realized in a predictable way. It follows that a set of property rights over resources affects decision-makers, and, therefore, the change in the property relations system will affect people's behavior, which essentially determines the allocation of resources which in turn determines the efficiency of production. It is therefore important that the institutional environment in which economic activity takes place should be defined in a consistent manner and that the full enforcement of the relevant rules is implemented.

Given the socioeconomic reality of Serbia, it is necessary to make institutional reforms one of the main goals of the new economic strategy. This implies the necessity of transforming the basic institutional conditions of economic activities in the country — the system of court proceedings and legal guarantees for the enforcement of contracts, the mechanism of court decisions enforcement, the system of interconnectedness of businesses and administrative bodies, especially those regulating economic activities, tax system, determination of competences and shared responsibilities in terms of the public sector functioning, the status of state monopolies and the framework for their activities, the financial and economic sector stakeholders etc. In all the abovementioned areas there are many unresolved essential issues that cannot be ignored in the process of creating the conditions for dynamic economic growth and successful modernization of the country.

In order to make institutional changes successful, it is essential to keep them in a strong correlation with the changes in the general economic paradigm. In terms of the national economy, this means that the state should take the responsibility and the initiative to create the enabling conditions for enterprises and companies whose activities provide employment growth, income growth, increase of exports and better taxation. On the other hand, a business that does not provide benefits to the society in the form of revenue from taxes and opening new jobs is a "black hole" devouring the national resources. The state is expected to show high interest in the implementation of any specific project that would produce reliable economic, budgetary and social effects. To achieve this goal it is necessary to use all available instruments of the national economic policy (fiscal leverage, credit lines, administrative control over the use of available state resources) along with the institutions.

4. Conclusion

The conclusion is that the economic system of Serbia is characterized by underdevelopment or even absence of key market institutions, which is the main reason why this system is unable to produce steady economic growth. Therefore, it is necessary to implement a set of reforms in all the spheres of the institutional framework, especially the legal system, in order to make this important sphere of society independent of power-holders. Higher level of the judiciary system independence will ensure a significant institutional support for both greater economic freedom and other relevant indicators of the institutional environment quality. By establishing the rule of law as a condition for the property rights advocacy and enforcement of contracts, the pursuit of profit instead of rent-seeking would represent the dominant behavior of economic actors. It is a requirement that must be fulfilled in order to make the economy revive from the economic decline by encouraging economic activities and directing them towards growth and development. The quality and functional institutional framework is imperative, as weak institutions impair the efficiency of the projected economic measures. Lasting development results can only be achieved in the environment of consistent and effective institutions, the creation of which represents great challenges for future researches.

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