SERBIA'S LAW ON TAXING EXCESS PROFITS AND THE RULE OF LAW

Svetozar Pejovich*

The recently published interview by professor Ljubomir Madžar has been among the best in the Serbian press since the end of Milosevich's regime. Professor Madžar's observations about recent events in Serbia are concise, clear, and, in my opinion, fully justified. For that reason, his interview deserves a broader public debate because it goes into the heart of the economic and legislative policies of the current government in Serbia. I would like to add a few words in support of his claim that the law on taxing excess profits is a step backward in the creation of the rule of law in Serbia.

1. If professor Madžar is right in saying that the law on taxing excess profits is retroactive and selective the enforcement of that law will be a major setback for the post-Milosevich's Serbia. In essence, the rule of law means the absence of arbitrary power on the part of the ruling group. It means that individual rights are protected from the majority rule. The rule of law depends on stable and credible individual rights, private property, freedom of contracts, and independent judiciary. Stability means that the majority (or a dictator) does not have discretionary power to change the rules. Credibility means that police and judiciary guarantee the enforcement of the prevailing rules. Therefore, in a rule of law country the word constitution comes before the word democracy. Prior to its return to China, Hong Kong did not have free elections, but it did have stable and credible rules of the game that ensured all its citizens their individual rights and created the basis for their economic prosperity.

After 60 years of legal arbitrariness, the new government in Serbia has a difficult job of convincing the country's citizens that the rule of law could be a reality. In order to accomplish that objective the government must make sure that new laws and regulations are consistent with the basic premises of the rule of law. Promises and good intentions alone can

* Professor emeritus, Texas A&M University, United States.

do no good. I believe that the law on taxing excess profits is a behavior that is not consistent with the rule of law. Thus it is a major setback for the people of Serbia.

In his discussion in *Srpska Rec*, Professor Madzar failed to raise a key question: Why did the new government of Serbia pass the law that is contrary to the rule of law? In my view, new political leaders in Serbia are the products of the legal arbitrariness that had characterized the governments of Tito and Milosevich. Their reaction to social problems reflects the cultural influence of sixty years of socialism. They believe that they know what is good for their country. Thus, they feel free to create and change the rules of the game at their pleasure. I have seen no evidence that new leaders in Serbia respect the basic premises of the rule of law including those that say that the social welfare function is a blackboard invention by social engineers, that the government cannot know individuals' subjective preference until they are revealed via free interactions, and that the knowledge of individuals' preferences, even if such knowledge were available, would make no difference in the way the state is run. In my view, the rule of law in Serbia must await a new generation that will not be burdened with customs and routines from the years of *l'ancienne regime*. To that end, what is being taught at the universities in Serbia is quite important.

2. Instead of the economic jargon of my profession that is sometimes more interested in the formality of presentation than the essence of the argument, I will state my opinion about the law on taxing excess profits within a basic *Economics 101* course. Suppose that in an arbitrary state without competitive markets (the reader should keep in mind that competitive markets without stable and credible private property rights are an illusion) Mr. A earned one million dollars. New government, which wants to create a private-property, free-market economy passes a law by which Mr. A must pay, say, 50 percent of that profit as tax on excess profits. This means that the new law on taxes will transfer $500,000 from the private to the state sector of the economy. This is the first problem with this law. Irrespective of the source of money, transferring resources from the private to the state sector would neither

reduce the role of the government nor increase economic efficiency. Even if he were a Mafia man, Mr A would have more incentives than the state to find an efficient use for $500,000.

Clearly, the purpose of the law on taxing excess profits is to punish Mr. A for abusing his political connections for personal gains. Of course, the punishment has its economic price. The price is the transfer of $500,000 to the state sector where the use of money is less efficient. Many academics received Nobel prizes for demonstrating the superiority of the private sector of the economy. The following simple story captures the essence of their research as well as empirical observations: The state is acting like a sailor in a port after three months of sailing. Both the sailor and the state are throwing their money around. The difference is that the sailor is throwing around his OWN money.

Suppose now that Mr. A. did pay $500,000 to the government. The government has two major alternatives for the use of $500,000. First, the government can spend $500,000 on various programs. Second, the government could choose to return $500,000 to the private sector via tax rebates. This alternative has its moral and economic advantages relative to the first. If Mr. A must pay the penalty in the form of a tax on excess profits, than the tax revenue the state collects from him should be returned to the citizens of Serbia at whose expense the profit was made. At the same time, returning money to taxpayers means that the command over $500,000 worth of resources remains in the private sector. The argument that every taxpayer (assuming 1 million taxpayers) will receive only a trivial amount of 50 cents is wrong. The amount spent in the private sector of the economy would be the same ($500,000) as in the public sector, but with one difference. Tax rebates reduce the role of government in the economy and promote competitive markets.

3. On the issue of privatization, I disagree with professor Madžar. I believe that giveaway privatization is a better solution. Perhaps voucher privatization has not been perfect, but that does not mean that it should be rejected–perhaps it is better to improve it on the basis of experience of other countries. However, I will be the first to say that this is a problem on which even the best economists may disagree. Very briefly, my reasons for a giveaway privatization are the following:

a. To me, privatization means the transfer of ownership in productive assets, not their sale. Some people say that the state cannot "give away" national wealth. That argument is plain silly. We are talking about two methods of changing the ownership in assets. In either case, the total stock of capital remains the same. I conjecture that selling state owned assets to individuals is less efficient than giving them away. Suppose that a factory is worth $1,000. If the government sells it for less, say, $500, the private sector will have new $1,000 worth of resources for production. At the same time, the sale of that factory would also transfer $500 worth of resources from the private sector of the economy to the public sector. Whatever the government does with those $500, the result will be less efficient than if those $500 were left in the private sector. I am sure that the government needs money to service its debts and other needs. But the fact remains that if privatization were free the private sector would have gained the command over $1,000 worth of resources while, at the same time, it would not have transferred $500 to a less efficient user (the state). In addition to academic research, empirical evidence shows, quite convincingly, that a very strong positive correlation exists between private property rights, low taxes, limited government, and the freedom of contract on the one hand and the rate of economic growth on the other.

b) The problem of privatization is even more complicated when we analyze the process of selling state owned assets in former socialist states of Eastern Europe. The price at which most governments sold or are selling those assets to individuals is either arbitrary, or based on "consultant" evaluations. In either case, prices at which state assets are sold are not scarcity prices. The latter can emerge only in competitive markets. And the absence of markets means that we cannot presume that assets are sold to the highest-valued users. The transaction costs of identifying them are quite high. Alternatively, a giveaway of assets (such as mass voucher privatization) gives each citizen a chance (for example, each family receives one share of each company) to participate, via individual trials and errors, in the creation of competitive markets.

Suppose that a family receives a share in a factory that we shall call Z. After sixty years of socialism the family does not understand the meaning and consequences of owning shares. Thus, the father sells the family share of Z for one beer. It might be a bad decision for his family. However, we have the first market price for shares of Z. The price has emerged via a voluntary agreement between two parties. Importantly, the sale of one share of Z has created a little bit of knowledge about its value. The buyer of one share of Z might now negotiate to sell it to another person for, say, one glass of wine. Now, we have even more knowledge (i.e. lower transaction costs) of the value of Z. Eventually, this knowledge-creating process that depends on voluntary agreements will keep moving resources from lower- to higher-valued users. Some people will end up being better off than others. But that is what it takes to make a change from the socialist oppression to a free society. In the latter, individuals make their own decisions and bear the consequences (good and bad) of those decisions in a credible and stable legal environment. The key point is that scarcity prices cannot exist without competitive markets. Let me quote Professor Buchanan, a Nobel laureate in economics:

> Economic performance can only be conceived in values; but how are values determined? By prices, and prices emerge only in markets. They have no meaning in a non-market context, where the choice-influenced opportunity costs are ignored. (James Buchanan, "General Implications of Subjectivism in Economics," Conference on Subjectivism, Dallas, Texas 1976.)

c. Finally, comparing privatization, for example, in England with Serbia is not correct. The purpose of privatization in England was not a fundamental change in the structure of the system but a marginal adjustment in the distribution of capital between private and state sectors. Private property and free market have been functioning in England for decades. This means that the transaction costs of identifying the highest-valued users of assets are much lower in England than in Serbia. The process might jump over the first glass of beer and wine in our previous example. Moreover, in England, where the rule of law is at a high level, the government was a legal owner of assets that were sold. In Serbia (and other countries of Eastern Europe), this is not the case. It is not difficult to argue that the Serbian government is selling assets that have been confiscated, nationalized or, to speak plainly, stolen first by Tito and then by Milosevich. Finally, it should be remembered that Mrs. Thatcher returned many resources to the private sector via monetary, fiscal, and regulatory policies.

Svetozar Pejovich
Professor Emeritus of Economics
Texas A&M University