



ECONOMIC AND LEGAL ASPECTS OF FOREIGN DIRECT INVESTMENT PATTERNS IN SERBIA AND LATVIA

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ABSTRACT

The study analyzes economic and legal aspects of foreign direct investment patterns in Serbia and Latvia. Its topic is relevant due to the fact that international investment in the modern world is one of the most important factors in sustainable economic development. The aim of this study is to examine, summarize and compare the investment climate and experience of attracting investments in two different European countries - Latvia and Serbia, paying special attention to economic and legal aspects. Another objective is to identify and describe foreign direct investment patterns in the two countries.

The methods employed the study include comparative analysis, descriptive approach, statistical analysis. Moreover, the regulatory framework and incentives are analyzed by applying the methods of content analysis.

Our findings indicate that in both Latvia and Serbia, the problem of the correct definition of the term "investment" is partially resolved at the legislative level (in Latvia - also in the context of the entire European Union). We believe that any uncertainty in the definition of the term "Foreign Direct Investment" should be eliminated in the coming years through the unification of pan-European legislation. For countries such as Latvia and Serbia (due to their economic characteristics), foreign investment is of particular importance. If these investments are well distributed in terms of the spatial planning and sectorial structure of the host country, then they act as unique locomotives, contributing to national exports and economic development. Another feature of the influence of foreign investment on the economic environment of Latvia and Serbia is that it brings in not only capital, but also promotes development of entrepreneurship. In the last decade, there has been a steady increase in the volume of investments in both economies. Although the growth is due to different reasons, these dynamics have a positive impact on the future development prospects of both countries. Legislators of both Latvia and Serbia promptly respond to the economic challenges of the modern world, improving national regulations. Despite the differences in economic indicators, legal regulation, history, and geography - the investment climate of both countries could be characterized as attractive.

Keywords: foreign direct investment, investment legislation, investment patterns, Serbia, Latvia

JEL classification: D25, E22, F21, G11, O16

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INTRODUCTION

In the modern world, the importance of investment is undeniable. Investment is a flow of funds that is especially useful for the economic development of the host country. It contributes to the introduction of new technologies, product innovation or development of new production methodology. In addition, the investment support the use and training of local labor, and, under certain conditions, provide new



employment opportunities. Often, along with investments, new management systems and new commercial experience come into the country.

The purpose of our article is to summarize and compare the investment climate and experience of attracting investments in two different European countries - Latvia and Serbia, paying special attention to economic and legal aspects.

Latvia is a small, open, service-based and export-oriented Baltic economy. The country nearly completed the process of privatization. The economy of Latvia is highly integrated into the world economy. This is evidenced by the fact that the country is a member state of the European Union, Organization for Economic Cooperation and Development and World Trade Organization. By all the major classifications, Latvia is today considered to be a developed economy. Much alike Latvia, Serbia too is a small, open, service-based economy. Over two thirds of gross domestic product in Serbia is based on the tertiary sector. The economy of Serbia can be classified as an economy in transition, and most international classifications list it in the group of upper-middle income economics. It is a landlocked and mostly free-market economy located in South-Eastern Europe. The process of privatization, closely related to transition, is completed for many sectors. However, there are still some sectors in which the state-owned enterprises maintain a dominant position. In other, privatized sectors, there is a non-negligible public influence on private enterprises.

Our comparative study revealed interesting similarities of Latvian and Serbian economies. These general similarities of the two economies make grounds for an interesting further and more detailed comparison of their foreign direct investment patterns and performances.

LITERATURE REVIEW

In order for the volume of investment in the economy to increase, first of all, correct legal regulation of this area is necessary. Here a number of practical investment and legal problems come to the fore, for example uncertainties surrounding the jurisdiction of investment tribunals over aid-financed 'investments' (Mottola, 2024). The International Law Commission (ILC) aims to promote the progressive development of international law and its codification. Following several decades of development of international investment law, some scholars argue that the time is ripe for the ILC to codify it (Ma, 2023); emphasizing the productive power of the state to take positive action that acknowledges ordinary citizens' embeddedness within, and dependence upon, surrounding structures, the vulnerability theory challenges the hegemonic perception of the state as a source of danger - a view which has hitherto undermined both the potency and the enforceability of investor obligations. Used as a heuristic device in studying both IIL's existing structures and the potential avenues for reimagining it (Küçüksu & Ünüvar, 2023); language problems of the investment treaty system, where analysis reveals a hegemony of Western European, rather than North American influence (Lie, 2023); the role of international investment law in environmental peacebuilding and natural resources management (Fauchald, 2023); public interest in investment arbitration (Feria-Tinta, 2023).



International experience is a reliable unification platform for legislation, however, it cannot be guaranteed that international investment law will be fully supported by all market participants. For example, Ranjan (2024) shows, how India's rendezvous with international investment law moved from zealously guarding India's in the first four decades of India's independence to delegating sovereignty to international law on foreign investment from 1991 onward. However, the period from 2011 onward saw India significantly altering its terms of engagement with international investment law (Ranjan, 2024). On the contrary, long viewed as a hostile environment in which to do business, the Saudi Government has enacted a broad sweep of measures aimed at restoring investor confidence in central aspects of the country's evolving private law framework. (Alotaibi et al. 2024).

The current situation demonstrates that legislators in both Latvia and Serbia are paying close attention to improving investment legislation – for instance, in the past few years Serbia has passed through strategic documents and laws that open the possibility of faster development of energy sector in the context of its investment attractiveness (Pavlović et al. 2022); the empirical part disclosed the level of mainstream implementation of sustainability in the operations of German investors in Latvia (Hofbauer & Limanskis, 2022).

There is no doubt that societal norms, legal rules, and market forces work together to shape the behavior of businesses (Pukała & Ismailov, 2023). Those three forces (normative, legal, and market) must work in harmony to encourage and support responsible business conduct (Johnson et al. 2023). In addition, the role of International investment law (Kriebaum, 2023) in the development of the investment process cannot be underestimated (El-Hosseney, 2023).

In this context, academic articles often focus on two complementary areas: public procurement and fraud prevention. Since public procurement and innovation policy are tied together (Kuchina-Musina & McMartin, 2024), in the previous studies, which were based on expert opinions (Krivins, 2014) and an analysis of the role of general legal principles (Krivins & Vilks, 2013), it was noted that transparent and fair investment is only possible if certain conditions are met that all market participants must comply with (Krivins, 2019). If the situation is developing in the opposite direction, as may be indicated by changing trends in corruption in certain countries (Krivins et al., 2023), then the connection between economic development and the problem of crime (Remeikiene et al., 2022) becomes more relevant, the problem of bribery (Krivins, 2018) and even the possibility of criminal liability for the board of a company (Teivāns-Treinovskis et al. 2022) is growing. All economic policies are undertaken in an environment of uncertainty. Hence, the risk of corruption is high (Abuseridze et al. 2022). It should be noted that the problem of investment fraud is relevant not only in Europe, but also all over the world, for example in 2022, the Indonesian Financial Services Authority (OJK) recorded that the total value of public losses because of investment fraud in Indonesia reached 117.4tn IDR (Sudarwanto & Kharisma, 2023). This review of scientific literature helped us focus on the most important aspects of the current economic and legal situation in Latvia and Serbia.



METHODOLOGY

We base our comparative analysis on a descriptive approach. Thereby, we consider the most important patterns of foreign direct investment inflows in Latvia and Serbia since the beginning of their reforms on the economic system and, in particular, on the foreign direct investment regulatory framework. Based on these comparisons we identify similarities and key differences in the approaches of Latvian and Serbian policymakers and consider how these differences affect identified differences in foreign direct investment patterns, structures, and dynamics.

In our study, foreign direct investment is defined as an investment of a resident of one country in an enterprise that is a resident of another country, whereby the investor receives an equity share of at least 10%. In this way, the investor, arguably, received the right to effectively control the foreign company. We adopt this definition of foreign direct investment as it is a standard one, adopted by the International Monetary Fund and the member countries use it in compiling their balance of payments foreign investment statistics. Therefore, it makes the data we consider that is based on this definition internationally comparable, which is a requirement for a robust comparative analysis.

The comparative analysis also considers similarities and differences in regulatory framework related to foreign direct investment in the two countries, as well as the incentives provided to the investors. Thereby, we define the incentives as various policies adopted by the two countries aimed at attracting foreign capital. Their policies take various forms, ranging from the facilitation of conducting business for foreign affiliates (and companies in general), through other fiscal stimuli, to the use of Special Economic Zones and financial incentives indirectly or directly affecting the operating and financial results of foreign affiliates. The common characteristic of these incentives and measures is the goal of influencing the decision of the investors related to the investment project, by affecting the project's associated costs and risks. The regulatory framework and incentives are analyzed by applying the methods of content analysis, which allowed us to identify and classify the main policy measures applied by the two countries, and make comparisons based on the said findings.

RESULTS AND DISCUSSION

In this section of the article describe our results regarding Latvia, then regarding Serbia, as well as a discussion of the results for both countries.

The policymakers in Latvia consider foreign direct investment as an instrument to promote economic development. They, thus, created a regulatory framework which is actively seeking to promote larger foreign direct investment inflows. The country realized considerable foreign direct investment inflows since restoring its independence in 1991. According to the data of Central Bank of Latvia, the country accumulated over 17 billion EUR of foreign direct investment over the previous 20 years. The share of foreign direct investment in gross domestic product of Latvia reached approximately 61% in 2021.



There are numerous factors positively affecting the attractiveness of Latvia as a destination for foreign direct investment. The accession of Latvia to the European Union was of a particularly strong positive influence, as evidenced by high foreign direct investment inflows that followed. The accession process and its successful completion open up new market opportunities for foreign investors. The investors also favored a stable monetary policy solidified by the accession of Latvia to the Eurozone in 2014. The accession process also resulted in the harmonization of legislation with the standards and regulations of the European Union. This enables the enterprises originating from other member states of the European Union to easily adapt their business processes when establishing affiliates in Latvia. The accession strengthened Latvia's diplomatic relations with other countries, further improving the market access for companies exporting from the country. Latvia is also attractive for foreign investment due to its favorable geographic factors.

Other benefits Latvia offers to foreign investors are related to labor market. Namely, the country offers highly educated, bi- and trilingual workforce at relatively low costs. Furthermore, the tax system is also competitive and supportive of business. Particularly strong point in this regard is the abolition of taxes on reinvested earnings the country undertook. Despite competitive tax system, the country maintains high levels of fiscal responsibility, contributing to foreign investors' confidence. The government is providing active support to new businesses and provides well-funded programs which enable the use of various incentive policies including fiscal and financial incentives. The government also support businesses by making use of Special Economic Zones - making them particularly suitable locations for conducting international business activities.

There are also some negative aspects limiting the inflows of foreign direct investment in Latvia - for instance Global Financial Crisis. Following the peak of foreign investment inflows, surpassing 2 billion EUR in 2007, there as a dramatic drop. However, policymakers in Latvia promptly responded with extensive austerity measures to counteract the negative effects of the crisis. This improved the confidence of foreign investors, who quickly restored their perception of Latvia as a stabile investment environment. Robust recovery of foreign direct investment inflows ensued during 2010s. New instability brought by the pandemic and conflict in Ukraine increased volatility in investment activities.

Other limiting factors are more local in nature. For instance, labor market in Latvia could be characterized as somewhat rigid. This reflects unfavorably upon business environment. The shadow economy in Latvia is relatively extensive for a country at its development level which has a significant potential of disrupting foreign investment inflows. With the population of approximately 1.88 million, the domestic market in Latvia is small and of little attractiveness for foreign investors conducting typical horizontal foreign direct investment. There are some regulatory constraints and deficiencies affecting foreign investment, as well. Namely, the protection of minority shareholders in Latvia is limited compared to the most developed economies of Europe. Additionally, the regulatory solutions related to resolving insolvency could be characterized as inefficient. Another regulatory problem is related to the lack of transparency and fairness in public procurement processes, which is perceived by foreign investors in the country.



The industrial base of Latvia is relatively underdeveloped, limiting the inflows of foreign direct investment in manufacturing sector. A possible danger for future inflows of foreign investment in Latvia is high reliance of its export-oriented industries on small number of export markets. Disruptions in any of these markets could induce divestment processes of the existing foreign affiliates and limit the investment into the creation of new ones. The access to other markets such as the more developed economies of European Union is limited by geographic factors and infrastructural connectivity. Another notable problem that could negatively affect foreign direct investment inflows in Latvia are low levels of investment in research and development activities. According to the data obtained from Organization for Economic Cooperation and Development, only 0.64% of gross domestic product in Latvia was invested in research and development in 2019.

More recent dynamic of the foreign direct investment inflows in Latvia are presented in Figure 1. The data indicates a high increase of foreign direct investment inflows in Latvia in 2023. This constituted a 30% annual growth compared to the previous year. Foreign investors implemented 46 investment projects, worth approximately 619 million EUR. The growth in foreign direct investment inward stock in Latvia was steady, leveling off at 24 billion EUR in the second quarter of 2023. During the 2020s, Latvia experienced record high annual inflows of foreign investment. Strong performances in attracting the investment in this period could be partially attributed to the global economy recovery following the period of pandemic. Observed more broadly, the inflows of foreign direct investment in Latvia could be characterized by a considerable cyclicity (Jurša, 2021).

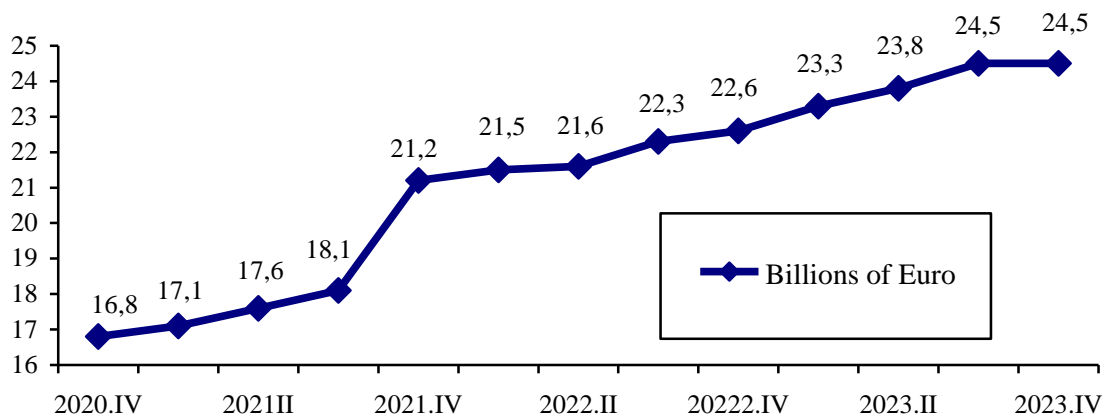


Figure 1. Foreign Direct Investment in Latvia (2020-2023)
Source: Central Bank of Latvia (2024)

Previously, Latvia had the most significant inflows of foreign direct investment in financial sector. In the beginning, the inflows were driven by privatization of financial institutions. Later, foreign investor continued to be attracted by this sector due to its relatively high profits and low intensity of competition from local Latvian banks. Over time, construction sector gained importance for foreign direct investment inflows,



achieving consistently high shares in total foreign investment inflows. In the most recent period, there has been a large concentration of foreign direct investment in professional, scientific, and technical services sector. The investment in this sector made up 22% of total foraging direct investment stock in the country by 2023 (Investment and Development Agency of Latvia, 2024). Another half of foreign direct investments inward stock in 2023 was evenly distributed among financial, real estate, trade and manufacturing sectors. More details on this structure are provided in Figure 2.

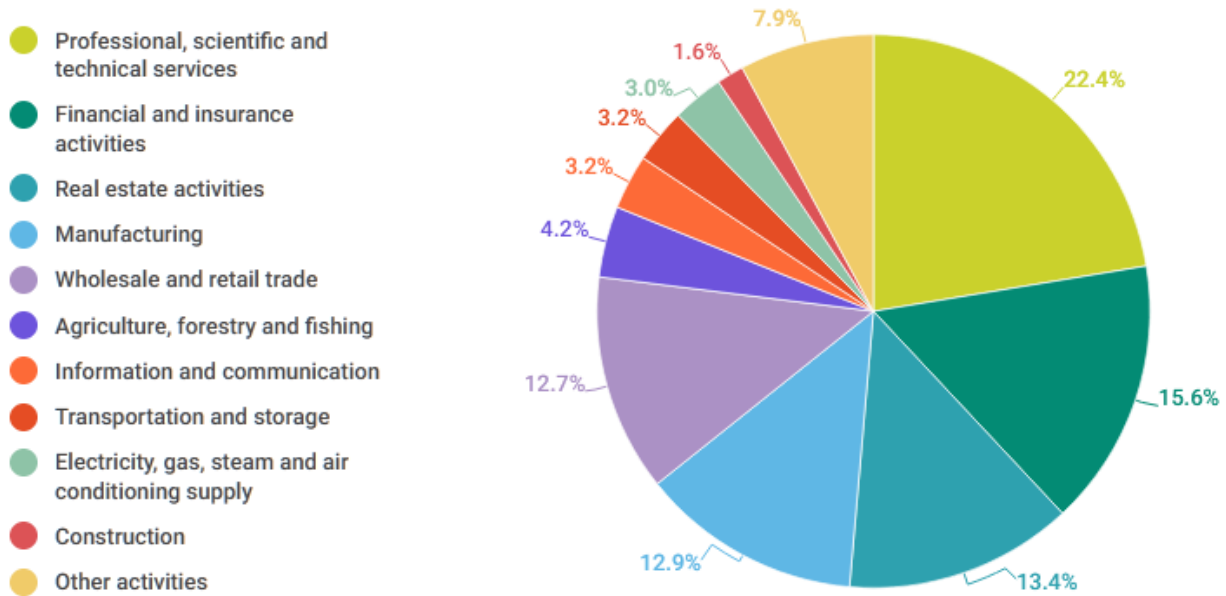


Figure 2. Foreign Direct Investment stock in Latvia by the Kind of Activity at the End of 2023
Source: Bank of Latvia (2024)

A notable trend in structural development of foreign direct investment in Latvia is a shift of investment inflows towards higher value-added activities. Examples of particularly propulsive sectors of this kind include smart energy, bioeconomics, information and communication technology. According to the fDI Intelligence data, 20 of these projects were greenfield investment projects (Fdiintelligence, 2024).

Geographic structure of these investment projects is also interesting to consider. More than a half of recent investment projects are located in Riga and Pieriga region. Another quarter of the investment projects are located in Kurzeme, while the others remain concentrated in Vidzeme, Latgale, and Zemgale.

Most of the foreign direct investment inflows in Latvia originate from other European Union member states. Namely, over 82% of the inward foreign direct investment stock originated from this group of countries by the end of 2023. Largest individual economy of origin is Sweden, account for up to 29% of foreign direct investment stock. Other notable sources of investment include Germany and other Baltic and Nordic countries. More information on the origin of inward foreign direct investment stock in Latvia is provided in Figure 3.

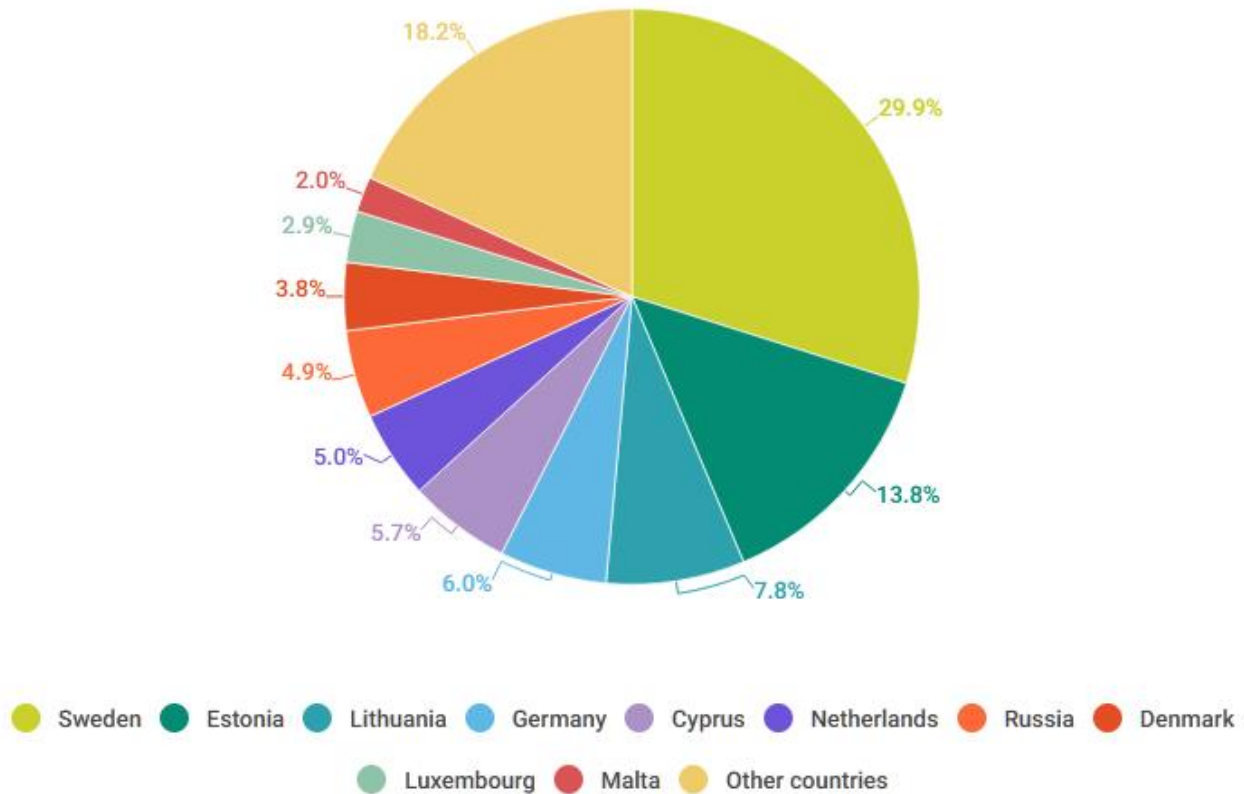


Figure 3. Foreign Direct Investment in Latvia by Country at the end of 2023
Source: Bank of Latvia (2024)

Micro-level statistics indicate a strong effect of foreign affiliates on the economy of Latvia. Foreign affiliates strongly contribute to the employment in the economy, with approximately 1 in every 5 Latvians being employed in a foreign-owned company. Moreover, foreign affiliates are of exceptional importance for corporate tax revenues, to which they contribute approximately 40%. In 2019, there were 21,228 foreign affiliates registered in Latvia. However, only 59% of these affiliated were engaged in any economic activity. The majority of these affiliates are fully-owned by foreign residents (Jurša, 2021).

Latvia developed a supportive institution framework actively encouraging foreign direct investment. A central institution within this framework is the Investment and Development Agency of Latvia. The institution is currently undertaking the Green Channel Initiative aimed at reducing the administrative burdens for high value-added foreign investment. The activities within the initiative are concerned with the facilitation of administrative procedures relate to territorial planning, residence permits and foreign workforce employment.

The regulatory framework of Latvia prohibits discrimination of foreign capital. Legal provisions provide equal national treatment to foreign affiliates. The only exception to this general stance exists in the sectors of national importance. In these sectors, including energy, telecommunications and media, there is a requirement of government approval prior to the realization of foreign direct investment projects.

The incentives for the investors are supported by the European Union Structural Funds. The financial support from these funds is projected to reach 10.5 billion EUR until 2027. Financing for this source is



mainly aimed at projects addressing the problems of climate change, sustainability, economic transformation, productivity and income inequality. Additional financial support for the investors is offered through InvestEU program. The program is particularly important for financing projects in green and digital sectors.

Finally, there are also government-supported trade finance programs realized through Altum, a national finance institution, which provides financing for all the companies conducting international business activities in Latvia. The programs supported by Altum are highly relevant to foreign affiliates, considering their strong export orientation in conducting their business.

In addition to financial incentives, the investment framework of Latvia provides significant fiscal incentives as well. Such incentives include tax rebates, that are closely related to business facilitation within Special Economic Zones. Within these zones, firms are offered up to 80% rebate for real estate, corporate income and dividend taxes. Foreign investors can use all the previously described investment incentives and privileges that are offered by the regulatory framework of Latvia to indigenous firms.

Much of the previously discussed aspects of foreign investment are applicable to Serbia. The development of the economy of Serbia was strongly influenced by historical factors. Unlike Latvia, the country was under the trade embargo and isolation imposed by the international community during the 1990s. Since the early 2000s, Serbian economy has gone through a recovery period. The processes of accession to European Union and World Trade Organization were (re)initiated. However, over two decades after initiating the integration processes, Serbia is still not a member country of the European Union and the World Trade Organization. Harmonization of regulation and economic policies aimed at adopting the international and European Union standards was conducted to some extent. However, the harmonization process is yet to be completed.

Still, Serbia did improve the level of integration of its economy. Particularly significant for Serbian economy are the exports of motor vehicles, machinery, plastic and rubber products, and food and agricultural products. Main trade partners include Western Balkan countries (Bosnia and Herzegovina and Montenegro, in particular), and the largest economies of the European Union (most notably, Germany and Italy). There is also a noticeable trend of the increase significance of trade flows between Serbia on one side and China, Russia, and Turkey on the other. There is an active support and promotion of these trade flows as an attempt to further intensify trade with these partners and diversify trade structure.

Lately, Serbia underwent fiscal consolidation. However, challenges related to the Covid pandemic and rising energy prices affected the continuation of the public debt growth. The same actors contributed to pursuant stagnation in income. The lack of capital for investment is a chronic problem of Serbian economy, caused by underdeveloped capital market, and further exacerbated by rising interest rates on international capital markets.

Covid-19 pandemic had a negative effect on the economy of Serbia. There was a slowdown of the economy as evidenced by the gross domestic product that fell by 0.9% in 2020. Private consumption was most severely affected, along with the international trade. The international trade of Serbia faced significant



logistical problems due to Covid-related measures, which exacerbated the problems of infrastructural connectivity of Serbia to foreign markets, which is naturally limited by its lack of coastal access. This was followed by a robust recovery the next year. Namely, in 2021 the growth of gross domestic product stood at 7.5% (Đuričin & Herceg-Vuksanović, 2022). In the following years, economic growth slowed down again, varying within the range between 2% and 3%. Despite this modest growth, there have been considerable negative spillovers from the globally uncertain and unstable economic and political environment. COVID-19 painted a vivid picture of the profound impact on both developed and developing countries. The uncertain economic landscape led individuals to tighten their belts, reducing their overall purchases. Simultaneously, businesses adopted a cautious approach, delaying investments and refraining from hiring new employees. It should be noted that generally, such economic downturns result in prolonged recovery periods (Abuseridze et al. 2022).

Various factors make Serbia an attractive destination for foreign direct investment. In spite of its unresolved integration processes, it provides the access to numerous important markets for foreign investors through regional and bilateral trade agreements. Most notably, it offers access to the markets of European Union, Russia, China and Turkey. The country is strategically well position and offsets its landlocked position through good logistical connectivity to other countries and markets.

It also offers a favorable investment climate. A large part of its attractiveness is based on its inexpensive, highly educated and, to a large extent, bilingual workforce. In addition, its attractiveness as a destination for foreign investment is further supported by competitive tax rates. The country further supports international business activities by making use of Free Economic Zones. According to the data provided by the Development Agency of Serbia (srp. *Razvojna agencija Srbije*) There are 15 such zones active at the moment in which 254 multinational enterprises employ over 45 thousand workers. These enterprises also account or approximately 10.7% of total exports from Serbia.

Contrasting these positive aspects of Serbian economy, there are also some factors limiting the inflows of foreign investment. The uncompleted accession process to the European Union and the World Trade Organization is among the most noticeable such factors. This halt in the accession processes implies not only limitations related to market access and protection of trade interests of foreign (and domestic) enterprises, but also that the relevant regulation has not yet been fully harmonized. This is particularly problematic, considering it imposes additional adjustment costs for foreign investors in order to be present on a rather small domestic market.

There are also both internal and external political factors negatively affecting foreign direct investment inflows. The political influence on the local economy is relatively extensive. The public sector is large and affects decision making in the private sector. The administration is relatively inefficient, placing additional burden on businesses. This is further exacerbated by the problems related to insufficiently developed rule of law. In addition to these internal factors, there are also some external political pressures. Another danger



comes from pressures to harmonize trade policies with the standards of European Union, which could deteriorate preferential market accesses gained from existing trade agreements with other countries.

A chronic problem faced by the economy of Serbia affecting the possibilities of investment is capital scarcity. The local capital markets are shallow and underdeveloped, contributing to high costs of locally financing the investment. Lately, another growing problem has been high inflation which further destabilizes the economic environment and limits new investment. Finally, a challenge for realizing higher inflows of foreign investment, particularly in more innovative economic activities, is low investment in research and development. The situation in this regard is improving each year, but by 2023, according to the data from the World Bank, the investment in research and development constituted only 0.99% of gross domestic product of Serbia, which is substantially lower than the average level of the developed economies. This lack of investment significantly limits the innovation capacities of Serbian economy.

Similarly to Latvia, policymakers in Serbia consider foreign direct investment as an important instrument for encouraging economic development, process of transition and economic integration and addressing the problem of capital scarcity. However, that was not always the case. During the socialist era, foreign direct investment inflows to Serbia were limited. Sanctions and general political instability severely limited foreign investment. The stabilization started at the beginning of 2000s, followed by the change in regulatory framework for foreign investment. The investment inflows rose steadily during the 2000s, until the wake of Global Financial Crisis. The Crisis negatively affected further investment - in 2010 there was an unsteady recovery of foreign direct investment inflows. Since 2012, the growth in inflows became persistent and by 2023 it resulted in high relative significance of foreign capital in financing the investment in Serbian economy, having a 37% share. Over the past 8 years, the share of foreign investment in gross investment was stable at around one third. Inward stock of foreign direct investment in Serbia surpassed the level of 59 billion USD, which is an equivalent of more than 81% of gross domestic product of Serbia. The effects of these inflows on the host economy could be characterized as strong, both in terms of economic development and the integration of Serbia into the world economy (Bjelić et al. 2016). More details on the dynamics of foreign direct investment inflows in Serbia is provided in Figure 4.

Figure 4. indicates a robust recovery of foreign direct investment flows since 2012. The inflows gradually rose from average levels of one billion EUR annually, to the levels consistently surpassing 3 billion EUR annually since 2017. These performances suggest that a favorable business environment in Serbia was created, and that the incentives for the investment proved to be an effective instrument of their promotion. The austerity measures implemented from 2012 also signaled foreign investors a relative stability of economic environment in the country, lowering their risks perception. The performances related to foreign investment inflows could also be explained by improved political stability. The period oversaw simultaneously increasing cooperation with European Union, Russia and China, which improved access to all the aforesaid markets, offsetting the problem of small domestic market of Serbia, and reducing the tariff and non-tariff barrier burdens on exporters in Serbia.

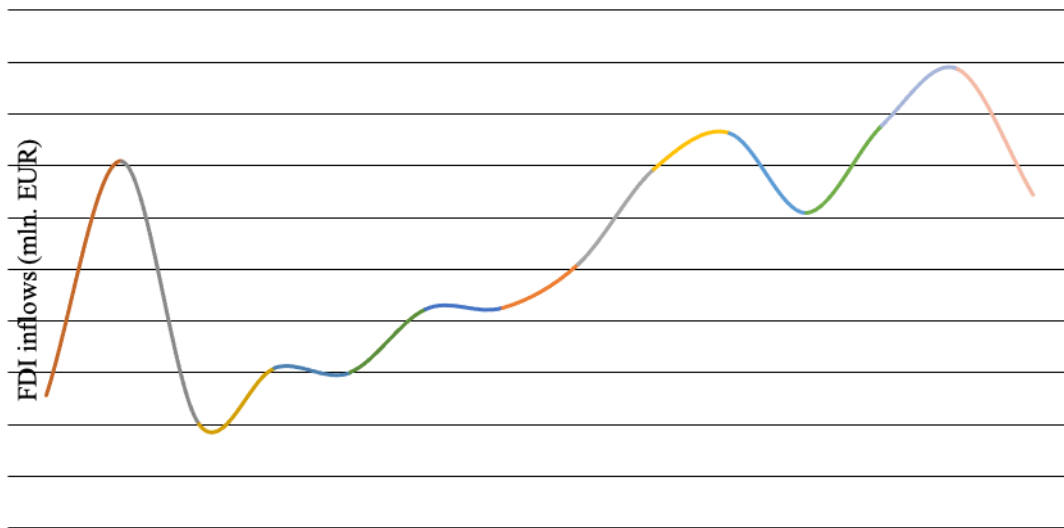


Figure 4. Foreign Direct Investment Inflows in Serbia (2010-2023)
Source: Authors, based on the data from National Bank of Serbia (2024)

Several large-scale strategic investments, such as the investment in automotive industry by Fiat-Chrysler Autos, were followed over time by numerous smaller supporting investment projects in related industries. The performances of services sectors also improved. The information and communication technologies sector built particularly high level of international competitiveness, making the firms in the sector attractive targets for foreign investment. During the 2010s there were also extensive public investment projects in infrastructure. This furthered favorable conditions for foreign investment projects, as the country significantly improved its roads and railroads net words and improved logistics capacity.

Figure 4 shows a sharp decrease in foreign direct investment inflows in 2020. This could be attributed mainly to the negative effects of Covid-19 pandemic. The pandemic generally reduced investment activity, by increasing risks and uncertainties in the global economic environment. Foreign investment inflows quickly recovered, however, with the strong growth in inflows in 2021. Such performances suggest high levels of resilience of foreign direct investment inflows in Serbia, and growing level of confidence of foreign investors. These strong performances in attracting foreign direct investment made Serbia the most important destination foreign investment in Western Balkans region.

Observed from a more microeconomic level, robust dynamics of foreign direct investment inflows could be attributed to favorable conditions results in relatively low operating costs of foreign affiliates in Serbia. This opens up the possibilities for cost savings compared to establishing similar affiliates in European Union member state. For example, foreign investment in Serbia could comparatively lead to a decrease of up to 74% in labor costs, 41% decrease in electricity costs and 55% decrease in real estate renting costs (Vukmirović et al., 2021). Rising inflation and economic instability of 2020s is eroding this position, but Serbia is likely to maintain its competitiveness as an investment location in the foreseeable future. Sectoral

structure of foreign direct investment inflows in Serbia is also worth considering. Information on this structure is presented in Figure 5.

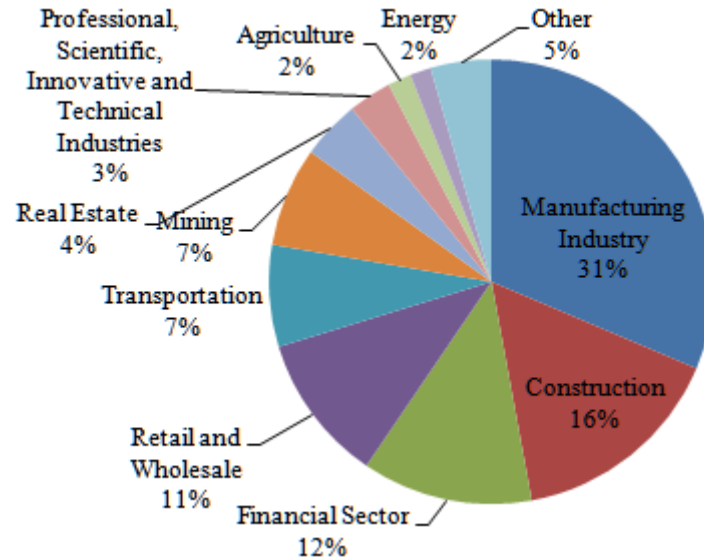


Figure 5. Structure of Foreign Direct Investment Inflows in Serbia (2010-2023)
Source: Authors, based on the data by National Bank of Serbia (2024)

The data on sectoral structure indicates high concentration of foreign direct investment in manufacturing industry, making up approximately 31% of total foreign investment inflows in the period between 2010 and 2023, or a total of 11.6 billion EUR. The highest inflows within this sector were reported in rubber and plastic industry (over 2.76 billion EUR in the observed period), motor vehicles industry (over 2 billion EUR), and food industry (approximately 1.98 billion EUR).

Relatively high inflows of foreign direct investment in manufacturing industry could, to a great extent, be explained by the existing industrial base in Serbia. Another reason foreign investors favored the particular aforementioned industries within manufacturing sector is the incentives system, which is dependent on job creation. Thus, the incentives offered to investor favor more labor-intensive industrial activities, increasing the attractiveness of such sector to foreign investors. Large investment inflows in certain manufacturing industries' could also be explained by the formation of clusters instigated by some of the strategic large-scale foreign investment projects. This produced positive spillover effects of industrial agglomeration and linkages between industries, making Serbia and increasingly attractive destination for some manufacturing activities.

Observed more generally, the foreign investment in Serbia were mainly directed towards industries in which Serbia has a comparative advantage. This is particularly evident in the case of food industry. Foreign investors in this industry make the best use of well-developed and competitive agriculture sector providing inexpensive inputs and high export competitiveness food products. In addition, Serbia is known as having solid foundation for competitive organic food production, and possesses strong tradition in the sector, with numerous products being regionally recognized. Over the last several years, there is a noticeable growing

importance of construction sector as a destination for foreign direct investment inflows. Over 5.3 billion EUR of foreign direct investment went into this sector in the past decade. The growth of foreign investment is fueled by rising real estate prices, which make investment in construction highly profitable. In addition, parts of foreign investment projects in the sector were directed toward providing support for public infrastructural development projects. Other important sectors receiving foreign direct investment include retail and wholesale, transport and mining.

Foreign direct investment in Serbia originates from several major sources. The information on the structure of foreign investment in the economy by countries of origin is provided in Figure 6.

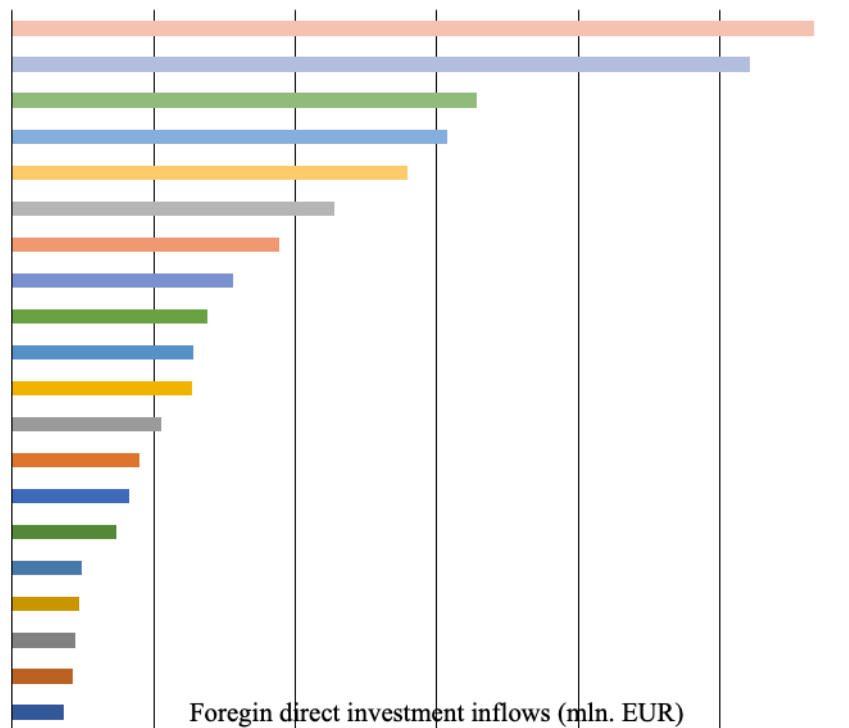


Figure 6. Structure of Foreign Direct Investment Inflows by Country of Origin (2010-2023)
Source: Authors based on the data from National Bank of Serbia (2024)

The presented results suggest that Serbia received highest inflows of foreign direct investment from developed economies. Particularly important economies of origin are member states of the European Union. The data could also reflect some possible distortions in the case of some countries, such as the Netherlands and Luxembourg. The existing micro-level empirical evidence suggests that oftentimes the capital flows are directed through these countries of origin. However, these flows are not conducted by actual multinational enterprises from these countries of origin, but rather by other investors (even the domestic ones), who reroute the capital through the aforementioned countries (Kastratović, 2023).

China is becoming an increasingly important origin of foreign capital in Serbia. From negligible levels, over the past decade, China has become second most important country of origin in terms of foreign direct investment inflows in Serbia. Other countries, including Russian Federation and the United Arab Emirates



have also become very important sources of foreign direct investment in the same period. Finally, Serbia receives substantial investment from other countries in the region, particularly from Slovenia, Croatia, and Bosnia and Herzegovina. Common characteristic of countries from which foreign direct investment in Serbia originates is typically larger size and (or) geographic proximity. The trend of decreasing reliance on sourcing foreign capital from European Union is particularly noticeable, alongside with diversifying sources by increasing inflows of foreign investment from Asia.

Foreign Affiliates Trade Statistics indicates that as of 2021, over 2,862 foreign affiliates were active in Serbia. The activities of these affiliates have important effects of local economy. The value-added of foreign affiliates is disproportionately high compared to their share in total number of enterprises in Serbia. The foreign affiliates participate with 34.8% in total value-added in Serbia. The affiliates also strongly contribute to output and employment. Currently, over 337 thousand workers in Serbia are employed in foreign affiliates, making their share in employment approximately 19.9%. At the same time, only 1.4% of enterprises in Serbia are owned by non-residents.

Regulatory and institutional framework for foreign investment in Serbia is overwhelmingly positive. Previously, during the 2000s, and early 2010s the framework provisioned positive discrimination towards foreign investment. The government actively subsidized foreign affiliates, in an attempt to hasten the increase in attractiveness of the country as an investment location. This positively discriminating framework was discontinued in 2015. The investors are guaranteed national treatment. The expropriation is transparently regulated. In addition to this, Serbia provides further guarantees for foreign investors on bilateral basis, basing them on bilateral investment treaties, which have been concluded with over 50 partner economies (Kastratović & Bjelić, 2023). The regulatory framework relevant to foreign investment includes no sectoral discriminatory practices or any requirements of pre-investment screening. The only notable regulatory limitation is related to agricultural land, where non-residents are prohibited from owning agricultural land in Serbia (Budak, 2022).

Central institution responsible for overseeing the implementation of promotion and incentive programs for investment in the Development Agency of Serbia. Established in 2016, the Agency aims to promote foreign and domestic investment. It also serves as a one-stop-shop, facilitating the administrative hurdles the investors in Serbia face. The Agency is responsible for implementing investment support measures defined by the Investment law (srp. *Zakon o investicijama*). Furthermore, the agency seeks to promote direct cooperation and linkages between indigenous and foreign-owned enterprises, and actively finances foreign affiliates.

The institutional framework also includes regional-level institutions. An example of such is the Development Agency of Vojvodina which provides a localized support for investment that is located in the Vojvodina region of Serbia. The agency provides consulting services to foreign investors, which is particularly useful in securing the compliance of foreign affiliates with local regulation. The Agency also support the investors in choosing the optimal location for their investment, and in establishing initial contacts



with local buyers and suppliers. Finally, the Agency is responsible for implementing financial support which entail distributing the investment support funds to the investors in the region. Finally, Local Economic Development Units at municipality and regional levels provide further local support for the investment, as well as consulting services.

Another institution relevant for incentivizing foreign affiliates in Serbia is Agency for Export Insurance and Financing (srp. Agencija za osiguranje i finansiranje izvoza). This agency provides trade financing and support for both indigenous firms and foreign affiliates.

The incentives scheme for investment includes financial, fiscal and other types of incentives. Interesting examples of such incentives are full tax and tariffs waivers provided in the event of purchases of equipment that is part of investment projects. Additional tax waivers are offered for salary contributions and social insurance of employees in the approved period of time. Finally, depending on the importance of a particular investment project, incentives framework in Serbia provides a possibility of under-market selling or leasing of public-owned real estate.

CONCLUSIONS

One of the the most significant problems in both the economic and legal spheres is the correct definition of the term “investment”. On one hand, at the theoretical and legal level, one can designate financial investments aiming at obtaining benefits that will arise over a relatively long period in the future. On the other hand, at the economic level, investments are usually defined objectively - on the basis of logical criteria (for example, “industrial goods”, “fixed assets”, etc.), which, in turn, are related to the nature of the specific activity or the nature of the product. It is quite natural that this question directly concerns the derivative term “Foreign Direct Investment”. In both Latvia and Serrbia, this problem is partially resolved at the legislative level (in Latvia - also in the context of the entire European Union). We believe that any uncertainty in the definition of the term "Foreign Direct Investment" should be eliminated in the coming years through the unification of pan-European legislation.

The legal regime and foreign direct investment are directly interrelated. Using the example of Latvia and Serbia, we note that improving the regulatory framework (for example, defining the conceptual elements of private industrial investment, reducing the bureaucratic burden, protecting foreign investments, fighting corruption, etc.) in different historical periods gave positive results - favorably influencing including on the economic, social, cultural development of the respective countries.

For countries such as Latvia and Serbia (due to their economic characteristics), foreign investment is of particular importance. If these investments are well distributed in terms of the spatial planning of the host country, then they act as unique locomotives, including contributing to national exports. Another feature of the influence of foreign investment on the economic environment of Latvia and Serbia is that it brings in not only capital, but also a philosophy of entrepreneurship. This circumstance can only be positive in situations where investors are classic, stable, non-corrupt entrepreneurs. Summarizing the results of our analysis, we



emphasize that in the last decade there has been a steady increase in the volume of investments in both economies (Latvia and Serbia). Although the growth is due to different reasons (for example, Serbia unlike Latvia, is still not a member country of the European Union and the World Trade Organization), these dynamics have a positive impact on the future development prospects of both countries.

Legislators of both Latvia and Serbia promptly respond to the economic challenges of the contemporary economic environment, improving national regulations. The results of our analysis imply that despite the differences - in economic indicators, legal regulation, history and geography - the investment climate of both countries could be characterized as generally attractive.

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