

FOUR YEARS OF TRANSITION IN SERBIA



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# FOUR YEARS OF TRANSITION IN SERBIA

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# Introduction

Transition in Serbia has entered its fifth year and it is time to review the progress made so far, to evaluate the ground covered and identify obstacles to be expected on the road to a liberal-democratic system, a market economy and the rule of law. In addition, this book aims to explain the decision-making mechanisms that have formed this transition and the factors that have influenced the decisions made. Politicians act rationally and react to incentives from their surroundings. This is why it is important not only to determine how far transition has progressed, but also to explain why the transition has taken the form it has.

In some respects this book is a logical sequel to the overall activity of the CLDS on the monitoring and the analysis of the transition. The first step in that direction was the collection of papers entitled *The Strategy of Reforms* (2003) comprising works written at the beginning and in the first phases of this wave of transition including texts by Vojislav Koštunica, Zoran Djindjić, Miroljub Labus and others. While those texts mostly dealt with the ideas and plans of reformists and high state officials, the texts in this collection offer an overview and analysis of the situation over the last four years. In this respect these two books are complementary.

1<sup>st</sup> September 2005.

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## General Overview of Transition in Serbia

### INTRODUCTION

In the developed part of the world, institutions evolved gradually during tens and hundreds of years, in order to get to the present rational and efficient forms. In 2000 Serbia attempted to compensate for at least part of the historic delay and, by using good political and economic concepts and accumulated experiences, conduct the reforms swiftly and build new, democratic and capitalist institutions. Today, four years since the beginning of transition, Serbia is in the middle of deep changes of the government, political, economic and social system. Changes are probably happening more slowly than they should, but also faster than is sometimes thought.<sup>1</sup>

Transition is usually defined as a change of the institutional system of a country, i.e. the group of domestic institutions and related mechanisms providing a framework for the behavior of individuals and their interaction, such as the market or elections. The institutional system covers, inter alia, the political and economic system, so it is possible to differentiate between the political and economic transition. Political transition essentially encompasses: democratization, i.e. multiparty system and fair elections; change in the character of the state, i.e. parliamentary liberal democracy instead of the party state; and the new role of the state, i.e. the state with the role limited to the protection of the rules of the game and moderate intervention, instead of the all-powerful paternalistic state. Economic transition encompasses the abandonment of the socialist model of economic activity, either centrally-planned, or self-management-market model, and the construction of the standard market model with the domination of private ownership.<sup>2</sup>

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<sup>1</sup> V. Gligorov (*Serbia and Montenegro: Situation and Proposed Reforms*, 2004) claims that transition in Serbia so far has been quite unsuccessful and is consequently still at the beginning.

<sup>2</sup> More details, L. Balcerowicz – *Socialism, Capitalism, Transformation*, Central European University Press, Budapest, 1995

For most East European countries in transition, the classification into political and economic transition meets the cognitive needs. It is different with the countries created by the breakup of the USSR and SFR Yugoslavia, which, apart from the narrow political and economic changes common to all countries in transition, also entered two additional transition processes: building of a (new) state and search for (new or innovated) national identity, which makes their transition much more complicated. This is particularly true for Serbia, which came out of the 1990s as a defeated side in the war for Yugoslav heritage and, thus, faced the problems of the determination of the new state (the issues of Montenegro and Kosovo and Metohia) and the formulation of a new national strategy.

Most of the literature on transition is dominated by its economic aspect. This is probably caused by the fact that economic transition is perceived as a more complex and less certain process than political transition, while the social aspect is, generally speaking, quite disregarded. This book is not an exception from the rule either: economic transition has been given most room, whereas much less space has been dedicated to political transition (only the most important issues will be dealt with) and even less to social transition. Nevertheless, when analyzing transition in a country, it should always be borne in mind that transition is a multidimensional phenomenon and that the economic component is only one of many.

## PRIOR TO OCTOBER CHANGES

### **Political developments during the 1990s**

The first wave of political and economic transition in Serbia was initiated already towards the end of the existence of the former SFR Yugoslavia, at the same time as in other republics, present independent states.<sup>3</sup> During the federal government of Ante Marković, at the very beginning of the 1990s, deep economic reforms of the old self-management economic system were initiated,

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<sup>3</sup> It is interesting that perhaps the first state reform paper in Eastern Europe with a developed concept of promarket reforms was prepared by a Milošević's committee and published in 1988. It called for shareholding as a way to solve the negative effects of Yugoslav social ownership. Still, in view of the subsequent developments, it is more likely that this was just a tactical move in bargaining with other republic authorities rather than honest pleading for procapitalist reforms.

whereas the party reform was initiated with the breakup of the Communist Union of Yugoslavia (SKJ) along republic lines.

Around 1990 an impetus to the reforms in Yugoslavia was certainly given by the collapse of socialism in Eastern Europe, as well as the inefficiency of the system of socialist self-management, so clearly demonstrated during the 1980s and before. Simply put, the then party and political elite realized that the old path, including cosmetic changes, was no longer viable. The only issue was how far to go with reforms. It was clear to some that the goal had to be capitalism, while the others, together with Gorbachov,<sup>4</sup> naively believed that the third path was possible – the path that would combine the best of socialism and capitalism. The former would give wide state interventionism and state ownership over large and important companies, while the latter would give the market, to the necessary extent. In the political sphere, democracy would be limited, i.e. there were dreams of the so-called non-party pluralism (Mihajlo Marković).

The beginning of reforms, stable exchange rate and opening of the country to the world brought the feeling of prosperity and confidence in progress in the years to come. However, the cruel reality was stronger, and 1990 was remembered in Serbia for a long time as the last normal, even beautiful year. The process of reforms and democratization of Yugoslavia was, however, powerless in the race against fervent national programs. What was for decades swept under the carpet as a problem best avoided – conflicting national goals and their history – arose in full force as soon as the iron fist of the communist party disappeared. Ante Marković did not stand a chance.

A brief and unsuccessful attempt to reach an agreement on preserving the state or on breaking it up consensually in the first half of 1991 did not give results and was followed by the proclamation of independence, and then by war(s). The finding of the Badinter Committee from 1991 that Yugoslavia had broken up signified a judgment on the guilt for war – it belonged to Serbia, which acted as a protector of a non-existing state – which led very quickly (already in the first half of 1992) to economic and political sanctions against it.

This was followed by an economic nosedive, as well as the reinforcement of the political position of the authorities. The then regime very skillfully rode the nationalist wave and did well in the elections, probably with significant abuse during elections. When it did not have majority by itself, SPS entered

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<sup>4</sup>The meeting between Gorbachov and Milošević in Belgrade in 1988 was interesting. While the former spoke about the necessity of reforms, the latter praised the virtues of socialism.

coalitions with other parties (New Democracy, Radicals, and SPO). SPS, later together with JUL, held firmly the levers of power and used them to the maximum extent: state media, police, finance, economy, judiciary... This was accomplished through personnel policy, i.e. convenient positioning of well motivated own people ('staff are the key to everything' – Stalin).

Military defeats of the Serbian forces in Croatia and B&H from the summer of 1995 and the Dayton Agreement ended the wars. The lifting of the trade, although not of financial sanctions from the end of the same year gave a certain breathing space to the country, but the political situation remained the same. The regime even seemed to have American support.<sup>5</sup>

In 1998 terrorist actions of KLA began at Kosovo, followed by a severe military-police response of Serbia, unsuccessful diplomatic mediation of the West and bombardment of Serbia in the period March-June 1999. Milošević capitulated, but, very comically, attempted to pass the defeat off in the media as a victory. The regime was definitely worn out, although its leader failed to realize it. He even unnecessarily announced the elections for the president of the FR Yugoslavia for September 2000 – and was defeated. He was obviously beyond any hope: he had lost all the wars, and Serbia's socio-economic situation was disastrous. He was apparently abandoned by the previously reliable pillars of the regime from the military, police and finance. It was time for new people and new strategies.

### **Transition and economic developments during the 1990s**

Economic crisis is practically immanent in the Serbian economy. Only the older citizens remember the last upswing from the late 1970s. Already in the 1980s economic stagnation was registered - GDP grew by around 1%, which was equal to the population growth, so GDP per capita remained the same. The cause of difficulties lay in the problems of servicing accumulated foreign debt, combined with the negative effects of developed self-management.

The government of Ante Marković, followed partially by the Serbian authorities as well, initiated in 1990 more comprehensive reforms. First macroeconomic stabilization was achieved, which was necessary after the inflationary wave from 1989, and presented part of the reform package according to the then fashion (liberalization + stabilization + privatization).

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<sup>5</sup>The American negotiator Holbruck, together with Milošević, condemned the boycott of 1997 elections by the democratic opposition.

The liberalization of prices and foreign trade were conducted practically at the same time, followed by privatization (according to the capital increase model) and tax reform (conducted in Serbia at the beginning of 1991). A rehabilitation of the banking system was also planned, but things never got that far. Problems arose immediately: already in 1990 wages and fiscal expenses grew at a pace leading to destabilization; at the end of 1990 banks were no longer able to pay out FX commitments to the citizens; devaluation from April 1991 marked the end of the stabilization program. Soon the former republics of the SFRY, now independent states, went their separate ways.

During the 1990s economic trends in Serbia were extremely unfavorable - from the collapse of GDP, real value of wages and all other personal income, reduction of employment, increase in unemployment and technological lagging, to thriving gray economy, criminalization of economic life and society as a whole, etc.

The breakup of the Yugoslav market in 1991, beginning of wars and UN sanctions against the FR Yugoslavia during 1992 and misguided economic policy resulted in a drastic decrease in GDP and hyperinflation in 1993: GDP was halved relative to 1990, and inflation, despite the constant price freezes, in December 1993 and January 1994 broke the world record for the period after World War II. Wages and pensions were reduced to 5-10-20 German marks a month, and production practically ceased in the autumn and winter of 1993/94, because any sale of goods was unprofitable. In January 1994 hyperinflation was interrupted and economic activity restored..

In those few war years reforms regressed in all respects. First, the trademark of the new policy was the elimination of the relatively liberal foreign trade regime upon the introduction of the foreign trade sanctions from May 1992 in a highly restrictive manner: licenses and quotas were reintroduced. This move was even extremely stupid, because it was precisely the freedom of trade, and in particular of imports that could have been the best defense from international sanctions.<sup>6</sup> Then, most of the economy was transferred to the semi-war system: it practically became a single company, whose management board was the Government of Serbia, while company managers were obedient executors.<sup>7</sup> The main goal of economic policy was the provision of sufficient

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<sup>6</sup> Imports control was probably part of the strategy for wealth accumulation by the political elite.

<sup>7</sup> This was ensured by personnel policy. If that was insufficient, there were other instruments: financial sanctions against the company via the control over banks; criminal prosecution of the manager for violating an unrealistic law (on the ban on foreign currency trading, for example); sending various inspections to the company; mistreatment by utilities, unfounded transfer of funds from the company accounts, etc.

quantities of basic foodstuffs for the population (bread, oil, milk, sugar), regardless of whether it was a profitable business or not.<sup>8</sup> The financial sector fared just like the real sector: banks, including the central bank, were placed under control and their task was to supply the enterprises and state trading companies with the necessary amounts of dinars and foreign currency, so it is no wonder that in the period 1994-2000 dinar lost 97% of its value, while banks were completely destroyed.

Privatization was interrupted, both due to the more restrictive law than the Marković's and the overestimated official dinar exchange rate and the fact that the Party did not give a signal that privatization should be initiated, i.e. did not conduct a campaign supporting it. Admittedly, informal privatization was very advanced, consisting of taking money out of socially- and state-owned companies and its transfer into private hands. Similar to privatization, there was a legal, although expensive possibility for the companies to eliminate surplus labor, but no managers were willing to do so, because the Party was obviously against it. The foreign exchange market was forbidden, and the state distributed foreign currency.

According to the Dayton Peace Accord, the foreign trade sanctions against Serbia were suspended at the end of 1995, but the financial sanctions were retained (the membership of the FRY in the IMF and the World Bank was not renewed, the ban on investment was introduced, etc.). After 1994 a mild increase in GDP was recorded, but the whole period 1994-1998 can be assessed as stagnant. Year 1997 presented somewhat of an improvement, because the Telekom sales proceeds increase incomes and demand, and partly the production as well. Already in 1998 industrial production exhibited a downward trend, with the Serbian economy returning to the old, low levels. The worst thing is that after Dayton the single company Serbia, managed by the Government of Serbia, was not dismantled, but preserved, and transition was nowhere to be seen.

In 1999 the NATO Pact committed aggression against Serbia, with the destruction or damage of numerous infrastructural, industrial and civilian facilities. As a consequence of the destruction and interruption of economic activity in many companies, GDP was reduced by a fifth relative to the previous year. In the second half of 1999 there was a certain, but insufficient recovery of production.

As a consequence of all these developments, the production structure in Serbia was changed: the share of industry (in particular metal, electric and

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<sup>8</sup>The price controls for basic products were not eliminated.

chemical) and construction was significantly reduced, with an increase in the share of agriculture, traditional services and energy. The decline of the formal sector was partly compensated by the gray economy. The Serbian economy practically returned to the pre-industrial phase, where it was half a century ago.

### **Situation before October 2000**

**Policy.** On the eve of 5 October, Serbia lived in a multiparty system, but with a great advantage of the ruling party based on the full control over government media, repression levers, judiciary, financial system, etc. There was also a group of parties ready to sacrifice themselves for Serbia, as Vuk Drašković said, and enter a coalition with SPS (and JUL) in order to participate in power. On the other hand, the democratic opposition was divided into a large number of smaller parties, often reluctant to cooperate mutually and full of leaders with delusions of grandeur. For the ruling party foreign policy failures (Kosovo was the last) and bad socio-economic situation in the country presented a bigger threat than the activities of the opposition itself.

The position of the Serbian authorities was burdened by two problems related to the stability and character of the state, which would continue to do so in the future as well: Montenegro and Kosovo. The Montenegrin authorities began already in 1997, under the guise of democratization, to sever the ties with Serbia, gradually taking over the federal areas of competence. Since June 1999 Kosovo and Metohia has only nominally been part of Serbia and Yugoslavia, while in reality it is a protectorate of the international community.

Formal institutional foundation of the system was the 1992 Constitution of Serbia. The opposition attacked it as the actual foundation of the Milošević's reign, which was an exaggeration. His power certainly did not stem from the authority the federal constitution gave the president of the FRY or the Republic constitution to the president of Serbia, but from the concrete control over the party which beyond the constitutional provisions, even unconstitutionally, controlled everything else (together with his wife's party). This constitution has its weaknesses – in the parts related to the economic system and vertical division of competence (excessive centralization) – but it is difficult to blame it for all political and institutional weaknesses in Serbia. Moreover, the experience after the October changes showed that this constitution does not present a serious obstacle to political and economic reforms.

**Economy.** On the eve of October changes, Serbia nominally had many institutions of standard market economy: there were laws on companies, property protection, privatization, bankruptcy, stock exchanges, securities, foreign investment, taxes, antimonopoly legislation, accounting, etc. The only significant exceptions were the non-existence of the formal foreign exchange and labor market. There were also institutions that were formally equal to those in market economies - independent companies, central bank and other banks, stock exchanges, free-trade zones, courts, arbitration, chambers, trade unions, etc. Entry into business was to a great extent free, although there were certain barriers; there was a freedom of possession and sale of property; competition of economic subjects was recognized. Despite all that, the Serbian economic system was certainly not a market system in the standard sense. The laws were usually bad and were often not implemented, while the state and policy informally and illegally took over the role of all-powerful arbitrator with decisive influence on all economic flows.

The suspension and then the annulment of transition during the 1990s made Serbia inherit almost all negative mechanisms of the operation of the economy from the previous period, with the addition of the new ones: domination of inefficient social and social ownership; discrimination of the private sector; domination of politics over the economy; transformation of companies into social care centers, which brings lack of financial discipline; abuse of the police and judicial system, leading to widespread criminalization of the society and corruption; reducing the market to the goods market, while the markets of money, foreign currency, capital and labor were semi-legal, with mostly administrative prices; bankruptcy legislation was not implemented for large companies; non-payment of taxes was common practice; administrative distribution of foreign currency and loans from primary issue to the favorites under preferential conditions was a rule; the closed economy concept continued to dominate (import substitution); debtors dominated the financial relations, not the creditors, etc. It is obvious that those nominal market institutions did not function.

The situation was almost desperate with regard to economic legislation. There were several types of laws: most were bad in the legal-technical sense, which enabled excessively liberal and wrong interpretations by the government bodies, at the expense of companies; furthermore, most laws were restrictive on purpose, so that the government bodies could prosecute the offenders at will; numerous laws enabled individuals to amass wealth through monopolistic benefits of different types; the few existing decent laws were not implemented, such as, for example, the bankruptcy law; laws were often replaced by government

decrees, which was unconstitutional; the government of Serbia often regulated by its decrees the issues from the federal area of competence; on occasion, it even behaved as if there had existed a regulation granting it a right to intervention, although this was not so.

It is not an exaggeration to say that in Serbia there was a legal anomaly, or lawlessness, so the chaos in economic life was an inevitable consequence. Practically no one respected the laws, partially because they could not be enforced and because the insistence on their enforcement would stall the economic life, and partially because that favored certain individuals from the ruling regime at the expense of other subjects. This created a situation in which nothing was safe, in which managing in an unclear situation was the only motto. Taxes were not paid, contracts were not honored (debts were not paid), the state was used as an instrument for amassing wealth, many did not live by their work or entrepreneurship, but like parasites, at someone else's expense. Modest resources were redirected away from the productive towards the unproductive, purportedly in order to preserve social peace. Social and state ownership became the place of unprecedented plunder. Such waste and abuse of money were directed towards not only the current income, but also at the expense of the existing capital and new external borrowing. Inevitable consequences of institutional weaknesses and legal anomalies were the insecurity of business operation, general lack of confidence and waste of scant financial resources, whose result was a deep economic crisis. Economic sanctions and wars only gave a significant contribution to it.

## AFTER OCTOBER CHANGES

### **Political dynamics**

Wear of the regime was demonstrated on 5 and 6 October 2000, when the pressure of the large masses of citizens in Belgrade removed it without difficulty.

Power takeover by DOS was performed in two steps: at the federal level immediately, with President Koštunica, with certain difficulties regarding the formation of the government, since it was necessary to win over the Montenegrin SNS, until yesterday the faithful ally of SPS; at the Republic level, first the technical government of relevant parties was established (SPS+DOS+SPO),

and, after the decisive victory of DOS in the parliamentary elections at the end of 2000, the new government of Serbia was formed in January 2001.

The DOS coalition was composed of 18 parties. It is probable that such a wide composition was necessary for a victory over the old regime, but it proved to be difficult in terms of government operation. As the time passed, the idea of Serbia's progress was a decreasingly cohesive factor.

The foreign policy position of the new authorities seemed excellent to begin with, as the world diplomacy was satisfied with the disappearance of Milošević. This was confirmed by pats on the back. However, the truth was much less favorable: Serbia was heading for various foreign policy, as well as domestic policy trials. The first of them was the so-called cooperation with the Hague Tribunal, or extradition of Milošević and many other civilians, military and police personnel. The other two, which are certainly not in the interest of Serbs and Serbia, are the gradual extinguishment of Republika Srpska, through the strengthening of B&H institutions contrary to the Dayton Agreement, and independence of Kosovo, which should resolve a difficult problem of Western diplomacy. At the end, there are complicated relations within the federal state, with Montenegro.

At the internal plane it seemed that the new authorities could not have bigger difficulties, because it possessed a large parliamentary majority and general popular support. However, tensions were soon evident within DOS. The two leading parties almost immediately got into conflict, starting from the old animosities and rivalries, adding new lover of power, while smaller parties persistently insisted on their cut.

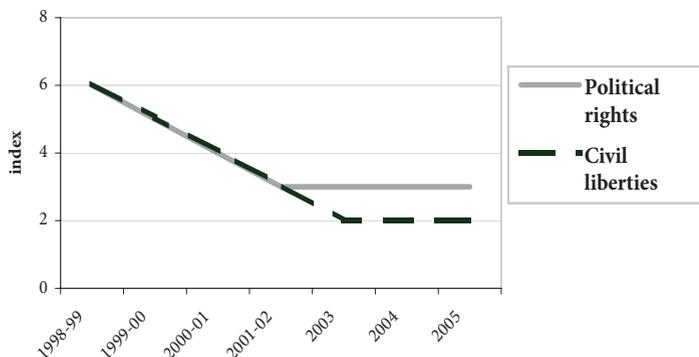
It is probably wrong to seek causes of the DOS breakup in the characters and personal relations of the main players, but we shall do this here anyway. One was pragmatic, all about solving problems, capable and brash, but uninterested in moral and ideological issues. The other is a politician of academic type, all about ideas of old writers and doctrinarian, personally honest and analytical, with somewhat slow reactions. Both very intelligent, even shrewd. The former considered the latter incompetent, while the latter considered the former dishonest. If they had been old, seasoned politicians, they would have found a *modus vivendi* and ruled together for at least a few years, and Serbia would have peacefully gone through the most difficult transition difficulties. However, they were too much involved intellectuals, and too little classic politicians and the conflict was inevitable to the detriment of Serbia, since too much political energy was spent on unproductive activities, such as fierce fight for power.

The first round of the conflict between DS and DSS was won by Đinđić, using disallowed methods as well (taking away the mandate of DSS MPs). For a while DS ruled Serbia unhindered, with Đinđić cheaply and skillfully buying the support of small parties. After his assassination, Zoran Živković, not particularly wisely, entered a conflict with G17, which made them definitely lean towards DSS, and the satellite SDP toppled his government. After the parliamentary elections from the end of 2003 a new coalition was formed led by DSS and G17, which, with the support of SPS, formed a minority government.

The new government, led by Vojislav Koštunica, was fortunate to enjoy a calmer domestic policy position, which enabled it to focus on important activities of a government in transition. This was certainly contributed to by both the ruling coalition and leading opposition parties. Heated passions on the Serbian political scene are gradually calming down and Serbia is increasingly looking like standard democratic states. High time. On the other hand, the foreign policy difficulties of Serbia significantly contributed to the growth of popularity of SRS, which, with around 1/3 of votes, has become the single strongest political party.

The progress in the political aspect of transition, i.e. in the position of citizens before the authorities, will be illustrated by the evolution of the freedom index, published every year by Freedom House. Naturally, it is only an indication, since both this methodology and the methodologies of similar indices are always disputed.

Figure 1. Freedom index



Source: Freedom House, different years

FR Yugoslavia, i.e. Serbia and Montenegro drastically improved their position at the beginning of this decade and in the last few years have had the status of free societies. Admittedly, the average of 2.5 for these two indices is significantly weaker than index 1 of all post-transition countries which became the EU members in 2004.

A particularly significant change occurred in the elections procedure, namely vote counting. After the October change counting is conducted fairly, unlike the 1990s when election manipulations were a standard procedure of the ruling party/coalition. Since 2000 there have been no objections to the procedure of result determination, except marginal ones in municipal elections at the end of 2003. Thus, it is to be hoped that Serbia has definitively joined the ranks of civilized states.

### **Economic reforms**

A country in ruins – that is the right area for reformers and a reform-oriented government. Serbia was indeed in ruins in 2000, not only in economic ones, but also in social and political ruins. And the Government of Serbia and the Serbian part of the Federal Government certainly were reform-oriented.

**The beginning of transition.** The changes have been already initiated by the departing old government when it liberalized all prices of basic articles with a single move (decree) of its vice-president from the Radical Party in October 2000 in the hope that by that it would cause political damage to the new regime. Similarly, the transitional government's minister for privatization, from the Socialist Party of Serbia, called upon the company managers to start privatization under the 1997 Law, which many of them did. His aim was probably to undermine the privatization potential of the new, upcoming government, which did occur: many of the best companies obeyed the minister and began the privatization process, meaning that they avoided the privatization under the future government's model, which was already in sight. An interesting fact is that, out of malice towards the new government, the departing regime's ministers were now doing what should have been done not only then, but also during the previous decade, when they ruled alone.

The first change at the federal level was the establishment of a real dinar exchange rate, i.e. the abolishment of the ridiculous, but permanent system with two essentially different exchange rates: the first being the official rate,

serving only to make the ruling elite rich, and the second one used in everyday transactions. At the end of 2000 and the beginning of 2001 foreign trade was liberalized and customs duties reduced significantly.

What kind of general reform strategy was adopted by the governments of Serbia and the federal state? Was the orientation liberal or social democratic? Were they seeking maximum speed or sequential consideration? Were the new authorities ready and did they have a reform concept or were they making it up along the way?

The answer to the last question is the easiest. The new government had at its disposal a prepared set of reform proposals of Pavle Petrović and his associates. However, that set did not satisfy the needs of new economic authorities either in its macroeconomic part, which was the better one, or in its institutional part, which contained considerably more weaknesses. That set was used by the G 17 in summer 2000 to make an economic platform for elections, in which promises were given and orientation announced, but without getting into operational policies.

**Liberal or social democratic orientation?** Nowadays, this dichotomy is not of essential importance for the analysis of European policies, since the difference between these two orientations in terms of economic organization is smaller than ever: modern social democracy has adopted, in its Third Path version, an essentially market concept of economic activity coordination and conducts reforms which, until recently, characterized liberals and conservatives exclusively.<sup>9</sup> The only more serious difference regards social policy: should the existing Western European welfare state be disassembled to a lesser extent (social democrats) or to a greater extent (liberals). Admittedly, in Serbia, the old-school social democrats still fight against economic reforms, attacking the local transition as a neoliberal one, and as being brutal to the working class.

The orientation of the first (Đinđić-Živković) government was essentially social democratic, in the sense as we previously defined modern social democracy. Namely, its reform strategy was based on two pillars:

- the first, creation of a real market economy, rather than a vague amalgam, i.e. giving priority to the economic logic over the political one when building the institutions of market economy, and
- the second, a strong social policy, which was supposed to facilitate transition by compensating the losers for at least part of their loss and raising them, as far as possible, above the poverty line; part of that policy is

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<sup>9</sup> See the Lisbon Agenda, i.e. the program of reforms which should turn the European Union's economy into the most competitive economy in the world by 2010.

not only the permanent priority in payments from the budget enjoyed by social transfers (including pensions), but also the toleration of increase in average wage in real terms above the productivity increase in the socially- and state-owned sectors, with the help of revenues from privatization, foreign assistance and loans.

A relatively liberal orientation of Đinđić's government was not part of a plan devised in advance, because there was no plan, but rather an outcome of the Prime Minister's instinctive understanding of the business needs, and of a technocratic approach of some of the line ministers.

The second (Koštunica's) government additionally intensified the social democratic component by the new Labor Law, which certainly aims at a wider protection of jobs and an expansion of the rights of employees, including numerous financial benefits.

Observed in a somewhat more classic coordinate system, the Serbian transition has so far been mostly a combination of primarily liberal<sup>10</sup> economic reforms and social democratic social policy, which is by no means the worst combination imaginable. Of course, in the given moment it is of least importance whether the governments were going this way sincerely, i.e. because they thought it was the best way, or under the pressure of the IMF and the World Bank (economic reforms) and for demagogic reasons (social policy). But, for the long-term sustainability of transition, the question of reform initiator is extremely important.

**Big bang or gradualism?** Ever since the beginning of transition in Eastern Europe there have been discussions about the best strategy – whether it is better to carry out reforms as soon as possible on the widest front or to establish a reasonable sequence of reforms and carry them out gradually.<sup>11</sup> The basic argument of the proponents of the first strategy is that it is necessary to use a good opportunity for reforms, which, for political reasons, may not exist for long, and try to carry out basic reforms very quickly in order to prevent reversible tendencies and return to the former or practically former state. The main arguments of the second strategy proponents were, firstly, that it is necessary to bring order into the sequence of the reform performance in order to obtain efficiency and, secondly, that it is necessary, for political reasons, to use the results of one group of measures to build other measures, along with the increase in the reputation of the government and reforms.

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<sup>10</sup> Liberal in a broader sense, rather than the radical libertarian one.

<sup>11</sup> See, for example, G. Roland – *Transition and Economics: Politics, Markets, and Firms*, MIT Press, 2000

There were no beforehand discussions or decisions in Serbia as to how to answer this question. The basic orientation was towards a rapid implementation of reforms, especially those that were clear and unambiguous or, at least, considered as such (for example, privatization and labor relations), while the reforms were carried out more slowly in the areas where basic solutions were not manifest (for example, financial markets or insurance). The present government also conducts intense reform-oriented legislative activity, with somewhat more favorable internal political conditions. However, when the previous four-year or five-year period is analyzed, it can be seen that transition develops more slowly than necessary, but also more slowly than planned by the main subjects themselves.

One factor of reform deceleration was beyond the control of the republic authorities – the influence of Montenegrin parties at the federal level. Namely, a system from the period of the Socialist Federal Republic of Yugoslavia was retained in the Federal Republic of Yugoslavia, according to which numerous important areas of the economic system were regulated entirely or basically at the federal level, such as the regulation of securities, companies, bankruptcy, pension system etc. The situation was alleviated to a certain degree by the fact that Montenegro was represented at the federal level by a coalition which wanted the federal state to function, but it also had its local interests (its rating in Montenegro) and it did not always agree with reform-oriented ideas coming from Serbia. Therefore, there was a lot of delay in the changes in certain parts of the economic and social legislation that concerned Serbia. The solution to this problem was brought by the Constitutional Charter at the beginning of 2003, when both Serbia and Montenegro now even formally assumed the right to regulate their own economic systems.

An important factor of deceleration was also the normalization of politics in Serbia, meaning the shift of the political life from a revolutionary phase to an ordinary, calculating phase, in which the political rating of the ruling party or coalition is taken very much into account.

Particular factors of transition deceleration are, firstly, insufficient administrative capacity of the government administration which failed to provide sufficient and necessary contribution to the formulation of reforms, as well as to their implementation and, secondly, the influence of business circles, increasingly manifest as the time passed (see further in the text).

On the other hand, there were also factors that encouraged reforms and were their drivers. The most important of those certainly is a sincere

commitment of the new government's leading people in favor of reforms, which was weakened only periodically by the needs of the political moment (or party rating) and an imperfect knowledge of technical matters demonstrated by line ministers. A very important role in the encouragement of reforms was also the role of the World Bank and the International Monetary Fund which, because of earlier failures in some countries, perceived Serbia as an opportunity to present themselves in the best light. Therefore they provided Serbia with technical knowledge and financial resources, which Serbia lacked, as well as with strong incentives (blackmails, practically) to continue with reforms even when the government's reform enthusiasm seemed dissipated.

The transition was made easier to a certain degree by using experiences collected in other countries in transition, due to Serbia's considerable delay. Therefore, for example, a better privatization model was chosen and unnecessary spending of money on the banking system rehabilitation was avoided. Nevertheless, there are local specificities in each country, on one hand, while on the other hand, the transition has not produced definitive manuals for changes, so a lot of space has remained for an innovative approach of Serbian reformers.

Let us conclude: the Government's orientation was essentially a big bang approach, but, due to various limitations, it was conducted as a gradualist program. The window of opportunity for reforms at the beginning of the second wave of transition was not used in the best way. In term of ideology, a combination of liberal and social democratic policies was carried out, just as in many other countries in transition.

**Insufficient administrative capacity of government administration.** After the October 2000 and January 2001 changes, the entire top echelon of the government machinery was changed, but it was also followed by the departure of a considerable number of skilled government employees. On the other hand, the ruling parties of DOS possessed a quite poor and inexperienced personnel structure, which was also reflected in their inability to fill numerous governmental positions with skilled and experienced people. The highest positions (ministerial and similar) were usually taken by individuals with the work experience from institutes or universities, which imply a lack of experience in administration. On the average, more experienced were our citizens that came to help from abroad. The West also sent its experts as part of technical assistance, but frequently they were of no particular quality. Particular difficulty was the deficit of capable experts in the positions of deputy

ministers and department heads, who should essentially carry the work and guarantee the quality of its performance. In simpler terms, Serbian government administration is still considerably more a Balkan one than a European one.

In the first years of this decade, the wages of employees in the government administration were kept low for demagogic reasons. Therefore, few capable people agreed to be employed in the republic administration in the presence of better paid jobs not only in the private sector but also in the local administration and public companies. Some, but insufficient, support was provided by some international organizations (UNDP, for example) by financing the wages of some leading experts (usually Serbs from abroad), while a small relief came from extraordinary, reward payments to domestic employees. It was only recently that the wages in republic administration were increased significantly, so that a positive motive for employment of skilled individuals appeared.

Insufficient capacity of the government administration is certainly a limiting factor for the transition progress. It is an obstacle both in the preparation of laws, since incorrect concepts appear or the good ones get spoiled, and, even more, in the implementation of reforms, or during the implementation of the law, when the weak government administration initiates and allows violation of the rule of law or the legal state principle.

**Transition phases.** The first phase of this transition wave represented a moment of enthusiasm about new opportunities and a honeymoon for democratic political forces both with each other and with the people.<sup>12</sup> Legislative reforms were being easily adopted at that time, and there were practically no opponents to the changes. There was some bargaining within the coalition (judicial laws in exchange for the labor law, traded between DSS and the remaining part of DOS), but it was considered to have little importance. Year 2001 represented a real starry moment of transition in Serbia.

Soon, however, the enthusiasm about the political change dwindled, naturally, and the political life took the normal course in which political costs of particular moves for the government were carefully considered and attempts were made to maximize its position. No one tried any more to make brave moves, without considering political effects. This cooling of transitional energy was certainly contributed to by increasingly intense conflicts between the two leading parties of DOS. Therefore, there was naturally a deceleration in transitional changes during 2002 and at the beginning of 2003.

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<sup>12</sup> At the beginning of 2001, DOS enjoyed support of even up to 65% of citizens, while at least 1/4 of the citizens were undecided. See *Public Opinion of Serbia and Montenegro, February 2002*, IDN, March 2002

The lamentable assassination of Prime Minister Đinđić oriented Zoran Živković's government towards the state of emergency and the operation "Sablja" (Saber), whereby yet another good opportunity for reforms was missed: at that time the government enjoyed exceptionally high popularity and was able, also due to the confusion of the opposition, to push through any reform law. It was only before the end of the year that the government turned to transition-related activities and sent several draft laws to the Assembly, but it no longer had majority: SDP found new coalition partners.

That deceleration of transition almost to a halt worried the World Bank and the IMF. They were probably particularly irritated by the demagogic behavior of the G 17 representatives during the election campaign and at the beginning of the existence of Vojislav Koštunica's Government. There was talk about patriotic protectionism, enormous budget deficits, unusually great social care for citizens and farmers, and the "developmental" budget and similar. That did not promise anything good. The first one to react, quite gruffly, was the World Bank's representative, otherwise a person very much inclined to Serbia, who in February 2004 insisted that the new majority adopt, within a month, a couple of dozens of laws prepared earlier. The IMF also showed its teeth: it immediately forced the Serbian Government to revise the just adopted budget and to reduce the deficit significantly. So the Government capitulated and the IMF continued its hard pressure towards reforms during 2005, making use of the fact that the IMF's positive assessment of extended arrangement with the SRY/S&M is necessary for the definitive write-off of 700 million dollars owed to the Paris Club Creditors. Conclusion: the reform activity of Vojislav Koštunica's Government is essentially determined by the permanent pressure of the IMF and the World Bank.

The passage of time should bring a change in the course of transition: while the first phase was unavoidably directed towards legislative changes, at the same time the second phase should be based on the intensified law enforcement, since the legislative reforms were mostly carried out. Although other countries in transition were also rather late with the reform of the rights protection system, especially private property,<sup>13</sup> in Serbia there is a clear weakness in the application of laws, not only in the private sector but also on the part of government authorities themselves. So, some laws are applied only partly, while there is usually a delay in the building of new institutions or agencies compared to the legal time limits. The weaknesses of the judiciary will be discussed further in a separate section of this book.

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<sup>13</sup> J. Svejnar – *Transition Economies: Performance and Challenges*, Journal of Economic Perspectives, No. 1/2002

**The influence of interest groups.** At the beginning of this wave of transition the influence of interest groups was weak, and a good opportunity for reforms was at arm's length. Businessmen of the former regime lay low, waiting for the revolutionary uproar to subside and trying to preserve their dubiously acquired wealth. Those that were on good terms with everyone and gave contributions at one time even to the parties which now came to power had not asked to collect for the investment yet, while the revolutionary morals provided control over businessmen of the ruling democratic parties for a while. Unfortunately, that important opportunity for reforms without resistance and influence of businessmen was utilized only partly, and with the passage of time businessmen consolidated their positions, establishing firm ties with the politics and politicians in power.

The making of peace between the new government and the businessmen from the period of the former government took place, maybe paradoxically, by means of the extra profit tax. Namely, the DOS government (including also DSS) presented this tax as a moral move which would ensure social justice, because it would have to be paid by those who abused their connections with the previous government and became rich in an unfair manner during the 1990s. Two things occurred during its application. First, there were difficulties in its realization, which is unavoidable with such a tax, so many people practically managed to avoid payment, reducing the whole effect of the law essentially to one man (Karić). Second, when the tax is paid on one part of (dubious) profit, then the remaining part must be considered legalized, so it is neither suspicious any more, nor may any action be taken against its owner again. Indeed, the new government has not initiated any investigation for establishing the (un)lawfulness of wealth acquisitions from the 1990s.

In time, several lobbies or groups of businessmen who obviously have influence over the policy of the government, including legislative activities, emerged. Four groups, or lobbies, are distinguished by their power and influence:

- the financial lobby, which, for a long time already, has been successfully blocking the laws on takeover and investment funds that were prepared a long time ago, as well as the necessary changes in the law on securities,
- the energy lobby, which obviously influences the decision making and almost regularly wins in state tenders relating to fuel supply, annulling the tenders in which it did not win,
- the "production" lobby, which actively advocates extension of customs protection with the help of worn-out arguments rejected long ago in the

economic science, of mercantilist type; it has also been successful recently, so the customs protection has been increased referring to the failure of harmonization with Montenegro as the reason,

- the media lobby, which has been blocking for years the application of the broadcasting law in the area of frequencies.

The influence of interest groups (or lobbies) on the politics, for their own benefit, is a lamentable, although unavoidable, fact of democratic life. In order to make it as benign as possible, it must be regulated and made transparent, which is certainly not the case in Serbia. Here, the corruption is somehow more likely.

**Specificities of transition in Serbia.** Transitions of various countries differ in many elements, but also have certain similarities. Two of them are a significant reduction of production in the first years of transition and a sharp increase in poverty.<sup>14</sup> The decline in production is mostly caused by the collapse of the old coordination mechanism before the new one was built and the elimination of companies which do not stand a chance in the market, while the increase in poverty is a consequence of a decrease in income, increase in inequality and slow building of efficient social security mechanisms.

In Serbia, the evolution of production and poverty during this phase of reforms went differently: production was increasing, while poverty was decreasing,<sup>15</sup> which can be interpreted as specificities of local transition. Let us look at the possible reasons.

There are several reasons for the absence of decline in production, or for its increase. First, Serbia did not have a radical break in the coordination mechanism unlike the vast majority of countries in transition, i.e. in 2000 it did not shift from a central planning system to a market system, since it was already in the market system, which, although deformed by the socialist government and party, was still a market system. According to economic institutions and the accustomedness of the people to the market, in 2000 Serbia was much better prepared for transition than the other countries of Eastern Europe had been ten years earlier. The liberalization of prices, foreign trade and business on the whole at the end of 2000 and at the beginning of 2001 merely abolished much unnecessary regulation, as well as the wide formal and informal administration by the government and the ruling party, which even had a positive effect on production: when unnecessary regulation, or state

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<sup>14</sup> See *Transition: The First Ten Years*, The World Bank, 2002

<sup>15</sup> See Chapters 2 and 12 of this book for the data.

intervention, is abolished, it is natural that there will be an increase in economic activity. Second, macroeconomic stabilization also brought improvement of the business environment and enabled growth. Third, the considerable inflow of external financial support (3.2 billion euros in the period October 2000 – end 2004) did foster domestic production, although considerable part of it was transferred to imports. Fourth, after the victory of the democratic forces the last sanctions against Serbia, the financial ones, were also lifted – that also generated a positive effect on economic activity. In other words, the beginning of actual transition did not bring any reasons for production decline, but, on the contrary, for its increase. And that is what happened.

Similar to that, there were no strong reasons for the increase in poverty. Quite the contrary. First, as a consequence of GDP growth, the population's income was increasing. Second, the increase in inequality was not large,<sup>16</sup> and so it could not cause a transfer of large number of people to the poor category. Third, in nominal terms there was also quite a developed social security system in Serbia in the past, which was only poorly financed, so the amounts owed to the beneficiaries were over two years in arrears (social benefits, children's allowances, etc.).<sup>17</sup> After the normalization of situation at the beginning of 2001, and with the aid from donors, the arrears were settled and a regular payment of current transfers was provided, which improved the situation of the poorest people. The provision of the regular payment of pensions had a similar positive effect on the position of the oldest citizens. And fourth, the considerable and already mentioned financial support from the world increased the purchasing power of the population over the level of domestic resources and enabled a noticeable increase in spending.

**New private sector.** The new private sector in Serbia is growing well, but does not represent such a driving force it represented in some other countries in transition (in Poland, for example), where it very soon became the main driver of economic progress. The causes of this are, firstly, the fact that the private sector had existed and been relatively developed even before the October changes, while in the majority of countries in transition it started from scratch and, therefore, exhibited very rapid growth in the first phases. Secondly, the essential limiting factor for the private sector development in Serbia is the weak banking sector, which did not, even remotely, manage to keep pace with financing needs. Namely, the old, state-owned banking system did not even have that role, so there was practically no financing of private

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<sup>16</sup> B. Milanović - *Incidence of social transfers; Inequality, in Poverty and reform of financial support to the poor*, Ministry of Social Affairs and CLDS, 2003

<sup>17</sup> Social policy was conducted mostly by controlling the prices of basic articles (food and utilities).

companies. After its liquidation, the new banking system was created, which, being still small, did not have the necessary financial potential. Several credit lines from abroad, as well as a specialized bank founded by foreign banks, have been very useful in the creation and growth of small private companies, but it is not sufficient. The main source of money for investment is still the company's profit and the owner's assets, which prevents more rapid development. And thirdly, there are all other problems that burden the economic life in Serbia and create barriers to the entry: complicated administrative procedures, poor law enforcement and protection of contracts, and generally low legal security, frequently uncooperative local authorities, problems with construction and building land and similar.

**Accession to the European Union.** The strongest impetus to reforms not only in Serbia, but in the whole Eastern Europe as well, has been the EU accession process. In order to become a member state, a country must meet the so-called Copenhagen Criteria of functional market economy, efficient protection of civil rights and the rule of law in general and political stability, which all implies the harmonization of the candidate country's legislation and practice with the European Union. In this way, a country aspiring to the EU membership is forced to gradually change its legislation towards reforms and improve the functioning of its institutions, and it is much easier for a government to push through often unpopular measures if it can refer to European standards and the accession process. Therefore the accession process may be considered as the best chance for encouraging reforms, or also as an instrument with which the reform enthusiasm can be maintained in the best way and for the longest time. Simply put, the EU membership was a carrot used to award reform efforts and the people's patience.

Unfortunately, Serbia's chances to join the EU soon are practically nonexistent, partly owing to the situation in Serbia, but partly also because of the current crisis of the European Union and the spreading of an opinion among the citizens and politicians of the EU countries that the rapid expansion should not continue and that many countries now applying are not European enough. It is therefore likely that Serbia may not expect to obtain the EU membership for at least another ten years, which means that the accession motive can hardly be a serious political reform driver.

### Where do we stand now?

The initial praises of our transition by the representatives of the IMF, the World Bank and similar institutions, as well as the overemphasizing of their importance by the domestic ministers and governors, created an impression that the transition in Serbia is exceptional and that the countries involved in transition for ten years were surpassed in a year or two. Nothing could be further from the truth: according to transition success Serbia is trailing not only within Eastern Europe, but also the Balkans.<sup>18</sup> Therefore it is not surprising that, according to basic economic and social indicators, after four years of transition Serbia is at the level of the group of countries in its immediate neighborhood: Bulgaria, Romania, Macedonia, Bosnia and Herzegovina, Montenegro. It is probably a sad fact that during the last fifteen years Serbia relatively regressed compared to its environment and became equal with it, while earlier it had been considerably more developed than all the countries mentioned.

Serbia entered transition at a quick pace, but in time it decelerated, so now the country is only halfway there.<sup>19</sup> Although numerous reform laws have been adopted (though many of them might already need improvements), the law enforcement, the so-called legal state, is still the weakest link in the chain.

The expectations of many people regarding a much faster economic and social progress may have been based on the DOS's exaggerated promises in the period before the September and December 2000 elections, but they certainly were not realistic. For there are not two or three exceptional moves that the government could make and solve the country's economic problems in that way. Serbia is simply a poor country which will need several decades of hard work and effort to reach the present European development level. It is unrealistic to expect any faster development than 4-5% per year.

Priority in further transitional efforts must be given to non-economic issues, because that is where the obstructions to transition are mostly located. The first is the question of state, the second is the stabilization and maturing of democracy, and the third is the building of institutions. Parallel to these, there are more specific economic measures: privatization continuation, monetary and exchange rate policy issues, reduction of taxes and public spending, restructuring of public companies and similar.

The basic obstacle to the transition in Serbia probably lies in the self-management and socialistic mentality of many citizens. The expression of that

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<sup>18</sup> *Transition Report 2004*, EBRD

<sup>19</sup> See *Serbia and Montenegro, Republic of Serbia, Economic Growth and Employment Program*, the World Bank, 6 December 2004.

mentality is, for example, the belief that companies exist so that the employees may receive wages and meal allowances, that the state is responsible if the payment of wages is irregular or if someone loses their job and that this has to be compensated for at the expense of taxpayers, that the one who earns something should share it with the ones who did not, that an individual should not bear any risk, and that he should be completely insured against all risks by the state, that each citizen of Serbia has inalienable rights to various services free of charge, and similar.

Most interestingly, this misguided leftist mentality has a stronger support in the so-called social intelligentsia and among politicians than in the people. The majority of the people, except part of employees in the former socially-owned sector who would still like to live at another's expense, know that they have personal responsibility for the results they achieve and for their position in the society. A convincing indicator of such majority opinion is the frequent electoral failure of the parties that appear with leftist programs and slogans.

Danica Popović

## Economic developments and macroeconomic policies in transition

### ECONOMIC ACTIVITY AND MACROECONOMIC POLICIES: GENERAL ASSESSMENT

**A ten-years long pre-transitional fall in the living standards and the absence of a political consensus on the core measures of the reform package are main characteristics of the first four years of transition in Serbia.<sup>1</sup>** Thus the average GDP growth rate of 4.5 percent on an annual basis during transition is considerably undermined by the fact that the economy kept falling over the previous ten-year period at an average rate of around 8 percent a year. That is why an impressive cumulative real growth in wages, which in four years doubled in real terms (consequently, real wages grew at an average rate of 20 percent), still seems too low to the once-well-to-do, and now impoverished, population of Serbia, which in the meantime grew by almost 400,000 refugees. Moreover, both the first transition government and the second one promised a very quick recovery, which objectively was out of the question. Still, despite these promises, neither of the governments has really got to grips with issues that are at the core of transition – the issues of imposing hard budget constraints and carrying out institutional reforms, which are the steps that had been initiated by the most successful transition governments immediately after their coming into power. For that reason, an attractive environment for an inflow of new (foreign and domestic) investment has not been created, consequently, it was not possible to avoid the key adverse results – *a rising balance of payments deficit of more than 13 percent of GDP, and a continuously increasing unemployment rate, which now stands at 34 percent. After four years*

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<sup>1</sup>The author of this text is of the opinion that the period 1991-2000 was totally lost from the standpoint of transition. In this period no significant reform step was made, hence this period will not be the subject of the analysis, either from the positive or normative aspect.

of transition, GDP is estimated at around US\$ 3,000 in per capita terms (around US\$ 5,200 in PPP terms), while slightly less than 11 percent of people in Serbia still live below the poverty line.<sup>2</sup>

In four years of transition, Serbian economic policy passed through four cycles: (1) reform cycle; (2) abandoning reform in mid-2003 and shifting the focus on issues (to be subsequently given up) of harmonization with the Montenegrin economy, with partial reversal of its own initial foreign trade liberalization; (3) coming into power of a new government (in early 2004), followed by almost nine months of systematic populist steps; and (4) a positive breakthrough and announcements of good reform steps (2005), which resulted from interventions by the IMF, WB and the EU announcement of the initiation of the SAA process as of October 2005. In this manner, in these first four years of transition less than half of the time was spent on serious transition issues, while the remainder was characterized by typical macroeconomic populism, with announcements of reexamining the privatization method, revisiting past privatization deals, reversing the already introduced liberalization measures,

Table 1. Aggregate assessment<sup>3)</sup> of macroeconomic measures and results

	Results						Measures				
	2001	2002	2003	2004	2005		2001	2002	2003	2004	2005
Economic growth	+	+	+	+	+/-	Subsidies	-	-	-	-	-
Inflation	+	+	+	-	-	Appreciation	-	-	+	+	+
Fiscal deficit	+	+	+	-+	+	Privatization	+	+	+	-	-
BOP deficit	-	-	-	-	+	FDIs	+	+	+	-	-
Unemployment	-	-	-	-	-	Wage policy	-	-	-	-	-

<sup>3)</sup> (+) позитивни помаци; (-) неповољне промене

etc. Therefore, the general public did not get the impression that the very process of transition is inevitable and irreversible, coming to believe that the most difficult reforms – elimination of subsidies, bankruptcies and large-scale cuts of non-productive jobs can, in fact, be indefinitely postponed.

<sup>2</sup> For GDP: IMF WEO Database, April 2005, for poverty: PRSP (2004), WB (2004). An alternative source on the unemployment rate – Labor Force Statistics, indicates a rate of 18.5 percent.

**Without no radical changes in macroeconomic policy, favourable initial results will become unsustainable** and that further boosting domestic demand seriously undermines macroeconomic stability. Hence, the burden of stabilization had to be shifted to the lowering of the share of fiscal expenditure in the GDP, which would make room for export-driven growth.<sup>3</sup> The policy pursued so far (based on the growth in domestic demand) has indeed enabled faster and easier initial results of reform, including the lower rate of unemployment (at the cost of a widening balance of payments deficit). Nevertheless, a turnaround is necessary primarily because (i) the balance of payments deficit has become unsustainable; (ii) public spending is too high, crowding out private investment; (iii) the institutional framework practically hinders further privatization of the state and socially owned sector; and (iv) the absence of a more serious increase in export earnings calls into question the capacity to repay external debt and threatens to spark a debt crisis. It means that subsidies must be reduced, wages must be limited by productivity growth, and privatization of state and socially owned companies must be completed (in the meantime, downsizing in the civil service and public enterprises is called for). Instead of the “development budget” concept and policy of further encouragement of domestic demand (a policy suitable only for the economy of Japan!), tight fiscal policy must not stop at the achievement of a balanced budget. Namely, the problem is not so much in the deficit, but rather in the size of the budget, which is such that it crowds out both domestic investment and exports, thus making the accomplished development results unsustainable.

**The political context for carrying out reform is considerably more challenging than in other transition economies.** First, in Serbia it was not possible to garner political support by simply abolishing central planning, state monopoly on foreign trade, etc., which assisted authorities in other transition economies to create a powerful transition momentum.<sup>4</sup> Second, the Serbian reformers are still facing three very controversial political tasks – issues related to the handover of suspects to the Hague Tribunal, the status of Montenegro vis-à-vis the Union and the resolution of the final status of Kosovo, which were as often as not included in the conditionality set by the developed world for both financial assistance and support to economic reform. In the meantime, Prime Minister Đinđić’s assassination in early 2003 and the election of the

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<sup>3</sup> This view, with an explicit recommendation to shift the burden of stabilization from monetary to fiscal policy, is advocated by both the World Bank (cf. WB [SEM, 2004], and the IMF [2004].

<sup>4</sup> Vaclav Klaus [1994]: “A very unique and an unrepeatable psychological euphoria prevails. There is a widespread readiness to actively participate in reversing the past, in getting rid of old, unpopular institutions and even in “belt tightening.” This moment is suitable for fast implementation of various painful measures.”

second reform government of Prime Minister Koštunica practically postponed reform by a whole year. Prime Minister Koštunica's government itself has then traveled the road from a feverish advocate of macroeconomic populism, "development budget", a high budget deficit and subsidies to public and socially owned enterprises, to the adoption of a revised budget with a fiscal surplus, announcing phasing out of subsidies and privatization of public and socially owned enterprises. A change in policy came after the IMF made the approval of a 15 percent write-off of the debt to the Paris Club of creditors (amounting to some 750 million dollars) to Serbia conditional upon accepting more radical reform. To a great extent, such policy of setting conditionality has compelled the (basically populist) ruling parliamentary majority to pass this quite restrictive package of economic policy measures.

**Delays in the fields of microeconomic and institutional reforms can easily result in an overall reform failure.**<sup>5</sup> No flexible and strong microeconomic grounds have been established, and thus macroeconomic policy suffers from the absence of clear, rapid and flexible response to its measures, and that is a basic prerequisite for sustainable growth in employment, exports, investment and domestic savings. Due to this incompleteness of the economic environment, some extremely good macroeconomic results (in the field of fiscal stability, declining currency appreciation, a moderate inflation rate, etc.) have not produced high growth, particularly not export-oriented growth. This text will look at the accomplishments and quality of underlying macroeconomic policies, as well as at alternative policy mixes which would enable the country to embark upon the road of sustainable, export-driven growth.

## ECONOMIC DEVELOPMENTS IN TRANSITION

### **Avoiding a transition recession**

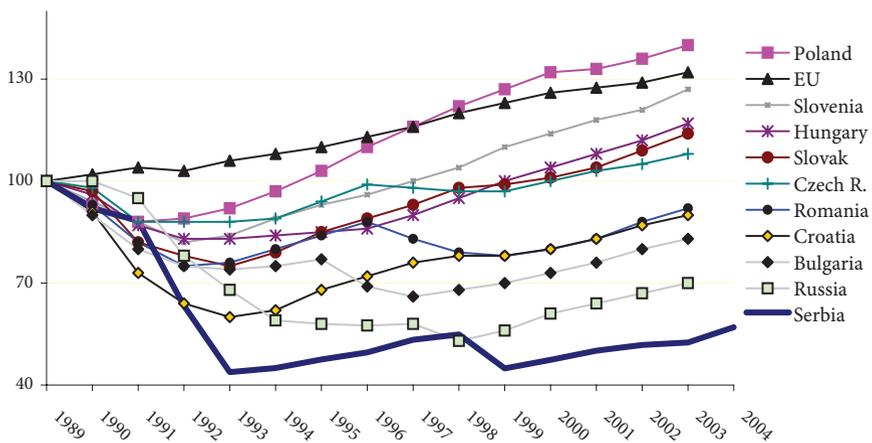
Transition in Serbia began as late as 2000, while ten years which preceded it are completely lost from the standpoint of transition. A sharp decline in incomes over that previous decade cannot be attributed to a classic

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<sup>5</sup> On the role of macroeconomic policies in transition cf. Blanchard [2000].

transition recession, because it happened as a result of the break-up of the country, hyperinflation, UN trade embargo (1992-1995) and the bombing of Serbia (1999). Despite the fact that over the said period the so-called insider privatization began, its main result resurfaced in *asset stripping*. A very non-transparent economic environment was created, where clientelism, insiders' privileges and corruption were flourishing. It should be pointed out that, owing to delays in creating a market-oriented institutional framework, even after four full years of transition in Serbia there is no sound market-based business environment or institutions which efficiently protect property and contracts. Similarly, the subsidizing of loss-making companies has been going on until the end of the fourth year of transition, now advancing well into its fifth year.

Figure 1. Real GDP Percentage Change Index (1989 = Base), 1989-2004



Source: Svejnar (2003)

Ten years of declining economic activity have brought about a change in the economic structure, in favor of branches with simpler technologies and a lower import content (agriculture, food industry, electricity, etc.), with a dramatic drop in output in the chemical industry, mechanical engineering, electronics, etc. The rate of capacity utilization went down from around 75 percent in 1989 to below 40 percent at the beginning of transition in the autumn of 2000. The structure of final demand also changed, in favor of private

and public spending, with a simultaneous dramatic drop in investment, which practically turned into disinvestment.

**There are two reasons why Serbia avoided the transition recession**, which certain countries experienced twice (Bulgaria, Romania, the Czech Republic, etc.).<sup>6</sup> Firstly, it seems that a paradoxical outcome of 1994 is happening again, when excessive postponement of a stabilization program eventually led to an antiinflation program accompanied with economic growth. A similar comparison comes to mind now: a heavy pre-transitional fall in economic activity has by itself led to the closing down or contraction of production of many non-viable firms, and that is why in all four years of transition, despite macroeconomic stabilization measures, GDP growth rates were positive. The same applies to industrial output, where no drastic fall was recorded: after a slight fall in the period 2001-2003, it subsequently also registered positive growth rates.

**The second, crucial reason for avoiding a transition recession is an active subsidizing policy of state and socially owned companies.** The private sector still produces only slightly more than half (55 percent) of the GDP, and a large portion of the economy is subsidized, which implies that not even this low level of economic activity is sustainable without permanent active government support. In a large number of these companies, even when they work (supported by subsidies) and increase physical output – value-added is falling in real terms. In mid-2005 Serbia is, explicitly or implicitly, still subsidizing 75 large socially owned loss-making companies, which employ around 150,000 workers.

In addition, the government is adamantly keeping control over public enterprises and public utilities (600,000 employees), which gives a total

Table 2. Relevance of the private sector in the Serbian economy, 2004 (%)

	2004.
private sector share in GDP	55
share of private sector employment	35
private sector share in capital	29

Source: Serbian Statistical Office (SSO), Trends, December 2004

<sup>6</sup>The second fall in economic activity happens due to belated implementation of tougher reforms: in Bulgaria after a hyperinflation, in the Czech Republic in three successive years (1997-1999) negative growth rates were registered, triggering the launch of a policy of export-based growth and “greenfield” FDI inflows; in Romania, over the same period, a sharp decline in economic activity was registered because of the opening of the already closed down factories and plants, which then collapsed anew, etc.

of around 40 percent of registered labor. Since most of them (according to the Minister of Labor – two thirds of them are redundant) are in principle – potential losers in transition, it seems that Serbian economic policy has tailored a whole set of measures precisely to their maximum protection: (i) the overvalued exchange rate, which enabled higher imports of consumer goods and higher living standards, particularly in the first two years of transition: (ii) high public spending, which kept wage increases high above productivity growth, (iii) delays in the implementation of bankruptcy legislation and an overly protective labor law, which kept the loss-making firms on the market, are just the key characteristics of that policy.

**A growing danger of the worst-case scenario – a simultaneous rise in inflation and unemployment – comes as a consequence of the delays in reforms, which generated deep macroeconomic imbalances.** Such an outcome would to a large extent shrink the space for potential winners – a new private sector, new exporters, retrained workers and the like, to faster attain a dominant position in the structure of Serbia’s economy. Such economic policy has become unsustainable, both because it has exhausted the room for “buying” social peace and because further financial support of the IMF is conditional precisely on radical changes in the mentioned economic policies.

### **Change in economic structure – yes or no?**

Besides changing ownership structure, transition also stands for turbulent sectoral reallocation of capital, labor and economic activity from the overdeveloped primary and manufacturing sectors to the underdeveloped service sector, which thus increases its share in the GDP.

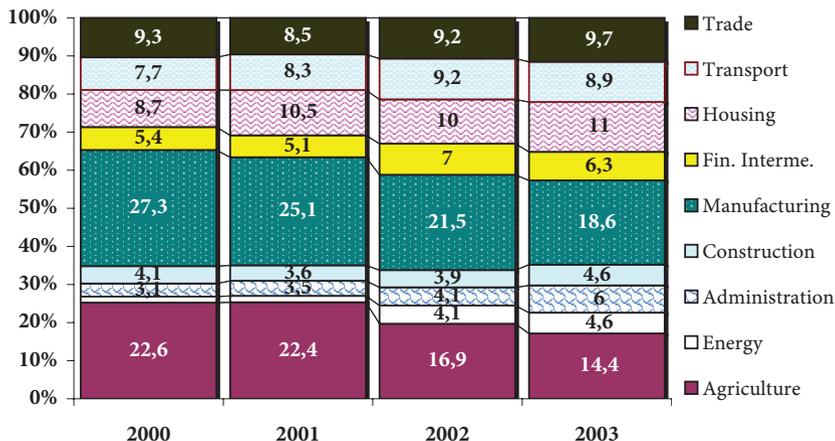
Table 3. Economic growth, 2000-2004 (%)

	2000	2001	2002	2003	2004
Gross domestic	4.2	4.8	3.7	2.6	7
Agriculture	-17	18.4	-3.4	-8.2	19.8
Manufacturing	12	0	1.7	-2.7	7.1
Services	5	8	8	7	12

Source: SSO, Communiqué no. 274, December 2004

In Serbia, agriculture is reducing its share from 22.6 to 14.4 percent, an even more dramatic fall has been registered in manufacturing industry – from

Figure 2. Change in Serbia's economic structure



Source: Source: SSO data '04

27.3 to 18.6 percent of the gross domestic product,<sup>7</sup> while other sectors have seen significant growth (cf. Figure 2).

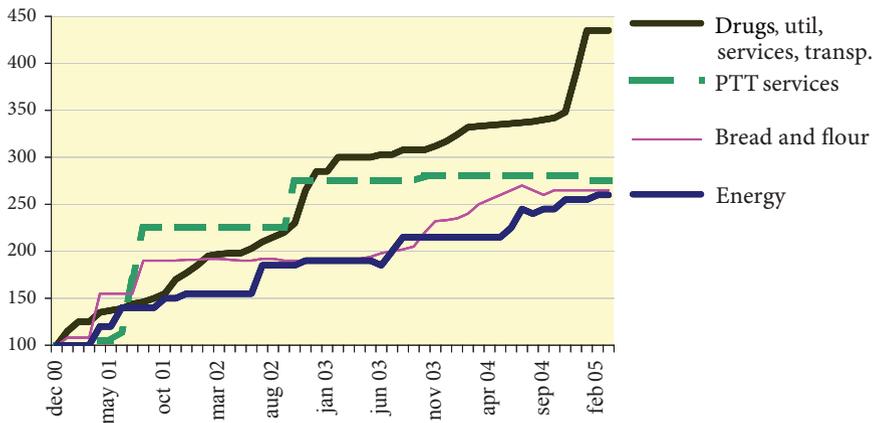
There are three reasons to hesitate about the fact that effective changes in economic structure took place in Serbia. Firstly, due to price liberalization from the very beginning of transition (2000), changes can partly be attributed to nominal adjustments. The tripling of the energy sector in the economic structure corresponds almost completely to the past price adjustments in this sector. A rise in the share of health, education, transport and utility services and social insurance can in part be attributed to the same cause.

Secondly, data for 2004 show that the increase in services sector was to a certain extent overestimated, and that restructuring is actually carried out more slowly than evidenced by the available data. Namely, the data for 2004 indicate that part of the previously registered drop in industry and agriculture (in 2003) was not of a structural nature, but a consequence of a bad harvest and

<sup>7</sup> As of January 2004, the aggregation methods for industrial output has changed: coverage has been increased, a new system of weights has been introduced and a new nomenclature of industrial products adopted, which points to the fact that one of the underlying reasons for the 2003 fall lies in the shortcomings of the statistical coverage of the emerging private sector.

a lag in effects of the privatizations carried out in the course of 2003. Similarly, the introduction of fiscal cash registers in 2005 has enormously increased the growth rate of trade (and thus the share of services in the economic structure),

Figure 3. Non-core inflation, 2000=100



although this, too, is not indicating an increase in turnover, but rather the curbing of the gray economy and increasing regular trade flows.<sup>8</sup>

Thirdly, statistical tests indicate that the structure of employment by sector has not changed significantly, and thus labor is neither “moving” to propulsive sectors, nor leaving those declining ones. The Lillien measure<sup>9</sup> (calculated as a standard deviation of annual sectoral employment growth rates) for the first four years of transition in Serbia amounts to 3.9 percent. Although the classification of sectors is not the same (hence this comparison should be understood only as an illustration) in the first four years of transition Lillien coefficient for the Czech Republic amounted to 20.9 percent, for Poland to 20.3 percent, for Slovakia to 14 percent, for Hungary to 9 percent, etc.

<sup>8</sup> Industrial output grew by 7.4 percent in 2004, while a rise in agriculture was 19.8 percent. In the first quarter of 2005, the GDP growth rate was 5.2 percent, with the socially owned trade sector alone (for which statistics are regularly available) was growing by more than 33 percent.

<sup>9</sup> The calculation is made for each year, and then the average for the reporting period is calculated. If the dynamics of sectoral rates of employment slightly deviate from the average, the Lillien coefficient will be close to zero, which will point to the fact that all sectors are moving along more or less similar paths, indicating that there is no structural reform. High values of the Lillien coefficient will point to turbulent changes in the economic structure.

Obviously, the intensity of structural reform in Serbia is still very weak. Both of the already mentioned causes – macroeconomic populism and the absence of financial discipline, coupled with the absence of reforms which would enable its implementation, largely explain such a slow pace in the restructuring of the real sector of the Serbian economy.

### **Imbalances in the structure of final demand**

**The two major imbalances – an overly low share of investments and high trade deficit – were “inherited” from the Milosevic era, but also maintained by reformist authorities.** Yet, one imbalance has started to “give in”, the share of investment is growing (though not fast enough), but the trade deficit is permanently deteriorating.

**A notable “expansion” of domestic demand (from 117 to 130 percent of GDP)<sup>10</sup> is a combined effect of the populist macroeconomic policies and unbuilt institutional framework.** Namely, lax financial discipline in socially owned and public enterprises (employing around 750,000 workers), and the substantially overvalued exchange rate in the initial period, are the main reasons for the growth in wages and private consumption (see figure 14). This helped to maintain “fictitious” employment and social peace, but reduced productivity and considerably undermined export competitiveness. Increased wages also significantly contributed to a rise in imports. The existing ownership structure, where GDP is formed predominantly in the social and state sector, has so far been maintained with the assistance of loose fiscal policy, which generated a steadily rising trade deficit of more than 30 % of GDP.

**The inherited difficult pre-transition situation can (to a certain extent) explain macroeconomic populism at the very beginning of reform.** A dramatic drop in real wages which lasted for almost ten years, and nearly doubled absolute poverty relative to 1990, have in a way determined the first basically populist steps of the reformist authorities.

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<sup>10</sup>Domestic demand includes private and government spending, as well as private and government (public) investment. A sum of all components of the gross domestic product is not always 100 because of the rounding off. One should keep in mind that the presented government spending of 18 percent of GDP includes only wages and purchases of goods and services of the public administration. Consolidated public spending amounts to 45.3 percent of GDP in 2005, and in addition to government spending and public investment (which is presented together with private investment in the graph), it includes pensions, social protection, subsidies, costs of public debt service (interest payment and repayment of principal) and other (cf. section on fiscal policy).

But macroeconomic populism gain further ground with the second reformist government of Prime Minister Koštunica in early 2004 – privatization was brought to a standstill, while the parliament adopted a “developmental” budget, increased social transfers and subsidies, etc., trying very hard to miss the agreed deficit target by almost full 50 percent<sup>11</sup>. Although six months later the plan was corrected and privatization resumed, distortions further deepened in the course of 2004, primarily because the key generator of the growing trade deficit and inflation was not eliminated: budget subsidies and the number of employees in the public sector remained unchanged. The IMF set this task to this same government as an imperative for economic policy in 2005, making it part of the conditionality for the write-off of the remaining 15 percent of the debt to the Paris Club of creditors (amounting to 750 million dollars). However, data indicate that the fulfillment of the undertaken obligations has been mixed: while the number of employees in public enterprises has decreased by about four percent, and there practically was no increase in the average wage, local public utilities kept on increasing both the number of employees and the wages, which went up by around eight percent.<sup>12</sup> Therefore, it is completely legitimate to say that there is no political will to fully honor the undertaken commitments.

**The most difficult and unavoidable task before Serbia definitely is to change the composition of final demand. The basic objective is to increase investments, and the share of private spending in GDP has to go down.** The investment rate in the medium term should increase from the present 17.5 percent to 25 percent of GDP, thus reaching the level in comparable transition countries. It requires a relative drop in private consumption to around 70 percent of GDP and a fall in material costs for public spending to about 15 percent of GDP. Of course, room would be still left for all the variables to grow, but not at the same speed: consumption would grow at a rate of around 2.7 percent in real terms, while the entire transformation would practically be based on an accelerated increase in investment of more than 12 percent a year, and on average annual export growth of 25 to 30 percent.<sup>13</sup>

**The policy of accelerating investments is the only exit from the vicious circle: wage growth above productivity – a rise in consumption and imports**

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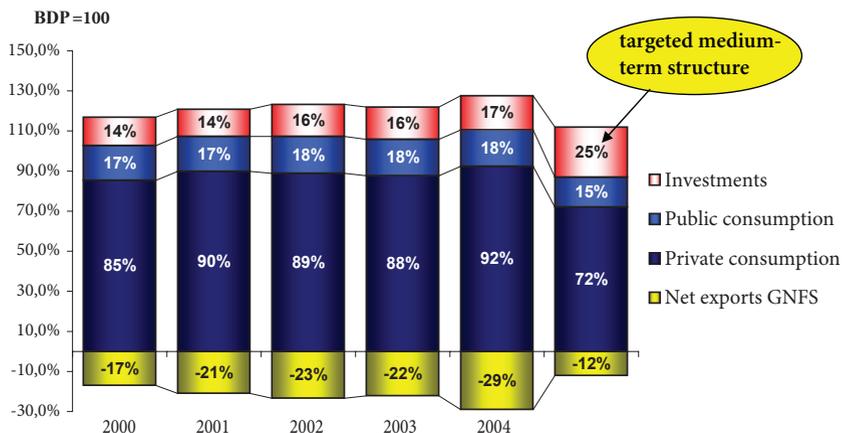
<sup>11</sup> It was a direct breach of the already achieved understanding with the IMF to cut the budget deficit from 3.9 to 2.5 percent of the gross domestic product. Under the pressure from the IMF, the deficit was later on reduced from 45 to 30 billion dinars (below 1 percent of the gross domestic product).

<sup>12</sup> The statement of the Deputy Director of the Federal Statistical Office, 7 July 2005, a MAT news conference

<sup>13</sup> See Appendix 2.

– a fall in export competitiveness – a standstill and a fall in economic growth. Since, on the other hand, national savings<sup>14</sup> will remain for a long time to come

Figure 4. The structure of final demand, 2000-2004



far below investment needs, this is where foreign direct investment comes into play as a variable of strategic importance.

Table 4. Rate of investment in transition countries

	Serbia (2003)	Bulgaria	Romania	Croatia	Hungary	Poland	Czech Rep.
Rate of investment	17.5	20.4	21.9	23.8	30.0	24.0	28.0

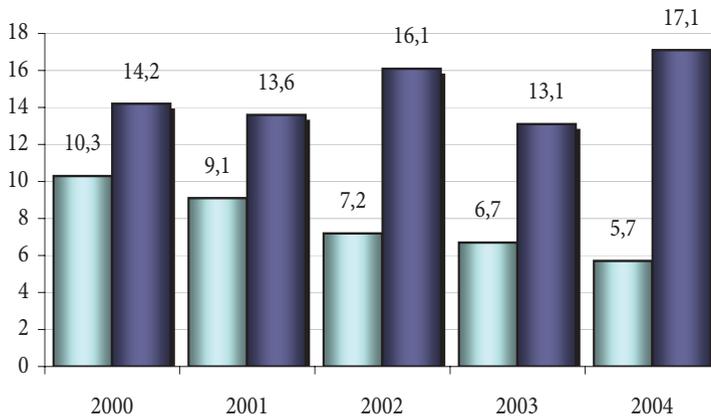
Source: IMF WEO

**The mechanism is as follows.** Growth in foreign direct investment ensures own self-sustainable growth of purchased or new companies, and also brings wage payments in line with labor productivity, etc. This creates demand for domestic inputs (intermediates, energy, services, etc.), which acts as an impetus for growth in production and investment in other economic sectors, which are developing as suppliers to strategic investors. On average, one job

<sup>14</sup> Domestic savings include savings of all institutional sectors: households, the corporate sector and the government. National savings constitute a sum of domestic savings and net factor payments. In the case of Serbia, the difference usually boils down to private remittances.

in the FDI sector generates the creation of 3-5 new jobs in the domestic sub-contractor sector (Klein, 2004). This scenario was applied not only in the most advanced transition economies, but also in the countries whose institutional frameworks bear more resemblance to Serbia's, such as Slovakia, Armenia

Figure 5. National savings and domestic investments



Source: National accounts

and the like, where it also proved effective. For all these reasons, all successful transition countries concentrate their efforts on attracting foreign investors, even granting them more favorable terms in comparison with the domestic ones.

**In 2003, thanks to large privatization proceeds, FDIs in Serbia reached almost US\$ 1.4 billion, but in 2004 they amounted to only US\$ 966 million** (Although Serbia had a significant inflow of FDIs in the period after democratic change in 2000 (in 2000 the inflow of FDIs was US\$ 25 million, in 2001, this inflow went up to US\$ 165 million, in 2002 to US\$ 475 million and in 2003 to US\$ 1,360 million), the main concern is related to the fact that Serbia has attracted just a few 'greenfield' investments, as well as the fact that investors identified significant shortcomings in the business environment in Serbia (FIC, 2003). In addition, Serbia is losing pace (i.e. according to the World Economic Forum ranking of global competitiveness indices, Serbia has fallen from the 77<sup>th</sup> place in 2003 to the 89<sup>th</sup> place in 2004 (Mc Kinsie, 2004)). Data of the Privatization Agency confirm a fall in foreign direct investment in 2004.

Out of a total of 1,270 privatization deals which were closed in the period 2002-2004 only 84 (6 percent) were FDIs. Out of this number, 20 privatization deals

Figure 6. Foreign Direct Investments in the Western Balkans, 1997- 2004

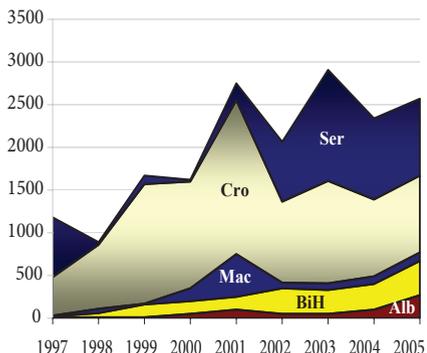
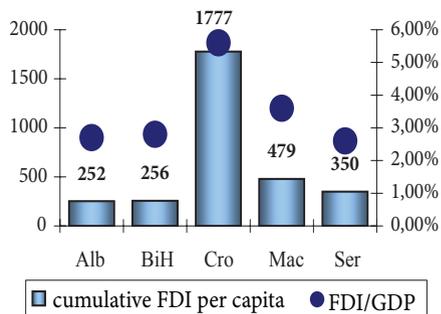
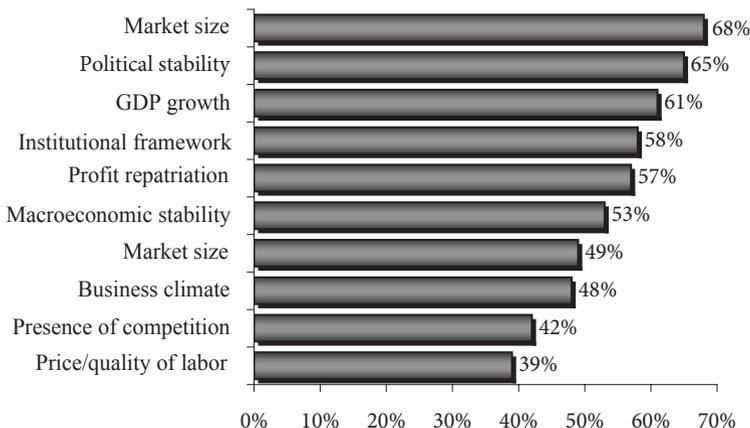


Figure 7. FDIs per capita and share in GDP



were realized in the course of 2002, 45 in 2003, and only 19 in 2004. The results themselves indicate that neither the climate, nor the policies, for attracting FDI in Serbia meets the expectations. In comparison with the countries of the Western Balkans, Serbia takes the lead in terms of volume, but not in terms

Figure 8. Key determinants for attracting FDIs



Source: FDI Confidence Index, AT Kerney 2002

### Box 1. Foreign Direct Investment - Macroeconomic Effects

Foreign direct investments are the main source of foreign exchange inflows and play a significant role in (non-credit) financing of the deficit on the current account of the balance of payments. In countries like Serbia, where it is very difficult to mobilize domestic savings, FDIs constitute a very important source of financing growing consumption and investment. Since these are, as a rule, long-term investments, the host-country is enabled in this manner to increase productivity and generate revenue for debt service, thus attaining a sustainable level of external debt. Since transition economies, like Serbia, by rule have poor access to the international financial market, their high balance of payments deficits, if they are not financed by FDIs or international financial institutions, result in lower consumption, investment and lower growth rates.

Table 5. Net inflow of FDIs (mil. USD)

	1996	1997	1998	1999	2000	2001	2002	2003	1993-2003	
									value (mil USD)	per capita
Albania	90	48	45	41	143	204	135	178	1,083	338.4
BIH	0	0	100	90	150	130	230	320	1,020	248.8
<b>Bulgaria</b>	<b>137</b>	<b>507</b>	<b>537</b>	<b>802</b>	<b>998</b>	<b>803</b>	<b>876</b>	<b>1,398</b>	<b>6,302</b>	<b>808</b>
Croatia	486	347	835	1,420	1,085	1,404	591	1,875	8,389	1,906.7
Macedonia	11	30	128	32	175	441	78	94	1,023	503.7
Romania	263	1,224	2,040	1,025	1,048	11,740	1,128	1,485	10,232	469.4
<b>Serbia</b>	<b>0</b>	<b>740</b>	<b>113</b>	<b>112</b>	<b>25</b>	<b>165</b>	<b>562</b>	<b>1,395</b>	<b>3,112</b>	<b>374.9</b>
Czech R	1,280	1,261	3,574	6,223	4,944	5,475	8,276	2,351	37,227	3,649.7
<b>Hungary</b>	<b>3,264</b>	<b>3,617</b>	<b>3,202</b>	<b>2,899</b>	<b>2,172</b>	<b>3,524</b>	<b>2,864</b>	<b>977</b>	<b>30,622</b>	<b>3,031.9</b>

Source: WB – ECA Regional Tables

The connection between FDIs and an increase in domestic investment is very obvious: irrespective of whether these are reinvestments on existing companies or greenfield investments, local firms in this manner secure sorely needed financial and physical capital, technology, management and export markets.

The influence on the labor market is ambiguous. The labor market generates demand for productive jobs, where offered salaries are often

## Box 1 (continued)

higher than in the rest of the economy. However, in the case of privatizations of existing firms, a direct effect will very often be labor shedding, but the indirect effect will be significant: in addition to the resulting increase in the number of firms which become their suppliers, room is created for vertical FDI's (e.g. in Serbia, after Coca-Cola and Sartid, Ball Packaging expressed interest in a greenfield investment), etc. As mentioned before, one job in the FDI sector spurs the creation of 3-5 new jobs in the domestic sub-contractor sector.

The influence on the balance of payments is not unambiguous, either. Foreign direct investments may cause deterioration in the balance of payments of the host-country, predominantly because they will, for instance, import equipment at the initial stage, and then continue with importing intermediates. Yet, the ultimate effect on the balance of payments will depend on whether a strategic investor will export its products or sell them solely on the domestic market. In the case of exporters, positive effects may spill over to domestic firms, which will supply them with necessary inputs, thus increasing the domestic content in exported goods. On the whole, empirical research (World Bank (2003a); d. Djankov and Murrell (2002); e. UNCTAD (1999)) has shown that FDI's have a positive effect on the balance of payments, and that through attracting them, a sustainable mechanism is created for financing the BOP deficit.

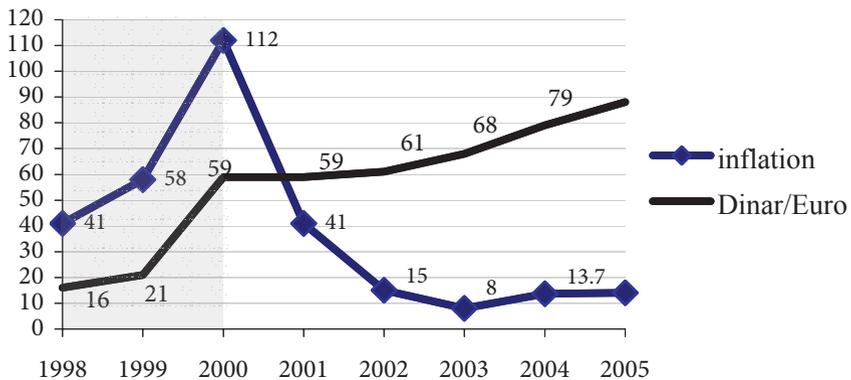
of per capita FDI, or in terms of share of FDI in the gross domestic product. The attractiveness of the Serbian environment for foreign direct investment is obviously still very alarmingly low, and on removing key obstacles to the inflow of FDI's the work is still done without enough money, human resources and, what is the most important, an unambiguous political conviction about the necessity of FDI inflow.

PRICES AND EXCHANGE RATE

Prices

The initial stage of macroeconomic stabilization was carried out very successfully, by eliminating the key causes of inflation: the monetization of the fiscal deficit was terminated and its non-inflationary financing has started, while huge quasi-fiscal deficits were substantially reduced, primarily due to comprehensive price liberalization. Ironically, the liberalization itself has not been initiated by the reformist, authorities, but was instead initiated as a “revenge of the outgoing” who probably reckoned that without price controls a chaos would be created on the market, which would seriously undermine, or, with a bit of luck, even topple the new reformist authorities. Yet, as diletantism in the conduct of economic policy was their main feature, the outcome was totally opposite to their expectations: inflation did initially almost double, but

Figure 9. Inflation and the exchange rate

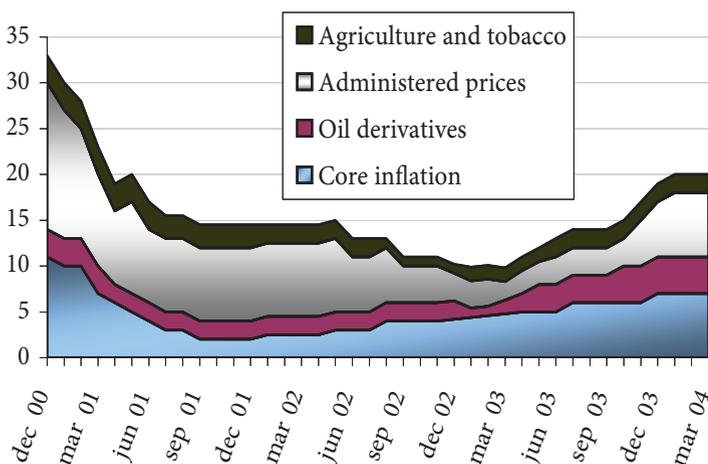


after a one-off rise in prices (which in part covered the quasi-fiscal deficits and eliminated pent-up inflation) stability was achieved, while all political odium, which price increases normally cause among the electorate, was rightfully attributed to Milošević’s outgoing government. In addition, superiority of that, so-called first generation of reform, was immediately visible: there were no shortages of edible oil, flour, milk, sugar, bread, gasoline, and the like. Prime

Minister Đinđić's government, owing to the credibility it earned (first and foremost through non-inflationary payments of all current budget expenditures and clearance of part of expenditure arrears), was very successful in lowering inflationary expectations. However, lagging behind in more serious elements of reform, which was caused mostly by the failure to impose hard budget constraints, resulted in new growth of aggregate demand, again much faster than production growth. That is why media discussions about which inflation rate could constitute a "psychological threshold" and whether inflation this year would be kept below the last year's 13.7 percent, or the government would miss the inflation target, are ever more frequent.

The policy of encouraging domestic demand had helped to mitigate the consequences of price liberalization for the poorest segments of the population, but in time it turned into a "reform trap", which practically blocked further reform. To begin with, in the first two years of transition the dinar was appreciating fast, which resulted in a large increase in wages expressed in euro terms, hence in increased purchasing power of the population for buying imported goods, which still account for a considerable share of total supply of goods in Serbia. Secondly, social safety was regularly financed by subsidizing state and socially owned companies, which further strengthened employees' purchasing power that kept growing far beyond labor productivity.

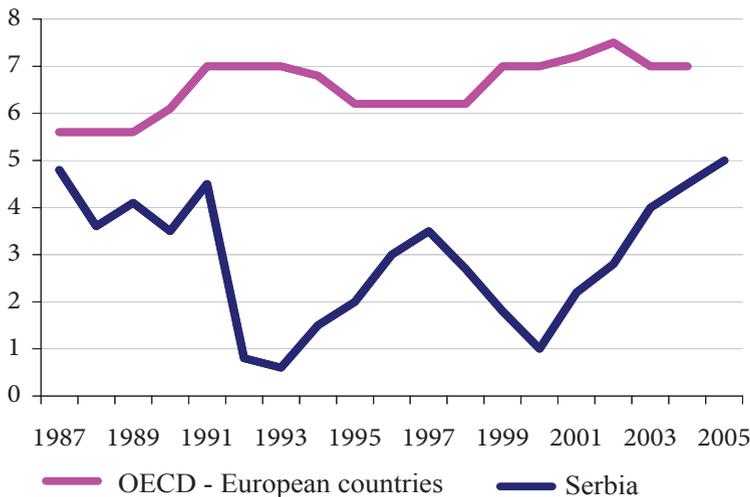
Figure 10. Core inflation and administered prices, 2000-2005.



Thirdly, the danger of losing the job due to bankruptcy is practically eliminated owing to the fact that bankruptcy legislation has not been implemented to this day, because transition has fallen into the classic “reform trap” of equilibrium at a low level of reform, and only after IMF’s conditionality the government has accepted and announced that it will start to cut the number of employees in the civil services, privatize remaining, state and socially owned companies, impose financial discipline and stop subsidizing and fueling domestic aggregate demand, thus lowering labor productivity and worsening the current account deficit of the BOP.

After three years of deceleration of inflation, the escalation of macroeconomic populism in 2004 was paid by another surge in inflation – from

Figure 11. Electrical energy prices, cents/kWh



7.8 to 13.7 percent. Moreover, core inflation doubled, which is an indication of the fact that the contribution from aggregate demand pressures to the inflation rate was higher than the contribution from elimination of price disparities or from price fluctuations on the world market (increases in the prices of oil and other primary products, whose prices are in part under government control).

Price liberalization policy has addressed one of the main sources of the inherited quasi-fiscal deficit. Still, further elimination of price disparities

constitutes an important basis for sustainable medium-term macroeconomic stability, because it considerably reduces public expenditures for direct or hidden subsidies. This is the most difficult part of the reform and it has not been completed even in the most advanced transition countries. The electricity price has been increased about 5 times, reaching the level of some 4 cents per KWh, which covers operating costs. The target level, which will enable EPS to operate normally, is 4.5-5 cents per KWh. Substantial adjustments have also been made in the prices of utility services, which is of great importance to the efficient use of resources, and thus to the achievement of sustainable medium-term growth. Namely, the objective is for the prices in the sectors under control to reach such level at which these companies will be able to independently cover not only operating costs, but also total costs. Until that level is reached, elimination of disparities will be an integral part of the total annual inflation rate.

A steep rise in the prices of crude oil reverted the authorities to the familiar populist practice of price freezes, which produced the well-known result – fuel shortages. As usual, this proved to be bad practice, which encourages wasteful consumption, stalls restructuring and increases future costs. According to the NBS data, the share of oil price increases in last year's total inflation was around 4 percentage points, which certainly increases costs, decreases productivity and widens the trade deficit, as experienced by other oil importing countries. However the estimate for OECD countries is that a rise in the oil price of US\$ 10 per barrel would increase inflation by 0.5 percentage points, with economic activity falling by 0.4 percent. Of course, countries with lower energy efficiency, like India (which consumes 2.5 times more oil per unit of GDP), inflation would rise by 2.6 percentage points, in Argentina by a mere 0.2 percent, etc. (Biro, 2004). Therefore, the publicized information that the contribution from oil price increases to the rise in inflation in Serbia was as much as 4 percent deserves detailed analysis, which, of course, is beyond the scope of this paper.

Table 6. Changes in basic macroeconomic indicators in case of oil price increase of US\$ 10 per barrel, 2002

	Real GDP	Inflation	Trade balance (%GDP)
Asia	-0,8	1,4	-1,0
China	-0,8	0,8	-0,6
India	-1,0	2,6	-1,2

	Real GDP	Inflation	Trade balance (%GDP)
Malaysia	-0,4	2,0	0,0
The Philippines	-1,6	1,6	-2,0
Thailand	-1,8	0,8	-3,0
Latin America	-0,2	1,2	0,0
Argentina	-0,4	0,2	0,2
Brazil	-0,4	2,0	-0,4
Chile	-0,4	2,0	-1,4
HIPC (heavily indebted poor countries (incl. Mexico))	-1,6	...	...

Source: IEA on the basis of IMF analyses

The evidence in transition economies proved that is that rising economic growth cannot be “bought” by higher inflation. It was also confirmed that disinflation does not cause a recession, just the opposite in fact. Extensive econometric surveys of transition economies (Balcerowicz, 2003, Svejnar, 2003) confirm that the main determinants of growth were – a low inflation rate, public spending cuts and resolute implementation of institutional reform. What may be surprising here is the fact that countries whose economic performance was better in terms of growth and inflation have also achieved more equality in distribution.<sup>15</sup> It turns out that sustainable growth in economic activity is based primarily on macroeconomic stability, inflow of foreign investment and growth in domestic investment, improved competitiveness and export growth, and *ex-post* (instead of *ex-ante*) growth in incomes and living standards.

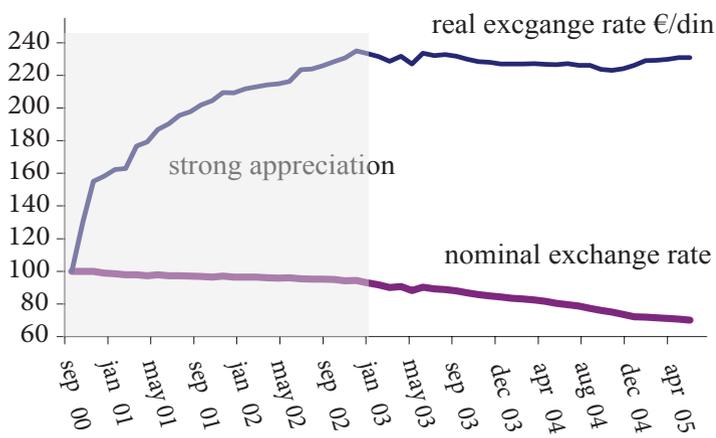
In such a mechanism of economic growth, major disturbances are created by overheating domestic demand, which infallibly points to macroeconomic populism at work, and entails a danger of inflationary expectations discouraging strategic investors, while the other two causes of inflation (elimination of price disparities and increases in energy prices) exert much less influence not only on inflation, but also on inflationary expectations and investment decisions of economic agents, with this latter being crucial. A rise in the price of fuel in Serbia has never resulted in lower consumption. Instead, it was interpreted primarily as a call on the decision-makers to “adjust wages to the cost of living.” Therefore, it is necessary to put an end to such practice.

<sup>15</sup> Cf. Balcerowicz, WB (2003). In Poland, the Gini coefficient went up from 28 to 31, but in Russia Gini rose from 26 to 51, in Azerbaijan it jumped from 29 to 50; in Ukraine from 24 to 46. Consequently, fast reformers experienced much less rise in inequality than slow reformers.

## Exchange rate

Although it was declared immediately after the beginning of transition that a dirty-float exchange rate policy would be pursued, in the recorded interval, two explicit sub-periods can be instantaneously noticed: a period of the fixed exchange rate (30 din/DM, later 60din/€), attended by strong real appreciation (2000-2002), and a period of managed floating of the exchange rate, which started after a “small speculative shock” that happened in late November 2002. The initial strong appreciation was primarily resulted

Figure 12. Real and nominal exchange rate, 2000-2005.



from boosting domestic demand, aimed at protecting the living standards of both the poor and those who live on fixed incomes, as dinars that were worth less and less could nevertheless buy increasing quantities of foreign exchange or imported goods. Furthermore, the fixing of the exchange rate and the overvalued dinar very well suited importers, a group which is a traditionally strong player in Serbian politics. Finally, this regime was advantageous to non-exporting, loss-making companies, as imported production materials were becoming cheaper and cheaper. For all other economic agents, such policy was harmful: the state was spending too much of its official reserves to defend the exchange rate, while exporters were losing potentially rising earnings. In that period, domestic prices *increased 2.5 times*, while the nominal exchange rate rose by a mere 2 percent roughly. Strong appreciation created expectations that

the National Bank would not be able to defend the existing parity for too long. In that context, after only one announcement by the then Prime Minister about a possible exchange rate adjustment, the demand for foreign exchange tripled, and interventions of the NBS rose from the average six million to around eight million euros a day<sup>16</sup>. Following that episode, banks in Serbia were refusing to sell foreign exchange, though they had to re-start selling eventually in order not to lose their licenses for exchange operations. After that, the dinar started to depreciate slightly, but, for all practical purposes, ever since November 2002, a policy of a constant real, instead of constant nominal, exchange rate has been conducted.

**The pass-through from the exchange rate depreciation to inflation is one of the fundamental undesirable effects of the implementation of the so-called “truly-floating” exchange rate regime.** In Serbia, however, in the first year of implementation (2003), no significant pass-through was registered, while in the following year (2004) the government of Prime Minister Koštunica to a large extent gave up on imposing fiscal discipline which would support such exchange rate regime.<sup>17</sup> In the course of 2003, namely, the dinar depreciated by about 12 percent, while inflation, even with elimination of price disparities, was almost halved (from 14 percent it dropped to 7.8 percent). As discussed in section 1 of this chapter, the trends have changed in the course of 2004, primarily due to the halting of transition and continuation of the policy of boosting domestic demand, which is strictly counter-indicated in the case of a floating exchange rate.

**Therefore, the issue of the choice of the exchange rate regime is primarily the issue of choosing the losers in this process: whether those would be workers, pensioners and the importers' lobby (to whom the fixed exchange rate suits better), or the export sector and workers who would find employment there, to whom depreciation is more advantageous.** Yet, for depreciation to be able to encourage exports, the rate of depreciation must be higher than the rate of increases in domestic prices. Bearing in mind that part of the costs is relatively fixed in the short run and foreign currency-indexed, real depreciation means that an increase in non-indexed costs must be considerably lower than the total inflation rate or, in other words, that they have to be nominally frozen. It implies a real fall in these costs, among which the largest items are net wages and salaries and pensions. Experiences of the countries which have successfully conducted floating exchange rate policy

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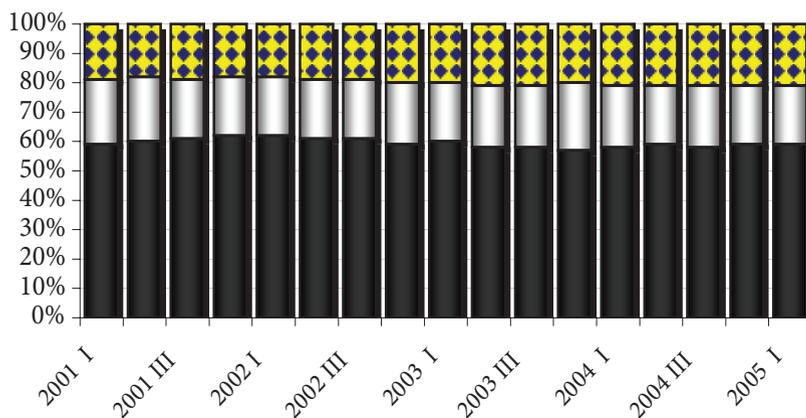
<sup>16</sup> *Ekonomist Magazin*, no. 133

<sup>17</sup> NBS estimates are that a rise in the euro rate by 1 percent would result in a gradual price increase of 0.32 percent (NBS, 2004).

actually testify to the above: real wage growth over the entire period of faster exchange rate depreciation was minimal, or non-existent.<sup>18</sup>

The issue the distance of the Dinar from its equilibrium exchange rate level (the issue of “misalignment”) in the pre-transition period, due to the self-containment of the economy, large distortions and non-market-based pricing, cannot be successfully resolved through standard macro-econometric methods.<sup>19</sup> Therefore, in this analysis one has proceeded from an unambiguous theoretical result – that a country which systematically (meaning every year, in a long interval) runs a trade deficit, definitely has a currency which is overvalued in relation to its equilibrium level. By using this criterion, we arrive at a conclusion that the dinar in Serbia has always been overvalued,

Figure 13. Structure of imports of commodities, 2001-2005



that exporters have been discouraged, and importers privileged, which is clearly evidenced by experience: macroeconomic populism, whose trade mark

<sup>18</sup>Depreciation policy for the purpose of attracting strategic investors was used by all successful transition economies. Hungary, for example, was permanently depreciating the forint in almost five consecutive years, in certain years even more than 2 percent a month, consequently, more than 25 percent a year, which was one of those key measures on the basis of which they managed to attract (and keep) strategic investors, whose exports nowadays account for 70 percent of Hungary's total exports.

<sup>19</sup>“Let's take a man who first climbs two meters up the dam, and then goes down three meters. Whether he'll drown or not depends on where he had been before he started to climb. The same problem arises when assessing whether a currency is undervalued or overvalued.” – The Economist, 26 August 1995.

is an overvalued currency, practically has not yet been abandoned in Serbia. The trade deficit in the first four years of transition was systematically rising from US\$ 2.8 billion in 2001 up to as much as US\$ 7.4 billion in 2004, which points to the fact that the overvaluation of the dinar is (1) undeniable and (2) obviously very high, and (3) again has a slight upward tendency, against the backdrop of an announcement by the IMF that the government has decided to use the exchange rate as a nominal anchor in the coming period as well.

**In Serbia, an above-average increase has been registered in imports of capital goods and intermediates**, where depreciation of the currency, in the nature of things, cannot vitally influence investment decisions. Yet, data indicate that overheated aggregate demand did manage to affect the composition of imports, in that the share of consumer goods in imports, despite the floating of the currency, almost constantly and steadily grows, which brings us back to the issue of the overvaluation of the domestic currency and the necessity of its long-term adjustment to its fundamental determinants (first and foremost to the level of the surplus which has to be run for a number of consecutive years in order to meet the debt service obligations falling due).

**Like all other transition economies, Serbia has to expect its currency to appreciate, even if core inflation is stagnant, because of both (i) elimination of price disparities, and (ii) leveling of wages in the export sector with the wages in the industries supplying solely the domestic market.** Since this latter wage growth is going to be higher than sectoral productivity growth, domestic prices will go up and the currency will appreciate. It is important to mention here that there is nothing that economic policy could do to avoid this (Balassa-Samuelson) effect, hence policymakers have to tailor their measures to such anticipated disturbances [ECE, 2000 59ff.]. According to some calculations, the real exchange rate in transition countries is appreciating considerably. Kovács/Simon (1998), Rother (2000) and Halpern/Wyplosz (2001) show that real appreciation caused by productivity growth amounts to around 3 percent a year, while De Broeck – Slok (2001), Corricelli – Jazbec (2001) and Égert (2002a,b), contrary to that, present more cautious estimates of 0.1 – 1.5 percent on an annual basis. All the analyses, however, have confirmed that the intensity of the BS effect is higher in the later years of transition. Therefore, one should expect such exogenous shocks in Serbia in the future and adjust macroeconomic policy to them.

## WAGES AND EMPLOYMENT

## Wages

An impressive four-year real wage growth of almost 20 percent a year (which has nearly doubled them in real terms) still seems too low to the once-well-to-do and now impoverished population of Serbia. Expressed in euros, wages in late 2004, due to high appreciation of the dinar, were as many as four times higher than in late 2000: from €80 (October 2000), gross wages reached the level of €320 in December 2004 and thus exceeded the level of average gross wages in Bulgaria (€230) and Romania (€210). Yet, relative to the average wage in Serbia of DM752 (€380) in December 1990, when the number of employees was also much larger, thus total household incomes as well, the perception of poverty in Serbia is much higher than one can possibly realize on the basis of available statistics.<sup>20</sup>

Figure 14. Net earnings and living costs

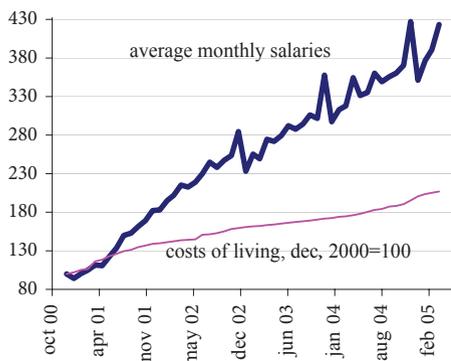
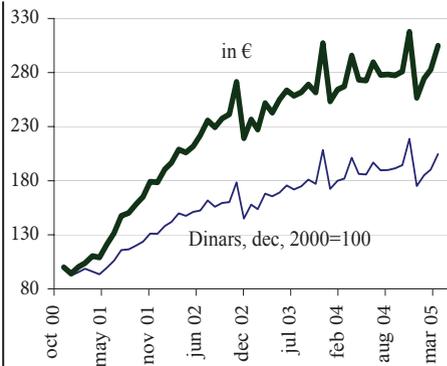


Figure 15. Real net earnings, 2000-2005.



Very soon after 2000, the population was again able to finance the minimum consumers basket out of one average wage. Generous initial foreign grants, policy of dinar appreciation and subsidizing domestic aggregate demand

<sup>20</sup>The average wage in December 1990 amounted to DM752, to reach its absolute minimum of DM21 in December 1993. In the period 1994 -1998, the average wage amounted to around DM 170, in the course of 1999 it fell to DM80, which was its level also just before the beginning of transition.

were key instruments to achieve that. The living standards of the population were additionally improved through a substantial inflow of private remittances, which to a large extent contributed to the high growth of consumer goods imports and had a substantial impact on the widening of the country's trade deficit. The estimates are that a difference between wages and total incomes of about twenty-odd percent has created room for an accelerated rise in demand for imported goods.<sup>21</sup>

Real wage growth of more than 20 percent a year, which happened in Serbia, has not been seen in any transition economy (Galgoci, 2002). In transition economies, a very clear mechanism was established, in which productivity growth was "pulling" growth in the gross domestic product, while real wages were growing at a much slower pace. Thus, almost no real wage growth (a mere 0.84 percent a year) accompanied high productivity growth in Hungary of almost 15 percent a year all the while to 2000, in Romania and Bulgaria productivity growth was accompanied by a drop in real wages (by

Table 7. Growth in gross domestic product, productivity and real wages in transition countries, 2003, in %

	productivity	GDP	wages	unemployment rate
Bulgaria	5,5	0,7	-6,6	12,7
Czech Rep.	6,7	2,0	5,1	10,6
Estonia	...	2,5	4,8	11
Hungary	14,6	3,4	0,8	6
Latvia	...	0,9	4,8	11
Lithuania	...	-1,7	3,1	13,2
Poland	11,3	6,0	6,8	17,9
Romania	7,9	0,6	-2,2	6,3
Slovakia	5,8	4,2	1,6	15,6
Slovenia	8,0	4,8	4,9	8
<b>Serbia</b>	<b>5,5</b>	<b>4,7</b>	<b>19,8</b>	<b>33</b>

Productivity and GDP from Galgoczi (2003), unemployment from Bishop, K. (2004)

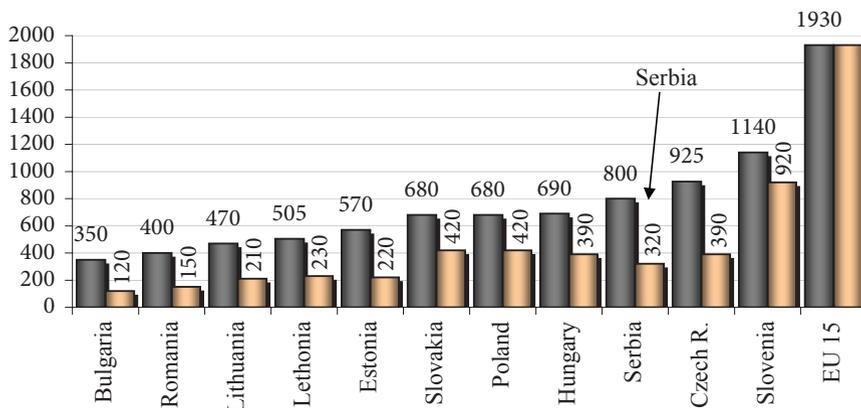
3 and 7 percent, respectively), while the countries which are considered the most "generous", the Czech Republic, Slovakia, the Baltic states and Slovenia,

<sup>21</sup>Practically every year imports of household appliances were doubled, but for TV sets they were tripled every year, and for washing machines increased five times every year. Imports of TV sets rose from 1.8 to 32 million dollars, imports of air-conditioners from around 5 to 29.5 million dollars, of washing machines from around 2.2 to 15 million dollars, and deep freezers from around 1.4 to nearly 11 million dollars, and of stoves from 488,000 dollars to around 8.8 million dollars.

registered wage increases of less than 5 percent a year. As demonstrated in Table 7, in almost all countries faster wage growth was “paid” by a higher unemployment rate.

Since purchasing power of the euro in all transition economies is much higher than in the European Union, it is of relevance to establish purchasing power of the average wage in transition economies relative to the

Figure 16. Gross wages, in Euros and PPP



Source: Galgoczi, 2003

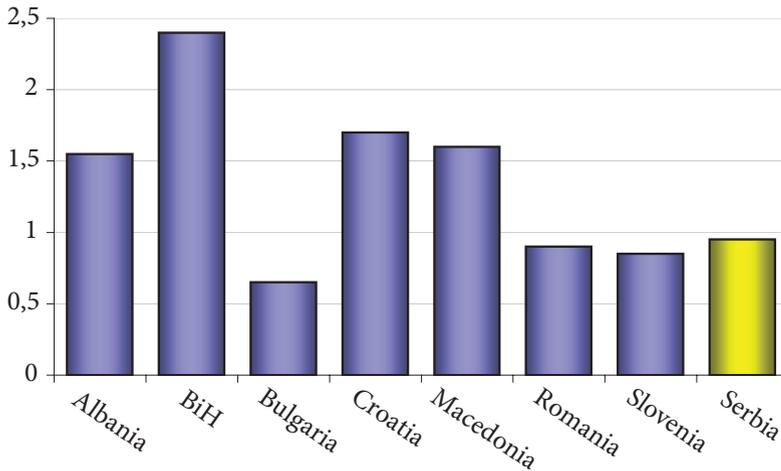
**EU countries.** By comparing the price levels of goods and services for private and household consumption, it has been established that the average wage in Serbia can buy 2.5 times more goods and services than in the EU, implying that with the average wage of €320, whose purchasing power is equivalent to the amount of around €800,<sup>22</sup> the level of wages in Serbia is higher than in most of the new EU member states.

It seems that high wages have not undermined the competitiveness of the Serbian economy, measured by unit labor costs. By comparing nominal labor costs with productivity (we obtain the so-called unit labor cost), we can see that Serbia is not lagging behind the countries in the region (IMF 2005a), that the unit labor costs are considerably lower than in Croatia, but that Serbia is still much behind the EU candidate countries, behind Romania, and in particular behind Bulgaria. However, it is indicative that this factor has

<sup>22</sup>For the sake of comparability, the calculation of PPP taken over from the archives of WIIW, Economic indicators for Serbia, corresponds to the empirical one.

not substantially contributed to the inflow of export-oriented foreign direct investments. Instead, investments were directed mainly toward “buying”

Figure 17. An estimate of unit labor costs, 2003 (annual net wages/per capita GDP)



markets, accordingly financial intermediation, trade, construction industry, beverage industry, i.e. non-export-oriented branches, but primarily focused on domestic consumption. It is obvious that for the creation of an export climate it is not enough to have relatively cheap labor force, which is, nevertheless, constantly and systematically becoming expensive, while strikes constitute a very frequently used method for solving various social problems of workers.

**In parallel to high real wage growth and significant widening of wage scales, in Serbia every one in six employees in the socially owned sector is not receiving any wage at all.** Bearing in mind that in Serbia the state is a dominant owner of capital and a dominant employer (see table 8) maintaining the status quo with respect to overstaffing is one of the ways to “buy” social peace, and there is great reluctance to lay off redundant workers. One of the ways to align expenditures with the level of activity was to accumulate wage arrears.

Data for 2005 show that more than 190,000 employees, or every one in six employees in the socially owned sector, are either not paid wages or their wages are paid with enormous delays, in some case as long as several years.

At least two conclusions can be drawn from the above: (i) a large number of workers is obviously employed in the gray economy, (ii) actual employment in private sector is greater than registered, and (iii) the total wage bill in Serbia is higher than statistics can register.

Table 8. Employees to whom wages have not been paid

	March 2005			
	Republic of Serbia	Central Serbia	Vojvodina	City of Belgrade
1. Total	1,287,529	950,467	337,062	361,489
2. Those who have not received wages	190,656	140,551	50,105	25,526
2:1 (in %)	14.8	14.8	14.9	7.1

Source: SSO, Communiqué no. 129, June 2005

### Employment

Along with fictitious employment, unemployment is a pressing problem of the Serbian economy. Official data indicate that there are 1,987,000 employees, and around 995,000 unemployed persons, and that the unemployment rate has reached the unbelievable 33.4 percent. Alternative research (LFS, 2003) indicates that the number of employed persons is higher by almost a million people, while unemployment is lower by one third, consequently the unemployment rate stands at about 18.5 percent. Here a deficiency of the monthly surveys has been redressed, since these surveys have not covered a large number of unregistered employed persons.

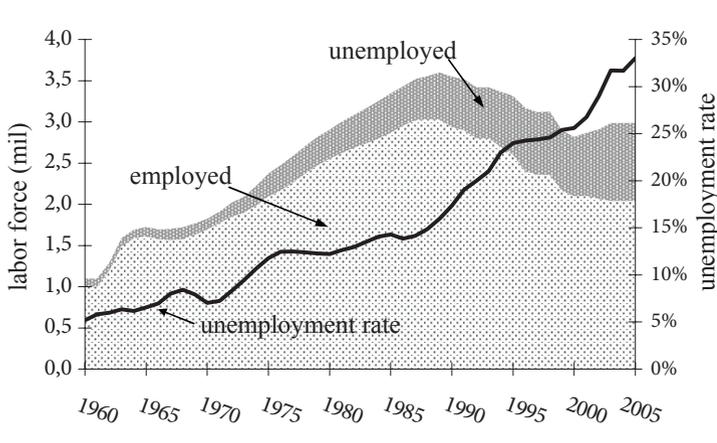
High unemployment in Serbia is predominantly a consequence of slow job creation, which can be attributed mostly to a poor business environment, and in particular to strict regulations on protection of employment, which were adopted despite warnings from strategic investors that such legislation would only undermine chances for employment growth<sup>23</sup>. In addition, job creation was also slowed down by relatively high unit labor costs which are for the most part a result of the pressure on wages exerted by insiders, i.e. workers in state owned enterprises or privatized companies. Other possible

<sup>23</sup> FIC, *ibid.*

causes for slow job creation and high unemployment, such as the structure of unemployment benefits, structure of wages, enterprise restructuring and related qualification and territorial mismatch, at best play secondary role. On the whole, more attention is paid to the preservation of the existing jobs, than to creation of new opportunities for employment.

Labor legislation in Serbia is extremely rigid and will disable employment growth. On the whole, that results in maintaining the status quo, since political factors in Serbia prone to the prolongation of *life* of non-viable firms, rather than to creating a sound business environment. Regarding

Figure 18. Employment



management rights in public enterprises. a deal has been reached for the ruling political parties on the basis of their electoral results. For unsuccessful (or successful) operation of these firms they are accountable to no one, which is to a large extent hindering any change in the existing business environment. Restructuring and privatization, therefore, are carried out at a pace imposed by international financial institutions, in particular the IMF, which has made the remaining write-off of the debt to the Paris Club creditors of around US\$ 750 million conditional particularly on the speeding up of structural reform and reduction of the share of public spending in the gross domestic products. The key danger which the failure to meet the obligations to the IMF entails, however, is related to the fact that this international financial organization practically produces an assessment whether Serbia's economic reforms are

successful or not, which has a direct impact on the country's credit worthiness, as well as on the investment rating of the country.

## DEFICITS

### **Fiscal deficit**

Once a country where wheat harvest was paid to farmers exclusively by money creation, in the four years of transition, Serbia has become an orderly fiscal jurisdiction. Numerous quasi-fiscal activities of the central bank were stopped, special budget funds and special accounts eliminated and a Treasury was set up, and in this manner a foundation was laid for conducting sound fiscal policy. Pension and child benefit arrear accumulation has become history, while old arrears are being gradually cleared. Finally, in the beginning of the fifth year of transition, the value added tax was introduced at last, which resulted in a significant budget revenue increase. With a view to reining in overheated aggregate demand, the fifth year of transition will be ended with a low budget surplus on a cash basis, in the amount of 1.2 percent of GDP. In that respect, Serbia has become a country with very strict fiscal discipline, which will, provided that such policy is pursued in the future as well, significantly increase Serbia's investment and credit rating.

**In Serbia, the budget balance as such does is not a problem, the problem is in the size of the budget.** Such a high share of public spending is typical of all former socialist economies, and in some of them it was over 60 percent at the beginning of transition, only to be dramatically reduced in all the countries during transition (cf. WB, 1998). It was empirically confirmed that public spending has negative effects on economic growth (Barro 2002), primarily because an overly high tax burden crowds out investment and thus "condemn" public spending to permanently remain at low absolute amounts. Therefore a cut in budget spending is an imperative, whose delay is going to be very expensive.

Such a high share of public spending is unavoidably pro-inflationary and inherently unsustainable, because internal equilibrium in the medium term crucially depends on fiscal sustainability. The past expansive fiscal

policy has led to rapid real wage growth and a high trade deficit, which finally passed through to a double-digit inflation rate and threatens to seriously undermine macroeconomic stability. As shown in Table 9, the deficit was first

Table 9. Consolidated public spending in Serbia, 2001-2005

	2001	2002	2003	2004 estimate	2005 projection
Revenue	38.9	42.8	42.7	45.2	44.8
Expenditure	40.3	47.3	46	45.5	43.7
Cash balance	-1.4	-4.5	-3.3	-0.3	1.2
Foreign grants	0.7	1.1	0.2	0.1	0.2
Foreign loans (net)	0	1.8	1.2	1	0.9
Privatization receipts	0	2.2	4.3	0.6	3.1
Domestic financing	0.7	-0.5	-2.4	-1.4	-5.4
Gross public debt (% GDP)	123.2	85.4	79.2	60.2	53.1
of which foreign currency denominated (of total debt)	92	91.9	91.9	87.9	95.1

Source: IMF, July 2005

financed out of grants, then out of foreign loans and privatization receipts. Thus, maintaining a too large budget proves to be harmful in two ways: not only that it crowds out private investment and slows down economic growth, but it also directs too much of the privatization proceeds, for the purpose of budget balancing, into consumption, which constitutes a classic example of disinvestment, i.e. irretrievable capital outflow into consumption.

**Public spending has to be reduced first in the fields of subsidies, public sector wages, health and pensions, while increasing the shares of public debt service and government investment spending.** If its share remains high, the growth rate will recede significantly. After restructuring, budget spending would be gradually reduced from the present 46 percent of GDP by one percentage point each year, to come down to around 40-42 percent of GDP by 2010.<sup>24</sup> In the case of Serbia, it is of utmost importance to put an end to the practice of financing losses of socially owned companies, which are given subsidies either from the budget, or through accumulation of contribution and tax arrears, or through subsidized energy prices, which the energy sector then shifts to the budget through their own payment arrears, etc. This problem

<sup>24</sup>This scenario is envisaged by the World Bank and IMF documents, as well as in the Poverty Reduction Strategy Paper.

in Serbia is, for all practical purposes, concentrated primarily in 75 large socially owned companies (with more than 140,000 employees),<sup>25</sup> where the restructuring process was initiated several years ago, but has not progressed much since then. An even more important problem is the fact that transfers are under a veil of secrecy, hence both their effectiveness and their final effect remain quite unclear.

Table 10. Fiscal revenue and expenditure. 2001-2004

	2001	2002	2003	2004		2001	2002	2003	2004
Total expenditure	40.7	48	47.3	47	Total revenue	39.1	44.3	43.1	45.5
1. Expenditures for employees	8.9	10.3	10.6	10.5	1. TAX REVENUE	37.3	43.1	40	41.7
2. Purchases of goods and services	7.1	7.6	6.6	6.1	1.1. Personal income tax	4.6	7	7	5.9
3. Pension benefits	11.1	13.9	13.9	13.6	1.2. Corporate income tax	0.5	0.5	0.5	0.5
4. Social protection	3.3	4.2	4	3.6	1.3. Sales tax	10.2	12	11.5	12.3
5. Subsidies	5.6	7.6	5.3	5.9	1.4. Excise	3.7	5.1	5.3	5.3
6. Capital investment	1.1	2.2	2.8	2.5	1.5. Customs duties and other taxes on imports	2	2.7	2.7	2.6
7. Public debt service	1.6	1.5	3.1	3.7	1.6. Other tax revenue	5.5	5	2.3	2.7
8. Other expenditures	2.1	0.8	0.9	1.2	1.7. Contributions	10.8	10.8	10.6	12.3
					CAPITAL REVENUE	0	0	0.4	0.5

Source: Ministry of Finance, Memorandum on the Budget and Economic and Fiscal Policies for 2006 with Projections for 2007 and 2008

**Public spending has been proven to reverse economic growth (Barro 2002), and also it was empirically confirmed that the restructuring of budget spending (creation of a healthy business environment and the building of a social safety net) has a very important effect on economic growth (Chadha and Coricelli (1997), Roland (1999)).** The importance of restructuring of

<sup>25</sup> There are still 1850 socially owned companies employing around 372,000 people.

public expenditures, primarily with respect to the creation of the social safety net, is best reflected in the light of political economy of transition. Namely, restructuring and reallocation of resources toward more efficient sectors cause transitory unemployment, rising poverty and inequality in income distribution. These costs can create a lot of resistance to reform and significantly slow down the restructuring process. *Hence, in principle, the point is to change the composition of budget expenditure* – by cutting current financing of (unearned) wages and starting with payments of severance pays. This can, to a reasonable extent, facilitate the restructuring process.

Reforms of the pension system, health care system and public administration strongly encroach on the acquired rights, and for that reason a strong political will and a consensus (reached at least in principle) between the government, employers and trade unions, are necessary for their implementation. However, since in Serbia the key reformer, that is, the government itself, is not demonstrating any willingness to relinquish its own management rights in public enterprises, reform has been almost completely halted, which naturally creates discontent and confusion among voters. That is why a surprisingly large portion of Serbia's electorate (15 percent) opted in the 2004 presidential election for a scenario of reopening previously closed factories and a series of similar populist proposals which would largely mean backtracking on reform. And that such a scenario is not impossible, one can see from Romania's experience, where in the course of the fifth year of transition happened exactly that: previously closed down factories and plants were reopened, privileged credit lines were reactivated, as were implicit or explicit fiscal incentives, which has (of course) provoked a macroeconomic crisis in 1996.<sup>26</sup> The Romanian electorate, who accepted this adventure fearing a decline in wages and layoffs, very soon had to face even more large-scale retrenchments and a huge real decline in wages, which was certainly the only outcome they wanted to avoid at any cost.

**The failure to implement hard budget constraints to a large extent can make pointless all the efforts in the field of restructuring and public spending cuts.** In a situation where privatization of large, bankrupt, socially owned companies has not been carried out, the climate of interventionism will be restored, in which it is more important for an entrepreneur to have good contacts in some ministry than to wisely respond to a change in market sentiment. Therefore, accelerated privatization and implementation of bankruptcy and anti-monopoly legislation, with the protection of private

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<sup>26</sup> World Bank, *Transition: The First 10 Years*, p.55.

property and contractual rights, are imperative. In fact, precisely that is the key role of the state – to produce public goods which most directly affect the quality of the business environment, which ensure protection of property rights and safeguard competition. Uncompleted and inconsistently carried out reforms have already produced such an effect that the majority of employees still believe that assets belong to workers, and responsibility to the government, which was a source of numerous protests and industrial actions that in the fourth year of transition became almost a daily event, while reform was very nearly suspended.

**Privatization of public enterprises and introduction of fiscal discipline in those companies as well, offers itself as an imperative here.** Privatization of public enterprises is indispensable, because there is a whole range of privileged large state owned companies in Serbia which call themselves “strategic” and to which, as long as they are owned by the state, the strict climate of bankruptcy and liquidation will not apply, and the culture of non-payment and clientelism will not be eradicated. Experiences of successful transition economies show that soft budget constraints were completely eliminated only after the privatization of the power industry, water supply company, telecom, and the like, in sum, companies which do not produce public goods and for which there is no rationale for remaining state owned.<sup>27</sup> However, in such a case, the political parties which are running these companies will become losers, hence every announcement of such a possibility provokes an immediate response from party officials, offering an explanation that such solutions are “bad for the country”, whatever that may mean. Experiences show that after privatization, the services of these companies, as a rule, become much better, costs lower and the political influence of new owners, in a good regulatory framework, is much weaker than the influence of political parties which acquire the management rights without investing a single dinar in it and, by rule, without adequate management capacities.<sup>28</sup>

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<sup>27</sup> Public goods are, namely, those goods which the private sector will not produce in sufficient quantities because it cannot adequately price them (law and order, the judiciary, defense, the business environment, etc.). Electricity, oil, air traffic, railroads, postal services, in brief, the production program of our public enterprises, certainly cannot be classified as public goods. The absence of privatization here can mean only one thing: that the socialist practice of buying social peace is continued through subsidized prices of these services, while in return the management boards of these companies gain a huge financial and political influence.

<sup>28</sup> “The Social Democrats will not support the privatization of JAT, EPS, NIS, the Railroad Company. Not because we are against privatization, but because we want partnership relations first with respect to these large systems,... Secondly, these large systems are of both state and strategic interest. They cannot belong to everybody and nobody. Thirdly, through a partnership approach, these large systems may increase their value and then they can be privatized, in, say, five years. And

### Deficit on the current account of the balance of payments

The current account deficit rose in the four years of transition from 10 to the unbelievable 15.5 percent of GDP. Thus, the experience-based rule – that any deficit in the balance of payments higher than 5 percent of GDP should be considered “dangerous” – has been exceeded as many as three times.<sup>29</sup> The deficit in the last observed year (2004), however, cannot be considered representative, because for the most part it is a consequence of “anticipated” imports, resulting from the introduction of the value added tax on products on which no dues were levied in the past. Nevertheless, the trade

Table 11. Current account balance of Serbia's balance of payments. 2001-2005

	2001.	2002.	2003.	2004.	2005. (proj.)
Current account balance, before grants, in mil. of U.S. dollars	-1.1	-2.0	-2.5	-3.7	-2.9
(% of GDP)	-9.7	-12.9	-12.9	-15.5	-11.0
Trade deficit, in mil. of U.S. dollars	-2.8	-3.9	-4.9	-7.4	-7.1
(% of GDP)	-24.5	-25.2	-23.6	-31.0	-26.6
Current account balance, after grants, in mil. of U.S. dollars	-0.5	-1.4	-1.5	-3.1	-2.5
(% of GDP)	-4.6	-8.9	-7.3	-13.1	-9.5

Source: IMF, 2005a

deficit was by just a couple of percentage points lower even before that, and the medium-term risk of such a high deficit causes great concern, because it arises from deep structural imbalances of the Serbian economy. Still, the short-term balance of payments risk is lower than the medium-term one, primarily due to the continued inflow of foreign direct investment, rising foreign exchange reserves, as well as to the low share of the short-term debt in the country's total debt.

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fourthly, *when you privatize EPS and NIS then you neither need government, nor the authorities in the country, because the capital is running certain things then,* 19 July 2005, a press release by the SDS, a party which has a key role in the minority government and “whose” line ministry has drafted the controversial Labor Law which provides for two working days off as a reward for blood donors (i.e. the healthiest and strongest people, for a completely harmless humane deed), etc.

<sup>29</sup> The critical limit of a current account deficit which is sustainable in the medium term is, however, double that value – 10 percent (EBRD). In addition to the level of the deficit, the risk is posed also by the length of the period in which it uninterruptedly lasts.

The key source of the huge trade deficit is in too low exports, which in the fourth year of transition have come to only 17 percent of the gross domestic

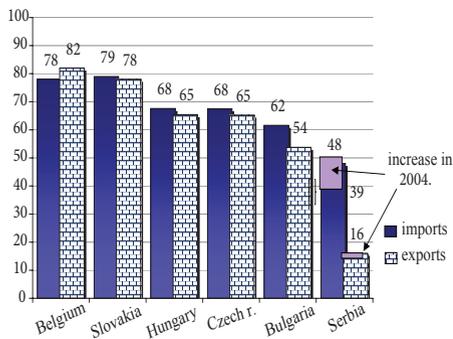
Table 12. Share of foreign trade in gross domestic product

	Trade in 1989			Trade volume in small open economies	Trade volume	
	Total	Inter-national	Inter-republic		1998	2004**
Import contents	48	19	29	50-80	26.2	48
Share of exports	42	17	25	50-80	15.5	17
Total trade	90	36	54	100-120	41.7	64

Source: WB, Trade Institutions and Policies \*) includes goods and non-factor services; \*\*) includes trade with former SFRY republics; comparable with the first column in the table.

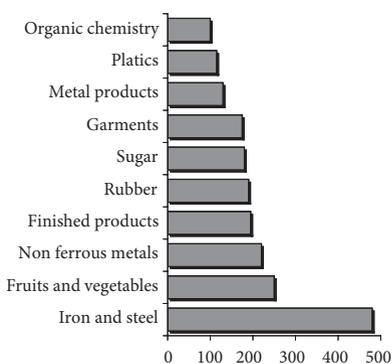
product, while imports, even with the explained sudden leap in 2004, have not yet reached even half of GDP. In comparison with other countries of a similar size, Serbia obviously belongs to relatively closed economies: total volume of Serbia's trade barely reaches 64 percent of GDP, while in other countries it ranges between 126 and 170 percent of GDP. (cf. Table 19)

Figure 19. Exports and imports in GDP, 2003



Source: Office for National Statistics; Eurostat

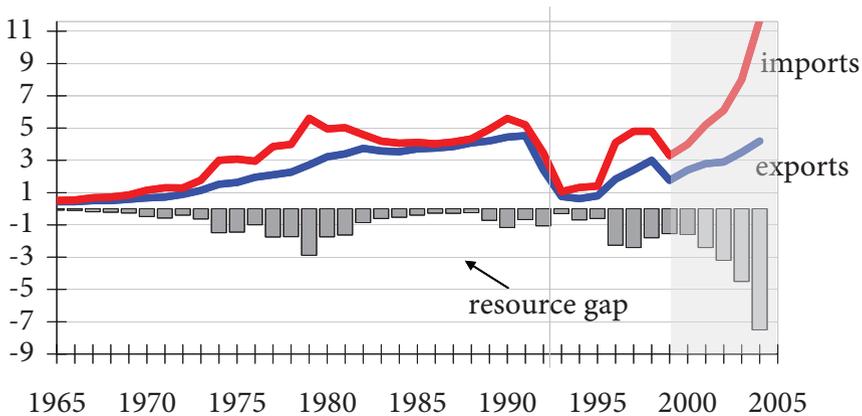
Figure 20. Major export products in 2004 (mil. USD)



Therefore the Serbian economy has to finally open up to the world, and current account must not be balanced by reducing imports. On the contrary, it should be carried out only at a significantly higher level of trade. To that effect, all prepared scenarios of Serbia’s sustainable economic growth envisage that the fastest rise has to be in exports (on average about 20 percent a year, while a fast rise in imports (too) is not ruled out (9 percent), not only because of import dependence of future export supply, but also because it was proved beyond doubt that closed economies have very poor economic performance and that their recovery usually coincides with economic opening (Srinivasan and Bhagwati, 1999).

A weak export orientation is a traditional feature of Serbian companies dating back to the times of former SFRY, where inter-republic (60 percent) trade was much more intensive than international trade. The reason is very simple and utterly rational: domestic firms managed to sell a good portion of their products in other republics on the basis of inter-republic political

Figure 21. Serbia and Montenegro: exports, imports and foreign trade deficit, 1965-2005.



dealings, and thus the same revenue could be generated with much less work on the quality and promotion of products, export channels, etc. With the break-up of SFRY, exports were falling much faster than any other variable, which certainly constitutes the key synthetic indicator of the concerted effects of sanctions (1992-2000) and bad economic policy conducted for ten full years prior to the beginning of transition in Serbia.

**Parallel to the fall in the volume of exports, their structure underwent significant disindustrialization.** The composition of the first ten products exported to the EU has also radically changed: exports of machines and spare parts for automobiles fell from more than 15 to less than 5 percent, and agricultural products increased their share from 4.8 to more than 20 percent. The leading export products, and at the same time the strong suits of Serbia's foreign trade, both last and this year (2005), are iron, steel, sugar, raspberries, tyres, polyethilen and drugs. The estimates of the Serbian Chamber of Commerce are that as many as 3,000 importers and 1,300 exporters operate in Serbia in 2005, which (ironically) more or less corresponds to the proportion between exports and imports in foreign trade performance.

**With annual exports of goods and services of barely 4.2 and the trade deficit of US\$ 7.4 billion, Serbia can solve none of its pressing problems: the domestic product will grow slowly, unemployment will remain high, and the country will not be able to avoid a debt crisis.** External debt sustainability analyses show that exports should grow at an average annual rate of around 25 percent in the period 2005-2008, and then continue growing at a rate of around 15 percent a year in order to eliminate this critical structural imbalance in the medium term (IMF, 2005). The situation is rapidly improving in the course of 2005, in the first semester exports recorded growth of 51 percent, hence it appears that the IMF's requirement will be met, that this year's export growth should be 25 percent relative to last year. One of the identified reasons for export growth is the introduced mechanism for VAT refunds after an export transaction has been closed. At the same time, it is an indicator that exporters were not reporting full amounts of their revenues in the past, in order to reduce part of their tax liability in that manner. If that was the main reason for such a sudden leap in exports, then there is a big problem, because thus created export growth does not leave room for further requested accelerated export growth.

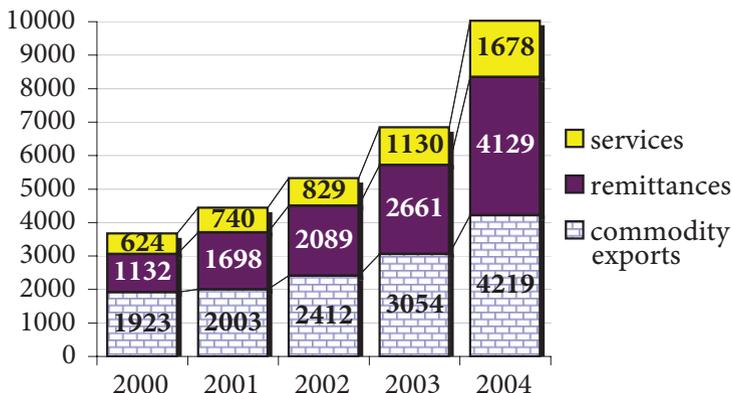
**Both future composition of exports and directions of trade will depend primarily on FDIs which Serbia will manage to attract, whatever may be enshrined in any national export strategies.** Namely, it has been evidenced beyond doubt that the domestic economy does not have sufficient technological, staffing, financial or export capacities to ensure sustainable annual export growth of more than 20 percent, which is the primary task and strategic economic goal. The indirect confirmation of this view is the fact that the largest Serbian exporter, for two years in a row, has, in fact, been the only multinational company that came – US Steel. Experiences of successful

transition economies point to fact that the mechanism of fast, export-oriented growth was precisely that: newly arrived multinationals were employing a range of domestic sub-contractors and thus influenced the growth of new small and medium-sized companies, which never exported on their own, but were building in the “domestic component” into finished goods exported by multinational companies. The data for 2003 indicate that in the Czech Republic 60.5 percent of exports “belonged” to multinational companies, in Hungary 89 percent, in Poland 60 percent, in Slovenia 30 percent, etc. These multinationals directly employed between 27 (the Czech Republic) and 47 percent (Hungary) of total labor force, and thus a faster rise in employment was enabled than what data on factor productivity in those countries could suggest (UNCTAD, 2004). Therefore, a good export strategy inevitably turns into a good strategy for attracting foreign direct investment.

*Remittances*

Serbia’s revenue from migrants’ remittances in 2004 reached almost 15 percent of GDP and practically became level with the earnings from exports of goods. According to the official data, more than 400,000 people from Serbia

Figure 22. Receipts, 2000-2004.



work abroad, while the number of emigrants is certainly much larger (around 3.5 million). It should be noted, however, that the statistical coverage of

remittances is still insufficiently precise, and therefore it cannot be established with certainty to which extent this surge in remittances can be explained by the increase in foreign exchange inflows through the banking system,<sup>30</sup> and which portion is explained by their real growth relative to the previous years.

**Although the propensity of emigrants to send remittances is falling over time, the total sum of remittances, as a rule, first grows for a very long period owing to new emigrations.** Analyses show that remittances in less developed regions are rising as long as the number of newly created well-paid jobs in the country is lower than demand for them. Consequently, the highest percentage of the money sent to the country will be spent on basic necessities, while only a small portion could be directed in long-term savings or directly into investment (*Quesada, 2005*). These conclusions are certainly relevant for Serbia as well, particularly because domestic savings have almost no tradition at all, predominantly because the main reasons for saving in developed countries – education, health and pension insurance – were non-existent in Serbia in the past, while confidence in banks (albeit not in the domestic currency) was restored only recently. The inflow of remittances will in all likelihood be maintained for quite some time to come, while the low standard of living of the population will, however, significantly limit the possibility for productive engagement of this, on an aggregate basis, huge inflow (*Muco, 2003*).

### *Imports*

**Liberalization of imports and a sudden rise in aggregate demand resulted in an above-average rise in imports, whose composition, however, did remain dominated by investment goods and intermediates.** Bearing in mind the need for accelerated economic growth, this trend should not be interrupted. The envisaged and expected inflow of foreign direct investment will only increase such imports, which is fully in line with inter-temporal budget restrictions of the companies as such and of the government, where the only constraint is the capacity to repay debts. Since the procurement of equipment is financed by private borrowing, the sustainability of such a scenario is not threatened.

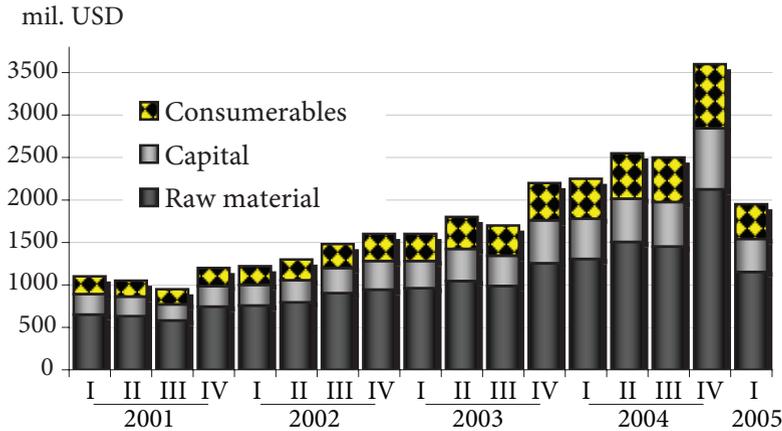
**A rise in imports of consumer goods is a consequence of the rise in aggregate demand and the lack of high-quality (and in some cases of any) domestic supply.** Thus the imports of household appliances were doubled every

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<sup>30</sup> In principle, variations in the level of remittances are attributed to the degree of appreciation, so with the stronger dinar the inflow of remittances is higher and vice versa. Namely, particularly when they come to the country, migrants compensate for the fall in the purchasing power of the currency they have brought through intensified conversion of foreign exchange.

year, imports of TV sets tripled every year, and of washing machines increased five times, etc.<sup>31</sup> The bulk of the money, accordingly, went for replacing long

Figure 23. Commodity imports, quarterly data, 2001-2005



depreciated household appliances, while part was spent on the procurement of less outdated models of used cars. Unfortunately, citizens are still far below the living standards they had in the past, and one already has to put an end to this policy. Namely, this part of aggregate demand is to a large extent financed directly out of subsidized wages, consequently, out of the central and local budgets, whose expenditures have to be radically cut. The economy has to be relieved of the high tax burden, foreign grants will keep falling, while the time for debt repayment is nearing. Therefore, one has to apply a completely different strategy of economic growth, which will be driven by exports, instead by domestic demand, and the only precondition for such a turnaround is to bring wages in line with labor productivity.

**The opponents of such policy will be public enterprises, political parties, socially owned companies living on subsidies, importers, as well as pensioners, of whom only part will manage to progress to the category of winners. Under this development scenario, profits are “moving” to exporters**

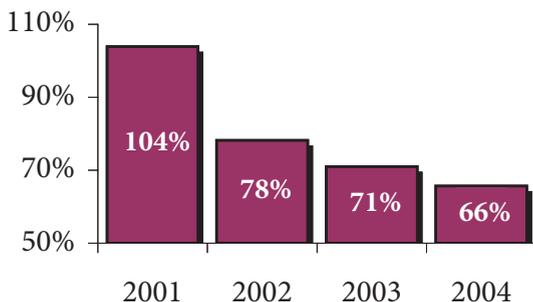
<sup>31</sup> Imports of TV sets rose from 1.8 to 32 million dollars, imports of air-conditioners from around 5 to 29.5 million dollars, of washing machines from around 2.2 to 15 million dollars, and deep freezers from around 1.4 to nearly 11 million dollars, and of stoves from 488,000 dollars to around 9 million dollars.

and their domestic suppliers and sub-contractors, on whose success, as the experience of transition has shown, the success of transition actually depends.

### Public debt

After four years of transition, and despite debt relief granted by the Paris Club, to be followed by the London Club, providing for a 2/3 debt write-off, Serbia's public debt is almost as high as its annual GDP (92.5 percent), while foreign-currency-denominated debt accounts for its largest portion: frozen foreign currency deposits and external debt. Serbia's external debt at the end of 2004 dropped in euro terms and rose in dollar terms and amounted to €10.3 billion, i.e. US\$ 14.1 billion. Total liabilities of the government for all kinds of frozen foreign currency deposits are estimated at around €4.2 billion, and the estimates are that 90 percent of holders of these deposits will be paid out in just two years.<sup>32</sup>

Figure 24. External debt, share in GDP



By applying World Bank criteria for assessing the level of indebtedness, it turns out that Serbia's debt is not high, but that Serbia has extremely low capacity to repay the debt out of current foreign exchange earnings. Namely, according to the present value of debt service to GDP ratio, Serbia is not belong to severely indebted countries, while according to the other criterion (the present value of debt service to exports ratio) it does belong (Table 13). Since each criterion is eliminatory, Serbia is still treated as a severely indebted

<sup>32</sup> See a detailed breakdown of external debt in Appendix 7.

country. Serbia's total indebtedness stands at 65.7 percent of GDP, while its capacity to repay is very weak: the debt is more than three times its annual exports (317 percent), while in less indebted countries debt can be repaid, in principle, with one year's export revenues. It practically means that through accelerated growth of exports (25-30 percent a year) Serbia could easily meet both criteria for moderately indebted countries and thus also obtain a better credit rating on the international financial market. In addition, there is still room for debt reduction by another US\$ 1.5 to 2 billion, through the write-off of US\$ 750 million of the Paris Club creditors' claims<sup>33</sup>, regularization of Kosovo and Metohija's debt (US\$ 1.2 billion), as well as through the settlement of the issue of surpluses with Russia, China, Kuwait and Libya, where the debt issue has not yet been regulated.

**The high tranches of debt service falling due in the near future will require an increase in foreign exchange earnings**, but also enough room on the expenditure side of the budget, from which part of the debt will be serviced. From another angle, they also point to the necessity of changing the structure of final demand, restructuring the budget and cutting fiscal expenditure. Namely, it is of utmost importance to ensure a stable rise in export revenue and thus accelerate economic growth, while putting an end to the subsidizing of non-

Table 13. Criteria for the level of indebtedness and Serbia's indebtedness in 2003

	Severely indebted	Moderately indebted	Less indebted	Serbia, 2003			
				2001	2002	2003	2004
Debt/GDP	$x > 80\%$	$48\% < x < 80\%$	$x \leq 48\%$	103.9	78.2	71.0	65.7
Debt/Exports	$y > 220\%$	$132\% < y < 220\%$	$y \leq 132\%$	429.5	383.2	387.0	317.0

Source: NBS, Serbia's external debt sustainability, April 2004

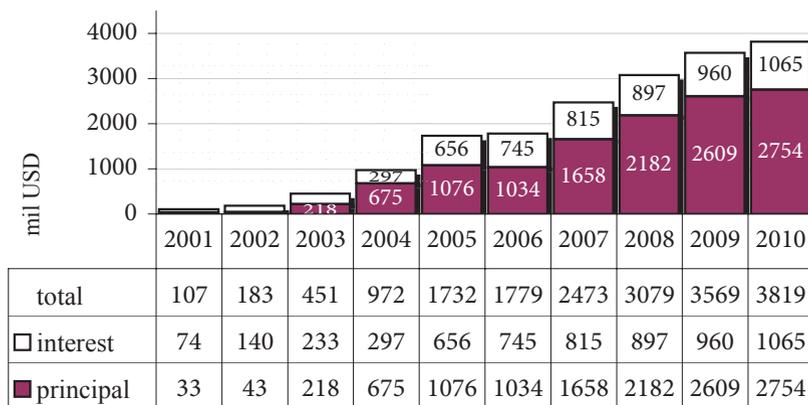
viable firms as soon as possible, and reducing the present too high burden of fiscal levies on other economic agents capable of creating export supply. That would ensure an alternative, productive use of these resources and creation of preconditions for export-oriented growth. The notorious "Argentine scenario" (see Box 2) happened precisely because economic agents were protected (by

<sup>33</sup>The completion of this debt relief requires a positive assessment of the Executive Board of the International Monetary Fund of the carried out privatization of public enterprises, strict implementation of bankruptcy legislation and imposition of tough fiscal discipline. The decision has been postponed for the end of 2005.

subsidies) against external shocks and were not prepared and did not have any incentives to respond flexibly to the changes in the environment, which finally caused a financial collapse and a debt crisis.

Numerous external debt sustainability analyses (IMF, 2005, World Bank, 2004, NBS, 2005) indicate that there is no danger that the “Argentine scenario” could be repeated. The threshold for maintaining external liquidity

Figure 25. Public debt repayments, 2001-2010.



is the average annual economic growth rate of 5 percent, a rise in the value of exports by 25-30 percent in dollar terms and annual inflow of foreign direct investment in the amount of US\$ 1.3-1.6 billion. A considerably lower growth rate would be very risky, because external debt service and public spending are almost independent from the output volume, hence they would grow in relative terms. The projected substantial export growth from 19 percent to 35 percent in 2010 implies that already in 2006 the value of exports should stand at around US\$ 6 billion, which based on comparisons with the neighboring countries seems to be feasible. Together with foreign direct investment, it constitutes the main strategic direction of Serbia's economic development (PRSP, 2004). Sustainability risks, however, are not negligible. They are related to slower inflow of foreign direct investment, a fall in privatization proceeds and deceleration of reform, which would reduce the economic growth rate and once again increase the rate of indebtedness.

## MACROECONOMIC POLICIES

In four years of transition, Serbia changed two governments<sup>34</sup>, and went through four cycles in the conduct of economic policy: (1) reformist, (2) abandoning reform in mid-2003 and shifting the focus to the issues of economic harmonization with Montenegro (to be discarded later on), with partial renunciation of its own initial foreign trade liberalization, (3) coming into power of the new government (early 2004), disorientation, the backtracking on reforms and almost nine months of systematic populist steps, and finally (4) a positive breakthrough and announcements of good reform moves (2005), which ensued after interventions of the IMF, WB and an announcement by the EU about the initiation of the stabilization and association process as of October 2005. Thus, in these first four years of transition less than half of the time was spent on serious transition issues, while the remaining part was characterized by typical macroeconomic populism, with announcements about reexamining liberalization which was carried out (the end of Prime Minister Živković's term in office), announcements about changing the method of privatization and revisiting past privatization deals, reversing the already introduced liberalization measures, etc. (Prime Minister Koštunica's government). For that reason, the general public did not get the impression that the process of transition was inevitable and irreversible, believing that the most difficult reforms – elimination of subsidies, bankruptcies and large-scale cuts of non-productive jobs, can, in fact, be indefinitely postponed.

Unlike the first government, which made its first transition steps rather resolutely, but circumvented the key issue of financial discipline, the current government gained the reputation of the builder of non-functioning institutions, as well as of a silent guardian of clientelism, which now unwillingly *has* to give in to IMF's requests. Namely, a gap between populist announcements and attempts, on the one hand, and a final, rather restrictive, set of measures implemented after the government's "successful" conclusion of negotiations with IMF missions, on the other hand, is quite obvious. Thus, for instance, the same government which in 2004 had passed a "development budget" with a deficit in the amount of CSD45 billion, reduced the deficit later in the same year by 1/3, while in 2005 it adopted a program envisaging a budget surplus and announced accelerated privatization of public and socially owned

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<sup>34</sup>To be more precise, Serbia has changed three governments, because after the assassination of Prime Minister Đinđić the government obtained a new Prime Minister – Zoran Živković. However, the composition of the government was not changed, and government policies did not undergo any major changes, and that is why this distinction was not highlighted in the text.

companies! Still, since the majority of reform steps are adopted after IMF's interventions, the reforms as such are basically not ascribed to the will of the government, and policy changes are accepted with less odium than it would normally be the case. In the macroeconomic domain, political agreement on the budget surplus was achieved relatively painlessly (the parliament adopted the revision of the budget), but, as previously mentioned, **the success will crucially depend on microeconomic reforms which deeply infringe upon party, financial and other interests**, where the losses of oligarchs, insiders and party structures are much more explicit and much more important to the government than the IMF's conditionality. Nevertheless, the failure to implement the announced measures agreed with the IMF mission would mean that Serbia has not fulfilled conditions for a write-off of 15 percent of the debt to the Paris Club creditors (amounting to US\$ 750 million). This condition is practically the only incentive to coalition partners to relinquish the acquired privileges and accept to continue transition.

Such "stop-go" policies are in complete contradiction to two key principles for successful macroeconomic policy, namely that (i) all the measures should be implemented in small dosages, thus reducing turbulence to a minimum, and (ii) every successive measure must be a recognizable and logical sequel of the previously implemented measures (Wyplosz, Burda, 2004). Only then economic agents cease to rely more on their cronies among ministers than on their own forecasts of future market developments. Such turnarounds happened not only after the second transition government decided (absolutely emotionally, in an unserious manner) to totally distance itself from all the actions of the first reformist government, but also in the first government, in which foreign trade liberalization from the beginning of transition was declared excessive and harmful 18 months later. The next government, on the other hand, breached its promise that it would undo everything what the previous government had done, and its Prime Minister even made a statement that he was beginning to better understand former and late Prime Minister Đinđić and a series of his pragmatic moves, whose most vocal and dangerous opponent was nobody else but him. Regardless of how ironically this may sound at first, such a statement is assessed in literature (Belka, 2004) as a sign of the strengthening of political stability of the country, which is reflected precisely in the fact that the former opposition has gained a realistic insight into the gravity of the reform task and attained maturity which will help in achieving political consensus on directions and methods of carrying out transition.

**In the four years of transition an array of missed opportunities can be identified. The most important undertaking for which the chance was missed is implementation of modern bankruptcy legislation.** Contrary to successful transition economies, in Serbia there was not enough awareness of the importance of, or political will for, establishing, declaring and implementing hard budget constraints soon after coming into power, which have not been implemented to date. In the first phase of reform, at the point when four banks were closed, further imposition of financial discipline on the rest of the economy was not even mentioned, so after a while the public gained the impression that the “storm” was over and that everybody could go on with business as usual, with subsidies, party privileges and “bypass mechanisms”.

**The most important missed opportunity of Prime Minister Koštunica’s cabinet is a failure to build a modern judicial system and the non-implementation of key enacted laws.** Therefore, not a single future step in Serbia can be predicted on the basis of previous steps, which to a large extent creates uncertainty and stirs great political discontent, practically driving a large number of voters away from the idea to build their own better future by themselves, for a simple reason that they themselves do not know what kind of future they want to create for their voters. Therefore, it is really necessary to follow the two mentioned criteria for a good macroeconomic policy – defined objectives should be implemented in small dosages and every subsequent measure should be created in such a manner that it constitutes a logical follow-up and consolidates the belief among the electorate that the government has both a vision and instruments with which to materialize it. This is something that fairly unbuilt democracies such as Hungary, Poland, Slovakia, and even Armenia managed to do, hence there is no relevant reason whatsoever to doubt that such a positive experience can be implemented in Serbia as well.

### **Monetary and exchange rate policies**

**The initial stage of macroeconomic stabilization was carried out by using the exchange rate as a nominal anchor for curbing inflation.** Parallel to the initial price liberalization, the exchange rate was fixed at the market level, the regime of the so-called managed floating was introduced, and then also the current account convertibility under Article VIII of the IMF’s Articles of

Box 2. “Argentine scenario” and threats to Serbia

The fact that Serbia is a heavily indebted country (which implies an implicit threat of an outbreak of a debt crises) very often arouses fears in Serbia of the so-called “Argentine scenario”, which is customarily ascribed to IMF’s wrong policies and pressures. Therefore, the table below presents a short comparative overview of implemented policies in order to see whether there is a danger that such scenario of a debt crisis might be repeated in Serbia.

Table 14. Argentina and Serbia – similarities

Crisis indicators	Argentina 1999-2002	Serbia	
		before 2002	2002-2004
Exchange rate*	currency board	fixed exchange rate	dirty float
fiscal deficit*	rising (-7%)	moderate (3-4%)	turnaround (surplus)
fiscal expenditure	extremely high subsidies	high subsidies	announced turnaround
fiscal revenue	huge evasion, only 21% of GDP	46% of GDP	45% of GDP
privatization proceeds	spent, without regulating monopolies	in progress	in progress
business environment	unbuilt, corruption, clientelism	unbuilt	unbuilt
pension reform	poorly implemented, deficit on the rise	not carried out	not carried out
export competitiveness	high appreciation, as well as subsidies	strong appreciation subsidies	subsidies + constant real effective exchange rate
vulnerability to shocks	pronounced	pronounced	pronounced
economic growth	steady fall in GDP	moderate growth	moderate growth
trade barriers	explicit protection	two liberalizations	FTA, WTO, SAA,
IMF’s “forbearance”	marked	moderate	none

\*) One school of thought advocates the position that the crisis was caused by the exchange rate regime (currency board), because economic agents were not able to adjust to external shocks (in particular to Brazilian devaluation), while the other school points to the fact that fiscal spending was too high.

## Box 2 – continued

As presented in the above table, with the introduction of the “truly floating” exchange rate and with the beginning of policy of public spending cuts, the risk of such an outcome in Serbia has been largely eliminated. **A huge risk in Serbia remains in the domain of delays in pension system reform**, where it is useful to highlight Argentina’s experience, which stopped halfway, when the inflow of contributions into the budget had ceased, and the obligation to pay pensions remained, which caused a rise in the fiscal deficit by another 3 percent of GDP (The Economist, 2002). However, surprisingly little apprehension is stirred by the **privatization of public enterprises in which state monopolies were replaced by private monopolies, where new owners fired previously hidden redundant labor, and local officials “cushioned” a fall in the living standards by paying wages out of local budgets**. Since local budgets were automatically receiving their respective percentages of revenue from the central government coffers, it was not possible to put an end to reckless spending, and the fiscal deficit kept rising. In addition, the situation with local budgets got out of hand, and their deficit rose to 60 percent of the country’s total deficit. **On the whole, the huge fiscal deficit is the reason for the outbreak of the debt crisis in Argentina**. Serbia has another problem – fiscal discipline is good here, but the budget is oversized, crowding out investment and hindering exports and economic growth.

In Argentina, the policy of trade barriers and subsidies completely “put to sleep” economic agents and caused a huge rise in corruption and clientelism. And the height of irony is that although all the blame was put on the IMF, its missions had tolerated it all – there was no conditionality related to either a reduction in the deficit or disinflation, and so in four consecutive years Argentina was running a rising fiscal deficit, had inflation, appreciation, negative economic growth rates, rising unemployment, but in its negotiations with the IMF it persisted in requesting to keep the same exchange rate regime (currency board). **Unlike Argentina, liberalization of foreign trade is proceeding in Serbia, albeit under pressure (harmonization with Montenegro, regional FTAs, WTO), but still proceeding, while the IMF is not tolerating a rise in inflation and the deficit.**

Clientelism and corruption from the Peronist regime can be recognized in Serbia as well (Begović, 2004). In Serbia, too, employees of socially owned

## Box 2 – continued

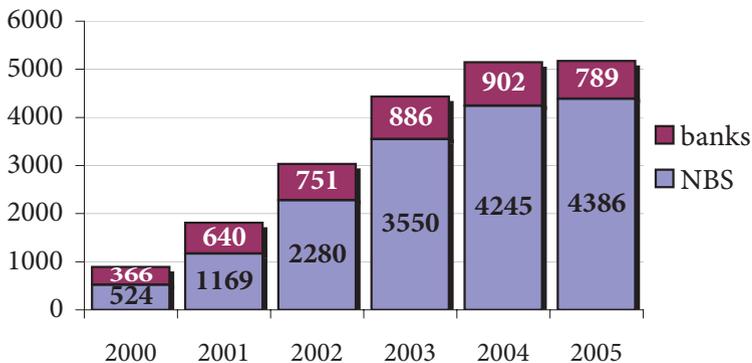
companies which are not working keep receiving wages out of subsidies, and the government has no incentive to stop this practice and thus make political foes out of its “clients”. **Therefore, IMF’s requests for rapid privatization of public enterprises are practically turning into a serious threat to the survival of the clientelistic order in Serbia. Elimination of this similarity to Argentina would eliminate every danger of “Argentine scenario” in Serbia.**

Agreement. In this manner, inflation fell from 111.9 percent in 2000 to 41 percent in 2001, and then to 15 percent in 2002. Inflationary expectations were cut short, which created a sudden rise in money demand and initiated strong remonetization. Consequently, the dinar appreciated strongly, domestic prices *increased 2.5 times, while the nominal exchange rate went up by around 2 percent only*. In late 2002, a period of stabilization of the real exchange rate and faster “floating” of the domestic currency began, with further disinflation, which in 2003 fell to 7.8 percent. However, a surge in inflation in 2004 (13.4 percent), coupled with increasingly strong growth in inflationary expectations in 2005, prompted the monetary authorities to revert to the old model of accelerated appreciation, with a view to anchoring inflationary expectations (IMF, 2005).

The end of the four-year period of transition is characterized by “more subtle” mechanisms of inflation generation. Thus, it was noticed that local governments practice to deposit money in commercial banks, and then banks use these funds to purchase government securities. That practically means that government money is used to buy government securities, and then the NBS has to sterilize that same amount of money in an effort to contain overheated aggregate demand and inflationary pressures – either by increasing the reserve requirement or by selling its own securities. Likewise, by imposing other levies – road tolls, TV subscription fee and the like, additional fiscal revenues are generated, the spending of which is not under direct control of the republican budget and which will also require further sterilization with a view to curbing inflation. These were key reasons for the IMF mission to agree to the use of the exchange rate as a nominal anchor in the coming period as well, in order to prevent a further surge in inflation.

Strong growth in foreign exchange reserves in the previous years is slowing down and stabilizing at the level of around US\$ 5 billion. Foreign loans and grants continue to be the most significant items of inflow, while outflow is related to the sales of foreign exchange on the foreign exchange market, repayment of frozen foreign currency deposits and the loan for economic recovery, as well as to interest payments which have fallen due. Foreign exchange reserves are almost 2.5 times higher than money supply (see NBS 2005) and have exceeded the amount of four months of imports, which

Figure 26. Serbian foreign exchange reserves, mil. US\$

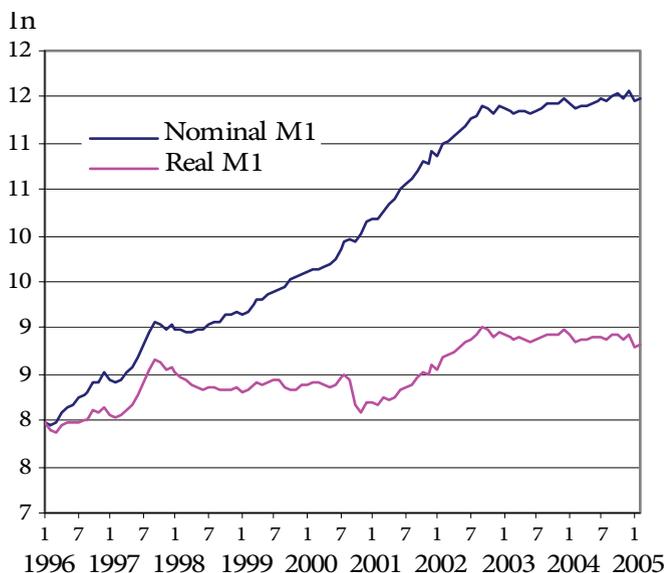


is very satisfactory. On the other hand, the fact that there is no capital account convertibility “protects” the reserves against speculative shocks, despite the existing, as well as announced, new appreciation of the currency.

**This time, in the fifth year of transition there is no excuse for returning to the policy of using the dinar as a nominal anchor:** if it was necessary to begin transition by at least slightly stuffing the wallets of the very impoverished population that needed a break, and then proceed by publicly telling them what was going to happen in transition and how to choose for themselves a winning strategy, now this policy constitutes a hurdle to continuing transition: instead of reducing aggregate demand, that is, instead of using fiscal instruments, inflation is curbed in the most expensive way there is, by making the domestic currency more expensive, which entails a rise in interest rates, intensified spending of international reserves and an increase in the degree of monetary restrictiveness. In an environment where exporters should kick-start growth

and enable a rise in new domestic production and employment, this is not a smart move. The absence of political will to initiate more serious reforms is once again paid by halting transition, and how aware interest groups are of the medium-term harm they are doing not only to others, but also to themselves, remains an open issue.

Figure 27. Nominal and real M1, 1996-2005



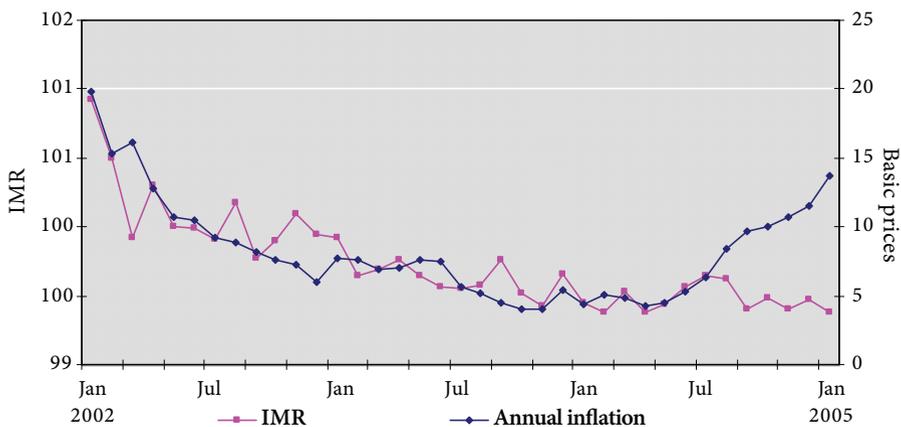
Source: NBS, Maravic, Palic (2005)

Despite strong remonetization, carried out primarily owing to the inflow of foreign grants, privatization proceeds and the euro conversion, which lasted as long as the middle of 2003, as well as to a very solid degree of monetary stability, the role of the dinar is still very limited, and our monetary system has a full dual-currency character, where foreign currency is a store of liquidity stocks and reserves. Foreign exchange reserves reached the level of around US\$ 5 billion in 2005 (cf. Appendix 2). Foreign exchange savings deposits in 2005 reached the amount of EUR1.8 billion, which is almost by one third higher than in 2004. **The dinar is used only in low-value transactions, and almost 80 percent of payments are made in foreign currency.** Therefore,

the domestic currency actually does not have the role of the integrator of the entire economy, which is an irony of its own kind, because the dinar is covered with 250 percent of foreign exchange reserves.

The announced return to the use of the dinar rate as a nominal anchor will increase the index of monetary restrictiveness<sup>35</sup> and thus discourage economic activity, which will specially worsen the environment for opening new small and medium-sized enterprises, on which future economic

Figure 28. IMR and annual inflation



Source: NBS, Maravic, Palic (2005)

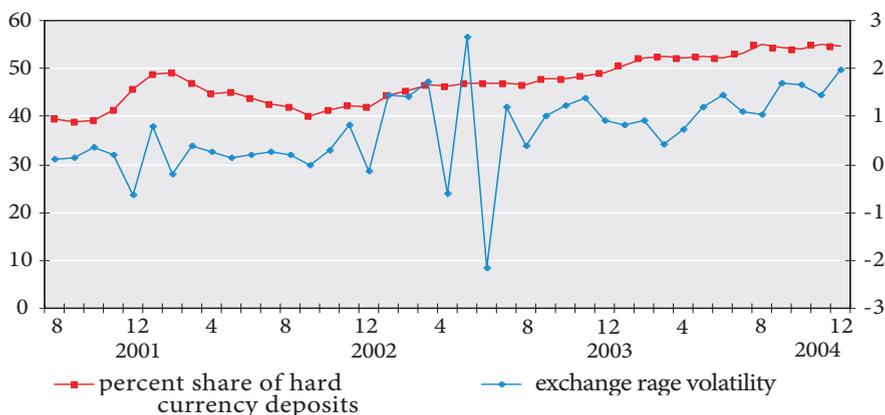
development should be based. Therefore, it is of importance to take a look at the movements in this index in the past four years of transition (NBS, 2005), where one can clearly see that the previously mentioned two sub-periods (2000-2002 and 2003-2004) differ considerably in the degree of monetary restrictiveness, which is systematically falling and already in 2005 the two curves are fully separated.

In the first four years of transition, the liquidation of four large insolvent banks constituted the bravest and the most accurately performed reformist step of the Serbian authorities, which unfortunately was not followed by further institution-building and appropriate measures either in monetary

<sup>35</sup> Index of monetary restrictiveness IMR is a weighted sum of changes in interest rates and percentage changes of the exchange rate relative to the base period  $MCI_t = w_i(i_t - i_0) + w_e(e_t - e_0) + 100$ ,  $w_i + w_e = 1$ . In the case the  $IMR > 100$  monetary policy was more restrictive relative to the base month, while values below 100 point to expansive monetary policy, Maravić, Palić (2004).

or overall macroeconomic policy. In monetary policy, the entire period after that event is characterized by a growing degree of monetary policy expansiveness, which is a result primarily of a poor set of instruments at the disposal of the National Bank, for which reason the National Bank was not able to efficiently sterilize excess liquidity. The peak was reached in the last

Figure 29. Degree of euroization and exchange rate volatility

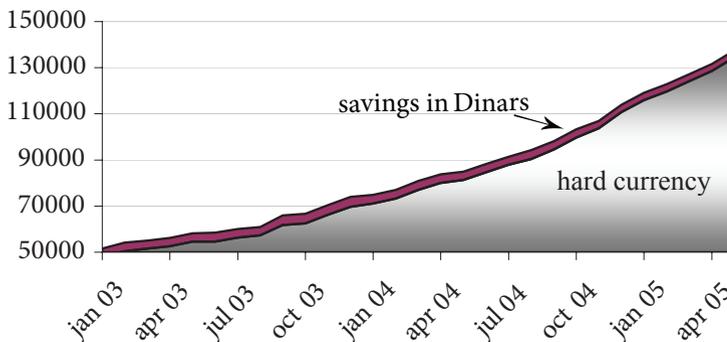


quarter of 2004, when bank lending rapidly increased, with commercial banks borrowing abroad, selling the thus obtained foreign exchange on the foreign exchange market and in this manner creating credit potential for approving corporate and retail loans. As a consequence, monetary and credit aggregates rose considerably, the inflation rate started to grow significantly, and the index of monetary restrictiveness began to fall. Changes in the reserve requirement did not always produce intended results, nor did the sales of NBS bills, hence inflation started to rise faster.

A limiting factor for the efficiency of monetary policy measures is a high and rising degree of euroization, predominantly due to a considerable share of the foreign-currency-denominated or foreign-currency-indexed component of banks' balance sheets. An analysis of the consolidated banking sector balance sheet (NBS 2005c) has established that in late 2004 the degree of euroization in the country was still growing and that at end-2004 it reached around 55 percent. A high contribution to the increase in the degree of euroization in 2003 and 2004 came from considerable amounts of foreign

exchange which the household sector had received through severance payments, as well as through the sale of shares in privatized companies, in addition to the contribution from the increased amounts of payments to households arising from frozen foreign currency deposits. Furthermore, the rise in the degree of euroization in the course of 2004 was also fueled by acceleration in inflation and inflationary expectations. Besides, the fact that foreign currency deposits are far better protected than dinar ones, both by the exchange rate depreciation and by the accruing real positive interest, is just further increasing the degree of euroization.

Figure 30. Hard currency and dinar savings, 2003-2005 (mil. Din)



Source: NBS, Maravic, Palic (2005)

Despite the dual-currency character of the monetary system, the switch to the euro is not a good solution for Serbia, first and foremost because such a step is not envisaged by the Euro area even for the new EU member countries, at least not for a period of two years. Unilateral adoption of the euro (dollarization) is appropriate for very small countries, i.e. for the countries whose track record is such that they are evidently unable to pursue a credible monetary policy. Since this is not the case with Serbia, this option should be ruled out. Leaving aside the issue of seigniorage<sup>36</sup>, Serbia should not deprive

<sup>36</sup> Countries which consider dollarization have to come to terms right from the start with the loss of seigniorage, whose level, nevertheless, should not be overestimated. Seigniorage is a difference between costs of putting a bill into circulation and its nominal value. For example, the cost of the printing of a one-dollar bill is around 3 cents, but the state can buy with that bill goods worth 1 dollar. Seigniorage in this case amounts to 97 cents. In the USA seigniorage amounts to around US\$ 25 billion a year, which is huge money, but still accounts for less than 1.5 percent of fiscal revenue and a mere 0.3 percent of the U.S. GDP. In Serbia, even in the periods of accelerated money creation,

itself of a very important economic policy instrument, which can play a key role, particularly in the following stages of transition, in finding the optimal policy mix for reconciling macroeconomic stability and creation of a competitive environment for future exporters.

**For a successful economic policy, but also for a country, it is very important to have a national currency which not stronger than the national economy.** Otherwise, adopting a foreign currency may be counterproductive, and making this shift too early entails a big risk (Popovic 2001). Furthermore, not even the fulfillment of four Maastricht criteria is enough to successfully switch to the euro.<sup>37</sup> Namely, it is quite possible for the country to make a certain effort in a year or two and to adjust its economic performance to these key criteria, although, realistically, its economy cannot take that pressure in the long run. Surveys have shown that even for the most successful new EU members the switch to the euro could result in a recession, primarily because the real exchange rates of these countries are still misaligned, hence the introduction of the euro could cause erosion of their external competitiveness and increasing debt accumulation (Bulir, Smidkova, 2005). Therefore, the appropriate policy for them (and for Serbia as well) would be further slight depreciation, in order to bring the real exchange rate closer to its equilibrium level and thus improve the current account of the balance of payments. Abandoning sovereign monetary policy, which the adoption of the euro would actually mean, would in the coming period rather inflict damage on Serbia than bring benefits to it.

**The domestic credit to GDP ratio stands at around 17 percent and is still low by regional standards (20 to 30 percent).** The share of loans to households and enterprises in GDP is much lower than the average for the European Union, and also considerably lower than in the EU candidate countries. The new legislation, as well as new institutional arrangements (see the section on financial policy), which are to be adopted in the near future, can ensure credit growth and encourage development of new financial instruments, while strengthening financial discipline and efficiency of banks' risk assessment practices.

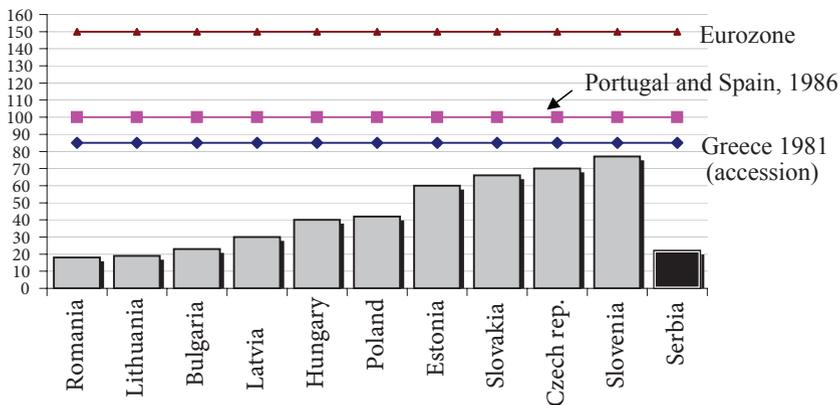
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(1994-2000) seigniorage amounted to around 2 percent of GDP, while restrictive policy pursued as of late reduces seigniorage to a minimum.

<sup>37</sup> Inflation has to be low and should not be higher than 1.5 percentage points above the average of three best European countries, members of the Euro area. The state must not have a fiscal deficit higher than 3 percent of GDP. Long-term bonds of the "candidate" country must not have significantly higher yields relative to government bonds of the countries in the Euro zone, while the exchange of euros and the currency of the candidate country must be carried out in two years within "normal margins of fluctuation" within ERM.

Financial intermediation has significantly increased its share in GDP, reflecting the rise in confidence into the banking system, while another general characteristic is rapid credit growth (private sector credit rose in 2004 by as much as 56.9 percent, while lending to households went up by all of 125.6 percent). Furthermore, in the course of 2004, credit expansion exceeded deposit expansion for the first time (36.5 percent). As a result, the amount of loans is higher than the amount of deposits which prompted banks to turn to the practice of using foreign exchange deposits to finance dinar loans. Against the background of the increasing risks related to depreciation, the risk doing business in the banking sector is going up again, while the previously mentioned index of monetary restrictiveness is beginning to fall sharply, resulting in a doubling of core inflation relative to 2003 and in a considerable rise in inflationary expectations in the course of 2005.

Figure 31. Domestic credits in GDP



After two years of permanent slight depreciation, the real effective exchange rate of the dinar embarked upon a path very similar to those registered in the most successful transition economies (cf. the graph on the next page). However, there were no effects on exports and economic growth, primarily due to the unresolved conflict between exchange rate policy and incomes policy, i.e. because the political elite has not taken a decision who (apart from them) should be the winners and who are going to be the losers of the transition. Except for paying lip service by declaring “export patriotism”,

the combination that was chosen in Serbia was in fact a loser's combination, according to which real incomes are not only growing faster than productivity, but their growth also completely compensates for the depreciation of the domestic currency. In such a scenario, individual gains of employees are minimal and their discontent ever greater, and all the while the chance to create an attractive environment for strategic export-oriented investors in Serbia is being missed.

Therefore, monetary policy for the coming period would have to abide by the golden rule according to which productivity growth has to be at least equal to the sum of real appreciation and real wage growth. Since it has

Figure 32. Real and nominal effective exchange rate in Serbia, 2003-2005, aug. 2004=100

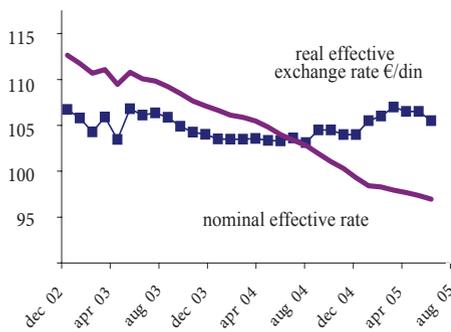
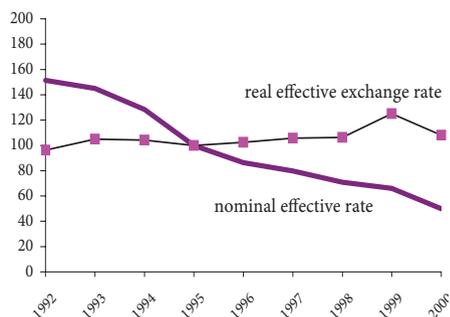


Figure 33. Real and nominal exchange rate in Hungary, 1992-2000, aug. 1995=100



been announced that the exchange rate should once again play the role of a nominal anchor, appreciation is, accordingly, inevitable. Hence, the golden rule should imply two steps – a wage freeze and accelerated creation of a business environment which would guarantee financial discipline and attracting of strategic export-oriented investors who would crucially increase labor productivity in Serbia. In this process, microeconomic reform and institutional reform will be vitally important, and their constant delays should be as often as possible emphasized to the public, thus finally pointing to interest groups, which usually advocate protection of employees while creating a clientelistic environment where only they have clear rising benefits.

Therefore, the recommendations (or unquestionable conditions) of the IMF and the World Bank that it is necessary to change the policy mix

**are really an essential prerequisite for successful continuation of transition.** Expansive fiscal policy and further increase in employment, wages, support to non-viable companies and redistribution of almost half of GDP is incompatible with the proclaimed objective of switching to the efficient capitalist method of production. Further appreciation and tightening of the degree of monetary restrictiveness deprives the government of the possibility to pursue the policy of a competitive exchange rate and to attract exporters, while at the same time keeping non-indexed expenditures under control. The success in further transition will depend predominantly on the political will to reduce public expenditure, and thus the power of party bigwigs, voluntarily, consciously or under IMF's pressure, to create room for private initiative. In the meantime, if the building of contemporary institutions for the protection of property rights does not take place, transition will be rendered senseless, because private monopolies are almost more detrimental than the state ones, which Serbia had a very good chance to see at first hand during the years in which Serbian telecommunications were run by the Italo-Greek consortium STET/OTE.

**Therefore, the repetition of the "Romanian scenario" in Serbia, with the reopening of the closed down companies (and all that for the purpose of reactivating gyro accounts for financing political parties in power), is more likely than the so-called "Argentine scenario", i.e. a debt crisis caused by too high and always public borrowing by the government.** Therefore, at the end of the fourth year of transition, risks to fail are still higher than numerous individual successes, while the overall outcome remains uncertain.

### **Fiscal Policy**

**At the onset of transition fiscal policy was to a large extent overlapping with fiscal reform.** A single sales tax rate (20 percent) was introduced, as well as so-called gross wages, which include all payments to employees (vacation vouchers, hot meal allowances) into the base for taxation. On the expenditure side, the bulk of the quasi-fiscal deficit was registered, resources were secured for the regular payment of pension benefits, a transition fund was set up with a view to helping those most affected by reform, etc. However, more serious reforms were, for the most part, considerably delayed. Thus the value added tax of 18 percent was introduced as late as the fourth year of transition. The tax was introduced successfully and did not cause an inflationary shock,

particularly in light of the fact that the rate was reduced from 20 to 18 percent, and for some goods the VAT rate has been set at 8 percent.

**The central problem of fiscal policy remains the level of public spending, and key necessary changes remain in the domain of its systematic and explicit reduction.** To this effect, the Government of Serbia has publicized a plan for reducing the tax revenue to GDP ratio from 41.8 percent in 2005 to 38.8 percent in 2008, with a view to reducing the share of direct taxes, contributions and “non-tax” revenue. **A reduction in the share, and a change in the structure, of public spending are priority objectives of public expenditure policy in the observed period.** The plan is to reduce the expenditure to GDP ratio from 45.7 percent in 2005 to 42.5 percent in 2008, while if public debt service is excluded, the cut in expenditures is even larger, from 41.9 percent of GDP in 2005 to 38.3 percent of GDP in 2008.

**Three problems surround the implementation of the adopted plan for public spending reduction: (i) a large quasi-fiscal deficit in still non-privatized public and socially owned companies (ii) very non-transparent policy of subsidizing and (iii) poor control of public spending in local budgets. Firstly, huge inter-enterprise arrears, that deeply rooted culture of defaulting, can be eradicated only by means of total privatization and implementation of bankruptcy legislation, while building a robust and recognizable regulatory framework. In addition to privatization of banks and companies, it is also necessary to privatize public enterprises, because these privileged, large public companies, which call themselves ‘strategic’, impede the introduction of financial discipline at all levels. The government has accepted this task in principle, but for the time being it is not showing any signs of willingness to carry it out. Instead of privatization, it has given itself a very long time limit for the selection of strategic consultants, which (judging by the well-known decade-long practice) can take any amount of time, after which another administrative obstacle can easily “pop up”.**

**Secondly, a very non-transparent subsidizing policy will be maintained to 2007, and probably long after that as well.** Namely, on the occasion of the adoption of the revised budget for 2005, it was announced that bank privatization will be completed by 2006, of socially owned companies by end-2007, and of public enterprises and public services by 2008. In this manner, by end-2007 subsidies to loss-making companies would be completely eliminated, but their share in the budget for the subsequent year, 2008, would account for almost 10 percent of the gross domestic product. **Thirdly, it is common**

knowledge already that “tightening of the belt” at the level of the Republic so far has often been accompanied by increases in all types of spending at local levels, hence it is necessary to set up local treasuries as soon as possible and establish full control over the accounts of local self-government units. This proposal deeply encroaches upon interests of the local authorities and deprives political parties of significant sources of financing, therefore it stands no chance of being adopted for now. Similarly, the voices talking about rises in extrabudgetary charges (road tolls, TV subscription fee) are ever louder, although their spending would also fuel inflation and make the task of containing its level in the current year below 15 percent by no means easier. Likewise, they do not provide assurances that the government will focus on environment creation and production of public goods, instead on solving its current financial and party problems.

Table 15. Consolidated public revenue and expenditure (in percent of GDP), 2005-2008

	2005	2006	2007	2008		2005	2006	2007	2008
<b>Total revenue</b>	46.2	44.9	43.7	42.5	<b>Total expenditure</b>	45.7	44.6	43.5	42.5
1. TAX REVENUE	41.8	40.7	39.8	38.8	1. Expenditures for employees	10.5	10.2	9.8	9.2
1.1. Personal income tax	6.1	6.1	5.9	5.7	2. Purchases of goods and services	5.6	5.3	5.0	4.8
1.2. Corporate income tax	0.6	0.6	0.6	0.6	3. Pensions	14.8	14.2	13.5	13.4
1.3. VAT	13.6	13.1	12.8	12.6	4. Social protection	2.9	2.7	2.6	2.5
1.4. Excise	5.3	4.8	4.7	4.7	5. Subsidies	4.7	4.4	4.0	3.8
1.5. Customs duties and other taxes on imports	2.6	2.6	2.7	2.7	6. Capital investment	2.7	2.9	3.4	3.9
1.6. Other tax revenue	1.6	1.6	1.5	1.4	7. Public debt service	3.7	4.2	4.4	4.2

	2005	2006	2007	2008		2005	2006	2007	2008
1.7. Contributions	12.1	11.9	11.6	11.3	8. Other expenditures	0.8	0.8	0.8	0.8
2. NON-TAX REVENUE	3.9	3.6	3.4	3.2					
3. CAPITAL REVENUE	0.5	0.5	0.5	0.5					

Source: Ministry of Finance, Memorandum on the budget

Therefore, the sequencing and pace of the envisaged cuts in public spending sound rather unconvincing. Namely, the party structures, instead of first carrying out “self-disempowerment” by privatizing public enterprises, and thus sending a clear signal that financial discipline will be introduced, they first impose the said discipline on everyone else, and on themselves only upon the end of the government’s term in office. Such sequencing simply points to the well-known practice pursuant to which all but reformers and their political cronies will be reformed, which is a practice doomed to failure, as a rule. The signals which are in this manner given to the judiciary, which should perform a “self-reform” and produce the most important public good – legal security and protection of property rights – will not be an encouragement for the improvement of the investment climate in the country. The presented sequence makes it quite obvious that this plan was imposed by the IMF, that the government itself is not convinced that such measures are necessary, and this sequence of steps is in fact nothing else but an “answer of a bad scholar to get the lowest passing grade.” Recalling here that it is necessary to have annual GDP growth rates of at least 5 percent, export growth rates of at least 25 percent, the question is raised as to the environment in which something like that is achievable, and the announced order of fiscal reforms related to this issue does not inspire confidence in the resolve of the authorities to implement these measures precisely and within the set time limit.

Two illustrative World Bank scenarios point to the fact that inconsistency in reforms is very expensive (SEM, 2004). According to the first scenario, which includes “high quality fiscal adjustment”, the all too often mentioned target of a GDP growth rate at around 5 percent a year could be achieved. This would boost private investment and a fast rise in productivity would come as a result of structural reform, privatization and enterprise restructuring and a strong inflow of foreign direct investment.

The second scenario of decelerated reform would generate by 2010 per capita GDP which would be by around 17 percent lower than under the first scenario and consumption would be falling, while public spending would maintain its overly high share, but would remain at a lower absolute level than in the first scenario.

Table 16. Two illustrative World Bank scenarios of possible outcomes of fiscal and structural reform

<b>Scenario 1</b>	2003	2004	2005	2006	2007	2008	2009	2010
GDP growth	3.0	4.4	4.5	4.5	5.0	5.5	6.0	6.0
Real per capita GDP (2004=100)			104.4	109.0	114.4	120.6	127.8	135.4
Total public spending*	46.8	47.0	44.9	42.4	41.6	40.8	39.8	39.0
Subsidies and transfers*	24.1	25.1	21.8	20.6	20.0	19.6	19.2	18.8
FDIs*	6.7	3.1	5.0	4.0	3.4	3.4	3.1	3.1
Financing needs***	3,247.5	2,583.3	2,418.6	2,638.7	2,920.0	3,292.9	3,453.0	3,382.5
<b>Scenario 2</b>	2003	2004	2005	2006	2007	2008	2009	2010
GDP growth	3.0	4.4	3.5	3.0	2.5	2.0	2.0	2.0
Реални БДП по становнику (2004=100)		100.0	103.4	106.4	109.0	111.1	113.3	115.5
Total public spending*	46.8	47.0	47.1	46.7	46.5	46.7	47.0	47.3
Subsidies and transfers*	24.1	25.1	24.9	24.4	23.5	23.5	23.5	23.5
Total public debt*	79.0	65.0	63.8	64.8	66.6	68.7	71.0	73.3
FDIs*	6.7	3.1	2.9	2.3	2.1	1.8	1.6	1.4
Financing needs***	3,247.5	2,583.3	2,962.1	2,605.0	2,924.3	2,899.8	2,762.7	2,505.5

\* % GDP; \*\* excluding grants; \*\*\* in millions of U.S. dollars.

For that reason, further implementation of inconsistent fiscal adjustment measures would bring Serbia dangerously close to the second scenario, which would make the continuation of reform thereafter much more expensive and uncertain.

The fear of extremely unequal distribution and “impoverishment of the poor, and enrichment of the rich” in the scenario of faster growth is not justified, in spite (or, precisely because) of the fact that, in such a case, the

state will intervene much less and subsidies to non-viable companies will seize. The experience has shown that accelerated reforms increase inequality to a lesser degree, while slow reforms exacerbate it. The Gini coefficient in Poland rose from 28 to 31, but in Russia, where reforms were slower, Gini grew from 26 to 51, in Azerbaijan leapt from 29 to 50; in Ukraine from 24 to 46. Therefore, it makes sense to say the inequality grows faster when there is no reform, than when reforms are carried out at an accelerated pace. A large number of surveys indicate that the only way out of poverty is accelerated growth and human capital building (cf. PRSP, 2003, 2004). Yet, the fact remains that one should expect further deepening of inequality in Serbia, as well as relative (but certainly not absolute) deterioration of the situation of the elderly. However, it is well-known that the best protection of the living standards of the most vulnerable segments of the population is economic growth, reform of the judiciary, inflow of FDIs and job creation in the private sector and the resulting accelerated economic growth, which generates sufficient revenue for health care and social protection, education and further (this time sustainable) growth in the standard of living.

### **Foreign trade policy**

In four years of transition, Serbia went through four divergent phases of foreign trade liberalization: (i) initial foreign trade liberalization in 2000 and 2001 (ii) further and unwillingly carried out liberalization aimed at (enforced) harmonization with Montenegro (iii) reversal of the measures adopted during harmonization with Montenegro, insisting on non-tariff barriers with a view to narrowing the widening trade deficit and increasingly strong rhetoric about the need for protection against uncontrolled imports, with concurrent (iv) application for membership of the World Trade Organization, signing of numerous bilateral free trade agreements with neighboring countries, as well as the initiation of the Stabilization and Association process with the EU. The “stop-go” policy has led to considerable confusion in this area as well, regarding true intentions of the government and its possible future steps.

Although initial liberalization in January 2001 is often called the neo-liberal shock therapy, the weighted tariff rate was reduced on that occasion by a mere 2 percentage points (from 9.7 to 7.5 percent) so that the level of protection after “shock therapy” stayed by far the highest in the region of the Western Balkans (Michalopoulos, 2003). The main objective, namely, was to

eliminate all non-tariff barriers (quotas, licenses), and to reduce the dispersion of tariff rates (the number of tariff rates was reduced to only 6 rates, with a range of 1 to 30 percent), while simplifying the entire system of foreign trade to a maximum<sup>38</sup>. The maximum rate of protection is envisaged for the products on which quantitative restrictions have been abolished, and all other goods have been classified according to the following methodology.

Table 17. Methodology for setting customs tariffs

Tariff rates (%)	Products
1	Intermediates and equipment which is not produced in the country
5	Intermediates produced in the country
10	Machines and equipment produced in the country
20	Consumer goods not produced in the country
30	Consumer goods produced in the country and luxury items

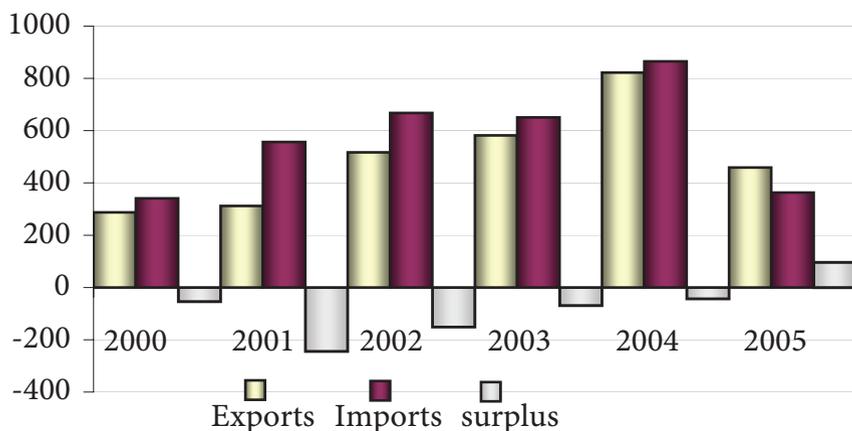
The greatest “winners” of this liberalization were producers of food, furniture, cars and mineral fuels, while protection was reduced the most in the sector of primary products (meat, zinc, wood, etc.). Cars and tractors were accorded two times higher protection than it is envisaged by the methodology (20, instead of 10 percent), while for a larger number of primary products a drop in the degree of protection was more substantial (agricultural products, sugar, meat, cereals, zinc, wood, aluminum, etc.)

**It is interesting to present here the experience of Serbian agriculture which systematically improves its trade balance, but not due to falling imports owing to increased protection. On the contrary, balance improves due to the permanent export growth.** As a consequence of liberalization, a deficit in the trade balance of agricultural products and foodstuffs had grown, and for that reason, in 2003 the Government introduced protective measures again. However, figure 3.1 shows that balancing after liberalization was not achieved through lower imports, but through higher exports, which could by no means be affected by liberalization. Still, bearing in mind Serbia’s endeavors

<sup>38</sup> Amendments to the Law on Foreign Trade of December 2000, decreased a large number of administrative barriers to trade, by eliminating numerous unnecessary controls, including the minimum value of company’s fixed assets and employment, the annual fee for registration of trade companies in the amount of DM 1000, and the obligation to file a tax return and pay the tax on import/export transactions to the Federal Ministry of Foreign Economic Relations, etc.

to become a member of the WTO, one could not expect that the existing level of protection can be maintained. In essence, protection has sent a wrong signal, so inevitable adjustments, which could make the sector more competitive on domestic and foreign markets, were unnecessarily delayed (cf. Ministry of Agriculture, 2004).<sup>39</sup>

Figure 34. Trade in agricultural products, 2000-2005



Further liberalization of Serbia's foreign trade regime was initiated in 2003 by means of an Action Plan for the Harmonization of the Economic Systems of Serbia and Montenegro. Through the process of harmonization, the average level of customs tariffs in Serbia slightly decreased (from 7.5 to 6.1), which placed Serbia in the middle of the list of transition economies.<sup>40</sup>

The adopted liberalization measures stirred up a lot of odium even among economic policy makers themselves, and the campaign for return to higher levels of protection in late 2003 became a trade mark of the election campaigns

<sup>39</sup>In late 2000 the European Commission approved the exemption from customs duties of all agricultural exports to the EU market (with the exception of baby beef and wine, to which tariff quotas apply, as well as to certain fishery products). One of the conditions was not to increase barriers for their agricultural products. Yet, Serbia has increased import protection for certain products 10 to 40 times, and for certain products (tomato, peas, spirits and tobacco) introduced special import levies which had not existed before.

<sup>40</sup>The average tariff rate in the countries of South East Europe in 2002 was 8.5 percent. The lowest rates were in Croatia and Moldova (5 percent), followed by Albania (7.4 percent), Bosnia (6 percent), Bulgaria (9.7 percent), Macedonia (12.6 percent) and Montenegro (6.1 percent in 2003)

of all opposition parties. Thus, with the coming into power of the new government, the quashing of all the measures adopted in 2003 was immediately announced, and after a twin-track approach was adopted in October 2004 in the negotiations between the EU and Serbia and Montenegro on the Stabilization and Association Agreement, that was actually done.<sup>41</sup>

Part of the delay in liberalization is certainly a consequence of lobbyist pressure (from certain non-competitive domestic producers), but the fact that newly arrived strategic investors are also accepting such practice should not come as a surprise, either. Thus, the multinational company *Henkel*, which

Table 18. Movements in average nominal and weighted tariff rates in Serbia

Tariff rate	Initial situation 2000	Liberalization 2001	Action plan 2003	Revision in 2005
weighted	9,7	7,5	6,1	6,1
non-weighted	14,4	9,5	8,8	8,7

Source: WB, 2004, Customs Administration, 2005

bought *Merima* of Kruševac in 2004, will be remembered for its statement in which it accused the state of not taking into account interests of foreign companies that have already invested money in Serbia. The biggest grudge that the management of *Henkel-Merima* had against the Serbian authorities was related to their liberalization of the imports of goods produced by that factory, which has exposed them to too much foreign competition, as if Henkel was not a company which formed and acquired its capital, reputation and expansive development strategy within the EU, and, as such, was used to “foreign competition”. Likewise, very often there are discussions about uncontrolled imports of foodstuffs and consumer goods which directly affect the development

<sup>41</sup> Parallel to the increase in the number of tariff lines, tariff rates for 170 products have been increased (in fact, they were returned to the level at which they were before harmonization with Montenegro), and reduced for 164 products (mainly for those produced predominantly or exclusively in Montenegro and which we were protecting here in Serbia). The increased rates referred mostly to leather, furniture, electrical appliances, and the reduced ones to raw materials, such as ferrous metallurgy, wood, aluminum, textiles. The total effect of these three changes (the increase in the number of lines and the parallel reduction, i.e., increase in rates) is a drop in the nominal average tariff rate from 8.8 percent to 8.7 percent. There were no changes in the weighted rate – it is still around 6.3 percent. Of course, if one took into account all the free trade agreements, the rate would certainly be considerably lower, which indicates that the time of customs protection is definitely history.

of domestic production, and that same rhetoric is used whenever there is a need to secure higher protection for one's own production.

Parallel to the strengthening of protectionism and the announcement of introduction of non-tariff barriers, Serbia continues to negotiate about its membership of the WTO, continues to use preferential treatment in trade with EU countries and expands free trade with Western Balkans countries. Therefore, it is obvious that the time of the closed economy and autarkic ideas is almost over and the rhetoric according to which "liberalization is a good thing, but the time is not right yet" could be expected to fade out before specific commitments stipulated in the documents referring to the WTO membership and in the future Stabilization and Association Agreement with the EU. Bearing in mind that these documents are almost exclusively related to specific steps in and pace of liberalization, economic policy in this field will become endogenous, which will make the economic environment much more transparent, and without doubt significantly facilitate to economic agents the assessment of profitability of their possible business decisions.

Integration into the world economy is the key to further economic growth of Serbia, which will inevitably lead to further systematic reductions in the degree of protection. Basically, it is in line with the tendency to attract FDIs, which certainly do not need measures for infant industry protection although they will be glad to take advantage of them, if available, like in the previously mentioned case of *Henkel-Merima*. Therefore, it is in Serbia's best interest (i) to make a definite break with "stop-go" policies and (ii) to make its policy for and pace of opening up endogenous, meaning, independent from future elections, future ministers, and, which is the most important thing, independent from the influence of lobbyist groups, which have so far not only halted every liberalization, but also systematically brought it back to square one. In this manner, a possibility will be opened to finally abolish the monopoly on oil imports, introduced at the very beginning of transition. This abolition, despite several dozen announcements, remains uncertain.<sup>42</sup>

In such a scenario of economic opening up and intensive FDI inflows there will be no room any longer for writing lengthy export strategies or for providing incentives to particular exporters (instead of creating a good export environment). Namely, positive effects of the arrival of foreign investments are realized only if a country has solid macroeconomic stability, high quality

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<sup>42</sup>The monopoly was introduced with an explanation that only in that manner illegal importation of crude oil can be combated, which, together with cigarette smuggling, was the most lucrative business in the gray economy of that period. Of course, the influence of the Serbian Oil Industry (NIS), which yields almost one quarter of the Serbian budget, probably was decisive here.

human capital and good infrastructure (SEM, 2004). Serbia has this potential, still, as mentioned several times, microeconomic reforms are lagging behind

Table 19. Degree of openness and economic growth rates, 2004

	Openness (% GDP)	GDP growth (%)
Estonia	177,7	6,0
Slovak Republic	152,7	4,4
Czech Republic	132,0	2,0
Belarus	143,4	4,7
Hungary	131,1	3,3
Bulgaria	112,9	4,8
Slovenia	114,4	3,0
Latvia	101,5	6,1
Lithuania	113,9	6,7

Source: WIIW, 2005

and calling into question the entire scenario, feasible in principle, of accelerated export-led economic growth.

### **Incomes and employment policies**

**Incomes policy will be key for deceleration of inflation, containing of domestic demand and growth in competitiveness.** In all four years of transition, the only economic magnitude which had a systematic high upward trend were – wages of employees, whose pace vastly exceeded labor productivity and thus systematically increased inflationary pressures and fueled inflationary expectations. Therefore, the government was forced, for the purpose of preserving macroeconomic stability, to limit wage growth and announce its future much more moderate growth.

**Since the government is the largest employer in Serbia, directly employing more than 30 percent, and indirectly almost half of the total number of employees, its behavior in this area will crucially determine the future inflation rate.** This is all the more true, because the completion of privatization is envisaged for as late as end-2008, so the wage bills in state owned and public enterprises have to be strictly controlled in the meantime. The problem is additionally aggravated by a high level of overstaffing in

these companies, for which reason it was announced (and agreed with the IMF) that the public sector employment will be reduced by 10 percent in the course of 2005. In this manner, nearly 60,000 workers would be laid off, which would make room for wage increases (but also wage decompression) in the administration, which would help to keep highly qualified staff and prevent them from searching for better paid jobs in the private sector.

**The current minority government which has gained the reputation of a silent guardian of clientelism, in essence will have a problem with accepting any policy which infringes upon acquired workers' rights, hence the main applied method is voluntary lay-offs, against redundancy payment, which partly compensates for the loss of future wages. Thus, in the course of 2005, some CSD10 billion will be paid to workers as severance payments (five billion dinars has already been allocated to the Transition Fund, another three billion is expected there after the revision of the budget, while two billion dinars will be secured from privatization proceeds)<sup>43</sup>. Although this amount of resources constitutes a huge burden, it is, according to its character, a one-off payment, and relieves the state of the obligation to pay in the future**

**Unemployment is certainly the greatest problem of the state, which will be inevitably exacerbated by additional lay-offs, and it is not very likely that new employment will be generated out of the resources set aside for severance payments.** Namely, the expectations of the government that workers will finance their own new employment out of severance payments were absolutely unrealistic, mainly because the largest number of workers who voluntarily left their companies against severance payments already had jobs in the gray economy, or have simply given up on searching for a new job due to inadequate qualifications, age, etc.

**The ambitions of the government that workers would finance their own new employment out of severance payments proved unsuccessful largely because political consensus has not yet been reached on the very essence of the reform, transition package. Firstly, the environment is still not conducive to investment.** If the government is not able to implement hard budget constraints and thus ensure financial discipline, it is hard to believe that inexperienced yesterday's workers would dare venture into self-employment, where there are no guarantees from anywhere that they will be able to collect their claims, in an environment where being a debtor still pays off better than being a creditor, and where any transparency of business operations, even the

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<sup>43</sup> News bulletin of the Ministry of Finance, May 2005

publication of a list of illiquid companies, is met with resistance, including from the Minister of Economy. Against such backdrop, it is obvious that the environment for foreign direct investors who would jump-start a chain of healthy, export demand, stands no chance of becoming a priority. On the other hand, the government itself has left the restructuring of “its own” companies for the end of its term, or even for the beginning of the term in office of some other government, thus announcing that it has no intention of giving up on the current clientelistic management model. **Transition is, namely, a holistic (comprehensive) process and individual good measures cannot be a replacement for not making other, equally important reform steps.** In the absence of decisive and consistent measures in privatization of “own” public enterprises, the signal which is sent to the population and economic agents is that radical reforms are being postponed for some other, more favorable times. The only remaining question is – how to achieve economic growth of 5 percent a year, export growth of more than 25 percent a year and be current on payment of obligations to creditors which will fall due in the absence of such reforms.

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Appendix 1. Main sources of real GDP growth in the first four years of transition

Main sources of real GDP growth in the first four years of transition were:

- In 2001, growth in agricultural production of 18.7 percent, growth in retail trade sales of 19.7 percent, growth in PTT and telecommunications of 20.9 percent and a rise in the volume of transport services of 9.6 percent;
- In 2002, industrial production growth of 1.7 percent, growth in retail trade sales of 23.9 percent, a rise in the volume of transport services of 6.9 percent and growth in PTT and telecommunications of 3.1 percent;
- In 2003, growth in retail trade sales of 12.6 percent, growth in PTT and telecommunications of 16.2 percent, a rise in the volume of transport services of 5 percent and growth in the construction industry measured by hours of work of 10.8 percent;
- In 2004, industrial production growth of 7.1 percent, growth in agricultural production of 19.8 percent, growth in PTT and telecommunications of 29.9 percent, growth in retail trade sales of 17.9 percent, a rise in the volume of transport services of 5.2 percent, in the construction industry measured by hours of work of 3.5 percent.
- In the past four years of transition, to real GDP growth contributed:
  - In 2001, real growth of value-added in agriculture of 17.5 percent and in the service sector of 3.5 percent;
  - In 2002, real growth of value-added in the service sector of 4.5 percent;
  - In 2003, real growth of value-added in the construction industry of 10.8 percent and in the service sector of 5.6 percent;
  - In 2004, real growth of value-added in agriculture of 19 percent, in industry of 7.5 percent, in the construction industry of 3.5 percent and in the service sector of 8 percent.

Source: Memorandum MEMORANDUM ON THE BUDGET AND ECONOMIC AND FISCAL POLICIES FOR 2006 WITH PROJECTIONS FOR 2007 AND 2008

## Appendix 2. Serbia's external debt – stock at end-April 2005 (in millions of U.S. dollars)

Foreign creditors	Principal	Regular interest	Late interest	Total
INTERNATIONAL FINANCIAL ORGANIZATIONS	4,817	5	8	4,831
IMF	870			870
IBRD	2,342			2,342
IDA	430			430
EUROFIMA	152			152
IFC	98	5	8	111
EIB	272			272
EC – European Community	336			336
EUROFOND – CEB	27			27
EBRD	291	0		291
GOVERNMENTS	3,371	172	106	3,649
PARIS CLUB	2,946	0	0	2,946
Consolidated debt	2,713			2,713
Loans contracted after December 20 <sup>th</sup> 2000	233			233
OTHER GOVERNMENTS	425	172	106	703
LONDON CLUB – reconciled debt	1,077			1,077
LONDON CLUB – unreconciled debt	42	32	12	85
OTHER CREDITORS	2,700	84	314	3,099
SHORT-TERM DEBT	1,286	1		1,286
CLEARING	93	13		106
TOTAL DEBT	13,384	307	440	14,132
Of which Kosovo:	1,147	21	62	1,229

NBS data

Long-term and medium-term debt, which accounts for around 97 percent of total debt, amounts to US\$ 13,740 million (stock at end-April), of which the

largest part is debt to IFIs (US\$ 4,831 million in total). It is noted that the stock of debt to IFIs at end-2002 was US\$ 3,355.5 million, while at end-2003 was by more than one billion dollars higher, i.e. amounted to US\$ 4,533.5 million. At end-2004 it amounted to US\$ 5,089 million.

Long-term and medium-term debt, relative to December 2004, was higher by more than US\$ 800 million at end-April 2005, while short-term debt was higher by US\$ 230 million (at end-April it amounted to US\$ 1,229 million). Debts to the World Bank (US\$ 2,342 million) and the International Monetary Fund (US\$ 870 million) account for a dominant part of the debt to IFIs.

Source: Serbian Chamber of Commerce, January-May 2005,  
<http://www.pks.co.yu/pks/pdf/mep/mepMaj2005.pdf>

## Appendix 2 (continued)

Table 11. Serbia and Montenegro: Stock of External Debt at December 31, 2004 1/  
(In millions of U.S. dollars)

Creditor	Total Debt	Of which: Arrears 2/			
		Principal	Interest	Late Interest	Total Arrears
Total debt	14,876	1,593	347	465	2,405
<i>Of which:</i>					
Serbia	14,099	1,543	332	428	2,303
Montenegro	777	51	15	37	103
Multilateral institutions	5,554	10	5	9	24
IMF	962	0	0	0	0
IBRD	2,839	0	0	0	0
IDA	462	0	0	0	0
EUROFIMA	170	0	0	0	0
IFC	134	10	5	9	24
EIB	313	0	0	0	0
European Community	361	0	0	0	0
EUROFOND - CEB	33	0	0	0	0
EBRD	280	0	0	0	0
Official bilateral creditors	3,923	288	177	102	567
Paris Club	3,227	0	1	0	2
Other official bilateral creditors	697	288	176	102	565
Commercial creditors	4,400	652	164	355	1,170
London Club	1,164	27	31	11	69
Other commercial creditors: convertible currencies 3/	3,052	466	108	344	917
Other commercial creditors: nonconvertible currencies 3/	184	159	26	0	184
Short-term debt 3/	999	644	0	0	644
Trade credits on oil & gas imports 4/	240	240	0	0	240
Other short-term debt	759	404	0	0	404

Sources: SM authorities, and IMF staff estimates.

1/ Debt figures reflect the Paris Club debt rescheduling agreement (November 2001) and London Club restructuring (signed in July 2004).

2/ Regular and late interest calculated in accordance with terms of original agreements.

3/ Debt is not owed by government and does not have government guarantees.

4/ Overdue obligations (trade credits) owed to oil and gas enterprises in Russia.

Source: IMF Country Report No. 05/233, July 2005, page 36

## Appendix 2 (continued)

Table 23. Stock of public debt of the republic of serbia at 31 december 2000 and 28 february 2005

№	Debt	Currency	Contracted amount	In thousands of eur		In thousands of US dollars	
				31/12/2000	28/02/2005	31/12/2000	28/02/2005
1	Long-term securities (liabilities to the nbs)	In 000 of dinars	19,701,120	87	244,675	93	322,775
2	Conversion of loans approved by banks for primary agricultural production in public debt of the Federation	In 000 of dinars	1,092,076	34,130	8,273	31,704	10,914
Short-term securities		In 000 of dinars	0	0	77,664	0	102,455
5	Frozen foreign currency deposits	In 000 of EUR	4,155,210	4,073,815	3,636,840	3,784,179	4,863,680
6	Loan for economic recovery	In 000 of EUR	56,000	0	40,158	0	52,976
TOTAL:				4,108,033	4,057,611	3,815,977	5,352,801

## Appendix 2 (continued)

## Two illustrative World Bank scenarios

Movements of selected variables under two illustrative scenarios, 2003-2010

<b>Scenario 1</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
GDP growth	3.0	4.4	4.5	4.5	5.0	5.5	6.0	6.0
Gross domestic savings*	-7.0	-4.0	-2.5	0.1	2.5	4.0	5.2	6.1
Real per capita GDP (2004=100)		100.0	104.4	109.0	114.4	120.6	127.8	135.4
Total public spending*	46.8	47.0	44.9	42.4	41.6	40.8	39.8	39.0
Wage bill*	10.3	10.6	10.1	8.9	8.9	8.8	8.7	8.7
Subsidies and transfers*	24.1	25.1	21.8	20.6	20.0	19.6	19.2	18.8
Public investment*	2.1	2.9	4.0	4.7	4.5	4.5	4.3	4.1
Government deficit* **	-4.2	-3.4	-2.4	-0.9	-0.8	-0.5	-0.5	-0.1
Total public debt*	79.0	65.0	63.0	59.5	56.1	52.5	49.1	45.6
Imports*	41.9	41.2	42.8	43.5	44.2	45.1	45.5	46.0
Exports*	19.2	20.4	22.8	24.0	25.5	26.9	28.0	29.2
Current account balance* **	-12.6	-11.0	-9.8	-8.8	-8.1	-7.6	-6.9	-6.2
FDI*	6.7	3.1	5.0	4.0	3.4	3.4	3.1	3.1
Total external debt*	68.2	64.0	64.0	63.2	63.9	64.5	64.6	64.2
Debt service/ Total exports	7.4	13.8	11.0	8.9	12.1	12.8	12.3	11.4
Financing needs***	3,247.5	2,583.3	2,418.6	2,638.7	2,920.0	3,292.9	3,453.0	3,382.5
<b>Scenario 2</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
GDP growth	3.0	4.4	3.5	3.0	2.5	2.0	2.0	2.0
Gross domestic savings*	-7.0	-4.0	-4.1	-3.7	-3.1	-1.9	-0.4	1.2
Real per capita GDP (2004=100)		100.0	103.4	106.4	109.0	111.1	113.3	115.5

Scenario 2	2003	2004	2005	2006	2007	2008	2009	2010
Total public spending*	46.8	47.0	47.1	46.7	46.5	46.7	47.0	47.3
Wage bill*	10.3	10.6	10.7	10.9	10.9	11.0	11.0	11.1
Subsidies and transfers*	24.1	25.1	24.9	24.4	23.5	23.5	23.5	23.5
Public investment*	2.1	2.9	2.6	2.6	2.6	2.6	2.6	2.6
Government deficit* **	-4.2	-3.4	-4.6	-4.6	-5.1	-5.4	-5.7	-6.0
Total public debt*	79.0	65.0	63.8	64.8	66.6	68.7	71.0	73.3
Imports*	41.9	41.2	40.8	40.2	39.5	38.8	38.1	37.4
Exports*	19.2	20.4	20.6	20.8	21.3	22.1	22.8	23.7
Current account balance* **	-12.6	-11.0	-10.8	-9.9	-9.0	-7.8	-6.6	-5.2
FDI*	6.7	3.1	2.9	2.3	2.1	1.8	1.6	1.4
Total external debt*	68.2	64.0	65.4	66.5	69.7	72.4	74.1	74.9
Debt service/ Total exports	7.4	13.8	12.6	11.1	14.6	15.7	15.3	15.1
Financing needs***	3,247.5	2,583.3	2,962.1	2,605.0	2,924.3	2,899.8	2,762.7	2,505.5

\* % GDP; \*\* excluding grants; \*\*\* in millions of U.S. dollar

Milica Bisić

## Public Finance Policies

### INTRODUCTION

Changes that Serbian public finance underwent in four years of transition have covered all its elements: policies as such, the manner of their implementation and the implementing institutions.

Serbia embarked upon an overhaul of public finance with a completely disintegrated budget system and practically non-existent policies of public revenue and expenditure. The lack of transparency of public finance was complete. More than 40 percent of public revenue went into a multitude of extrabudgetary funds, which were financed out of over twenty different earmarked taxes. In the course of the 1990s no serious tax policy was pursued to begin with. Instead, one could say that the efforts of the policymakers were focused on identifying a possible base for taxation for the purpose of immediate collection of public revenue. For example, in 1998, 1999 and 2000, tax revenue (consumption taxes, corporate income tax, personal income tax and property taxes) accounted for a mere third of total public revenue, while around 14 percent of public revenue was collected from various fees and levies. New public dues were introduced by virtue of bylaws, while in tax laws multiple tax rates and sectoral tax policy were a rule. The responsibility for assessing, collecting and controlling public revenue was shared among three mutually completely uncoordinated institutions: the Republican Public Revenue Agency (PRA), the Financial Police (FP) and the Payment and Clearing Bureau (ZOP). Tax compliance was almost non-existent, while selective and biased write-offs of tax debts and offsets, which accounted for as much as 25 percent of the Republican budget's revenue, were standard practice. The role of the Ministry of Finance in budget execution reached as far as transferring the resources to the accounts of budget beneficiaries. Individual budget beneficiaries managed the transferred budget allocations autonomously, spent them or deposited

them in banks as “savings”. That is how an absurd situation was created, that the Republic was running a budget deficit, while the beneficiaries of budget resources had excess funds sitting in banks.

A logical consequence of this situation in Serbia’s public finance were irregular and unreliable payments from the budget, arrears and failure to meet obligations, and all that has ultimately resulted in accumulated internal indebtedness to households and businesses, amounting to over 5 billion euros (frozen foreign currency deposits, social security funds, arrears to suppliers) and foreign debt, which was estimated at more than 10 billion euros (Paris Club, London Club, World Bank, as the largest creditors).

Macroeconomic stability is one of the essential prerequisites for transition. Stability and reliability of public finance are, on the other hand, the key to macroeconomic stability. For that reason, the issues of stabilization and establishment of a public finance system, of definition and implementation of public revenue and public expenditure policies, naturally arise at the beginning of a transition process as the most important ones for the success of transition as a whole. Concurrently, huge expectations of the population with respect to immediate improvement of the living standards, the political sensitivity of policy choices that, in the nature of things, constitute a redistribution among social groups, coupled with an inherited and deeply rooted tradition of soft budget constraints among all economic stakeholders – the population, economy and state at all levels of government, made up a very complex set of restrictions in opting for policies.

Furthermore, the changes brought about by transition, such as privatization or reform of the judiciary, were logically putting some specific requests, too, before the policies of both public revenue and public expenditure. Changes in the structure of the state had a direct impact on the organization and even choice of public finance policies, namely both the formal cessation of the existence of the federal state and the formation of the present-day State Union of Serbia and Montenegro, as well as the changes in the status of Vojvodina. The first change meant new competences for Serbia, the second one for Vojvodina, and both posed new questions for the organization of public finance. In addition, the unresolved state status of Kosovo and Metohija, a province over which Serbia has no jurisdiction, but has the obligation to provide financial assistance for the stabilization of conditions of living there, poses another problem. Moreover, the fact that Montenegro and Kosovo and Metohija are separate tax jurisdictions within what is formally a single State Union requires special solutions, particularly in the implementation of tax laws.

In brief, those were the circumstances in which the transition of Serbia's public finance was initiated and carried out. This paper will describe it, and evaluate its achievements and results through a discussion about critical issues it endeavored to resolve and objectives set before it. In other words, the analysis of public finance policies in this paper will not follow the chronological order of events, but will focus on the analysis and assessment of the successfulness of the outcomes of the chosen policies. The analysis will first deal with public revenue policy, and within it, primarily with tax policy, and then with public expenditure policy, focusing on the budget system.

However, in order to enable the reader to get an impression of sequencing, a concise chronology of the most important steps in changing Serbia's public finance will be presented first.

#### A CONCISE CHRONOLOGY OF THE MOST IMPORTANT LEGISLATIVE CHANGES

The entire year 2001 was devoted to tax policy. In March and April 2001, new laws were adopted on the sales tax, excises, personal income tax, corporate income tax, property taxes, in a word, on all tax forms which are governed by laws. The Law on Public Revenue and Public Expenditure was amended, too. The most important changes include the introduction of a single sales tax rate of 20 percent and the establishment of the concept of gross wage as a base for taxation. Likewise, the Law on the Wage Bill Tax, Law on the Financial Transaction Tax and Law on Taxes on Use, Possession and Carrying of Goods were enacted. The first one defined a new source of financing for local budgets, while the other two basically constitute the integration of the tax system through statutory regulation of levies previously governed by decrees. In June 2001, the Law on the One-off Tax on Extra Profit and Extra Property Gained through the Use of Special Privileges was also adopted.

The year 2002 was marked by the adoption of procedural laws: the Budget System Law (Organic Budget Law) and the Law on Tax Procedure and Tax Administration. These laws have set procedural and institutional foundations for budget preparation and execution and application of tax laws. In the said year, all material tax laws were also amended, both in order to harmonize them with the adopted procedural tax law, and in order to pursue a policy of reducing the tax burden and increasing tax incentives for investment and employment.

In the mentioned year, a new Payment Operations Law was adopted, which provided for the elimination of the Payment and Clearing Bureau in 2003 and the transfer of payment transactions to commercial banks. In 2002, another two laws were adopted, whose implementation put the budget of the Republic under a long-term obligation. These are the laws on the regularization of FRY's public debt arising from frozen foreign currency deposits and on the regularization of FRY's public debt arising from contracts on foreign currency household deposits placed as term deposits with *Dafiment banka* and *Banka privatne privrede* (Private Business Bank). These laws have obliged Serbia to issue foreign currency bonds which it will be purchasing according to the statutory schedule by 2016.

Of 2003 it can be said that it primarily was the year of the implementation of the already adopted laws. In early 2003, the application of the Law on Tax Procedure and Tax Administration commenced and the Tax Administration, an organizationally and functionally completely new institution that was founded on the strength of it, began its operation. In that year payment operations were moved to banks, and the Public Payment Agency started to work, entrusted with the tasks of performing payment operations for budget beneficiaries and administering the treasury single account system. In 2003, the preparations also began for the introduction of fiscal cash registers. The most important law adopted in that year was a new Customs Law, which governs customs procedures and provides for the incorporation of the Customs Administration into the Ministry of Finance, which legislation-wise has rounded off the transfer of competences in this domain from the former federal state to Serbia. Some tax laws were once again amended in that year. The most important changes include amendments to the Law on Excises, which eliminated a number of excises and defined a long-term excise policy vis-à-vis tobacco products.

In 2004, two new, extremely important laws were passed: the Law on the Value Added Tax and the Law on Contributions. The first one has completely changed the method of taxing consumption, while the other one has defined contributors, bases and rates for mandatory social security contributions in a single piece of legislation, and established a single minimum base. That year was important also because of the elimination of the financial transaction tax and wage bill tax. The elimination of the second one coupled with the introduction of the value added tax (VAT) sharply underlined the necessity to resolve the issue of financing local self-governments, which were also faced in the said year with the beginning of the implementation of the Budget System Law as well as with the setting up of their own treasuries and application of relevant

procedures. All material tax laws were amended in 2004 as well, both because of the harmonization with the value added tax and the implementation of the policy of further tax burden reduction. Similarly, the Law on Fiscal Cash Registers was adopted, which replaced a decree with the same name, whose legal grounds were in the Law on the Sales Tax, supplanted by the VAT Law. In late 2004, almost unobtrusively, another completely new tax law was passed, which introduced a new and, as it seems, completely unorthodox tax form into Serbia's tax system: taxation of non-life assurance premiums. In 2004, with the adoption of the Law on the Regularization of Obligations of the Republic of Serbia Arising from the Loan for Economic Recovery, a method was prescribed for the repayment of yet another part of the state's public debt to households, and the budget of the Republic was put under an obligation to repay a total of 56 million euros of this debt by 31 July 2007.

In all these years the central government annual budgets were adopted under the watchful eye of the International Monetary Fund (IMF), whose approval was one of the implicit, yet key prerequisites for submitting the budgets to the Parliament for adoption. It was not easy to reconcile the key requirements related to the deficit levels and hard budget constraints on public expenditure with wishes of budget beneficiaries and social and political demands. On the whole, however, it should be noted that the crucial IMF's requests were support in the establishment of stable public finance in Serbia, rather than an obstacle to it. This does not mean that all the IMF's recommendations, and in particular the suggested policy mix for the achievement of a particular objective, were always appropriate for the Serbian circumstances, but it does mean that the IMF played a role of an additional safety catch for the preservation of still very fragile stability of Serbian public finance.

## PUBLIC REVENUE POLICIES

### **Developments in the field of public revenue collection and structure**

It should be noted at the beginning of the analysis of public revenue policies that the basic indicator of the validity of a tax policy – in its normative and administration parts alike – is very measurable – and that is the size of

government tax revenue. Tax policy sets the rules of the perpetual (mainly uncooperative) game between the state and taxpayers. The outcome of this game is reflected in the ability of the state to finance its expenditures. This outcome also constitutes the most important comment on all tax laws, both past and present and future.

Therefore, table 1 presents the data on the size, dynamics and structure of tax and quasi-tax revenues in Serbia in the period from 1998 to 2004. The need to compare this final result of tax policy in the transition period with the one of tax policy in the previous period imposed the choice of collection indicators. Due to significant changes in the definition, coverage and distribution of public dues among different levels of government, it is possible to measure only the data on gross collection and groups of tax and quasi-tax forms. The piece of data on gross collection of public dues indicates the size of the revenue collected in the territory of Serbia, irrespective of whether that was the revenue of the republican, municipal or city budgets or of one of the funds for mandatory social insurance. Other taxes include: the wage bill tax, the financial transaction tax, taxes on lottery, taxes on the use, possession and carrying of goods, the tax on the use of motor vehicles and the extra profit tax. The fees include administrative, court and utility fees, while levies constitute a sum of royalties for the use natural resources, road tolls and fees for the use and development of buildable land. Fees, levies and contributions could be considered quasi-tax forms.

The data are self-explanatory. In 2001 and 2002, total revenue was doubled in real terms, while in 2003 and 2004 it rose by 25 and 27 percent, respectively. In the first two years of transition the revenues from all the taxes were more than doubled, while the most significant contribution to the rise in total revenue was made by the increase in the consumption tax revenue, whose share accordingly increased the most. Similarly, in all the years between 2001 and 2004, strong growth was registered of revenues from all the taxes, several times higher than real GDP growth. Since the changed tax laws have not provided for practically any rise in tax rates - on the contrary, certain tax rates were cut - the rise in revenue is indubitably a result of changes in tax policy and improved public revenue collection, which also reflects a significant improvement in the work of the tax administration.

Table 1. Gross collection of tax and quasi-tax revenue: absolute amounts, real growth rates, structure and changes in the structure (absolute amounts in billions of dinars)

	1998		1999		2000		2001		2002		2003		2004	
		%		%		%		%		%		%		%
Total	64.9	75.0	140.0	55.2	320.5	102.9	410.8	105.7	479.5	24.9	599.8	26.9		
Taxes	22.0	25.0	46.0	53.0	155.6	200.1	252.9	160.9	281.9	19.2	341.5	22.9		
Sales tax	10.9	13.9	26.6	58.7	73.9	146.2	107.6	133.7	126.5	25.8	156.8	25.8		
Excises	1.7	1.4	2.0	21.7	22.7	907.0	46.6	229.2	58.5	34.2	69.1	19.8		
Corporate income tax	0.5	1.0	1.1	-3.0	3.4	167.3	4.4	108.0	6.0	43.7	6.9	17.6		
Personal income tax	7.8	7.4	13.9	57.0	39.8	153.8	53.3	114.9	62.2	24.8	76.3	24.3		
Property taxes	1.1	1.3	2.3	44.3	6.2	136.3	8.8	129.4	9.2	11.6	12.0	32.7		
Other taxes					9.5		32.1	440.3	19.5	-35.0	20.3	5.7		
Fees and levies	9.7	9.5	20.4	78.2	18.5	-19.7	16.4	42.5	30.1	96.2	39.9	34.5		
Fees	4.3	6.0	14.4	98.8	10.8	-33.1	8.4	24.0	18.5	135.6	23.8	30.6		
Levies	5.4	3.5	6.0	42.8	7.6	12.3	8.0	68.9	11.6	55.0	16.1	40.7		
Contributions	23.8	28.5	50.4	47.1	114.4	101.2	115.2	61.6	136.3	26.6	181.7	35.3		
Pension and disability		16.6	29.5	47.6	71.8	115.8	69.8	56.1	84.3	29.2	116.2	39.8		
Health		11.0	19.3	46.3	38.7	77.4	41.5	72.4	47.5	22.3	59.2	26.4		
Unemployment		0.9	1.6	48.7	3.9	119.2	3.8	57.3	4.5	26.0	6.4	43.2		
Customs duties	5.9	5.7	11.0	59.3	21.1	70.2	24.7	88.1	29.2	26.6	34.3	19.0		
Other	3.4	6.3	12.3	62.1	11.0	-20.7	1.6	-76.8	2.0	36.2	2.4	22.4		

Structure	1998.		1999.		2000.		2001.		2002.		2003.		2004.	
	100.0	%	100.0	%	100.0	%	100.0	%	100.0	%	100.0	%	100.0	%
<b>Total</b>	<b>100.0</b>													
Taxes	33.9	-1.8	32.8	-1.4	48.5	47.9	57.8	19.0	56.7	-1.8	54.1	-4.6	54.1	-4.6
Sales tax	16.8	18.6	10.7	2.3	23.1	21.3	24.6	6.6	25.4	3.6	24.8	-2.4	24.8	-2.4
Excises	2.7	1.8	-32.2	1.4	-21.6	7.1	396.2	10.6	50.1	11.8	10.5	-7.0	10.9	-7.0
Corporate income tax	0.8	1.3	63.0	0.8	-37.5	1.1	31.7	1.0	-5.2	1.2	18.3	1.1	1.1	-8.7
Personal income tax	12.0	9.8	-18.1	9.9	1.2	12.4	25.1	12.2	-2.0	12.5	2.8	12.1	12.1	-3.5
Property taxes	1.7	1.8	6.6	1.7	-7.0	1.9	16.4	2.0	4.6	1.8	-8.1	1.9	1.9	3.0
Other taxes						3.0		7.3	146.4	3.9	-46.5	3.2	3.2	-17.9
<b>Fees and levies</b>	<b>14.9</b>	<b>12.7</b>	<b>-15.0</b>	<b>14.6</b>	<b>14.8</b>	<b>5.8</b>	<b>-60.4</b>	<b>3.7</b>	<b>-35.0</b>	<b>6.0</b>	<b>61.5</b>	<b>6.3</b>	<b>6.3</b>	<b>4.4</b>
Fees	6.6	8.0	21.2	10.3	28.1	3.4	-67.0	1.9	-43.4	3.7	94.0	3.8	3.8	1.4
Levies	8.3	4.7	-43.9	4.3	-8.0	2.4	-44.6	1.8	-23.0	2.3	27.6	2.6	2.6	9.2
<b>Contributions</b>	<b>36.7</b>	<b>38.0</b>	<b>3.4</b>	<b>36.0</b>	<b>-5.2</b>	<b>35.7</b>	<b>-0.9</b>	<b>26.3</b>	<b>-26.3</b>	<b>27.4</b>	<b>4.2</b>	<b>28.8</b>	<b>4.2</b>	<b>5.0</b>
Pension and disability	0.0	22.2		21.1	-4.9	22.4	6.3	15.9	-28.8	17.0	6.3	18.4	18.4	8.5
Health	0.0	14.6		13.8	-5.8	12.1	-12.6	9.5	-21.4	9.6	0.7	9.4	9.4	-1.9
Unemployment	0.0	1.2		1.1	-4.2	1.2	8.0	0.9	-28.3	0.9	3.7	1.0	1.0	11.1
<b>Customs duties</b>	<b>9.1</b>	<b>7.6</b>	<b>-16.2</b>	<b>7.8</b>	<b>2.6</b>	<b>6.6</b>	<b>-16.2</b>	<b>5.6</b>	<b>-14.2</b>	<b>5.9</b>	<b>4.2</b>	<b>5.4</b>	<b>5.4</b>	<b>-7.7</b>
Other	5.3	8.4	58.1	8.8	4.4	3.4	-60.9	6.5	91.2	4.0	-39.4	5.4	5.4	36.2
RPI		141.4		170.0		191.8		119.5		111.7		110.1		

Source: Serbian Ministry of Finance, Tax Administration

The data obviously testify to the fact that Serbia has not only avoided a drop in budget revenue so common for transition countries, but has consolidated and stabilized its public finance already in the first years of transition. This apparent success of public finance policies has at the same time created the key prerequisites for the accomplishment of the monetary policy objectives as well, and not only of them, but also of the structural transitional policies, which stand no chance of success without stable and reliable public finance.

For this reason, a general assessment of the significant progress and great success achieved in the revamping of the entire tax system of Serbia in the first years of transition is not in any way undermined by certain vagaries and mistakes which will be discussed in the analysis of choices and arrangements in the designing of certain taxes, or by the fact that a lot still remains to be done.

### **Taxing consumption**

The basic forms of consumption taxation in Serbia's tax system are the sales tax, which was replaced in January 2005 with the value added tax, and excises.

For the sake of precision, it should be noted that some other tax and quasi-tax forms have similar characteristics or essentially constitute the taxation of consumption. For example, the tax on transfer of absolute rights (title assignment) has the features of an indirect tax – the burden is shifted on the buyer, although the taxpayer is the seller, like in the case of the sales tax, i.e. the VAT. The base for this form, however, are transactions with property rights to statutorily defined forms of assets (real estate, shares...). The very nature of the base, hence, excludes it from the group of consumption taxes, and that is why this tax form will be analyzed as part of the group of other property taxes. Similarly, some levies, such as the royalties for the use of mineral resources or forests, due to the collection method, essentially constitute special sales taxes, accordingly excises. Owing to their negligible revenue effect, as well as to the fact that they essentially do not belong to taxes, which gives rise to other non-tax issues in relation to them, they will not be discussed in this section.

**The sales tax.** The Law on the Sales Tax adopted in March 2001 constituted a truly fundamental positive change relative to the hitherto system of taxing trade in goods and services. The previous seven different rates were replaced

by a single 20 percent rate, comprising 17 percent of the republican tax and 3 percent of the federal tax. In addition to exemptions from taxation of trade in goods at the stages which precede the retail sale, i.e. the final consumption, which is typical of the sales tax, the manner in which the eligibility for exemption from taxation has been defined also points to the intention of the lawmakers to provide sufficient normative grounds for preventing tax evasion by fraudulent presentation of retail sales as wholesales.

The number of unconditional exemptions was considerably reduced. In the original version of the Law, they were really reduced to the minimum for Serbian circumstances. If one leaves out the exemptions of bread and milk, publications of special interest to science, arts and culture, trade in agricultural produces when the seller is a farmer – natural person (farmers are anyway technically practically impossible to cover by taxation in Serbian circumstances) and humanitarian aid, internal turnover of other goods exempted from taxation cannot be considered to be final consumption to begin with.<sup>1</sup>

Another novelty that was introduced by this Law was the obligation to install fiscal cash registers for recording transactions and to issue receipts for all retail purchases.

Subsequent developments have shown that the strictness of the law was too much for Serbian circumstances, and after the initial shock the advocates of the maintenance of the living standards through exemptions from the sales tax, as well as foreign donors, quickly came to and organized pressures to amend the law. Thus, all four amendments to this law in less than four years of its period of validity laid down new exemptions.

Already in late 2001, meaning in the same year in which it was passed, the Law was amended in order to integrate the former federal 3 percent sales tax into the single general sales tax with a rate of 20 percent. However, the amending of the Law has also resulted in the unconditional exemption from the sales tax for fruits and vegetables, drugs from the special list, firewood

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<sup>1</sup>The list of eliminated exemptions from the sales tax included edible oil and lard, imports intended for sales in duty free shops at border crossings, products procured through special committees and headquarters set up for the purpose of redressing the consequences of natural disasters, wars and the like, medicines, textbooks, teaching aids, stationary, books, brochures, newspapers and magazines, tourist-information-advertising material, potable water (from the water supply system), orthopedic aids, fuel and energy from renewable sources, coal and firewood, services in air traffic, railroad transport, public transportation and commuter traffic, utility services, services in agriculture in soil cultivation, leasing out open-air green market stalls, services in the field of water and air pollution prevention, catering and construction services, and insurance services.

and utility services. As an attempt to at least formally preserve the impression that the strictness has been maintained, these exemptions were limited to 2002 and 2003. Yet, this only created trouble in late 2003, when it was necessary to extend these exemptions in the circumstances in which the government was a caretaker one and the parliament was not constituted. To which extent the non-payment of the sales tax on these goods was considered an acquired and inviolable right can be inferred from the fact that the extension of the validity of these exemptions by virtue of a decree, inadmissible from the legal standpoint, was tacitly accepted as the only proper solution, which was pushed through without any criticism whatsoever.

The second amendment of the Law which took place in 2002 is, for all practical purposes, related only to the definition of new exemptions, because apart from not so significant specification of the already existing provisions on fiscal cash registers and fines for those buyers who fail to take receipts, all other changes constitute new exemptions. The winners on this occasion were consumers of edible oil and sugar, enterprises and shops which use masut as production material (as propellant or for heating), foreign donors – because both goods and services which are procured out of the resources of foreign grants are exempted from the sales tax, and lessors natural persons because no sales tax on trade in services is levied on rents if the lessor is a natural person.

Admittedly, this last exemption may be considered a rational decision of the lawmaker and not his giving in to pressures, bearing in mind that levying a consumption tax on rental fees is, generally speaking, dubious. On top of that, in situations where, like in Serbia, rents are first taxed by the personal income tax withheld at an effective rate of 16 percent, and then by the sales tax at a rate of 20 percent, and in the conditions where administrative capacities of the tax administration are weak, the willingness of the citizen - lessor to file a tax return on his own too feeble and the possibility to operate in cash huge, this was the right thing to do, with a view to creating a prerequisite to, at least, make the payment of the personal income tax acceptable.

Not even the third amendment of the Law in 2003, which was necessary to define the tax status of financial leasing as a new form of transactions in which the recipient of the good does not become its formal and legal owner at the point of taking over the good could not be spared from a new exemption. This time the press breathed a sigh of relief, because dailies and periodicals were exempted from the sales tax.

The fourth amendment of the Law in 2004 was passed by the new parliament at the proposal of the newly elected government, at the point when it was clear that, due to the adoption of the Law on the Value Added Tax, the sales tax would cease to exist in less than six months. This time, the only change referred to authorizing the Government to exempt individual taxpayers at a joint proposal of the Ministry of Finance and the Ministry of Trade from the obligation to install fiscal cash registers, namely those taxpayers with respect to whom these two ministries have assessed that “due to the specific nature of their activities, they are not able to develop software applications in line with the technical and functional properties of the fiscal cash register.”

This provision has exempted certain taxpayers, to be subsequently identified in a decree, from the obligation to record their business transactions in a manner which would transparently enable the Tax Administration to review the tax base. Since the value added tax, fortunately, is less convenient for tax evasion through a simple concealment of the base, such amendment does not have too great tax significance. It represents, however, a visible sign of the inclination which the newly elected government cherishes toward discretion, and which will be repeated in the case of amendments to some other tax laws, to be discussed below. In this case the government proposed, and the Parliament accepted, for the selection of taxpayers to be more specifically elaborated in the process of defining the manner in which the law is to be implemented, which practically means in a bylaw, despite the fact that it is one of the fundamental issues whose definition directly affects the material status of taxpayers, hence it should be enshrined solely in the law.

Although it is no longer relevant from the standpoint of the future, because the sales tax has been replaced by the value added tax, it is still necessary to point to certain dilemmas, even mistakes which, from the viewpoint of fiscal policy, existed in the regulation of the sales tax.

The fundamental dilemma is related to the choice regarding the level of the tax rate. Comparative research into the sales tax and value added tax has shown that the sales tax rate of 10 percent is a maximum from the standpoint of its vulnerability to tax evasion. Anything above that rate in the sales tax regime creates a strong incentive for tax evasion which is, taking into account the number of possible taxpayers, irrespective of the capacities of the tax administration, very difficult to curb. This is, in fact, the reason why the VAT enjoys great popularity among tax officials, being far more resistant to tax evasion due to the collection technique which makes tax evasion too expensive even at considerably higher rates of taxing consumption.

Bearing in mind a very strong rise in the revenue from this tax,<sup>2</sup> which in 2001 rose by 146 percent in real terms relative to 2000, in 2002 by 134 percent against 2001, and in 2003 and 2004 by a very solid 26 percent, it is obvious that the integration of different surcharges in a single tax rate, a reduction in the number of exemptions and the consolidation of the tax administration, as well as of the entire state for that matter, have significantly increased risks involved in tax evasion. Therefore, the incentive for evasion created by the high tax rate did not have a significant impact from the revenue standpoint in the four years during which the Law on the Sales Tax was in force.

Nevertheless, what certainly is a mistake when it comes to the level of the tax rate is the setting of the same tax rate for trade in services and trade in goods. The mistake is in the fact that the taxation of services in the sales tax regime is necessarily multiple, because due to the intangible nature of services it is not possible, like in the case of goods, to conditionally exempt them from the sales tax even when they economically constitute an indispensable input, just like intermediate goods, for the production of another good or service. Thus, even in those cases where a service was rendered in only two phases of trade the effective tax rate was going up to 44 percent. In addition to the fact that such an arrangement in principle constitutes a distortion, it is certain that it has also pushed a fair share of the service sector either into the gray area or out of business.

Likewise, defining the service of wholesale as the subject of taxation is a major inconsistency in the Law. If trade in goods intended for further sale is conditionally exempted from taxation, the taxation of the wholesale margin cannot be considered to be the sales tax, but some sort of withholding tax on total income. Although the idea behind defining the price differential as the base for taxation was to collect part of the tax revenue from wholesalers who were crucial in the sales tax avoidance chain, nothing relevant was achieved through this, except for the unnecessary inconsistency in the Law. First, major tax evaders had founded wholesale companies for a limited number of “business deals” and then they closed them, i.e. abandoned them. Second, big wholesale companies which were in this business permanently were given a strong incentive for tax evasion.

Regardless of these mistakes, as well as some predominantly administrative awkwardness in the Law, which are not worth mentioning in the present-day context, the Law on the Sales Tax passed in 2001 constituted a safe and big step toward transformation of the revenue side of Serbian public finance.

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<sup>2</sup>Data on the revenue from this and other tax forms are presented in Table 1.

**The value added tax.** As of the adoption of the Law on the Value Added Tax in July 2004, and the commencement of its implementation in January 2005, consumption in Serbia has been taxed in the manner long in place in other European countries.<sup>3</sup> The law itself is the so-called “EU model” VAT, which is collected at all stages of the production and sales cycle, i.e. the model which is in accordance with the 6<sup>th</sup> EEC Directive on the common value added tax system of the member states. It means the following: the VAT introduced in Serbia is a consumption type VAT which is not levied on the procurement of capital goods, hence the macroeconomic base is equal to private consumption. In assessing tax liability, the so-called credit method is applied, which defines tax liability as a difference between output tax (calculated on sales) and input tax (calculated on purchases). Consumption is taxed according to the principle of destination, which means that exports are exempted from taxation, and imports are taxed.

In comparison with the sales tax, the VAT Law has significantly broadened the tax base, which, combined with its superiority in the identification of the tax base, essentially enables the revenue neutral VAT rate to be considerably lower than the sales tax rate.

The tax base has been broadened not only by including in the taxable base the trade in those goods and services which in the sales tax regime were exempted, but also by the manner in which the taxpayer is defined. Unlike the sales tax in which an individual who had no registered business entity (an enterprise or a shop) practically could not become a taxpayer, in the value added tax an individual who generates annual income above the statutory threshold (presently 2 million dinars) by working independently automatically becomes a VAT payer and has an obligation to register for the VAT.

Still, the VAT Law has abandoned the principle of a single tax rate and thus consumption is now taxed at four rates, depending on the type of the product (18, 8, 5 and 0 percent) compared to the two tax rates which existed in the sales tax system (20 and 0 percent).

The 18 percent rate is the standard value added tax rate, applied to all the services, supplies and imports of goods which are not in the special 8 percent rate regime.<sup>4</sup>

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<sup>3</sup>In Bosnia and Herzegovina, which is now the only European country where the VAT has not been introduced, the Law on the Value Added Tax was adopted in October 2004, and the Law has specified July 1, 2005 as the day on which its implementation is to begin. Yet, there is a high probability that its implementation will be postponed until January 1, 2006 due to the insufficient preparedness of the newly established tax administration at the B/H level.

<sup>4</sup>The special rate is applied to supplies of bread, milk, flour, sugar, edible oil and fats; of fresh and cooled fruits, vegetables, meat, fish and eggs; drugs on the special list; fertilizers, plant protection

The reasons for taxation at a reduced rate of the products which were previously exempt from the sales tax, as well as of the products used in medical treatment, which in the sales tax were in the regime of conditional exemptions, accordingly purchased without tax provided that the statutory conditions had been met, may be clear. Their taxation at the standard rate would objectively mean a rise in their prices of 18 percent with a proportional impact on both the general price level and the cost of living, i.e. medical expenses. Therefore, the opting for a lower rate means at the same time a commensurately lower price impact, which could be a valid reason for this decision. However, it remains unclear why it was necessary to reduce the tax rate on tourist services of accommodation from 20 percent, which was the sales tax rate, to 8 percent of the VAT. Whether the lawmaker wanted to make vacation more affordable to the wider population and whether something like that can be done at all by setting a lower VAT rate, are the questions which will remain unanswered on this occasion.

The compensation which is paid to farmers at a rate of 5 percent is essentially a separate tax rate, too. This compensation has been defined as an obligation of VAT payers to increase by 5 percent the level of the price they pay for purchasing staple agricultural produces from individual farmers not registered as VAT payers. The purpose of the introduction of the VAT compensation for farmers is to provide compensation to this category of producers for the VAT paid on inputs, irrespective of the tax status.

There are three main arguments for the introduction of this compensation. Firstly, irrespective of the formal status of farmers, agricultural production, based on its economic nature, is not consumption, hence it should not be taxed as such in the first place. Secondly, due to the very system of VAT collection this problem cannot be resolved in the manner in which it was solved in the sales tax regime, where most of the inputs and outputs in agriculture were unconditionally exempt. Thirdly, farmers by rule are not eligible to become VAT payers and most of them for technical reasons, on account of their inability for, or lack of practice in, maintaining books and keeping records in connection with the VAT, will not use their right to voluntarily register as VAT payers. It means that in the VAT regime they will, on the one hand, pay the tax on their inputs, while on the other hand, they will not be able, as a rule,

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products, propagation seed, planting material and breeding stock; textbooks and teaching aids; daily newspapers; monographs and serial publications; firewood; utility services; orthotic aids and prostheses, and surgically inserted medical implants; dialysis materials; services of accommodation in hotels, motels, vacation homes, residences and camps. With the exception of the last three groups of products, all other products were unconditionally exempted from the sales tax in the sales tax regime.

to compensate for that from the VAT collected on their outputs, because they will not meet the requirements. In order to resolve this problem at least with respect to the part of supplies of agricultural produces which obviously has the character of intermediate trade, in other words in the case of supplies of staple agricultural produces to VAT payers, the VAT compensation should be equal to the level of the tax rate levied on basic agricultural inputs,<sup>5</sup> which is, however, set at the level of 8 percent. By differently defining the relative levels of the VAT compensation and the VAT rate which is applied to the purchases of agricultural inputs, the possibility has been diminished of achieving by means of this compensation the objective for which it was introduced, while the number of tax rates has been unnecessarily increased.

The VAT Law has stipulated three groups of tax exemptions: with the right to deduction of the input tax, without the right to deduction of the input tax and tax exemptions for imports of goods.

The zero tax rate is only the exemption from the VAT with the right to deduction of the input tax, while the exemption from the VAT without the right to deduction of the input tax basically constitutes the exclusion from the VAT system, for which reason the suppliers of goods the trade in which is exempted without the right to deduction of the input tax are accorded the tax treatment of end-consumers. In the case of exemptions of imported goods, these refer either to special customs procedures within which the goods, in effect, are not freely sold on the domestic market or to valuables (gold for the NBS, securities, money).

With one exception, the selection of goods classified in all three groups followed the logic of the chosen VAT model and common guidelines applied by the EU member states.

The zero tax rate laid down for the bringing in of goods into free customs zones and the provision of services to the users of free customs zones is the above mentioned exception. Namely, the legal frameworks of the EU member countries which have tax exemptions for the bringing in of goods into free zones regulate the free zone itself and the operation in the zone in a different manner. First and foremost, the very area of the free zone has an extraterritorial status within the country where it has been set up, hence the very bringing in of goods into the zone may be considered exports. The basic precondition for the establishment of the zone in the first place is that the bulk of the zone's output is exported, therefore the share of exports in total output of the zone, as a rule,

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<sup>5</sup> Fertilizers, plant protection products, propagating seed, planting material and breeding stock.

has to be 65, 70 or more percent. The manner in which the establishment and operation of free zones in Serbia is presently regulated results, on the whole, in imports by the users of free zones being several times higher than exports. At this point, they constitute, at best, the manner in which importers postpone the payment of customs duties and taxes on the goods they are importing. However, it is not so rare that free zones are used to simply avoid the payment of taxes, because the existing rules do not create conditions for control.

It means that this exemption has practically introduced a zero rate in domestic trade, which opens an obvious and easy possibility to prolong the time limits for the payment of the tax, even for tax evasion. This tax exemption should not have been introduced before regulations have been adopted and implemented, which would in an adequate manner govern free zones and operations in them, and establish strict controls over the turnover of goods brought into the zone, as well as over the turnover taking place in the zone itself. Only with a proper legal framework there could be a rationale for this tax exemption.

On the other hand, the provision which certainly needs to be changed as soon as possible is the one on the level of the threshold of total turnover above which a person (an enterprise, shop or an individual) becomes a VAT payer. The Law sets it at a mere 2 million dinars, which at the present euro rate amounts to slightly more than 24,000 euros. Such a low statutory threshold implies high administrative costs for the Tax Administration for covering small taxpayers by any sort of control, yet without any revenue impact. By defining a considerably higher threshold, amounting to, for instance, 10 million dinars, the VAT revenue would not be threatened at all, bearing in mind that all the persons generating incomes below this threshold would have the status of end-consumers, i.e. they would pay the VAT on their inputs. By allowing voluntary registration for the VAT system, a possibility would be offered to small manufacturers of goods or providers of services to use its advantages, and their self-registration would at the same time automatically create a database on them in the Tax Administration, thus enabling their control as well. Bearing in mind that good and efficient administration of the VAT is critical for the successful implementation of the VAT, it is not wise to direct the already overstrained capacities of the Tax Administration, without adequate IT support, to the tasks which are insignificant in terms of revenue they would bring, which is basically the consequence of such a low statutory threshold for mandatory inclusion in the VAT.

Of paramount importance to the credibility of the whole VAT system, and the basic prerequisite for its neutral effect on economic activity, are regular and consistent with the Law VAT refunds made in a timely fashion to those taxpayers who had higher input tax than the output one in the tax period. Therefore the fact that already in the second month of its implementation such refunds were made really augurs well. The procedure applied on that occasion – the issuance of temporary decisions – admittedly points to a certain lack of understanding of the basics of the VAT, in which the refund is part of the system, rather than a consequence of a mistake of either the taxpayer or the tax administration, which is the case with other tax forms, when a decision is necessary as an act of the administrative procedure. Having in mind, however, that the period of implementation was really very short, both this and some other administrative vagaries, and in particular total lack of preparation of the Customs Administration for the administration of the VAT, may be rectified after gaining some experience, in which case they will not undermine the overall positive assessment that the introduction of the VAT in Serbia has deserved.

**Excises.** A new Law on Excises was passed concurrently with the Law on the Sales Tax, in March 2001. It could be said that the greatest asset of this Law relative to the previous one, from the standpoint of fiscal policy, is the fact that, within the prescribed amounts of excises, it has integrated all earmarked surcharges that had been levied under special decrees issued by the Government of the Republic of Serbia. In such a manner, the bulk of earmarked taxes governed by bylaws has been eliminated from Serbia's tax system. A change in the base for the calculation of excises, which under the new Law is a measurement unit, instead of the selling price, as well as an appropriate change in the manner of determining the level of the excise burden, which has been defined as a specific excise for each excisable good, and not as *ad valorem* excise, resulted in significant simplification of the assessment and control of the excise liability.<sup>6</sup> Additionally, a provision prescribing that cigarettes and

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<sup>6</sup>The only exception is excise on luxury items, for which the selling price of a product has been set as a base, while the excise is defined as a percentage whose level depends on the "type" of the luxury item. This differentiation in the level of the excise burden (20 and 30 percent), depending on the "type" of the luxury item, is the only innovation in the domain of excises on luxury items relative to the old law. Being of a negligible revenue impact, this innovation could be interpreted only as a symbolic populist step of the new authorities. It is not very likely, however, that (symbolic) benefits from this step are larger than (actual) costs of administering this inefficient fiscal instrument.

alcoholic beverages are to be marked by duty stamps printed exclusively in the National Bank of Yugoslavia's printing house, constitutes an almost decisive improvement in efficiency of control over the calculation and payment of excises for these two groups of excisable goods. At the same time, as a penalty for the taxpayer who sells cigarettes and alcoholic beverages not specially marked by control duty stamps, a ban on the performance of the activity has been introduced.

An increase in the number of products on which excises are paid, which include lamp oil, motor and jet oils, mineral and other lubricants and soft drinks made from fruit bases, and the keeping of excises on salt, ethanol and coffee, however, can not be assessed as good or reform-oriented actions. In principle, excises are introduced as a special consumption tax whose objective is to additionally tax the consumption of products for which demand is high and inelastic with respect to prices, hence the expected tax revenue is generous, and which do not belong to the group of basic foodstuffs. None of the mentioned excisable goods has all these features at the same time. Therefore, it does not come as a surprise that the revenue collected from excises on the mentioned products is either negligible or relatively low. Moreover, common EU excise policy recognizes as excisable goods only petroleum products, tobacco products and alcoholic beverages.

On the whole, the amendments to the Law on Excises have produced a huge increase in excise revenue. In 2001 alone, the excise revenue increased as many as 10 times in real terms relative to 2000. One should, however, take into account that this rise was a result of not only indubitably great administrative improvements whose contribution was significant, but also of a different coverage of excise revenue.<sup>7</sup> In addition to the impact of the amendments to the Excise Law on this increase, one should not disregard the impact of the Decree on Special Terms and Manner of Importing and Refining Crude Oil, i.e. Petroleum Products on the rise in the revenue from excise on petroleum products, which was passed at the same time as the Law on Excises, providing for a ban on free imports of petroleum products. Without making any assessment on this occasion of this to the competitiveness of the market harmful decree, the fact remains that, as a consequence of its implementation, the only payers of excise on petroleum products were refineries, which brings the sophistication and costs of control to the minimum.

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<sup>7</sup>Part of the revenue, which in 2000 was classified as revenue from fees, in 2001 was excise revenue, while earmarked fees and surcharges were eliminated, which explains a drop in these revenues in 2001 (Table 1).

A subsequent rise in revenue: its triplication in real terms in 2002 relative to 2001, and further considerable growth of revenue in 2003 and 2004, should be attributed rather to rises in the amounts of excises than to significant changes in excise policy as such, despite the fact that the Law on Excises underwent seven changes in the four years that have elapsed since its passage. In the mentioned period excises on gasoline and diesel were increased four times, and excise on tobacco products three times.

From the standpoint of excise policy the amendment in mid-2003 was significant, as were all three amendments in 2004. In July 2003, excises on salt for human consumption and luxury items were eliminated, which can be considered a step forward toward a rational selection of excisable goods, as well as the excise on wine, which is an attempt to improve the competitive position of domestic wine producers. Through this amendment of the Law, a long-term excise policy for cigarettes has been laid down as well, which has defined a schedule of cigarette excise increases in the period from 2005 to 2010. Important changes set out in the long-term excise policy for cigarettes are as follows.

As of 2005, the method of setting excises on cigarettes depending on the quality group they belong to has been eliminated. According to this method, the excise was lower for cigarettes in lower quality groups. In practice, this method for setting the level of the excise burden effectively constituted a higher excise burden on imported cigarettes (which were all classified in the highest quality group) and a lower excise burden on domestic cigarettes (which all, with the exception of one brand whose volume of sales is negligible, were classified in the other two lower quality groups). The competence over the classification of cigarettes into quality groups belonged to the Ministry of Finance based on the opinion of the Ministry of Agriculture. Depending on that decision, i.e. the opinions of these two Ministries, was also the level of excise levied on certain types of cigarettes. It was not a good arrangement, bearing in mind that it created a great incentive to manufacturers and importers to try and influence the decisions or opinions of these two Ministries in various ways, i.e. it created a direct incentive to corruption. Therefore, the elimination of this method for setting the level of excises was a good decision.

For 2005, the introduction of the so-called excise duty stamps was also envisaged, which would entail the payment of excises before taking over excise duty stamps. It means that it has been prescribed that as of 2005 the payer of excise on cigarettes will be obliged to submit a calculation of the retail price

which would be indicated on the excise duty stamp and which would be a base for the calculation and payment of excise when ordering excise duty stamps. In such a manner the excise revenue of the budget would depend only on the volume of cigarette production, while the entire risk of sales would be shifted to the producer. At the same time, the costs of selling cigarettes on the black market would be significantly increased, manipulations with the level of the retail price for the purpose of reducing the absolute amount of the excise burden would have no point, and a strong incentive would be created for manufacturers to influence the curbing of the black market for cigarettes through their business decisions. On the other hand, bearing in mind the financial strength of the industry, the initial impact on liquidity which would be created through the shifting of the obligation to pay excise to the point of taking over excise duty stamps, instead of the point of supplying goods to the buyer, the industry would relatively easily overcome. This change can be assessed as good administrative support to the setting of excise as a percentage of the retail price, which is envisaged to enter into force in 2005 as well.

The structure of the excise burden, the combination of specific and *ad valorem* excises, has been defined in keeping with the guidelines for excise policy, which apply to the EU member countries. The schedule of increases in *ad valorem* excises, with an appropriate amount of specific excise, has been defined in a manner which will enable a gradual fulfillment of the requirement set out in the EU guidelines, according to which the excise burden on cigarettes should not be lower than 57 percent of the retail price of the best-selling brand of cigarettes. A deviation from the standards of EU excise policy, as well as from neutral tax policy, was the introduction of different levels of specific excises on imported and domestically produced cigarettes. Although it has been envisaged that this difference, which for 2005 has been defined as 1 to 10 ratio (1 dinar of excise per pack of domestically produced cigarettes relative to 10 dinars per pack of imported cigarettes), should be gradually reduced, to be totally eliminated in 2010, in the described manner a five year period has been defined in which domestic production of cigarettes will be greatly favored over imports through a lower excise burden.

The choice of such a policy was a clear incentive for privatization of the tobacco industry in Serbia carried out in 2003, namely, the point was not only in establishing a difference in treatment between domestic producers and importers. The very fact that a long-term excise policy, which sets out a schedule of cigarette excise increases, has been stipulated in a law essentially points to an attempt to establish certainty of the future influence of tax policy,

very significant for this industry, on the structure of the product price, and thus indirectly on the pricing policy and competitive position on the domestic and regional markets. The enhanced certainty of future tax policy definitely provided the then potential buyers in the privatization of the Serbian tobacco industry with some clear indicators for decision-making. In view of the fact that in the autumn of that year the Tobacco Factory in Niš was bought by Philip Morris and Tobacco Factory in Vranje by British American Tobacco, and that relatively high privatization proceeds were generated in these deals, it can be noted that the adoption of the long-term excise policy on cigarettes in 2003 has achieved one of its possible immediate objectives.

Nevertheless, the amendments to the Law on Excises in 2004 create an impression that the entire excise policy has assumed the form of some kind of tariff policy. The manner in which excise on alcoholic beverages has been determined, though not formally differentiating between domestic production and imports, results in a significant increase in the difference in the excise burden between traditionally domestic alcoholic beverages and those which are normally imported, making the absolute burden on the former group two and a half times lower than on the latter one. Similarly, an explicit obligation has been introduced of paying excise only on imported non-alcoholic beverages. Taking into account that the decree prohibiting imports of petroleum products is still in force, pursuant to the existing excise policy practically just in the case of beer no difference is made in the level of excise on the basis of origin (imported or domestic).

The elimination of excises on jet fuel and kerosene, motor oils and lubricants, liquefied oil gas and lamp oil, and on ethanol constitutes a good move for the reasons explained above. The elimination of excise on heating oil, however, once the ban on imports of petroleum products is lifted, may open an opportunity for a fraudulent presentation of diesel as heating oil to a larger number of excise payers, who would be proportionately more difficult to control than now, when only refineries are subject to control, bearing in mind that these are identical products, different only in color. This difference has actually been prescribed in an effort to exempt certain uses of diesel from excises and that is how, in fact, heating oil came into being as a separate petroleum product. From the standpoint of efficiency in the collection of excises, as well as for the purpose of achieving the objective of exempting heating oil from excise, it would be more appropriate to introduce the same excises for all types of diesel, including heating oil, while at the same time securing adequate budget resources for the procurement of necessary quantities of heating oil

for target groups of consumers financed out of the budget (hospitals, schools, army barracks and the like).

The introduction of the possibility to receive reimbursement, in other words a refund of the paid excise, for diesel used as propellant for tractors, building machines and cargo ships, was an effort to exempt from excise, as a production input cost, those producers who use the mentioned means. Considering that such efforts always create the need for a lot of administration in order to prevent the abuse of the facility (this time authorized distributors, general rules regarding consumption and the procedure for the exercise of the right have been prescribed), total budget losses (direct in the form of administration costs and indirect in the form of forgone revenue due to errors or corruption in administration) are normally larger than the sum of gains for the target groups. On top of it, the issue which is always raised is the issue of selection of target groups, hence one could rightfully ask why this time transportation by ship was accorded a better tax treatment than road transport, or why the construction industry was favored over, say, open pit mines. Therefore this excise policy measure cannot be considered appropriate.

The amendments to the Law on Excises have also eliminated the obligation to introduce fiscal duty stamps in 2005, and the obligation of calculating and paying excise has been, contrary to the initial idea of the quashed decree, postponed to the point of delivery of excisable goods from the excise warehouse. Bearing in mind that in 2005 the implementation of the combination of specific and *ad valorem* excises on cigarettes began, this change has imposed additional administrative costs for controlling the calculation of excise in the case of domestic producers. It is not very likely that the provision setting out that the Finance Minister shall issue licenses for dispatching products to the excise warehouse will improve the efficiency of control, but it is quite certain that it has increased the paperwork and costs of administration.

In the end, one can conclude that the future promotion of excise policy certainly implies the elimination of the remaining inefficient excises, such as excises on imported non-alcoholic beverages and coffee,<sup>8</sup> complete discontinuation of discrimination against imported goods in favor of the products with domestic origin<sup>9</sup>, elimination of reimbursement of excise for certain consumers and general improvement of administration of this tax form.

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<sup>8</sup>The revenue from excises on imported non-alcoholic beverages in 2004 accounted for 0.004 percent of total tax revenue, while excise on coffee accounted for 0.3 percent of total tax revenue.

<sup>9</sup>That could be achieved while completely eliminating excise on non-alcoholic products, by introducing excise which would be set in a specific amount according to the percentage of alcohol content per measurement unit, which is how excise on alcoholic beverages is defined in the EU countries now.

## **Taxation of corporate and personal income**

**Taxation of corporate income.** Unlike the new taxes on consumption which introduced major changes in taxation of consumption, no significant changes took place in the taxation of corporate income with the adoption of a new Law on the Corporate Income Tax in March 2001.

The definition of a resident taxpayer has remained the same, while the definition of a non-resident taxpayer has been slightly changed, in terms of an attempt which was made to more precisely define permanent establishment that the non-resident taxpayer has in Serbia, whose income constitutes the subject of taxation. Bearing in mind, however, that neither the previous Enterprise Law, nor the present Company Law, provide for an adequate legal form of the permanent establishment of a non-resident legal entity, the provisions of the Law on the Corporate Income Tax applying to the permanent establishment of a non-resident taxpayer have so far remained without any practical significance.

Taxable income as a tax base has been defined in an identical manner, as well as the adjustment of income for the purposes of assessing taxable income. Slightly changed are the provisions on the adjustment of expenses, in that revaluation expenses, grants for financing the reconstruction of the country, provisions for non-performing claims have been excluded from expenses, expenses for health, humanitarian, religious, environmental protection and athletic purposes are recognized as expenses in the amount of 3.5 percent instead of 3 percent of total income, expenses for investing in culture are recognized as expenses in the amount of up to 1 percent of total income, while the restriction on the recognition of expenses for promotion and advertising together with entertainment costs has remained unchanged, that is 3 percent of total income. In addition, in the case of banks, the required reserve in accordance with the Law on Banks has been recognized as an expense, while a positive result of revaluation has been included in the tax balance with one third.

The new law has ceased to differentiate between long-term and short-term capital gain and loss, hence the possibility to include in the taxable income just 50 percent of capital gain generated through the sale of assets which have been in the company's possession for more than 1 year no longer exists. The provisions on preventing thin capitalization have been made more specific, while the provisions on transfer prices and tax consolidation have remained the same.

The proportional tax rate of 20 percent has remained the same, as has the procedure for the assessment of tax liability by virtue of a decision of the Tax Administration on the basis of a tax return and a balance sheet submitted by the taxpayer.

As regards tax incentives, the new law defines their objectives in a somewhat different manner. In addition to the same commitment to boosting economic growth, employment and environmental protection, the new law explicitly refers to encouraging small enterprises and concessions, while investment of foreign capital has been excluded from tax incentives.

With the appropriate measure of eliminating discrimination between domestic and foreign investors, i.e. establishing equal tax treatment of investments irrespective of whether the origin of invested capital is domestic or foreign, it could be said that the new law has in effect narrowed the scope of tax incentives.

The right to accelerated depreciation, tax exemptions for non-profit organizations, concessions, enterprises for vocational training and employment of persons with disabilities, business units in underdeveloped areas, as well as a reduction in tax liability in case of new employment, have remained the same, while the previous exemption from the corporate income tax of newly established companies for a period of three years, or five years in the case of their establishment in underdeveloped areas, has been eliminated.

As regards tax incentives for investments, the new Law has limited the right to tax relief only to investments in fixed assets, reduced the amount by which the corporate income tax can be decreased from 100 percent to 10 percent of the investment made and kept the amount of maximum tax relief at 50 percent of the total liability, while granting the right to carry forward the unused amount of the tax credit for five subsequent years. A more favorable tax treatment of small enterprises is reflected in the right to tax relief of 40 percent of the amount of the investment made, with a ceiling which is 70 percent of the assessed liability in this case. The provision on the possibility to levy a flat-rate tax on small enterprises' income was rightfully left out of the new Law.

However, the amendments to the Law on the Corporate Income Tax of 2002 defined a new policy of taxing corporate income in Serbia. The primary objective of this policy was boosting economic activity, in particular investment and employment. The tax rate was cut from 20 percent to 14 percent, the previously existing tax incentives were increased, and some new ones were introduced. The amount by which the tax liability can be reduced

was increased from 10 percent to 20 percent of the value of the investment, i.e. from 40 percent to 100 percent of gross wages of the newly employed, while the period has been extended from five to ten years, in which the right to pay lower tax on account of an investment may be carried forward. A special tax incentive was formulated for the so-called large investment (an investment which is worth at least 600 million dinars). This incentive allows a reduction in the tax liability commensurate with the share of the investment value in total fixed assets of the company in a ten year period, starting from the first year in which the company made profit. Similarly, a special tax incentive was laid down for investing in the so-called areas of special interest to the Republic. In this case, provided that the investment is worth more than 6 million dinars, the tax liability will be reduced commensurate with the investment in a five year period, starting from the first year in which the company made profit.

Through these amendments to the law, Serbia obtained one of the lowest corporate income tax rates in Europe<sup>10</sup>. It has indubitably given Serbia a comparative advantage over the region, without undermining budget revenue, bearing in mind a relatively high rate of the taxes on consumption which account for the most significant part of tax revenue<sup>11</sup>. Additionally, the low tax rate, along with a simultaneous increase in costs of misrepresenting the actual tax base, which is a result of improved work of the tax administration, as well as of the setting of stricter lending criteria in the domestic banking system, constituted another incentive to accurately account for taxable income. As a result, revenue from this tax has significantly risen.

However, the question arises of the appropriateness of the mentioned tax incentives. This question, in addition to its principled dimension, also has a practical one.

On the one hand, the principle of neutrality of tax policy is based on the well-known theoretical finding that losses in efficiency due to the introduction of taxes basically come from their impact on relative prices, and thus on economic choices that individual economic agents are making. Therefore, a neutral tax policy, meaning the policy pursuant to which the size of the tax liability depends solely on the size of the tax base, which is defined in the same manner for all taxpayers, minimizes the losses in efficiency.

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<sup>10</sup>In 2002 in Republika Srpska the corporate income tax rate was lower and amounted to 10 percent, while in 2004, the corporate income tax rate in Montenegro was cut to 9 percent.

<sup>11</sup>The share of consumption taxes, the sales tax and excises, is more than one third of total public revenue and more than two thirds of total tax revenue, while the corporate income tax accounts for about 1 percent of total revenue, and about 2 percent of tax revenue.

On the other hand, empirical evidence shows that the connection between tax incentives and the desired developments or actions of economic agents who are the targets of the incentives is very weak or non-existent. If one adds to that the unavoidable increase in the administration costs caused by the need to check, i.e. prove, the fulfillment of the requirements for exercising the right to tax relief, it seems quite certain that tax incentives result in losses of tax revenue and increased administration costs, while failing to accomplish the objective for which these costs were incurred in the first place.

Such an outcome should not come as a surprise, if one takes into account that decisions on investing in the capital and/or labor production factor primarily depend on the projection of future economic developments and it is highly unlikely that they can be crucially influenced by a tax incentive which exists in the present, in particular because there is no certainty that it will exist in the future as well. A good argument to corroborate this statement is the fact that in the past three years there was not a single company which took advantage of the tax incentive for the large investment. Not a single company has availed itself of the tax incentive for investments into the areas of special interest to the Republic either, which, admittedly, can be explained by the fact that such areas have not been defined at all, hence it is not clear who could qualify for this incentive.

The amendments to the Law on the Corporate Income Tax of April 2003 provided for the harmonization of taxation of corporate income generated by banks and other financial organizations with the application of the International Accounting Standards (IAS), which for banks started in the mentioned year, hence that was a technical adjustment. Additionally, the procedures for the exercise of the right to tax credit in the case of a large investment or an investment in a region of special interest to the Republic have been simplified, i.e. the authority to control the fulfillment of requirements for exercising these rights was vested in the Tax Administration, while the issuance of a decision by the Government was dropped, since it would anyway be an unnecessary administrative step.

There are two basic groups of changes introduced by amendments to the Law on the Corporate Income Tax in 2004.

The first group may be positively assessed, regardless of certain technical shortcomings. These are the provisions dealing with the harmonization of the procedure for taxation of corporate income with the International Accounting Standards whose application was extended as of the said year to include

companies as well, with the related definition of the rules for calculating tax depreciation and, what could be the most significant positive change, with a switch to self-assessment as a method for establishing the level of the tax liability. In addition to a significant decrease in the administration costs, the switch to self-assessment means also a different division of responsibilities between the tax administration and taxpayers. The right to assess the tax liability was taken away from the Tax Administration and granted to the taxpayer. However, the responsibility for the accuracy of the assessed tax liability has also been shifted to the taxpayer, while the Tax Administration is entitled to check the mentioned accuracy at any point in time without being obliged to institute a renewal of the procedure, which was a necessary step when the corporate income tax was assessed by virtue of a decision of the Tax Administration. In addition to the administrative change in the method of tax collection, this change has additional significance in Serbian circumstances. It has, at least in this tax domain, fundamentally changed the attitude of the state to the individual: the proceeding point is the assumption that the individual is able to independently, conscientiously, responsibly and truthfully honor his obligations and bear full responsibility for his decisions.

The second group comprises changes related to a cut in the overall tax rate and additional tax incentives, which were introduced despite the already existing generous tax deductions.

Apart from delivering on election campaign promises on the reduction of the tax burden, where this reduction will be the least painful for the budget, it is difficult to find other reasons for the cut in the tax rate from 14 to 10 percent. The 14 percent rate is already extremely low in comparison with European tax systems, therefore no major broadening of the tax base can be expected as a response to the lowering of the rate to 10 percent. In addition, one could not expect this reduction to increase the attractiveness of investing in Serbia to both domestic and foreign investors, because the level of the tax rate of 14 percent cannot be considered an obstacle. An investment growth could be expected only as a result of confidence to be built into the stability of the overall economic and political system in Serbia. Among other things, it cannot be built through frequent changes in tax rates, even if these changes mean lowering tax rates.

Special tax incentives for certain economic activities introduced through these amendments, however, in addition to being demagogic, also constitute a step backward in the setting up of a good tax system. They glaringly breach

one of the fundamental principles of efficient tax policy, and that is its sectoral neutrality. Not to mention the questions which necessarily come to mind whenever government is trying to pursue any sort of sectoral policy. For instance, why would an investment in the production of textile yarn and fabrics be more important to the state than an investment in software development? In such circumstances, the choice of activities is always political, i.e. completely arbitrary from the economic viewpoint, because there are no positive economic criteria which would enable any sort of objective selection in the first place. Furthermore, whoever was involved in tax policy or tax administration, however little, is aware that providing more tax incentives to particular activities does not yield any results, except for increased administration costs and opportunities for abuse.

Discrimination in the exemption from double taxation of corporate income, first as corporate income and then as dividends, based on who receives the dividends, is not good either. The domestic taxpayer is exempted from the obligation to pay tax on dividends and shares in profits if he is paying them to residents that are not individuals. Non-residents and resident individuals are still taxed twice on this basis. The principle of equal conditions for doing business requires that the tax treatment of domestic and foreign investors should be the same. It means that if no withholding tax is paid on dividends and shares in profit of the company, which were realized by the founder – domestic company, this tax should not be paid on dividends and shares in profit of the company, which were realized by the foreign founder. The principle of taxation of corporate income in the tax jurisdiction in which the income was generated would not be undermined by such equal treatment, because both dividends and shares in profit are paid after taxation of income.

The maintenance of double taxation of corporate income in the case of owners individuals (under the Law on the Personal Income Tax, personal income from dividends is taxed at an effective rate of 10%), could be interpreted as an endeavor to encourage reinvestment. It is difficult to conceive that this measure can achieve the set objective. Since, at the end of the day, corporate income constitutes income of an individual, it is not going to be difficult for shareholders, i.e. owners who exert a significant influence on business decisions, to ensure a desired amount of income for themselves by using legal methods, i.e. through costs. On the other hand, double taxation of these incomes is objectively a disincentive for the development of stockholding and the financial market, where decisions by individuals to invest in securities which give the right to income from dividends are actually decisions on savings.

Still, the one provision of the Law whose nature remains by far the most problematic is the provision according to which the government is authorized to prescribe, in case a separate law has set out “public interest in encouraging the development of a certain activity”, additional incentives for “encouraging the development of that activity”. It gives rise to many questions as to the direction in which overall economic policy, and not just tax policy, will go and the manner in which it will be pursued. Does it mean that the government intends to propose a law which prescribes that a particular economic activity is of public interest in terms of boosting development? What would the contents of this law look like and in which manner would these activities be identified and who would identify them? In addition to tax incentives, are there any other incentives? One could infinitely go on with questions, but answers can hardly have any economic rationale.

Furthermore, it is also important to stress a major formal-legal shortcoming of this provision, under which the Parliament has delegated to the Government an authority which should not at all be vested in it as the executive branch. The government may not be authorized to prescribe tax incentives. It is the subject-matter which is governed exclusively by laws. The present arrangement gives the government discretionary power which does not belong to it, opens opportunities for corruption and pressures from different interest groups and introduces instability and uncertainty into the tax system of Serbia.

**Taxation of personal income.** The Law on the Personal Income Tax which was in force before the adoption of a new law in March 2001, was amended more than ten times, some of its provisions which resulted from these amendments were declared unconstitutional by virtue of decisions of the Federal Constitutional Court of March 2000 and the Serbian Constitutional Court of October 2002, either because they were not consistent with other laws or due to their unconstitutional retroactive effect. If nothing else, the passage of a new Law on the Personal Income Tax was welcome for the mentioned reasons.

Apart from elimination of obvious illogicalities in the old law, the new law has not introduced any major novelties from the standpoint of overall policy of personal income taxation. The most important change was the change in the tax base which the new Law defines as the gross amount of income. It means that, depending on the type of income, on which the level of the tax rate and the procedure for assessment and payment have remained to depend

in the same manner as in the old law, the tax rate is applied to the amount of gross personal income which, in addition to the net amount received by an individual, also comprises the tax and contributions for mandatory social insurance. This change, however, is just a formal change from the viewpoint of the one who carries the tax burden, and as such it does not alter his position.

Only in the case of wages a really significant change has occurred in the tax base, which now includes besides the take home wage all the cash benefits that the employee receives from the employer, meaning the hot meal allowances and vacation vouchers. After this change the wide-spread practice of redirecting take home wages into various forms of cash benefits for employees in order to avoid the total tax burden on labor, which had been really high before that, including not only taxes but also contributions for mandatory social insurance, no longer paid off. At the same time, measured in relation to the net wage, the total tax wedge has been reduced from around 105 percent to around 72 percent. Nevertheless, if one adds to this tax wedge also the wage bill tax, which was introduced in the same year for the purpose of securing a relatively generous tax revenue for local self-government units, and which was eliminated in 2004, taxes and contributions amounted to 77.2 percent of the net wage. These changes present a good example of the lowering of the tax rate while widening the tax base, and at the same time reducing the proportions of the distortions which exist in the taxation of personal income. However, if one excludes contributions for mandatory social insurance, that is, if the tax burden in its strict sense is observed, it has increased since the tax rate has remained the same, 14 percent, but what used to be non-taxable income is now included in the tax base.

The new law has maintained the taxation of personal income by type of income, as well as the definitions of different incomes and levels of tax rates. The tax rate on wages has remained 14 percent, and 20 percent on all other types of personal income: from agriculture and forestry, self-employment, copyrights and industrial property rights, capital, real estate, as well as on capital gains and the so-called other incomes. However, a change has occurred with respect to the level of standardized costs for some types of personal income. Bearing in mind the administrative complexness and limited use of the existing possibility to prove actual costs, this change has basically resulted in a change of their respective effective tax rates. In the case of incomes from rents and personal service contracts, the effective tax rate has gone up because standardized costs have been reduced from the former 35 percent to 20 percent, while on income

from dividends it has been cut, because tax deduction has been increased to 50 percent instead of the previous 10 percent of the paid dividend.

The progressive tax rate (10, 15 and 20 percent) on annual income of individuals has also been maintained, as was the method for assessing and paying this tax. The only special tax relief that was introduced relates to alien residents employed by domestic legal or natural persons and sets their annual non-taxable income at a level which is almost five times higher than the one for Serbian citizens. The purpose of this much more favorable tax position of alien residents is to a certain extent understandable. The threshold above which the tax is paid on annual income is relatively low because incomes in Serbia are low relative to the European average, and therefore all alien residents would become payers of this tax. Although it is true that Serbia needs foreign investors because of economic growth and not for the purpose of increasing the number of individual taxpayers, after taking into account the relatively low rate of the tax on annual income, this provision which discriminates taxpayers based on their nationality cannot be considered justified.

Through amendments to the Law on the Personal Income Tax of 2002 the tax rates on income from agriculture and forestry and from self-employment were reduced to 14 percent, concurrently with the cut in the corporate income tax rate. These amendments have also defined a tax exemption for severance payments to laid off redundant workers, and in this manner tax policy has made its contribution to the facilitation of enterprise restructuring. The progressive rate in the taxation of annual income has been repealed and replaced by the proportional one, set at 10 percent. In addition, a new category of income has been introduced, the so-called incomes of athletes and sporting experts, whose effective tax rate has been practically reduced from 16 percent to 10 percent by setting the level of standardized costs at 50 percent. This was an attempt to capture significant amounts of money from transactions in sports and include them into legal flows by reducing the tax burden. Although insignificant in terms of the relative amount (revenue from this source accounts for some 0.2 percent of the personal income tax), the fact remains that in 2003, 214.6 million euros from transactions in sports was covered by taxation on this basis, while in 2004 the amount was 242.3 million euros. These data corroborate the thesis that the tax base in Serbia is elastic to changes in tax rates, and that the low tax rate policy has been a good choice. It should, however, be applied to all types of income, and not only in the case of those taxpayers whose power to exert influence and ability to conceal the tax base is relatively high. Through such discrimination of taxpayers those compliant ones are punished and their

reluctance to pay taxes intensified, which can by no means be considered a desired outcome.

The Law on the Personal Income Tax was amended in 2004 as well. The tax rate on income from self-employment has been reduced to 10 percent, which constitutes harmonization with the change of the same kind in the corporate income tax rate. The position of entrepreneurs who maintain their business books according to the system of double entry bookkeeping has been equalized from the tax standpoint with that of enterprises, and those who opt for inclusion in the VAT are put under an obligation to maintain their books in this manner, irrespective of the volume of turnover or type of activity. Similarly, the tax treatment of entrepreneurs was also accorded to taxpayers who generate income from agriculture and forestry, if they are VAT payers or have opted for becoming VAT payers.

The number of effective tax rates in taxing income from copyrights and related rights, resulting from different amounts of standardized costs, has also been reduced by classifying all these incomes according to the level of standardized costs into three, instead of former five groups; the rights related to the copyright have been defined, and flat-rate taxation of income from performing pop and folk music has been eliminated. Income from interest on dinar term deposits has been exempted from taxation, which was the end of the taxation of interest on dinar savings deposits on the whole, since dinar demand-deposit savings had been exempted from taxation prior to that.

This ends the list of positive changes in the taxation of personal income which were brought about by amendments to the Law on the Personal Income Tax of 2004. Other changes are either obviously demagogic or unnecessarily create new distortions in the taxation of personal income.

The demagogic changes include introduction of a tax incentive for just one year, which is utterly unusual in tax policy. Namely, employers who in 2005 hire new workers on a full-time basis will be exempt from the payment of the payroll tax on the wages of their new employees. Not only that the probability is close to zero that this short-lived incentive will encourage employers to hire new workers, but it is also in complete contradiction, according to the manner in which it has been defined, with the concept of gross wage, introduced in early 2001. Namely, the payroll tax is an integral part of the gross wage, i.e. the taxpayer is the employee and not the employer. It implies that the benefit from this incentive should accrue to the newly employed worker, in the sense that he will receive the net wage which has been increased by the entire amount of

the tax from the payment of which he has been exempted. In such a manner, of course, labor costs for the employer would not be lowered, which seems to be the basic purpose of this incentive. This purpose, however, has been achieved in that the state authorized the employer, by virtue of a tax law, to appropriate something that is an integral part of the employee's wage. This is, to put it mildly, improper and one could even find arguments which point to the unconstitutionality of such provision. The fact that trade unions, which should be interested in defending the rights of employees, have not protested against this provision, probably indicates that in the minds of employees there still exists only the right to the net wage, while the tax they pay on it and mandatory social security contributions they perceive as an obligation of the employer, and not their own right and duty.

Recognition of higher standardized costs for income from rents, when lessees are travelers and tourists for whom the tourist tax has been paid, in the amount of 50 percent instead of the previous 20 percent, which has reduced the effective tax rate from 16 to 10 percent, could be interpreted as an incentive to the legalization of personal income from tourism and collection of the tourist tax. The effects of this incentive remain very uncertain. What is certain, though, is that a new distortion has been created, with an inevitable increase in costs of administration.

However, the tax exemption of interest on debt securities only if the issuer is government (the Republic, Autonomous Province or a self-government unit), or the National Bank of Serbia, constitutes a very bad discriminatory measure in the field of taxation of income from capital (dividends, interest, capital gains), which is problematic both from the standpoint of the concept of tax policy and from the standpoint of overall economic policy (encouraging saving, discouraging borrowing, developing the financial market, etc.)

First, the clear commitment to taxing consumption as the most important tax source is in obvious contradiction with any type of taxation of returns on savings, which in their economic essence constitute future consumption. Through the taxation of interest on money deposits and interest on debt securities, future spending is practically taxed twice, the first time as return on savings in the present, and the second time through taxes on consumption at the point of spending the savings in the future.

Second, it lowers relative prices and thus encourages spending in the present. It is certainly not the objective of the current economic policy bearing in mind the ongoing efforts to contain spending by households, both through

monetary policy measures aimed at discouraging borrowing and through wage controls in the public sector and administration.

Taxation of return on risky securities, that is dividends, in the countries with developed stockholding, i.e. this segment of the financial market, has the same effects as taxation of interest. In Serbia, where the largest number of shareholders have received shares for free through the process of privatization, possible return that they bring to such holders cannot really be considered returns on savings, bearing in mind that the very ownership of them was not created by investing in shares, which implies refraining from present consumption. However, by persistently taxing dividends, one persistently taxes this income twice, the first time as corporate income and the second time as personal income of an individual owner, and therefore the effective tax rate on this revenue, which amounts to 19 percent (10 percent of the tax on dividends, paid after taxation of income at a rate of 10 percent) is now among the highest rates at which personal incomes are taxed (the only higher rates are those of the tax on interest on foreign currency savings deposits, on capital gains, lottery prizes and on incomes from insurance against forgone earnings, which are 20 percent). From the perspective of overall economic policy, this perseverance discourages the development of stockholding and of the financial market as a whole, which is certainly in contradiction to the proclaimed objectives of economic policy, to say the least.

Similar questions can be raised also with respect to taxation of capital gains. Although the most recent amendments to the Law on the Personal Income Tax have provided for tax exemptions of incomes generated in transactions with rights, if the property rights have been acquired through inheritance or if transactions are performed among relatives in a direct line or between present or ex spouses, the manner of taxation of capital gains in the Serbian tax system remains problematic concept-wise. In addition to the questions raised with respect to taxation of returns on deposit savings and securities, in the case of taxation of capital gains the very selection of the taxpayer is problematic. From the tax standpoint the only justification for the taxation of this income may be found in the case where the purpose of the transaction with property rights is the income from that transaction, i.e. the situation in which an individual generates his personal income from this activity. A sign which could signal that this situation exists, though not completely reliable, is the fact that the property right which is the subject of the transaction has been in the ownership of the seller for a relatively short time. The conclusion that directly follows is that the taxation of capital gains would have to be limited to transactions with

property rights which an individual acquired in the previous relatively short period of time. Before the adoption of the new Law on the Personal Income Tax in 2001, such a provision existed, stipulating that there was no capital gain in those cases where property rights were in the portfolios of individuals for more than five years. This provision was without any justified reason replaced by a provision under which capital gain does not exist only in those cases where property rights were in the possession of an individual before 24 January 1994. Conceptually, this is not linked to tax policy, but has to do with the problems of denominating the purchase price in a currency which after hyperinflation in 1993 could no longer be used as a standard.

As for the tax exemption of interest on debt securities which depends on the issuer, in this specific case some direct questions can be raised. Firstly, it directly discriminates in favor of government and the NBS against all other issuers. Secondly, perceived from another angle, the present owners of these securities are generously rewarded. Bearing in mind that these are predominantly frozen foreign currency savings bonds, the question may be put whether the adoption of this tax incentive is a result of the influence of a potentially very powerful interest lobby in whose portfolio these bonds are concentrated through trading on the secondary market?

The amendments to the Law on the Personal Income Tax stipulate also that the income from agriculture and forestry will not be taxed in 2004 and 2005. This has just postponed the solving of the problem of taxation in this field, whose tax treatment, with the exception of adjustment to the introduced VAT, has remained completely the same as it was before tax reforms in 2001. From the administrative standpoint, this measure, provided that it is temporary, may be considered justified, bearing in mind that tax revenue is negligible, primarily due to decades of underestimating cadastre income as a base for taxation, and costs of assessing tax liability by virtue of a decision issued by the Tax Administration are probably higher, hence net tax revenue is in all likelihood negative. However, it would be very bad if this measure was just continuation of the practice to conduct a demagogic fiscal policy toward this politically important grouping of taxpayers, bearing in mind how numerous it is. In this manner, agricultural households pay extremely low taxes, which is unjust to other taxpayers and which at the same time slows down structural changes in agriculture.

On the whole, taxation of personal income and taxation of corporate income, which is ultimately nothing else but personal income as well, are

areas where the most significant distortions are concentrated. In the corporate income tax they are created by different levels of exemptions which depend on the size and activity of the taxpayer, as well as on the territory in which it invests. In the personal income tax, the source of distortions are different levels of effective tax rates depending on the source of income of an individual. Although taxation based on the type of income may be explained by the fact that the tax administration, for a number of reasons, still does not have high quality and comprehensive data on incomes of individuals, which means that it would be very difficult for it to measure and control the tax base for the taxation of the so-called global income of an individual, the existing differences in the tax burden on different sources of income and different taxpayers may not be justified by this administrative reason. The differences in the levels of effective tax rates and in the treatment of taxpayers in the case of the same base testify to the existence of a totally inconsistent system which was created as a result of different one-time changes and intentions, and without a comprehensive approach to taxation of personal income. The table below is the best illustration of the accuracy of the above observation.

Table 2. Effective tax rates on personal income

Effective tax rate	Personal income
20%	<ul style="list-style-type: none"> <li>- interest on foreign currency deposits</li> <li>- interest on debt securities not issued by government or the NBS</li> <li>- capital gains</li> <li>- lottery prizes</li> <li>- insurance premium for forgone earnings</li> </ul>
19%	- dividends
16%	<ul style="list-style-type: none"> <li>- rent when the lessees are not travelers or tourists for whom the tourist tax has been paid</li> <li>- incomes from personal service contracts and work on the side</li> <li>- remuneration to members of management and supervisory boards, members of the Parliament, bankruptcy trustees, court experts, lay assessors and sworn-in court interpreters</li> </ul>
14%	<ul style="list-style-type: none"> <li>- wages and other receipts arising from employment</li> <li>- income from agriculture and forestry</li> </ul>

Effective tax rate	Personal income
12%	<ul style="list-style-type: none"> <li>- income from copyrights and related rights, royalties for pop and folk music performances, production of phonograms, videos, broadcasts, databases</li> <li>- income from the sale of materials for recycling, forest plants and medicinal herbs</li> </ul>
10%	<ul style="list-style-type: none"> <li>- income from self-employment</li> <li>- income from copyrights and related rights for paintings and graphic works, works of applied art and architecture, scientific, technical and non-fiction works</li> <li>- rent when the lessees are travelers or tourists for whom the tourist tax has been paid</li> <li>- income of athletes and sporting experts</li> </ul>
8%	<ul style="list-style-type: none"> <li>- income from copyrights and related rights for sculptures, tapestries, artistic ceramics, fresco paintings made by application of special techniques, fashion designs and artistically processed textile</li> </ul>
0%	<ul style="list-style-type: none"> <li>- interest on dinar deposits</li> <li>- interest on debt securities issued by government or the NBS</li> </ul>

The wage bill tax was not a separate fiscal instrument in relation to the payroll tax, because the tax base was the same – the gross wage of the employee. Although the reason for the introduction of this tax can be understood, which is securing revenue for local self-governments, this tax had significant shortcomings both from the standpoint of tax policy and from the standpoint of overall economic policy. First, it was yet another source of distortions in the taxation of personal income, which created additional administrative costs for companies at that, since they were forced to calculate, separately account for and pay two types of taxes and three types of contributions on the same base. Second, this tax was further increasing the already high burden of labor taxes, made job creation more expensive and created incentives for avoiding formal employment. For these reasons, its elimination in March 2004 was a good decision, irrespective of negative reactions which it naturally caused with local self-governments.

Contributions for mandatory social insurance have very high relative importance in Serbia's public finance: contribution revenue accounts for more than one quarter of total public revenue, while expenditure for these purposes accounts for about two fifths of total public expenditure. Although, strictly

speaking, contributions for pension insurance, health insurance and insurance against unemployment should not be considered taxes, bearing in mind that by paying them the contributor acquires specific and defined rights, in Serbia, in terms of their character, they are rather a tax on personal income than insurance. The tax character is derived from their obligatoriness and, with the exception of pension insurance to a certain extent, from the absence of a link between the level of payments and scope of rights. Due to their importance to public finance and taking into account their now predominantly tax character, without any pretension to analyze the system of insurance as such, this part is devoted to discussing changes in the method of establishing the base and rates of contributions, hence to strictly fiscal issues.

Insurance against unemployment practically amounts to an earmarked tax paid by employees (as some kind of imposed solidarity), whose purpose is to finance different forms of assistance to those who have been laid off. The very obligatoriness of this contribution makes it a tax, and as long as it exists, the tax character of this contribution will not be changed, irrespective of its possible modifications.

In the case of health insurance, the situation is somewhat different. The contribution for health insurance could assume the character of insurance through appropriate changes, first and foremost through the establishment of a link between the level of payment and the scope of medical services to which the contributor-insured person becomes entitled, which it essentially does not possess now due to the absence of this link. These changes, however, would have to provide for an opportunity to opt for the level of the obligation for insurance, consequently to introduce elements of voluntariness in the entire system. In such a case, this contribution would preserve the character of an earmarked tax the revenue from which is used for financing medical services in the part in which a mandatory minimum rate of health insurance contribution would be prescribed, while in the part in which a choice would be free, it would assume the features of insurance. In the present circumstances, it has entirely the character of an earmarked tax.

The reform which was carried out in the first four years of transition in the domain of pension insurance enabled this contribution to have the largest number of insurance features. Considering that the replacement of the present pay-as-you-go system of financing pensions by a funded pension system requires the resources which are non-existent for the time being to finance the switch from one system to another, the changes made so far are beyond

doubt a maximum in terms of making progress against the backdrop of given limitations. This is also the only contribution where there is a link between the level of contribution payments and the level of pension benefits to which one is entitled, as well as a defined maximum annual base for the payment of contributions, in addition to the minimum one, while payments above that maximum give the right to a refund of the contributions paid in excess.

In order to understand the changes introduced by a new Law on Contributions adopted in 2004, it is necessary to make a short reference to the previous situation. Before the adoption of this Law, the insured person, the contributor and bases were set out in the laws governing the rights arising from insurance. The rates at which contributions are paid were not laid down in laws, but the power to set their levels was vested in relevant funds. These are four pension funds: for employees, for the self-employed, for farmers and the military pension fund; the Republican Health Insurance Fund and the National Employment Service.

So, the minimum bases for different categories of contributors were laid down in three laws, while the funds had an obligation to periodically prescribe their levels. The minimum bases were mutually harmonized between the Law on Pension Insurance and the Law on Employment and Insurance against Unemployment, which were amended in 2003, and they were defined as a percentage of the average wage earned in the Republic in the previous quarter. In the Law on Health Insurance, which was not amended on that occasion, the system of determination through coefficients remained, therefore in practice the amounts of minimum bases were harmonized among funds, but only in those cases where bases for insurance were the same.

Although the basic principles were the same for all three types of mandatory insurance, they were applied in practice in different manners, making the whole system extremely complicated both for the payment by contributors and for the control by the Tax Administration. There were as many as thirty five different bases and twenty different rates. For the basic, that is, predominant basis for insurance, employment, eight minimum bases were established, depending on professional qualifications. The assumption that bases for insurance in all the cases should be in a positive correlation with the level of education, in the same manner in all the activities and with all the employers at that, clearly was not realistic, nor should the base for insurance necessarily depend in this manner on the formal level of education.

Therefore, the adoption of the Law on Contributions for Mandatory Social Insurance constitutes major progress and a necessary step in the consolidation

of the area which, on the one hand, constitutes the largest individual item on the revenue side of Serbia's public finance, and on the other hand, one of the most sensitive items on its expenditure side. Generally speaking, the main improvements brought about by this Law are the elimination of the complicated system with eight minimum bases related to educational levels, the definition of all insured persons, i.e. contributors in one instead of three different laws, as was the case before, and the fact that mandatory contribution rates are laid down in a law, as it should be, and not in decisions of the funds.

The established levels of the contribution rates, however, contrary to the expected cut, resulted in an increase in the burden on wages of employees, i.e. a rise in the labor costs. Now the burden amounts to 35.8 percent on a cumulative basis, and relative to the previous 33.6 percent it is an increase of 2.2 percentage points. Generous promises from the 2003 election campaign that 2004 would see radical cuts in expenses for public dues which burden the wages have thus boiled down to the modest 1.3 percentage points, when one takes into account the elimination of the wage bill tax.

This outcome, however, does not come as a surprise, because even superficial knowledge of the subject matter of the social security system in Serbia would be enough to conclude that only a radical reform of the expenditure side, i.e. of the insurance system per se, can make possible a reduction in the fiscal burden on wages on this basis.

### **Taxation of property**

After the adoption of a new Law on Property Taxes in 2001, these taxes continued to cover a) the tax on property rights to real estate, shares and stakes, b) the tax on assignment of these property rights, as well as of the rights to industrial property, used cars and the permanent right to use city buildable land, and c) the tax on inheritance, i.e. gift of these rights, as well as on movable properties, money deposits and cash money inherited or received as a gift. The tax base in all the cases has remained the market value of the property right which is owned, i.e. which is the subject of the transaction. Definitions of the taxpayer, who is defined as the owner of the right, donee or inheritor, i.e. the seller of the established property rights, have also been maintained. The exemptions from taxation, as well as tax credits, concept-wise have also remained the same.

In cases where an immovable property is part of business assets of the taxpayer, the tax rate has remained 0.4 percent, while in the taxation of immovable properties whose owners do not maintain business books, a progressive tax rate has been introduced with the following scale: if the market value of an immovable property is up to 6 million dinars, the rate is 0.4 percent, if it ranges between 6 and 15 million dinars, the rate is 0.8 percent for amounts exceeding 6 million, if it ranges between 15 and 30 million, the rate is 1.5 percent on amounts exceeding 15 million, and if the market value of the immovable property has been appraised at more than 30 million dinars, the tax rate is 2 percent on the value exceeding the said amount. The new Law has preserved the already existing progressiveness in the taxation of inheritance and gifts, but has laid down a higher tax rate for inheritors and donees who are not related to the testator, i.e. donor, which rose from the previous 3 percent to 5 percent, reaching the same level as the tax rate on transfer of absolute rights (title) to real estate.

The tax on immovable property, as well as the tax on inheritance and gift, are consequently the only taxes in Serbia's tax system with progressive tax rates. Without the intention to get into a debate in principle about theoretical reasons, as well as about practical advantages and disadvantages of progressive taxation per se, as in the case of the concrete tax base, it does not appear that this progressiveness in Serbia has yielded any significant practical results. With the exception of the political message that the rich must shoulder a relatively higher tax burden, revenue effects of progressive taxation of real estate and inheritance and gifts are almost negligible. Since inheritance and gifts are by their nature a sporadic tax base from which no generous tax revenues can be expected, the most important reason for proportionately low revenue from the tax on real estate is the method used to determine the market value as a base for taxation.

Although the Law has prescribed that the tax base shall be the market value, the tax administration, in whose competence the assessment of tax liability falls, in following the rules prescribed by a bylaw issued by the Ministry of Finance, has been assessing the tax liability, as a rule, by heavily underestimating the tax base. The immediate proof of that is also the fact that the tax base for the transfer of title to real estate, also determined by the tax administration, is eight to ten times higher for the same immovable property.<sup>12</sup>

The reason for these instructions to the tax administration is not so difficult to understand, irrespective of whether it is justified or not. Namely, in Serbia,

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<sup>12</sup>See the study B. Begović *et al*, *Reform of the Tax System (2)*, CLDS, Beograd, 2004.

in the first years of transition preceded by decades of economic devastation, two hyperinflations, sanctions and war, as well as by the privatization of apartments previously socially owned, which were granted to employees by their companies in line with the then socialist self-management practice, who then became owners of those apartments on privileged terms after inflation had eaten up their value, the market value of immovable property could hardly be an indicator of wealth for the majority of the population. On the other hand, the fact that the number of citizens who are taxpayers, and who are in principle unaccustomed to paying taxes, is large makes the assessment of tax liability a politically sensitive issue. In addition, unorganized, incomplete and non-up-to-date records on ownership of real estate prevent full coverage of taxpayers, which additionally creates disgruntlement on the part of those who are paying this tax.

In light of all these problems, a policy which would produce higher revenue effects in taxation of ownership of immovables should aim at realistically evaluating the tax base and at ensuring full coverage of all taxpayers, and abandon progressiveness which in the present circumstances is just paying lip service. That would enable this tax to become a more significant pillar of the financing of the functions of local self-governments, whose revenue it is. This objective would have to be one of the priority objectives of tax policy in order to strengthen local finances and reduce their pressure on the central budget. Although in 2004 certain progress was made toward a more realistic evaluation of the tax base for the taxation of real estate, it cannot be considered sufficient, particularly because essentially it is not based on a system which would enable permanent and unbiased measuring of the tax base.

As for the taxation of ownership of shares and stakes, this tax base is in essence a legacy from the previous socialist system where private ownership of companies was not an indicator of wealth, but a socially unacceptable symbol. An analysis of its harmful consequences for the development of stockholding and the financial market, as well as from the standpoint of tax policy of improper multiple taxation which it caused, is almost identical to the one already discussed in the case of taxing income from capital. Therefore, it is good that this base for taxation was eliminated by amendments to the Law on Property Taxes in 2004.

The transfer of shares and stakes has, unfortunately, remained the subject of taxation even after the Law on Property Taxes has been amended in 2004. This tax only increases transaction costs of trading in securities, which are

substantial even without this tax, bearing in mind the regulation of trade in securities and the imposed obligation to trade through authorized brokers, who are charging not so insignificant commissions, and on the stock exchange. Based on amendments to the Law on Property Taxes, the Central Securities Registry is even under an obligation to automatically collect this tax and is authorized to charge the seller of shares a fee for that. Bearing in mind that the revenue from this tax both in 2003 and 2004 accounted for a mere 0.02 percent of total tax revenue, it is definitely not clear why one persists on the taxation of these transactions.

The amendments to the Law on Property Taxes have also introduced a new lower rate for taxing transfer of ownership of used cars and agricultural land, which is now 2.5 percent, while the rate of the tax on transfer of real estate has remained at 5 percent. This differentiation in tax rates can hardly be considered a reflection of a well-thought-out tax policy. It can be understood only as a compromise between a promise given earlier on, that the tax rate on transfer of ownership will be reduced from 5 percent to 2.5 percent, and the importance which the tax on transactions with immovable property has in financing budgets of local self-governments. A cut in the tax rate for transfer of real estate to 2.5 percent would have left local self-governments with halved revenue from this tax, and all that would have happened in the run-up to the introduction of the VAT, on account of which they were already faced with a loss of revenue from the sales tax, when the effects of the VAT introduction were uncertain, and local self-governments without too much confidence that the previous revenue from the sales tax would be compensated through transfers from the republican budget.

In principle, the taxation of capital transactions discourages trading in capital/assets, which is a source of inefficiency, and encourages further irrational resource allocation. Therefore, except in those cases where there are compelling fiscal reasons, such taxes should not exist at all. From the fiscal standpoint the only significant revenue, and only for local self-governments at that, is the revenue from the tax on transfer of real estate, which accounts for around 1.5 percent of total tax revenue, hence before its elimination a possible tax source should be identified, which would be compensation for the loss of this revenue. In all other cases the revenue from the tax on transfer of absolute rights is negligible, hence, there are no fiscal reasons for its existence whatsoever.

### **Specific tax forms**

**The tax on financial transactions** which in 2001 was created as a replacement for two levies that had existed before, the solidarity “fee” and the solidarity “contribution” on payment transactions, from a narrower tax standpoint certainly constituted an improvement because instead of two earmarked quasi taxes, a single tax was introduced as a budget revenue without a predetermined purpose, while the tax burden on payment transactions has not been increased. Its economic effect, however, was bad in many respects. Firstly, the price of using an already scarce and expensive input – capital was going up. Secondly, the performance of financial transactions through legal channels was discouraged in a situation where business operations carried out in cash and outside the legal payment system already constituted a big problem. Thirdly, the circulation of money was slowed down and costs were shifted to the entire legal economy at high speed. Additionally, in those days when payment operations were carried out through ZOP this tax could be regarded an efficient fiscal instrument, whose collection did not produce additional administrative costs to the tax administration. After the transfer of payment operations to commercial banks and after a cut in rates in late 2002 and numerous exemptions in 2003, this instrument became extremely complicated for administration which banks, rightfully, did not want to take over. The outcome was its fiscal inefficiency on top of everything. Therefore, the decision on its elimination, formally passed in the Parliament in 2004, was absolutely right.

The passage of the **Law on the Tax on Use, Possession and Carrying of Certain Goods** constituted a replacement for numerous levies introduced by virtue of decrees in the period before 2000, which, for the most part, were various extrabudgetary earmarked revenues. To the extent to which this Law has integrated the tax system, it can be considered an improvement of the tax system. The maintenance of tax forms, though, which can be understood in no other manner but as an attempt of the lawmaker to specially and additionally tax richer individuals by using selected indicators (proxies) in the absence of an information base and a method to progressively tax personal income in an efficient manner, definitely can not be considered justified.

The first problem with this tax is a difficulty to accept such method of estimating a base for taxation on principled grounds. The second problem is the selection of goods as such, whose use or possession is taxed. It is true that cars, mobile phones, boats and yachts, as well as arms to a certain extent, are

usually possessed and used by relatively rich citizens of Serbia. However, their number, after excluding owners of cars and mobile phones, is negligible and therefore revenue on all bases in 2002, 2003 and 2004 on average accounted for around 1.3 percent of total tax revenue.

A good illustration of the applied logic of taxation is a very instructive example of the charges for stay and mooring of boats, boat-restaurants, and other facilities for catering, entertainment and recreational purposes (vacation and excursions). These charges are paid on as many as three bases. Firstly, a charge is paid to the public water management company, which is one of the charges for water supply, although it is definitely unclear why and for which service exactly. Secondly, the Law on Local Self-Government has prescribed that the local self-government units may introduce utility fees in almost identical cases. Although this arrangement is not the best there is, this fee is at least part of public revenue of local self-governments. Consequently, some kind of local tax without a specified pre-defined purpose, admittedly with a fairly retrograde method for the selection of the tax base. Thirdly, the Law on the Tax on Use, Possession and Carrying of Goods also provides for the payment of a tax in similar situations, the revenue from which belongs to the budget of the Republic, hence the owners of these facilities are taxpayers of the Republic as well. And so, it turns out that the owners of these facilities are the most important taxpayers in Serbia, at least judging by the number of fees, charges and taxes they are paying.

This Law should by all means be repealed, thus eliminating from Serbia's tax system a conceptually unfounded and fiscally inefficient tax. Instead of being repealed as a whole, this Law was amended in 2004 in that the tax on mobile phones paid by post-paid subscribers, which, by the way, accounted for almost half of the revenue from this tax, was eliminated. Furthermore, the amounts paid by owners of cars have also been changed in that they have been reduced for all cars of up to 1600 cm<sup>3</sup>, and increased for cars of more than 2000 cm<sup>3</sup>, the tax on boats has been eliminated, but remained on vessels of other kind. By way of illustration, even when boats were taxed, tax revenue did not account for as much as 0.5 percent of the revenue from this tax (in an absolute amount, the revenue from the tax on boats, vessels and yachts amounted to 6.3 million dinars). Therefore, apart from political demagoguery, this tax has no reason whatsoever to exist.

In late 2004, almost unobtrusively, the tax system in Serbia got a rather unusual tax: **the tax on non-life assurance premiums**. This Law of 13 Articles has laid down as a base on which a tax is levied at a rate of 5 percent the

amount of the total insurance premium stipulated in a contract on non-life assurance transactions. The taxpayers under this Law are insurance companies. Exempt from the tax are: insurance against an accident, injury at work and occupational disease, voluntary health insurance, insurance of motor vehicles whose owners are persons with disabilities, insurance of residential and export loans, insurance of loans which households are repaying in installments and insurance of agricultural loans. These exemptions, under the circumstances prevailing in Serbia, are practically leaving only the insurance of immovable and movable property as a base.

With the exception of purely fiscal arguments, which are difficult to evaluate at this point, in the principles of tax policy or in tax practice of European states it is not possible to find arguments for this Law. It is obvious, though, that the logical shifting of this obligation to an insured person will further slow down the already very slow development of the insurance market in Serbia. Therefore, this Law should not have been adopted in the first place, and it would be advisable to rescind it as soon as possible.

The famous **Law on the Tax on Extra Profit**, whose full title is the Law on the One-off Tax on Extra Profit and Extra Property Gained through the Use of Special Privileges, from the standpoint of tax policy constitutes the largest and maybe the only total failure in the period of transition. This is not a tax law at all, but a political attempt to do justice *post festum* through retroactive taxation. The tax that should have been collected on the strength of this Law is not actually a tax, but a fine whose amount was supposed to depend on the extent of “special privileges” which individuals or companies enjoyed in the previous regime. This is the fundamental problem of this Law. A tax is not a fine, but a regular, statutorily defined, known in advance and certain duty of the citizens of a country, by whose fulfillment they contribute to the production of public goods and services they themselves use.

It was logical for an attempt to subsequently redress or punish injustice or undeserved political privileges by levying a special tax designed particularly for that purpose to get entangled in the issue of defining the tax base, on which, for all practical purposes, the selection of taxpayers directly depended. And the base could not be defined in a manner which would enable unambiguous and accurate assessment of tax liability, because there was no such tax liability to begin with at the time when “special privileges” were used, hence there are no relevant records. For that reason, most of the rulings were quashed in administrative disputes before the Supreme Court. An absurdity which is also

a logical consequence of reaching for a means inappropriate for the underlying intention is the fact that tax liability was assessed to socially owned companies which were neither able to pay it, being either in or on the verge of bankruptcy, nor had any real benefits as companies from “special privileges” that their managements could have at the time of the previous regime.

In the end, it is necessary to note that the rule of law in any democratic state implies that a penalty is pronounced in regular judicial proceedings and for a proven criminal offence or a petty offence. Hence, the issue whose resolution was attempted through the adoption of this Law should have been resolved in such a procedure, instead of involving the Ministry of Finance and Tax Administration into tasks which are not, and neither could nor should be, in their competence.

It remains to be seen when the Government and the Ministry of Finance will muster the courage and propose the rescinding of this Law, which is, in effect, nothing else but a demagogic, populist step from the first days after the toppling of the previous regime, and which was presented to the people as justice finally done. If for no other reason, then because of the fact that too much time has already been spent on establishing all possible bases prescribed by this Law, hence both its revenue-yielding and political uses have been exhausted.

Instead of investing efforts in such undertakings, Serbia desperately needs investing of efforts in establishment of permanent tax institutes and institutions and in building of administrative capacities, which will enable their consistent and comprehensive implementation.

### **Local public revenues**

Sources of financing of local self-government units are governed by the Law on Local Self-Government, adopted in early 2002. Guided by the commitment to initiating the process of fiscal decentralization, this Law has stipulated that the revenue from the tax on the wage bill, as well as revenues from rents should be ceded to municipalities and cities, in addition to the revenues which have already been ceded to them or which are shared with local budgets (property taxes, part of the sales tax and part of the payroll tax, and the total revenue from taxing other sources of income). It has also defined originally local revenues (the tourist tax, local utility fees, self-imposed

taxes), and provided for additional sharing of the revenue from some fees. The latter, however, was not harmonized with the laws introducing these fees, which have stayed unchanged, or with the Law on Public Revenue and Public Expenditure, which is a basic law stipulating to which level of government different public revenues should accrue. Upon eliminating the wage bill tax, and after introducing the value added tax, as a replacement for the revenue from the sales tax and the wage bill tax, the share of local self-government units in the payroll tax has been increased and transfers from the budget of the Republic established.

Local self-government units have become significantly more independent since 2002, particularly in the budget procedure, under which they autonomously decide on the size of their budgets, which was not the case before. The local public revenues per se, which are divided into shared and originally local revenues, however, have not undergone any major conceptual changes, except for the changes necessitated by the introduction of the VAT.

Shared public revenues of local self-governments, and these are relevant parts of revenues from taxes and fees for which the tax rate, or the amount of the obligation, is governed by laws, government acts or acts issued by line ministries, on average account for three quarters of current revenue of local self-governments. More than half of their original revenues, which comprise revenues from fees and charges for which the level of the obligation (a rate or an absolute amount) is established by the bodies of a local self-government, is yielded by the fee for using and the fee for developing buildable land, which are regulated by the Law on Planning and Construction, i.e. a non-tax law. As much as four fifths of the total originally local revenue is yielded by these two fees, two utility fees – for putting signs displaying names of firms and for possession of motor vehicles, as well as by the rent which local budgets collect from leasing out real estate.

Therefore one could say that the changes in Serbia's public finance policy have just opened issues concerning the method and sources of local self-government financing. Before addressing these issues, as a preliminary problem, the link has to be analyzed between the real economic power, i.e. the resulting fiscal capacity, and the scope of their competences. Only after settling this preliminary issue, one could more seriously proceed with selecting the measures for fiscal decentralization and its forms, as well as with defining the relations between local governments and the central government in whose competence, in the nature of things, the levers of fiscal policy have to remain.

In this selection it is necessary to bear in mind two following facts. First, the largest number of local self-governments in Serbia are fiscally unsustainable on their own. Second, the whole of Serbia is economically and territorially relatively small for establishing sustainable fiscal federalism and territories larger than the existing municipalities and cities without calling into question the effectiveness of the country's fiscal policy, and even the country itself in the political and territorial sense. Therefore, it is neither realistic, nor justified, to search for the solution to the problem of financing functions of local self-governments in the introduction of special local taxes with respect to which they would be independent in defining taxpayers, the tax base and rate.

Therefore, it seems that the most appropriate thing to do, instead of trying to invent and introduce some special originally local taxes which would be in the jurisdiction of local self-governments, is to invest efforts into formulating criteria and procedures which would be used to determine the level of transfers from the central budget to each of them. Now, after the introduction of the VAT, these transfers are practically the most important individual revenue of local self-governments. Also, it is possible to make those taxes from which the revenues already now fully accrue to local budgets more generous by introducing appropriate changes in their regulation (for example, by determining a real value of the tax base for the tax on immovable property)<sup>13</sup>, to grant partial autonomy to local self-governments in setting tax rates (for instance, by prescribing in a law a range within which the level of the tax rate may be set) and to enhance the coordination of operations between the Tax Administration and relevant bodies of local self-governments in controlling and collecting these taxes.

However, the manner in which original revenues of local self-governments are regulated now also deserves attention. Belonging to those with the largest number of tax features are local utility fees. In this domain, there practically has been no change relative to the previous period, because the section of the Law on Local Self-Government, adopted in 2002, which deals with local utility fees, is just a slightly changed relevant section of the Law on Utility Fees and Charges adopted in 1992, as amended in 2000.

Pursuant to the existing arrangements, a local self-government may introduce utility fees for using rights, objects and services. In principle, the payer of this fee is defined as the user of the rights, objects and services, for the use of which the payment of the said fee was prescribed. The day of the commencement of the use of the right, object or service, for the use of which

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<sup>13</sup> See B. Begović *et al*, *Reform of the Tax System (2)*, CLDS, Beograd, 2004.

the payment of the fee has been prescribed, is defined as the point in which the obligation to pay the fee is generated and this obligation will be in force for as long as the use of the right, object or service lasts. A local self-government is entitled to set different levels of the same fee, depending on the type of activity, area and technical characteristics of facilities, and on the parts of the territory, i.e. on the zones, in which facilities or objects are, or in which services are rendered for which fees are levied. Likewise, it has been prescribed which local utility fees are set in daily amounts, and which in annual amounts.

The issue of time limits and frequency in changing the levels of these fees is not regulated in any way, thus local self-governments can, in principle, keep changing the levels of these burdens all the time. Bearing in mind that these are fiscal obligations after all, this situation creates uncertainty among economic agents with respect to the amount of total costs for public dues. It also creates big problems for the Tax Administration in administering this type of public revenue, with an additional aggravating circumstance being the fact that local self-governments have differently defined the competences of the tax administration in the procedure for collection of these public dues.

A legal definition of the bases for the introduction of local utility fees is completely vague. Thus, for example, it is not clear on the use of which right, object or service the fee for displaying a sign with the name of the firm on the business premises is paid. Is it the right to publicly display the name of the firm? The question is then raised: How does one acquire this right? Is it acquired by the establishment of the company, i.e. registration of an entrepreneurial activity? The same or similar questions can be put with respect to any of these fees. A logical consequence is the variety which now exists among local self-governments in respect of the choice of the base, payers and levels of fees. A recent survey<sup>14</sup> has shown that there are, firstly, huge differences in the levels of the fee for the same base in different local self-governments; secondly, that local self-governments differently define payers of the same fee; thirdly, that differences in the incidence of fees in various local self-governments are very substantial; fourthly, that local self-governments are not able to project revenues from individual fees, which is the best indicator of how much uncertainty there is with respect to these fees; and, fifthly, that some local self-governments also introduce utility fees which are not laid down by law.

In principle, all presently existing local utility fees may be classified into three groups which concurrently point to the relevant changes in the regulation as well.

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<sup>14</sup> See B. Begović *et al*, *Reform of the Tax System (2)*, CLDS, Beograd, 2004.

A fee for displaying a sign with the company name on business premises is the only fee which essentially constitutes a local tax. Its characteristic is the payment obligation which is not related to the use of a public good or service, but the base for the payment of the fee is the business activity or assets of the payer. In the case of this fee, it would be necessary to establish in a law the base, the payer and a range within which local self-governments could independently set the rate, i.e. the amount of the obligation, as well as a procedure for assessment and collection, so that some certainty could be created as to the magnitude of this levy, which at the same time constitutes the cost of the payer. By way of illustration, the revenue from the collection of this fee, recalculated on the cumulative base of the corporate income tax and the personal income tax on the income from self-employment, gives an average tax rate of about 3 percent. The fact that the rates of the corporate income tax and of the tax on income from self-employment are now 10 percent corroborates the fact that this fee needs to be regulated in the above-described manner.

The second group comprises local utility fees for which the payment obligation is generated only if the payer uses a public good or service. The fees from this group should be eliminated as local utility fees, and the base for the collection of these revenues redefined into an adequate form. The adequate form, depending on the base for payment, may be rent, payment for a service in those cases where the service itself is clearly identified or the payment for a license for starting up and performing a particular economic activity.<sup>15</sup>

The third group is comprised of local utility fees which are simply unsustainable, and should be eliminated. This group covers all those fees for which no service is provided nor can it be provided, or for which identification of the base or payers requires inappropriately expensive administration, or those which introduce multiple taxation of a specific economic activity.<sup>16</sup>

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<sup>15</sup>This group includes fees for using public areas for business purposes, billboards, parking lots for parking road motor vehicles and trailers on regulated and marked places, free areas for camps, for the setting of tents or other forms of temporary use, for the use of the coast for business or any other purposes, showcases for displaying goods outside business premises, as well as for restaurants and other catering facilities on water, possession and use of vessels and other facilities on water, with the exception of quays used in border river traffic, boats and rafts on water, with the exception of boats used by the organizations which maintain and mark navigation routes and possession of gambling machines (jackpots).

<sup>16</sup>This group includes fees for: displaying and writing a sign with a company name outside business premises on facilities and areas which belong to the municipality (road surfaces, sidewalks, lawns, lampposts and the like), occupation of a public area with building material, organization of musical programs in restaurants and cafes, the keeping of pets or exotic animals, and the possession of motor road vehicles and trailers, with the exception of agricultural vehicles and machines. The revenue from the last one, which for local self-governments is not negligible, could be compensated

### **Building the tax administration**

In 2003, the implementation of the Law on the Tax Procedure and Tax Administration (LTPTA) commenced. That is also the year in which the Tax Administration, set up pursuant to this Law, simultaneously initiated two complex processes, the first one being the transformation of the tax administration itself, while the second one was the consistent implementation of material tax laws in accordance with a comprehensive procedural tax law adopted for the first time.

The transformation of the Tax Administration and full establishment of all the functions provided for by the LTPTA implied large-scale and far-reaching changes in all the domains of its operation. This transformation began in the circumstances in which the prevailing method for assessing tax liabilities was the issuance of decisions, without IT possibilities to automatically monitor compliance, without off-site controls, with almost exclusive reliance on on-site inspections in which the choice of taxpayers to be audited was mainly haphazard, and as often as not political, too, and which was carried out by the organizational part of the administration (financial police) which had almost no operational connections with other functional parts of the administration (Republican Public Revenue Agency) and against the backdrop of an almost confederation-like decentralized territorial organization.

One of the most important possible problems from the operational standpoint faced by the Tax Administration, which is a logical consequence of the previous situation and previous organization of the administration itself, is the absence of a centralized tax accounting. Centralized tax accounting should provide a comprehensive picture of the opening stock, current liability and payments of an individual taxpayer with respect to all his tax obligations. Non-updated and unreliable parts of this picture existed in territorial units, and when it comes to current debts for the sales tax, excises (excluding those collected at the customs) and withholding taxes and contributions, data were available on current liabilities and payments, but without opening stocks. In other words, on the basis of tax accounting itself it is still not possible to obtain a precise enough piece of information on the composition and level of debts of individual taxpayers, or on the composition and level of the total tax debt of registered taxpayers.

The Tax Administration made a huge step in 2003 toward setting up an information system necessary for efficient and impartial implementation

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by doubling the annual fee for road motor vehicles, whose level under the presently applicable regulations is set by the government, but the revenue belongs to local self-governments.

of tax laws. Before end-2003, a single registry of taxpayers was established, by assigning tax identification numbers to around 400,000 taxpayers legal entities and entrepreneurs. By assigning tax identification numbers and by introducing them into payment transactions through the mediation of banks and the NBY, a basis was created for the building of an integrated information system of the Tax Administration and automatic booking in tax accounting. Centralization of tax accounting was carried out for withholding taxes and sales taxes. In January 2004, for the first time all payers of incomes were under an obligation to submit to the Tax Administration tax returns containing data on all the payments to all individuals. In such a manner, the foundations were laid for the setting up of a database on incomes of citizens, and thus also of an adequate information basis for measuring this tax base, and a prerequisite was created for the application of the method of cross-assessment of the tax base. Parallel to all these processes, preparations for the implementation of the VAT were carried out, whose successfulness critically depends on the ability and efficiency of the Tax Administration.

Although the Serbian Tax Administration is still faced with many problems that it needs to solve, particularly in the building, development and use of IT capacities and a comprehensive and uniform system of procedures for implementation of tax laws, in a very short period of time it managed to create a solid basis for fast transformation into a modern tax administration. The basic precondition that has to be met in order for this transformation to be carried out in full is complete depoliticization of this institution, which implies that all the staff, and in particular the management, are selected exclusively on the basis of their professional knowledge and skills rather than on the basis of their party affiliation. This is a lesson which, unfortunately, party leaders in Serbia have yet to learn.

## PUBLIC EXPENDITURE POLICIES

**Public spending**

Data on consolidated<sup>17</sup> public spending in Serbia presented in table 3 bear witness to very limited leeway which budget decision-makers have in the given circumstances. At the same time, they also speak about the achievements of the policy pursued so far in this area, which, as it appears, has exhausted possibilities to accomplish, without truly radical cuts on the expenditure side, the stability and orderliness in the meeting of obligations on the one hand, and the modernization and efficiency of the operation of the public administration and a drop in the share of public spending in GDP, as a genuine indicator of a reduction in the tax and quasi tax burden, on the other hand.

Transfers to households in every year since 2001 have accounted for more than 40 percent of total expenditure. These transfers include expenditures of the social security funds and expenditures of the budget for these purposes, as well as for different types of social assistance. Expenditures for pension benefits account for more than two thirds of these expenditures.

Table 3. Consolidated public spending in Serbia  
(billions of dinars, current prices)

	2000		2001		2002		2003		2004	
Gross domestic product (GDP)	381.7		771.8		998.3		1198.1		1400.6	
Rate of retail price growth %			91.8		19,5		11,7		10,1	
Real GDP growth			5.5		3.8		2.7		7.2	
<b>Total expenditure and net lending</b>	<b>129.6</b>	<b>100.0</b>	<b>283.9</b>	<b>100.0</b>	<b>445.3</b>	<b>100.0</b>	<b>511.9</b>	<b>100.0</b>	<b>593.0</b>	<b>100.0</b>

<sup>17</sup> Consolidated public spending actually constitutes net expenditure. For example, expenditure for wages is just net wages, without contributions, which are the revenue of budgetary funds, and expenditures for goods and services do not include the sales tax which also constitutes budget revenue. For these reasons, the data in this table are not directly comparable with the data on public revenue in table x.

	2000		2001		2002		2003		2004	
Total expenditure and net lending % GDP	33.9		36.8		44.6		42.7		42.3	
Total expenditure and net lending, real growth			14.2		31.3		2.9		5.2	
<b>Current expenditure</b>	<b>118.6</b>	<b>91.5</b>	<b>266.7</b>	<b>94.0</b>	<b>407.8</b>	<b>91.6</b>	<b>476.5</b>	<b>93.1</b>	<b>555.1</b>	<b>93.6</b>
Expenditure for goods and services	61.6	47.6	123.4	43.5	172.3	38.7	201.7	39.4	237.6	40.1
Wages	33.4	<b>25.8</b>	65.4	<b>23.0</b>	95.3	<b>21.4</b>	113.2	<b>22.1</b>	132.9	<b>22.4</b>
Purchases of goods and services	28.2	21.8	58.0	20.4	77.0	17.3	88.6	17.3	104.6	17.6
Interest payment	2.2	1.7	5.6	2.0	8.8	2.0	11.3	2.2	17.7	3.0
Subsidies and other current transfers	54.8	42.3	137.7	48.5	226.7	50.9	257.2	50.2	290.5	49.0
Subsidies	7.1	5.5	23.1	8.1	42.6	9.6	40.9	8.0	43.1	7.3
Transfers to households	47.7	<b>36.8</b>	114.6	<b>40.4</b>	184.0	<b>41.3</b>	216.3	<b>42.3</b>	247.4	<b>41.7</b>
<b>Capital expenditure</b>	<b>11.0</b>	<b>8.5</b>	<b>10.8</b>	<b>3.8</b>	<b>33.4</b>	<b>7.5</b>	<b>27.9</b>	<b>5.5</b>	<b>36.0</b>	<b>6.1</b>
General reserves	0.0	0.0	0.0	0.0	1.8	0.4	0.0	0.0	0.0	0.0
Net lending	0.0	0.0	6.3	2.2	0.6	0.1	7.4	1.4	1.8	0.3
Net transfers from Montenegro	0.0	0.0	0.0	0.0	0.0	0.0	2.0	0.4	0.0	0.0
Budget balance	-0.8	-0.6	-7.4	-2.6	-42.6	-9.6	-34.9	-6.8	-0.3	-0.1
Foreign grants	0.1	0.1	3.4	1.2	9.6	2.2	1.9	0.4	0.9	0.1
<b>Budget balance</b>	<b>-0.7</b>		<b>-4.0</b>		<b>-33.0</b>		<b>-33.0</b>		<b>0.5</b>	

	2000		2001		2002		2003		2004	
Budget balance % GDP	-0.2		-0.5		-3.3		-2.8		0.0	
Financing	0.7	0.5	4.0	1.4	33.0	7.4	33.0	6.5	-0.5	-0.1
Domestic financing	0.7	0.5	4.0	1.4	-2.1	-0.5	-29.2	-5.7	-20.1	-3.4
Banking system	0.3	0.3	5.2	1.8	-2.1	-0.5	-17.5	-3.4	0.0	0.0
Non-bank	0.4	0.3	-1.2	-0.4	0.0	0.0	-11.7	-2.3	-20.1	-3.4
Foreign financing	0.0	0.0	0.0	0.0	17.2	3.9	12.9	2.5	12.3	2.1
Privatization receipts	0.0	0.0	0.0	0.0	17.9	4.0	49.3	9.6	7.2	1.2

Source: Serbian Ministry of Finance, IMF

More than half of the subsidies are in essence transfers to households. They include expenditures for the railroad company, which in this manner ensures funds for the wages of its employees, and subsidies to sixty-odd companies under restructuring, which also pay wages out of them. It turns out that almost half of total public spending is actually used to support, for different reasons, economically inactive population. When one adds to that the expenditures for salaries of civil servants, accounting for slightly more than one fifth of total public expenditures, foreign debt service and repayment of domestic public debt, it is clear that not much leeway is left in opting for public expenditure policies.

Additionally, the following facts should be taken into account.

Firstly, the share of public spending in gross domestic product has remained high, hence its reduction should be a logical objective of public finance policy.

Secondly, apart from the effects that the introduction of the VAT will have in 2005, in the coming years public revenue cannot be expected to grow much faster than GDP. It turns out that a leap in public spending typical of 2001 and 2002 cannot be repeated.

Thirdly, in the coming years, repayments of both domestic and foreign sovereign debt will increase. Namely, Serbia is yet to make repayments of its

debts to the Paris Club (a debt amounting to around 2.5 billion), the London Club (a debt amounting to around US\$1 billion), and the World Bank (a debt amounting to US\$2.1 billion); out of the total value of issued frozen foreign currency savings bonds amounting to around 4.2 billion euros a mere 15 percent has been paid out, another 56 million euros has been included into the domestic regulated public debt arising from the loan for economic recovery, while a debt to households, mainly to the social security funds, in the amount of around 55 billion dinars, has not yet been regulated, and the same applies to the 20 billion dinars of debt to enterprises, i.e. to suppliers of the budget.

On the basis of the above facts, a conclusion inevitably follows that further reduction of the share of public spending in GDP and changes in its composition fall beyond the realm of real power of public finance policies to exert influence. An absolute precondition for the accomplishment of these objectives is the political will to undertake radical reform, primarily of the social security system and public administration, as well as to accelerate the transition of the real sector of the economy. Only then one can expect to see in the government coffers substantially more resources than what is needed to cover the costs of the public administration, transfers to the social security funds and debt repayment.

It also means that, in the existing situation, all the statements about strengthening the so-called development component of the budget are just wishful thinking or political demagogy. However, it does not mean that such statements should be disregarded. If the development component implies so sorely needed modernization of the operation of government services, necessary for efficient and proper provision of public services, and investment in infrastructure, it will certainly be very welcome. If the development component is a screen for government interventionism, which means using tax revenue to arbitrarily reduce operating costs of the selected champions of economic development, as a rule through various funds, it can be a threat to the stability of public finances, built with so much effort and still fragile. And this is not all. Such steps would be in direct contradiction to the fundamental assumption of sustainable economic growth – which is growth in the efficiency of operation of domestic companies.

### **Regulation and establishment of the budget system**

The establishment of a comprehensive system of public spending started with the adoption of the Budget System Law. This Law constitutes one of the most important system-related laws, which completely reforms the budget system and governs the management of public finances in the entire country. Under this Law, Serbia's budget system consists of the central budget, budgets of local self-government units and financial plans of the organizations for mandatory social insurance (Republican Fund for Pension and Disability Insurance of Employees, Republican Fund for Pension and Disability Insurance of the Self-employed, Republican Fund for Pension and Disability Insurance of Farmers, Republican Fund for Health Insurance and National Employment Service).

The primary objective in passing this Law was to establish uniform procedures for adoption and execution of the budgets. Consequently, it regulates in a uniform manner for all levels of government, the Republic, Autonomous Province of Vojvodina and local self-government units, as well as for the organizations for mandatory social insurance, the planning, preparation, adoption and execution of budgets and time limits for individual stages of the budget process, budget accounting and reporting, borrowing, issuance of guarantees and debt management, as well as control and audit of the budget, budget beneficiaries and enterprises in which the Republic or local self-governments have direct or indirect control.

With respect to institutions, the most important novelty introduced by this Law is the setting up of a treasury whose main functions are: direct execution of the budget, cash management, debt management and budget accounting and reporting. The Treasury of the Republic was established immediately after the adoption of the Law, while local self-governments were obliged to set up their respective treasuries before January 2004, after which date they also have the statutory obligation to apply the treasury system in the execution of their budgets.

The most important technical change brought about by the Law is the setting up of a treasury single account. The treasury single account constitutes one or more accounts into which budget receipts are paid, in which they are deposited and from which budget expenditures are paid. A set of treasury single accounts of all the treasuries in the Republic constitutes a system of treasury single accounts.

This Law has also established the Public Payment Agency, entrusted with the task of administering treasury accounts, performing payment transactions on behalf of budget beneficiaries, recording and distributing public revenues to appropriate levels of government to which they belong, and executing and recording expenditures of the budgets at all levels of government (Republic, local self-governments). The Public Payment Agency has inherited the infrastructure and around one thousand two hundred employees of the former ZOP.

On the whole, this Law is a major step and a good basis for further development of the system for managing Serbia's public finance, as it sets the rules and defines the institutions, instruments and information necessary for an effective conduct of public expenditure policies.

Besides certain technical deficiencies, first and foremost the vagueness of certain terms, of which one could not say that they vitally affect the above assessment, this Law contains certain provisions which need to be amended, however, in order to ensure smooth development of the public finance system. An acute problem is posed by the scope of competences that the law has vested in the Public Payment Agency, which will be discussed in more detail below.

At the very beginning, the Republican Treasury faced challenges in the restructuring of the payment system of the country; preparation and introduction of the general ledger and a system for budget execution. Major successes include automation of budget execution, electronic control of its execution and cash management planning through appropriations and quotas. The established system enabled daily monitoring of budget execution, so that the information is available at any point in time on how much resources have been transferred, to which beneficiary and when. In this manner, the quality of control that the government and the National Assembly have over the execution of the Republic's budget has been significantly improved.

One of the major successes of the establishment of the budget system, or to be more specific, of the setting up of the Treasury of the Republic, was the consolidation and control of government deposits in commercial banks. In January 2003, the treasury single account showed 11 billion dinars of surplus cash sitting in the accounts of budget beneficiaries. As a rule, these resources were deposited in non-interest bearing accounts with banks. In order to preserve the stability of the banking system, which could be threatened by a sudden withdrawal of these funds, the Treasury first prepared and concluded contracts on deposits with commercial banks, stipulating an interest rate at

the level of 1/3 of the discount rate. In this manner, more than 300 million dinars of budget revenue was generated over a period of six months. Before the end of 2003, all deposits of beneficiaries of the central budget were transferred to the NBS. It was accomplished without undermining the liquidity of the banking system or financial security of the budget beneficiaries. That is how an absurdity was finally ended that the Republic was running a budget deficit, while users of budget resources had surpluses.

In early 2004, a similar effect was produced by the obligation on the part of local self-government units to set up treasuries. Through the consolidation of the accounts of their budget beneficiaries, they have obtained an efficient instrument for cash management, and the interest rate on deposits with banks at a minimum has to be equal to the interest rate given by the NBS on the available resources on the treasury single account of the Republic.

A remarkable success is also the fact that the Republic of Serbia, on 15 April 2003, for the first time since the Second World War, financed the budget deficit on the domestic capital market, by using contemporary debt instruments. Since that date, the Treasury has regularly held auctions, and it raised over two billion dinars from domestic sources of financing until end-2003. The financing of the budget by market instruments has laid the necessary foundations for credit growth, and created benchmarks for investment. The level of the interest rate at which Treasury borrowed, amounting to around 20 percent a year on average, which corresponds to the adjusted foreign exchange interest rate, i.e. the price of frozen foreign currency savings bonds denominated in euros, however, testifies to the still high risks attached to investing in government securities.

One of the most important ultimate goals of the establishment of the Treasury is centralized payment directly from accounts of the budgets at relevant levels of government for the execution of functions or for budgeted expenditures of budget beneficiaries. It means that budget beneficiaries do not make payments themselves, hence they have no need to have any accounts or perform any payment operations. Instead, the relevant treasury, upon their order and in keeping with the budget, effects all the payments.

Yet, the accomplishment of this final goal of the establishment of the treasury implies extremely well developed IT and administrative capacities of the treasury, which were non-existent at the time when the Budget System Law was adopted, and which require several years of preparation and development of capacities. That was one of the reasons why in the Budget System Law the

lawmaker resorted to a transitional arrangement according to which all budget beneficiaries have been defined as direct or indirect.

However, on the basis of the definition of direct and indirect budget beneficiaries as such, on the basis of the statutory obligation to quarterly publish a list of direct and indirect budget beneficiaries, and particularly on the basis of the list itself, it is obvious that the above mentioned technical reason for the transitional arrangement was not the only reason, neither was it the most important one, as it seems.

As direct budget beneficiaries, the Law defines agencies and organizations of the Republic and local authorities, while the group of indirect budget beneficiaries, as defined by the Law, is very heterogeneous and includes judicial bodies, institutions founded by the Republic, i.e. the local authorities, run and managed by the founder, in conformity with the Law and through direct users of budget resources.

The list of budget beneficiaries includes even some theaters, museums, cultural and artistic clubs, state owned pharmacies, rehabilitation centers, some soccer clubs, Institute for Nuclear Sciences Vinča, Institute Torlak and the like.

The very idea that the list of budget beneficiaries should be refreshed and quarterly published in the Official Gazette shows that a good portion of these budget beneficiaries does not really have any connection with the budget. Otherwise, any refreshment of the list would require a corresponding revision of the budget adopted by a relevant assembly.

It is obvious that in anticipation of the abolishment of ZOP and transfer of payment operations to banks, one of the most important probable motives was to maintain a centralized insight into the revenues and expenditures of different entities established by the state at some point in time, irrespective of the nature of their functions as such. In order to ensure this insight all budget beneficiaries were put under a statutory obligation to open their accounts with the Public Payment Agency.

This is how a big confusion was created as to what is the real function of the Public Payment Agency, with which more than 23,000 accounts were opened for the operation of around 10,000 beneficiaries. Thus, instead of devoting its efforts to the development of administrative capacities for the execution of the budgets of the Republic and local self-governments, the Public Payment Agency has remained a mini ZOP.

Therefore, for the accomplishment of the main objective of the establishment of the treasury it is necessary to redefine the notion of budget beneficiary and remove from this group all the entities which are not part of the government apparatus, that is, which perform activities of such a nature that they generate revenue on the market by rendering services or producing and selling goods. It does not mean that the government cannot be a buyer of these services or goods, or that it cannot regulate the activities and obligations of these entities by virtue of a law, but this, however, does not make them budget beneficiaries. In addition to the damage inflicted by the confusion they create in the budget system, as well as by maintaining unneeded functions of the Public Payment Agency, such a position is detrimental also to these entities, because as budget beneficiaries they are obliged to have budget accounting of the type appropriate for budget institutions and not for operations on the market.

Another big confusion was created when payment operations were transferred from ZOP to banks, and it is related to the definition of the method for making payments of public revenue. Namely, with the intention to apply the GFS (government fiscal statistics) classification to public revenues, despite the fact that in essence it has nothing to do with the pay-in account for public revenues, a very complex procedure has been defined for identification of the type of public revenue and a municipality to which the revenue may belong. Practically every fiscal instrument has its own pay-in account, and the burden of administering analytical data on public revenues has been unnecessarily shifted to the taxpayer, whereas it should be an obligation of the state and not of the taxpayer. Since the Public Payment Agency is also in charge of recording public revenues, more than 57,000 pay-in accounts for public revenues have been “opened” with it, of which 720 are the so-called synthetic ones (for the same number of public revenues), and others are analytical, for the needs of municipalities, cities, autonomous provinces, the Republic and organizations for mandatory social insurance.

In this arrangement, almost everything is wrong. The fact that each type of public revenue has its own pay-in account and the fact that these accounts are administered by the Public Payment Agency alike.

The existing rules for performing payment operations also enable the creation of an individualized order, or an individualized part of a payment order, which could be used for paying taxes and other public dues. Through a rational distribution of elements that it needs to contain, the existence of only

one account for public revenue would be made possible, while concurrently recording the payer, the type of public revenue and the level of government to which it belongs (the Republic or a self-government unit). This would simplify and facilitate the administration both to taxpayers (who now have to calculate their pay-in accounts by applying special methods), and to the Tax Administration, which should take over the responsibility of recording public revenues.

Namely, it is totally illogical for the Public Payment Agency, which does not have any competences in the tax procedure, nor does it maintain tax accounting, to record and distribute public revenues according to the level to which they should accrue. This is even clearer when one takes into account that only net tax revenue is available for expenditures, i.e. that only net tax revenue goes into a relevant budget, meaning the revenue left after refunds on the basis of decisions, or on the basis of tax returns in the case of the VAT.

It is completely natural for the public revenue account to be administered by the Tax Administration, which would also be in charge of distributing public revenues to relevant budgets, since it is already responsible for the refunds of public dues which were paid in excess or by mistake. At the same time, it would enable automatic, electronic booking in tax accounting maintained by the Tax Administration on an individual basis for each taxpayer. Not only that such an arrangement is normal in public finances of other countries, but there is also good experience of the Large Taxpayers Unit, which keeps records of the payments of large taxpayers, bearing witness to the ability of the Tax Administration to take over this task.

It means that for the establishment of efficient and appropriate administrative support to public finance management in Serbia such an organizational set up should be established, in which the Tax Administration would be responsible for the control and recording of payments of public revenues and tax accounting, while the PPA would be in charge of payments of public expenditures upon the order of a relevant treasury, budget accounting and reporting. The only appropriate role that the PPA can play in the future is to perform these duties for the republican and 165 local treasuries. In such an organizational setup, the Serbian Treasury, as well as local treasuries, will be able, in accordance with their competences, to concentrate on cash and debt management, on regular planning of budget expenditure execution, as well as on efficient investment of temporary surpluses of cash money on the financial market. Without waiting for the necessary amendment of the Law, one can

apply some of these solutions immediately, by making slight adjustments (such as the method for payment of public revenues and transfer of competences in this domain to the Tax Administration), while others require more time and sizeable funds for the development of IT and administrative capacities (such as full automation of all the payments out of the budget and establishment of adequate IT support to local treasuries). However, they have to be implemented in order to finally put in place an efficiently rounded-off organizational setup of Serbia's public finance.

Unfortunately, it does not seem that current decision-makers in the domain of public finance have these issues in sight. On the contrary, the role of the Public Payment Agency is being continuously expanded to the domains in which there are neither conceptual nor administrative reasons for it to have any role at all, such as keeping records of pension insurance bonds or registration of farmers who are receiving subsidies. In this manner, the Public Payment Agency is for no obvious reason moving further away from the only justified purpose it can have in the public finance system in Serbia.

## CONCLUSION

In order to make a comprehensive assessment of the successfulness of any change, thus of the changes carried out in the first four years of transition in Serbia's public finance, a comparison should be made of what has been accomplished with two reference points. The first one is the inherited situation, and the second one is the targeted situation, i.e. the situation that was or should have been the intended result of the undertaken measures.

In order to make that possible, it is necessary to recall the features of the system of public finance that the economic theory considers desirable, which, for the sake of simplicity, will be grouped in this discussion into four basic virtues.

The first one is efficiency. It implies a minimization of the influence of tax policy on relative prices, i.e. on taking economic decisions, in particular decisions on resource allocation. Practical instructions offered by the theory in this domain are for tax policymakers to refrain from creating distortions. They are created by introducing different tax rates for, in terms of its economic nature, an equal tax base, or, what can amount to the same thing, by

providing tax incentives which are envisaged by the economic policymakers to encourage taxpayers to act in a desirable manner, instead of letting market criteria influence their behavior. This virtue implies also prudence in defining the proportions of redistribution which is in the domain of public expenditure policy. It also requires a careful selection of target groups to be granted subsidies. The reasons are the same as those cited for tax policy. A minimization of influence on individuals' decisions, who can choose in such a case to direct their efforts toward creating conditions for receiving subsidies, rather than toward productive economic activities through which they would actually generate revenue.

The second one is simplicity. It recalls that for any revenue, including tax revenue, it is necessary to bear certain costs. In the case of collecting taxes, direct and indirect costs are incurred. Direct costs are those created by the existence and operation of the Tax Administration, and indirect ones are those incurred by taxpayers in performing their tax duties, which are, in terms of their economic essence, transaction costs. The simplicity of a tax system minimizes both direct and indirect costs, and increases net tax revenue.

The third one is clarity. It is predominantly related to public expenditure policies and requires that taxpayers are familiar with the purpose and use of taxes they paid. In other words, the public must be familiar with public expenditure policy, at least with its global indicators, and the budget process must evolve under well-known and clear procedures and within defined time limits. Once the annual budget is adopted, discretion in using public revenues has to be minimal.

The fourth one is fairness. It requires, in very simple terms, that equal individuals should pay equal amounts of tax. This is a very important principle, because in addition to the ethical one, it also has a very substantial practical significance. Namely, if taxpayers notice that there are large differences among them in the shouldering of the tax burden, be it on account of tax laws as such or on account of inefficiency or bias of the Tax Administration, they will lose a never too strong desire to voluntarily pay their tax liabilities. In a situation in which the tax system is discarded as unjust by the majority of taxpayers, it is very difficult and administratively very expensive to secure that it is implemented.

When one compares the features of the inherited situation and of the situation in which Serbia's public finance currently is, with the above virtues, major progress achieved in the past four years of transition is obvious. An

apparent success is the consolidation and stabilization of the revenue side of public finance. A big step was also made in the building of the system of public finance which would possess the above-described virtues. However, a lot still remains to be done. The text below provides a brief overview of the most important achievements and the most significant changes which should be carried out.

From the standpoint of efficiency, the most important breakthroughs have been made in the field of taxing consumption, first through the consolidation of the sales tax, and then through the introduction of the VAT. When it comes to the VAT, the greatest challenge is now before the administration, which should as soon as possible adapt its knowledge to its demands, where the most critical aspect is the lack of preparedness of the Customs Administration for administering this complex tax form.

Relative to the initial situation regarding the efficiency criterion, a similar thing can be noted also with respect to excise policy. Relative to the targeted situation required by this principle, however, it is further away than the VAT. The first thing that needs to be done is to eliminate discrimination which now exists between domestic and imported excisable goods. At the same time, for the sake of both efficiency and simplicity, it is vital to eliminate revenue inefficient bases for excises.

Bearing in mind that in the previous period tax policy obviously chose the taxation of consumption as the principal source of revenue, low tax rates on corporate and personal income are, from the standpoint of the efficiency principle, a good choice. In order to eliminate the existing distortions, it is necessary, however, to bring the effective tax rates on personal income to the same level, regardless of the source of income, and eliminate the taxation of income from capital, bearing in mind that it basically means taxation of future consumption in the present. It is particularly important to eliminate if not all, then certainly sectoral and regional incentives in taxation of corporate income. These changes would, at the same time, further simplify the entire tax system.

However, as usual, the fairness criterion is here in contradiction with the efficiency criterion. On the one hand, individuals do not have equal incomes, i.e. they face different budget constraints in spending. On the other hand, the consumption of basic necessities is equal. It follows that unequal individuals shoulder an equal tax burden, in that the poorer ones spend most of their income, if not all, on these goods, while those richer ones have more choices, including investment and saving. Bearing in mind the present

revenue (non)generosity of different bases for taxation of income from capital or taxation of property, in which progressive tax rates are also applied, as well as the objective underdevelopment of relevant markets, which prevents them from generating at this point in time potentially significant individual or tax revenue, and insufficient administrative and IT capacities of the Tax Administration to meet the challenges of progressive taxation of income, it seems that it is more important now to observe the efficiency principle.

In the current circumstances, fairness has to be achieved through efforts to ensure full coverage of all taxpayers and their equal treatment in conformity with the law. From this standpoint, as one of the greatest successes of the policy so far, the adoption and implementation of the procedural tax law has to be underscored, which clearly and comprehensively sets out rights and duties of both taxpayers and tax officials. The biggest challenge in this domain is the continuation of the consistent implementation of this Law, full depoliticization of the Tax Administration and development of IT and other capacities of this, in any country, the most important executive institution.

From the standpoint of clarity, the greatest success is the adoption and implementation of the law which governs the budget system. The implementation of this Law has established a clear budget procedure, the same for all levels of government, and made data on types of expenditures and beneficiaries of the central budget available on a daily basis. What remains to be done is to do the same thing for each local self-government unit, as well as to achieve the ultimate goal of the establishment of the treasury – automatic payment on behalf of budget beneficiaries, as they should have no discretionary authority in the process of making payments as such, after the adoption of the budget.

A large field which will be one of the greatest challenges in the further transformation of public finance in Serbia is the field of local public finances, where the revenue domain has yet to see a comprehensive regulation. Likewise, it is necessary to do a lot more on enhancing the simplicity of the tax system in which there still exist more than one hundred different fiscal instruments and many more individual fiscal forms administered by the Tax Administration.

Finally, a real reform of public expenditure policy is yet to happen. It implies, first and foremost, making a definite break with subsidies to enterprises, reform of the social security system and genuine restructuring of public enterprises. Obviously, these are all measures which can hardly be called popular, and which, at the end of the day, have been postponed particularly

for that reason. The time has come, however, when they can no longer be postponed. And just as public finance policy successfully consolidated the revenue side in the previous period, and thus enabled the orderly execution of the expenditure side of the budget, cushioning in this manner a significant portion of the problems which normally arise when structural policies are implemented in transition, in that same manner acceleration of privatization, implementation of the bankruptcy law and other structural policies, have to enable public finance to reduce the pressure which public spending exerts on the economy and macroeconomic equilibrium as a whole.



Boško Mijatović

## Privatization of the Real Sector

### INTRODUCTION

The fact that social and state ownership are less favorable than private ownership need not be proved in Serbia. This is quite obvious. For that reason, privatization was adopted by the government, at least formally, already in 1989-1990 and since then has become part and parcel of transition instruments, used with more or less success.

The short and fairly sad history of privatization until 1997 is as follows. The first wave was initiated by the federal government of Prime Minister Ante Marković in 1989, with the adjustment in 1990. The privatization method was capital increase, with discounts related to socially-owned capital, believing that even such partial privatization of capital in the company would lead to an increase in management efficiency. Privatization was not obligatory, but was stimulated by the provision that the employee wage growth could be paid only in shares. During the reform year 1990 privatization was widespread (1,200 companies moved to the status of mixed-ownership companies), partially due to technical weaknesses in the model implementation and possibilities of abuse.

In order to improve the model, in 1991 Serbia adopted its own law on “ownership transformation” which to a significant extent stalled privatization precisely by making the procedures more strict and removing loopholes from regulations. A significant slowdown in privatization was also contributed to by the war in the area of the former Yugoslavia.

An unexpected impetus to privatization came in 1993 with high inflation which devalued the debt from the purchase of shares in installments. At the end of 1993, at the time of hyperinflation, by using the non-existence of the provision on debt revaluation due to inflation, a large number of companies

were fully privatized. After the price stabilization in early 1994, a question arose whether to do anything with these inflation gains and if so, what. In the race between SPS and DS for the grand moralistic role, DS won and at its initiative, which was admittedly supported by the ruling party, the revaluation law was adopted, annulling the inflation gains of citizens, and privatization was significantly pushed back.

The annulment of conducted privatizations based on revaluation presented a severe blow to the privatization idea in Serbia, because it demonstrated that the political power could, at its will, amend the law retroactively and annul privatizations conducted in accordance with the current regulations. For that reason, in the following period, until 1997, even later, there was practically no privatization in Serbia.

### **Privatization Law from 1997**

The 1997 privatization concept presented a continuation of the old, Yugoslav model of privatization whose basic characteristics were that privatization was still autonomous (decentralized), voluntary and directed towards employee shareholding. The voluntary nature of privatization was combined with incentives, i.e. significant discounts in the limited time period, which was supposed to induce workers to privatize their companies.

The significant solutions were as follows: all employees and former employees in the socially- and state-owned sector, including pensioners, and insured farmers had a right to free shares in the amount of DM 400 for each year of service; a discount of fixed 20% and 1% for each year of service was restored, and up to DM 8,000 for shares; maximum 60% of the company's capital could be issued as free shares, 10% of capital was to be immediately transferred to the pension fund, and at least 30% of capital was to be sold to interested parties; the capital remaining after the subscription of shares was to be transferred to the ownership of the state Share Fund.

The voluntary nature of privatization (autonomy of corporate bodies in decision-making whether the company will be privatized or not) left the process of privatization to a very complex game of motives and incentives of the employees and managers.

Employee shareholding is a highly undesirable concept of privatization from the economic aspect, because it leads to the preservation of a staid

manner of company operation and significant slowdown of the greatly needed restructuring of the Serbian economy in the management, organizational, technological, financial and any other sense. It has shortcomings from the aspect of economic efficiency. The first weakness lies in the creation of companies in which the dominant owners are employees, preserving some characteristics of the self-management system – those that work manage, and everything remains more or less the same. Second, employee shareholding leads to the domination of internal owners and separates the company from the capital market, because external investors are not particularly willing to invest in companies owned by employees. This is because insiders can, and in Serbia they usually do so, conduct a policy which suits only them, but not the other owners and company as a whole – profit direction to wages, etc. Third, for the efficient management of companies it is necessary to have a certain concentration of ownership, so that the owners could and would have an interest in monitoring the managers.

Employee shareholding does not provide such concentration; instead, it fosters pronounced ownership dispersion, so that the efficiency of management suffers. Thus, employee shareholding is an insufficiently efficient ownership arrangement, whose long-term maintenance stalled transition and economic recovery of the country.

Employee shareholding would not present such a problem if a full sale of shares were allowed, because then ownership concentration would be achieved in time, but this was not allowed under the provisions prescribing that every year only 10, 20 and 25% of shares obtained could be sold during the next six year. This solution postponed the creation of the capital market.

Furthermore, this model cannot be considered fair, because it provides only one part of population of Serbia free shares and discounts, whereas all others (around half of adult population: students, the unemployed, housewives, employees in the private sector, etc.) remain without such privileges. Even if it had been implemented more widely, this model would not have brought efficient or fair privatization in Serbia. A question remains whether it would have brought privatization at all, in view of its voluntary nature, which, theoretically speaking, perpetuates the inefficient social capital. However, employees and managers could find an interest in entering the privatization process. The legislator provided for a bait in the form of free shares to employees, hoping that it would provide sufficient impetus for privatization. However, it did not and privatization did not make progress during the following four years.

Employees were both interested and uninterested in privatization. They are interested, in order to obtain free shares and acquire assets, and they were not interested because privatization brought to them different risks (for example, from the loss of employment). Managers were not in favor of privatization in longer term because that way they would often lose a favorable position, but in short term they could accept that risk, since employee shareholding fostered ownership dispersion and enabled them to retain managerial positions.

Until 2000 a small portion of socially- and state-owned capital was privatized in Serbia. By autumn 2000, the process of privatization was initiated according to the 1997 model in around 350 companies and completed in only 18. They were mostly small companies, with modest capital, so the total value of issued shares reached only 12 billion then dinars. The only large company that was (partially) privatized was Telekom, where 49% of ownership went to STET and OTE in 1997.

## PRIVATIZATION SINCE 5 OCTOBER

### **Transitional regime**

After the political changes of 5 October 2000, the so-called transitional government was formed in Serbia, consisting of a technical coalition of parties of both the new and the old regime, pending the Republic parliamentary elections in December that year, which brought definitive victory of DOS. The Minister of Privatization was Oskar Kovač, from SPS, and the old privatization law from 1997 continued to be in force.

Somewhat unexpectedly, Minister Kovač invited the managers and employees to initiate privatization of their companies under the existing law. His motives could be different: first, ideological, i.e. the belief that the then model of privatization was the best, and that the one to be introduced after the victory of DOS would certainly be inferior; second, political, in order to protect the managers from SPS from the probable dismissal by employee shareholding and ensure in such a way that the party would preserve control over part of the economy; third, economic, in order to use the opportunities provided by the radically increased German mark exchange rate and achieve significantly

higher free gains for the SPS managers and employees, calculated in dinars. Fourth, also a political motive, to aggravate the position of new authorities by ensuring the privatization of the best companies, leaving them with worse companies and loss makers.

Thus, many followed the Kovač's call and initiated the procedure of privatization. During the three winter months, for around 500 companies, either already partially privatized under the previous laws, or companies exclusively socially-owned, a public invitation to share subscription was announced under the then prevailing old law. Among them were many sizeable and successful companies. From 25 January DOS's Ministry of Privatization faced a dilemma about how to proceed: to tolerate, prohibit or even annul these privatizations, because it could not prepare and bring to adoption its own new law, based on different principles, within a short period of time. Apart from that, it was obvious that, first, the economy was being privatized according to the model of employee shareholding, which is bad, and, second, that there was danger that almost all decent companies would be privatized according to the old law even before the new government started privatization according to the new law, which would signify its failure at the start, leaving only bad, loss-making companies in the portfolio.

Already on 12 February 2001 amendments to the Law on Ownership Transformation were adopted, temporarily suspending privatization under that (old) law, until the adoption of the new law, during not more than six months. Privatizations initiated under the 1997 law could be continued and completed. A committee was established with a task to check the suspicions that there were significant irregularities during these privatizations, but nothing more serious was found.

In such a way, privatization according to the employee shareholding model was terminated, "preserving" some of the best companies for privatization according to the new model and the new law. The work on the new privatization model was initiated by a working group even before the formation of the Serbian government on 25 January. The selection and implementation of the model were, to a certain extent, affected by a text entitled *New Model of Privatization in Serbia*<sup>1</sup> and suggestions of the World Bank experts.

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<sup>1</sup> B. Begović, B. Mijatović, B. Živković – *New Model of Privatization in Serbia*, CLDS, December 2000.

## PRIVATIZATION LAW FROM 2001

**Introduction**

The Privatization Law was considered and even pronounced a major reform law. Despite some exaggeration,<sup>2</sup> there was certainly some truth in it. From the one hand, the socially- and state- owned sector used significant resources, although their value was significantly smaller than it was believed. Those resources were to be engaged in a productive way, if possible. On the other hand, the socially-owned sector presented an important social factor, or better put a problem, whose resolution was inevitable if a functioning market economy was to be created in Serbia. Namely, the staid socially-owned sector, with prevailing self-management frame of mind and addiction to generous government subsidies, presented the largest obstacle to reforms in the political and social sense.

At the end of 2001, the capital structure was dominated by the socially- and state-owned sector, and the ownership of the small privatized portion was dispersed among a large number of owners, consequently without much influence on management. In many companies, old SPS managers were replaced by new ones from DOS, but the “party” principle of their appointment remained the same. On the other hand, the economy was inefficient, technologically outdated, with high surplus labor and overburdened with debt. For many companies it was the last moment to attempt saving them through privatization, because the only alternative was bankruptcy. The expansion of the market role in the resource allocation certainly disabled the old mechanisms of maintenance of badly run socially-owned companies.

The new government in Serbia faced the issue of privatization model selection. Should the previous model of employee shareholding be continued, leading to the perception by many workers that they have created national wealth (without debt)? Should the voucher model be selected, which was very popular around mid-1990s in some countries in transition? Should the classic sale model be selected, as used by developed countries?

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<sup>2</sup>Laws creating market institutions were underestimated. Also, the transition experience of the Eastern European countries has already shown that the new private sector is more important for the economic future than the old, even if privatized state sector.

*Basic elements of the model*

The new government of Serbia, which came into office on 25 January 2001, selected a partly modified model of classic sale. The main cause for such selection was the previous transition experience of other Eastern European countries and experience and circumstances in Serbia itself.

The basic characteristics of the selected model were as follows:

**Sale, not free distribution.** The distribution of socially- and state-owned capital to all citizens through vouchers was a popular option in Eastern Europe in mid-1990s, after the swift privatization in the Czech Republic and Slovakia. However, subsequent developments were not so successful: investment funds, which were entrusted with most vouchers and shares, turned out not to operate as conceived, so the corporate governance of privatized companies was not efficient either. The experience of Serbia was even worse, where large discounts and gifts led to employee shareholding, an economically inferior type of company management. There seemed to be truth in the claims of skeptics towards voucher privatization when they stated that an individual would not equally successfully manage the assets he obtained as a gift as the assets he purchased with cash.

In other words, the method of sale of socially- and state-owned capital was selected with the idea to attempt to find the right buyers, i.e. those that would get the most out of the companies that were being privatized (economic resources). This is because the standard reasoning in economics is that the one who is paying knows why he is paying so much and that the one who is paying the most is likely to know best what to do with those resources. This brings efficiency.

Naturally, any government is eager to get hold of sizeable budget revenues from privatization, so this motive is certainly not to be disregarded. Quite the contrary. The Serbian government prepared a socially generous transition concept, where the people would respond well to changes because social benefits would be significant, with those social expenses being financed from privatization proceeds and foreign assistance and other forms of support, at least in the first few years.

Sale as a method of privatization also has a general weakness: it is usually slower than the voucher systems, since it implies the preparation of each company, which is, in particular in view of the limited resources of government administration, a fairly time-consuming process.

**Sale to strategic investors.** When the sales concept is already selected, then the next step - sale to majority strategic investors - is fairly easy. Namely, the alternative is the sale of shares by public subscription, which usually leads to dispersed ownership and weaker corporate governance. A country in transition (Serbia) is not America, so that dispersed ownership would not present an obstacle for good management of the company. When choosing the privatization model, the government rightfully set great store by corporate governance in the postprivatization period, so it opted for the sale of majority package (70%) of socially/state-owned capital to a single investor. This enabled the takeover of full control over the company being privatized by a majority owner that could, in his own interest, manage the company without special complications. The idea was to facilitate and make more efficient the very complex process of company restructuring in the postprivatization period.

The experience of not only the transition, but also developed countries, shows that the principal-agent problem is always very difficult and that there is simply no easy cure. The issue of preventing the management or owners that have only a relative majority from making selfish illegal moves is particularly complex in the countries in transition, in which the necessary institutions (judiciary, registers, stock exchange, etc.) are still underdeveloped. In such countries it is better to rely on the majority owner, thus removing at least part of the principal-agent issue – the one related to dispersed ownership.<sup>3</sup>

**Smaller part is given for free to citizens and employees.** The Privatization Law does envisage gifts, this time both to employees and all other citizens. Employees are given 30% of shares in companies sold by auction (i.e. in smaller companies) and 15% in companies sold on tenders (i.e. in larger companies), whereas 15% of shares in latter companies are reserved for citizens. In such a way this law is more just than the previous ones, because shares are given not only to employees but also to everyone else. Individual right was not changed: EUR 200 for each year of service.

However, the question is why there are gifts. The answer is easy: obtaining political support for reforms and demagoguery, i.e. an attempt to bribe employees and citizens with government funds. Such an approach is certainly not surprising: reforms are conducted in a political environment and for that reason ignoring political motives of main participants is certainly wrong in the analytical sense. Most that can be expected from politicians is a combination of demagoguery and reforms that does push forward, while bold, reform moves

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<sup>3</sup> *Corporate Governance Improvement*, CLDS, 2003

made regardless of their possible unpopularity surprise us pleasantly, but also very rarely. Serbia is no exception in that respect.

It is important that the gift of 30% of the company's capital, no matter how significant numerically, does not alter the model of privatization: there is still a majority owner with 70% of capital in newly-privatized companies, which is important for corporate governance and, more generally, for the manner of operation of the company. This gift essentially presents only a politically motivated expense for the budget (gift to citizens instead of sales revenues).

**Competitive sales methods.** The Law provides for two sales methods, both competitive: auction for smaller and weaker companies and tender for larger and better ones, intended for foreign investors.<sup>4</sup> It is always 70% of non-privatized capital that is sold (residual after giving away 30% to employees and citizens, as stated). It is commendable that direct bargaining between the state and the buyer is not mentioned among the sales methods, since, despite being theoretically convenient and apparently necessary for bad companies for which there is no demand, it is still to risky from the point of view of the state as it enables, or rather fosters, corruption. In those bad companies arranged restructuring or bankruptcy will be conducted.

Exclusive use of competitive methods of sale were to ensure maximum transparency of the process, i.e. prevent corruption and other abuse of the privatization outcome. Namely, when public and regulated contest of interested parties is ensured under the rules known in advance, then it is truly difficult to organize fraud and provide someone with undeserved advantage.

For larger, but weaker companies, restructuring is planned (division into several companies, reduction of the number of employees, etc.), with a firm commitment to avoid what happened in several Eastern European countries: financing of loss-making companies for years for political reasons.

The most important novelty refers to the right of the Agency to initiate the sale of socially-owned capital in any company, abolishing the voluntary nature of privatization in Serbia and ensuring that privatization does end. Although the Serbian Constitution has not been amended in the meantime, the previously popular claims that it prevents the compulsory and time-limited nature of privatization have ceased.

The privatization model is oriented towards cash payment for the acquired company, immediately after the signing of the contract. Still, certain flexibility is permitted. The first is related to frozen foreign currency savings deposits,

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<sup>4</sup> Obviously, the division is not absolute.

whose mature bonds are equal to money, with even the bonds that have not matured yet accepted if there were no buyers for cash or mature bonds.<sup>5</sup> The second is related to deadlines: individuals (natural persons) may pay for the capital acquired at auctions even in six annual installments. This was to encourage domestic buyers, as they did not have to pay immediately for their acquisitions; instead, they could pay for it in time from the company profit. Nevertheless, this is a risky solution, as the experience showed in several cases, as it enabled the unscrupulous to take over a company without any money of their own, drain it in a short period of time and leave it to the state to deal with it subsequently.

Some time ago the centralized method of both the sale of capital and the entire process of privatization was severely criticized (all done by the Agency for Privatization).<sup>6</sup> Nevertheless, the question is whether such criticism is justified. On the one side, the large role played by the Agency enabled a significant increase in the level of professionalism of the privatization process, which a decentralized form would hardly been able to provide. On the other hand, the distribution of privatization revenues cannot be called centralized, because local communities, Vojvodina, the employee pension fund and the denationalization fund participate in the distribution.

**Price, investment and social program.** It is interesting that neither the privatization law, nor the government decrees on tenders and auctions prescribe which criteria determining the winner are. Thus, it is left to the Agency for Privatization to decide on the criteria in each concrete case.

Previous practice has shown that the Agency used three criteria in tenders: offered price and the level of investment and social program. The price is certainly an undisputed criterion, but a question remains whether the amount of planned investment and social program should be used as a criterion. Strictly economically speaking, the seller, in this case the state, should not be interested in anything except the sales price. How much the new owner will invest in the company is his business, because the profit will go exclusively to him. A special problem, as shown by the experience in the countries in transition, lies in the inability of the state to “punish” subsequently the buyer who did not respect the contract provision on the investment program. Serbia attempted to resolve the problem by being strict: first, a bank guarantee is requested and second, there is a threat of privatization annulment without compensation. The latter could increase the degree of discharging the undertaken commitments, but it will at the same time increase the business risk for the buyer, thereby decreasing the

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<sup>5</sup> More than two hindered companies were sold in the second auction, i.e. for bonds not yet matured.

<sup>6</sup> *Nationalized Privatization*, Prizma, May 2001.

attractiveness of Serbian privatization for potential investors. Essentially, the more the commitments (burden) are transferred to the buyer, the lower the price he is ready to offer will be. This particularly refers to the social program, which, for the buyers, presents a cost equal to the price of the company, so that is how he calculates; in other words, the more expensive the social program, the lower the offered price. The state realized this in the end so in 2003 it abolished an obligation, in tenders, to guarantee employment for the following 3-5 years, and in auctions one year; instead, it took upon itself social programs, rationally expecting higher sales revenues. Upon reviewing this, both criteria appear to be superfluous, and are/were used mostly for political marketing reasons: to demonstrate that the government is concerned both with development and employees.

**Restitution.** Each privatization program must take a position towards the idea of restitution/denationalization, because one part of the assets being privatized used to be privately owned and was later nationalized. It is not fair for the government to sell what should be returned to the previous owners, and was nationalized calling for ideologically motivated liquidation of private ownership.

The Privatization Law took a completely pragmatic stance: it provided that from each sale, 5% of revenues should be allocated for future compensations for nationalized assets. Therefore, the claims of former owners have been implicitly recognized, but the privatization law did not preempt legal solutions from the law that should completely and comprehensively resolve the problem of denationalization/restitution. In such a manner, however, it was decided that privatization would not wait for denationalization (that might not even take place), and that all assets in the economy, even the nationalized ones, would be subject to privatization. Any denationalization of economic assets would not be performed in the physical form, but in the form of monetary compensation. Therefore, in this way the issue of denationalization was removed from the path of privatization.

Later developments were not to the taste of the former owners and their heirs. The Denationalization Law has not been adopted, and the 5% of revenues are not deposited in a designated account but is spent regularly so that it exists only as a potential debt of the budget to the former owners if the denationalization law is adopted in the future. In return, restitution requests are blocking the privatization of 50-odd companies.

### Privatization process

The basic data on privatization developments up to 2004 are given below, starting with a previous note on why they commence with 2002. Namely, during 2001 no companies were privatized, so the series begin with 2002. During 2001 there was no privatization because during that year a new regulatory-institutional framework was prepared: the Privatization Law was adopted in June, accompanying by-laws (decrees and regulations) were adopted by August, followed by the formation, or capacity building of the Agency for Privatization and Share Fund, which all lasted until the first quarter of 2002,<sup>7</sup> which was when the privatization activities could really commence. Admittedly, in the autumn of 2001 the tender for cement plants was issued, which was supposed to present an initial success that would silence the critics and give impetus to further privatization.

**Number of companies.** In these four years 1382 companies were privatized, which is two per business day. This is certainly a good pace, but the problem is that there are still many companies in the privatization line, so the end of the process is nowhere near. It was initially believed, or at least claimed, that the privatization of the commercial sector (i.e. without state-owned companies) would be completed in 2004, with this deadline lately being pushed back to 2006. The basic problem, I believe, lies in the previously mentioned weakness of the sales method: it requires a lot of technical and administrative resources, which is why it is relatively slow, so not even the greatest efforts could result in a miracle.

Table 1. Number of privatized companies

	2002	2003	2004	Total
Tenders	12	19	9	40
Auctions	194	651	262	1,107
Capital market*	48	121	66	235
TOTAL	254	791	337	1,382

\*Sale of shares by the Share Fund

Source: Agency for Privatization

<sup>7</sup> M. Cvetković – Current Situation in Privatization in Serbia: Inherited Situation, Current Model, Results and Prospects, in Z.Vacić and B. Mijatović (ed) – *Reform Strategy*, CLDS, 2003, p. 332

Despite the acceleration of privatization during the first half of 2002, Prime Minister Đinđić was dissatisfied with the pace and in the summer called for additional efforts and privatization of a thousand companies by the end of the year. The author of this text was concerned that, for the sake of acceleration, the quality would be sacrificed, but he was wrong: Mirko Cvetković was appointed the General Manager of the Agency and speed was increased, while maintaining the quality. At the end of 2002 and in early 2003 all records were set. In the first quarter of 2003 as many as 329 companies were privatized, the record which has remained unbeaten to date. The pace was somewhat slower in the following quarters, but remained very high – 200 to 250 companies per quarter. Year 2003 is recorded as the best year of privatization in Serbia.

In order to accelerate privatization, some legal amendments were introduced. First, in August 2002 the decree on auctions was amended, simplifying their procedure, and significantly reducing the high initial prices. In such a way the interest in auctions increased considerably, as did the successfulness of outcome. Then the amendments of the Privatization Law from March 2003 eliminated the need for employees to agree with the sale, providing that it is only the state that leads the sale and signs the contracts. It was a reaction to several cases (for example, Beočin cement plant) in which the employees insisted on their own demands to the ultimate limits, and even beyond them, prolonging the procedure and even putting off the buyer. At the same time the policy related to social programs for tenders, since there were several failures due to excessive demands: from three and five years, the ban on layoffs was reduced to only a year, with the government financing severance pays, not the buyer. The last element presented a recognition of the reality: if at the beginning of privatization, when the best companies were sold, it was still possible to set high social demands before the potential buyers, with the deterioration of the company offer in the privatization portfolio, this was no longer possible. Several tenders were unsuccessful, because the potential buyers either did not want to deal with the surplus labor on their own during five years or they were ready to pay the minimum price for the company, due to high social program costs. With this, no gift was made to the buyers: the cost the government pays for the employment restructuring would be recuperated in the form of higher sales price, because the company's price was truly increased in such a way.

In 2004 the pace of privatization was significantly slower. This was caused by several factors. First, during the change of the government, a significant number of professional staff left the Agency, which inevitably slowed down

its operation, at least for a while, until the engagement of new staff and their acquisition of necessary experience. Second, until his dismissal, the new manager of the Agency was more involved in politics than in his own work. Third, in time there was a decreasing number of good companies in the Agency's portfolio, and an increasing number of bad ones, which are not only difficult to sell at a decent price, but which are also more difficult to prepare for a tender or auction (ownership disputes, negative or dubious capital value, etc.).

**Privatization revenues.** The total revenues from the sale of capital in 1,382 companies amounted to EUR 1.5 billion in these three years. This is not an amount to be proud of: a medium-sized Western company unknown to the public is worth as much. This gives rise to serious questions: did someone seriously mess up? How much is what was sold truly worth? Was the method of privatization wrong? Is privatization important at all?

Table 2. Privatization revenues, EUR 000

	2002	2003	2004	Total
Tenders	201,456	600,269	15,234	816,960
Auctions	57,139	261,590	121,681	440,411
Capital market*	81,610	67,768	51,406	200,784
TOTAL	340,206	929,627	188,321	1,458,154

\*Sale of shares mostly by the Share Fund

Source: Agency for Privatization

First we must examine the reasons why privatization revenues are lower in these three years than expected. First, this was a privatization of a smaller part of the Serbian economy. Many of the best and most valuable companies were privatized according to the 1997 law, so for this wave of privatization only a few good and a lot of medium-quality and bad companies remained, and smaller ones at that. Then, significant capital is in the group of larger companies which have been for a while the restructuring program. Large state-owned companies, whose value could be considerable, have not entered the process of privatization. Second, the price of capital being sold in Serbia is certainly reduced by the high political risk of investment. Namely, bad political circumstances in the country and around it (ranging from the issue of state

borders and the Hague Tribunal to intensive internal political strife, etc.) unfavorably affect the country's attractiveness for investors. Potential foreign investors certainly have an impression that Serbia is not a country that is well integrated in the world politics and economy. Third, the Serbian market is small, with low purchasing power, not particularly dynamic either, so the interest of investors is not large. Fourth, the accession to the European Union is constantly being postponed further into the future, putting off those investors who are searching for a cheap entry into the EU. Fifth, belligerent trade unions, as well as employees used to self-management ideology and prone to strikes, did not attract investors. The state occasionally played into their hands, avoiding to implement the law in order to maintain the political rating of ruling parties (the case of Jugoremedija, etc.).

The low prices realized at auctions and tenders are, in principle, certainly realistic, given the conditions. The claim that a company is worth more than someone is ready to pay for it does not make sense, since it has no immanent value, just market value. A company that might be identical in all other respects is worth different amounts depending on its environment: in Serbia the circumstances were not favorable, so the obtained prices were not high either.

The question is only whether another privatization model should have been selected or changed during implementation, or the sales delayed until better times when it was seen that things were not going according to the plan, which advice was heard (Danijel Cvjetićanin).

The author of this text is inclined to give a negative answer to all three questions, although it is difficult to provide sufficiently strong arguments to support his case. First, at the beginning harmony seemed to reign at the political plane (good response to 5 October in the world, good cooperation in the course of forming the DOS government), so it was not easy to predict all political snags that later to a significant extent led to a considerably smaller interest of foreign investors in tender privatization than expected. Second, during implementation, it is difficult completely to change a privatization program (think of both political and technical problems), in particular in view of the belief that unfavorable factors are temporary and that things would be resolved quickly. Furthermore, what is the alternative? Employee shareholding? Vouchers? They are still inferior from the point of view of economic efficiency, and bring the government even less revenues (employee shareholding) or none at all (vouchers).

Third, it is quite uncertain whether the delay of sales would be a good solution. A precise answer to this cannot be given, as we do not know what kind of prices would be obtained in the future. Still, there are two questions disputing that idea. First: in what kind of shape Serbian companies would have greeted those better times, i.e. how many would have still existed then, and how many would have even recorded even deteriorated market and financial results in the face of competition from the new private sector or from abroad? In other words, the inevitable intensification of market competition and interruption of subsidies of different kinds would probably have a negative effect on the operation of the not-so-well-managed socially- and state-owned companies, consequently reducing their value/price. Furthermore, for many companies on the verge of bankruptcy swift privatization was the only salvation; stalling would have jeopardized their existence. Second: would the future sales price been so much higher as to justify the sale delay? Because, if discounting is introduced in the analysis, which is necessary, then the future price would have to be much higher since Serbia needs (needed) the money as quickly as possible, even badly so. If the discount rate is only 10%, then a million euros increase to 1.6 million in five years, and if it is 20%, then it reaches 2.5 million. Therefore, for the delay to be justified from the financial standpoint, the prices of companies would have to increase significantly in the foreseeable future, which is not quite certain. In some periods and in some places there were instances of successful restructuring of state-owned companies, for example in Poland, and there were also, admittedly few, successful self-managed companies. However, the overall experience with state ownership and restructuring is very negative.<sup>8</sup>

An alternative method of presenting the successfulness of privatization is given in the next table, through the ratio between the offered and sold companies in different privatization channels.

Table 3. Success rate

	2002	2003	2004	Total
Tenders	50%	48%	75%	53%
Auctions	76%	84%	81%	82%
Capital market*	55%	57%	54%	56%
TOTAL	69%	77%	74%	75%

\*Sale of shares mostly by the Share Fund

Source: Agency for Privatization

<sup>8</sup> For references see S. Djankov and P. Murrell - *Enterprise Restructuring in Transition: A Quantitative Survey*, Journal of Economic Literature, No. 2/2002

This means that three quarters of sales were successful, which is not unfavorable. However, it is not good that the success rate in tenders is only about a half, since they are the basic sales channel for large companies and should bring the state the largest income, while being prepared in most details.

The sale success rate is the highest in auctions, in which buyers are mostly domestic. This is caused most probably by the relatively low initial price and non-existence of expensive social programs. The low success rate in sales by the Share Fund points to the modest interest of investors in minority stakes in the companies privatized under the previous laws.

The ratio between the sales price and bookkeeping value does not present particularly indicative data in the absolute amount, because the bookkeeping value is neither relevant nor illustrative in the economic sense. Still, when observed in dynamic terms, this data can be useful.

Table 4. Ratio between the sales price and bookkeeping value

	2002	2003	2004	Total
Tenders	1.47	1.44	0.23	1.32
Auctions	0.73	0.81	0.64	0.74
Capital market*	2.47	1.10	0.85	1.30
TOTAL	1.37	1.16	0.59	1.07

\*Sale of shares mostly by the Share Fund

Source: Agency for Privatization

From the previous table it is obvious that the ratio is reduced from one year to another, for all three methods of sale. In tenders for 2002 and 2003 and the Share Fund in 2002 there were a few very favorable transactions (cement plants, tobacco plants, breweries, etc.), so the value of this ratio was high. However, as the privatization increasingly moved towards the areas of unattractive companies, the ratio inevitably dropped. It is particularly low for tenders in 2004, pointing to a tender privatization crisis. Prospects are not favorable either, in particular when the sale of companies in the restructuring group is initiated, whose sales price, despite the write-off of government debts, will frequently be low, if even exceeding one euro.

The next table presents compulsory investments, i.e. the investments that are part of the sales contracts and present the buyer's obligation. Naturally, the new owner can exceed them. The total amount is around EUR 830 million.

Table 5. Contracted investment, EUR 000

	2002	2003	2004	Total
Tenders	305,929	319,939	75,389	701,257
Auctions	13,591	59,498	48,965	122,053
Capital market*	5,902			5,902
TOTAL	325,421	379,437	124,354	829,212

\*Sale of shares mostly by the Share Fund

Source: Agency for Privatization

According to expectations, the amount of contracted investments is the largest in tenders, because it presents a criterion in selecting the most favorable offer. In auctions a standard request were investments in the amount of 150% of depreciation, whereas in the sales by the Share Fund there were no such requests (except in a very specific case), since they refer to the sales of minority packages.

**Restructuring.** For companies for which there would be no realistic chances of finding a buyer in the present state, the process of restructuring is envisaged as a preparation for privatization. Around seventy companies are included in the group for restructuring, including RTB Bor, Geneks, Zorka (Šabac), IMR, IMT, Viskoza, Magnohrom, Goša etc. There are two basic ideas how to assist them: first, to divide some of them into several companies and sell attractive ones and initiate bankruptcy in those that do not find a buyer; second, to write off part of the debt to the state, so that their value would rise above zero. However, the slow progress of restructuring in the past year increases the chances of the program being transformed into something it should never be: a reserve for bad companies sustained by state subsidies for social and political reasons.

**Privatization revision?** Turning of the privatization process into a political issue is inevitable not only in Serbia. Government opponents, in

particular those from the left side of the political spectrum, always spend a lot of ammunition on ownership changes, accusing the government that it is plundering the people's resources and, under the guise of privatization, orchestrating the increase in wealth of its supporters. There is only one step from such accusations to the threat of privatization revision in the event of coming into power – and it is usually made quite easily in Serbia.<sup>9</sup>

A revision was already conducted in 1994 under the guise of revaluation, which was previously dealt with. During the protests in 1996-97, Zoran Đinđić frightened the buyers of Telekom by threatening them with revision when he came into power. The Government whose Prime Minister he was immediately formed a committee to examine previous privatizations, with no result. The most intensive campaign against privatization was on the eve of elections at the end of 2003, when the then opposition parties and later ruling parties showered the authorities with a barrage of accusations and announcements of revisions of that “daylight robbery”. Already the lack of facts in their accusations clearly pointed to what happened in the end: there was no review, or a revelation of corruption or irregularities in the behavior of government bodies.

**Dirty money?** One of the accusations against the current privatization model is that it enables the tycoons from the Milošević's period to purchase companies for little money. It does seem that no one in Serbia has money except them and that, because of that, there is no one else to collect the profit from low prices of companies.

However, this theory has more weaknesses than it seems at first sight. First, which tycoons purchased companies during privatization? The leading ones certainly did not. Karić did not, since he stuck with the companies he had previously established himself. Mišković also created most of his empire *ab ovo*, and only entered the trade chains (*Pekabeta* already during the 1990s). There are also buyers with anti-Milošević inclinations, who are now purchasing companies. For example, Zoran Drakulić, who certainly cannot be criticized as Milošević's tycoon or profiteer.

Obviously, there are many individuals who entered the process of privatization with relatively modest amounts (several tens or hundreds of thousands of euros) earned under the Milošević's regime and purchased something relatively small, but they are neither tycoons nor is that money

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<sup>9</sup>For example, some time ago Vuk Obradović publicly asked for an urgent interruption of the current method of privatization and revision of the already completed company sales. According to him, it is a “mafia-statist model” via which those in and close to power robbed the citizens and state property. Obradović forecast that such a situation would result within a year in a small number of enormously wealthy people in Serbia, whereas others would “belong to the world of the poor”.

suspicious in advance. At least part of that money appearing in privatization was earned after 5 October. Relatively low prices of a larger number of companies created possibilities for the people who do not have large capital, but modest, to appear as buyers. This led to the “democratization” of privatization, i.e. shares became accessible to a larger number of people.

Second, at a formal, legal level, this money is clean until proven otherwise. The Agency or the Ministry for Privatization cannot and must not determine who is a Milošević’s tycoon and whether money someone is using for purchase is quite clean or not, leading to a conclusion of a contract or auction cancellation.

Generally speaking, the tax on extraprofit essentially presented a method of legalization of money earned in the Milošević’s period. The new authorities, rightfully or not, made a political decision that they would not examine the formal correctness (legality) of the acquisition of that wealth, but to tax it and restore at least part of it to the people. In such a way, what remained after taxation is quite legal and moral, at least in the political sense.

Essentially, why should it be morally disputable that they are buying companies which are being privatized and not when they are investing that money in new plants? From the economic and social standpoint, it is even better that they are investing their capital in Serbia, rather than taking it abroad.

This entire story about extraprofit and, wider, dirty money slowed down privatization at the beginning, because many investors refrained from participating in order not to show their money at an unfavorable moment for them.

**Change of regulations in 2005.** There are three important changes. First, the Agency was given a right to terminate the contract with the buyer independently and very easily if he fails to comply with the provisions of the contract. The court procedure may have been slow so far, but this desire for speed and efficiency brings excessive rights to one interested party, at the expense of the protection of rights of the other contractual party. Second, striving to make unattractive companies more attractive, the legislator provided for a conditional write-off of government receivables from the company that is being privatized – the goal is to ensure that it has a positive value and that it is sold – with the government creditors (the budget, utilities, state banks, etc.) collecting as much as they can from privatization proceeds. It is not a bad trick, but it will work only in companies with such configuration that this conditional write-off transfers them from a negative value to positive. Those

who already have positive value do not need such write-off, nor can it help those with a very negative value. Third, managers could no longer prevent the listing of their companies' shares by simply refusing to sign the prospectus. This currently refers to around four hundred companies, the best known being *C-Market*.

## CONCLUSION

The results of privatization in Serbia so far have disappointed many. However, it is difficult to expect that a privatization of a practically devastated economy, such as the Serbian, can quickly turn it into a prosperous one. The economy of Serbia was truly in a poor state, after decades of self-management, sanctions and, finally, bombardment. However, the result are there: privatized companies are now the main drivers of economic activity and productive employment.

The process of privatization developed relatively successfully, without big affairs. The Serbian government administration demonstrated its ability to operate properly, so the area of privatization is probably one of the best run reform areas. Certain mistakes in procedures are probably a reflection of a game with big numbers (large number of privatizations in a short period of time), and not corruption, as some believe.

Privatization still has another half of the road to cover, and the more difficult one at that. In the commercial sector mostly lower-quality companies remain. There are also the companies from the restructuring group, a certain number of which will end in bankruptcy proceedings. State infrastructure companies and utilities, whose privatization is more complex both conceptually and technically, are also awaiting their turn.



Boris Begović and Marko Paunović

## Real Sector Restructuring

PAST RESTRUCTURING – WHAT HAS AND  
WHAT HAS NOT BEEN DONE

### **Introduction – differences among companies in the real sector**

At the beginning of transition in Serbia, in late 2000, i.e. in early 2001, the real sector in the Serbian economy comprised, for all practical purposes, five groups of enterprises:

1. Completely new private companies, established through private investment after 1989, when private business was legally sanctioned.
2. Companies which were partially privatized under the privatization model in application as of early 1997, until end-2000.
3. Socially and state owned companies whose capital is majority, or completely socially/state owned, which do not need pre-privatization restructuring.
4. Socially and state owned companies whose capital is majority, or completely socially/state owned, which need pre-privatization restructuring, i.e. which cannot be privatized without such restructuring.
5. Public enterprises with state and socially owned capital.

With the exception of the companies in group 1, all other companies in the domestic real sector constitute the legacy of socialism in the Serbian economy, with all their minor or major weaknesses displayed long before a political crisis that broke out in 1991. All weaknesses of these companies were just intensified in the course of the 1990s, with changes in the region, i.e. new catalysts which came from the break-up of the country, international sanctions and isolation of the Serbian economy, extraordinary political circumstances

and an institutional vacuum of its own kind that was caused by the implosion of institutions of communism, which was not followed by the building of market economy institutions. Consequences of these developments for good many companies in the real sector were numerous: inferior and outdated technology, poor production programs, uncompetitive products, a lack of good incentives to employees, low economic efficiency. In line with the above, the situation of the Serbian real sector in early 2001, namely at the beginning of transition, was such that its large share was not competitive according to the world market criteria, i.e. at the international level.

For this reason, a vast majority of companies in the real sector (including some companies from group 1) should undergo restructuring to a smaller or larger extent, i.e. make adjustments to new market and institutional circumstances. Consequently, there is a need for restructuring, i.e. structural adjustment, practically of the entire real sector of the Serbian economy. Of course, the scope, i.e. degree and character of restructuring, differ from case to case, principally at the level of individual companies, but also at the level of branches of the economy.

A key strategic decision related to this issue was adopted in early 2001: in all the mentioned cases, except for the specific case of public enterprises, restructuring should be carried out by a private owner, i.e. owners, of those companies. That decision was based on the assessment that the private owner can do the job of restructuring far better than the state, hence a conclusion was drawn that post-privatization restructuring would be economically more efficient than pre-privatization one. In that sense, a precondition for efficient restructuring of the real sector is its privatization, i.e. the sale of companies in that sector.

Namely, at that time such model of privatization was chosen which was based on the sale of the majority socially, i.e. state owned equity stake (at least 70 percent of shares) in the real sector companies. One of the main motives for the application of such a privatization model was to establish concentrated ownership, i.e. to create a private owner of the company's capital, who has efficient incentives and mechanisms to carry out its restructuring, embodied first and foremost in his indisputable majority stake in ownership.

The strategic decision to leave the restructuring of the real sector to private owners for the most part can be assessed as justified, bearing in mind that there are unarguable theoretic and empiric findings which indicate that a private owner is much more efficient on this job and that better results of

restructuring can be expected by opting for such approach in comparison with the alternatives. However, it is much more interesting to consider political circumstances in which such a decision was taken. Namely, against this decision, that is, the restructuring strategy, were those who cannot benefit from restructuring as such, primarily those who will be left jobless. In early 2001 those interest groups were not well defined and did not have mechanisms for projecting their interest into the decision-making process. That was the time of a firm reformist coalition and great political energy focused on reform. Simply, the political opposition of that time was deadened. In addition, financial and political support of the international community was very strong then, so an image (an illusion) was created that the said support will be enough to resolve by itself the problem of redundant labor in the real sector, i.e. of unemployment which was to be generated. Finally, the policy of the World Bank, that is, consultancy provided by that international financial institution in this field, significantly influenced the adoption of that strategy.

Before proceeding with an analysis of the restructuring of the real sector of the Serbian economy, it is necessary to clarify what is the best measure, i.e. indicator of restructuring. A methodological debate about this subject (Smith *et al.* 1999, Estrin and Rosever, 1999 and Djankov and Murell, 2002) has shown that there are several indicators which can be classified into quantitative (those derived from annual financial statements, i.e. financial reports of companies) and qualitative (those arising from surveys, i.e. expert evaluations of the course of enterprise restructuring). Without going into a methodological debate of this type, in the rest of the paper the restructuring indicator will be understood to mean its results: the ensuing economic performance of the company. This implies results in the field of changing the total output volume, i.e. changing the productivity of total engaged production factors.

### **Previously privatized companies**

Bearing in mind the thus defined framework of the relationship between privatization and restructuring, the first problem, that is, the question that the then government was faced with, was which attitude to adopt vis-à-vis the companies in group 2, i.e. those companies which had been partially privatized under the privatization model applied as of 1997, until end-2000 inclusive. Namely, the result of the application of that model was great dispersion of ownership of shares of these companies, with high insider share-holdings, as well

as with part of shares still owned by the state (held by the Share Fund on behalf of the government). Although such ownership structure, in principle, is not conducive to restructuring, the question was raised whether a comprehensive and deep restructuring of these companies was a dire need, all the more so because in the said period the best companies of the Serbian real sector were privatized, concentrated in the food processing industry, beer industry, pharmaceutical industry, as well as the best companies outside the mentioned branches. In that context, the assessment was made that such restructuring was not a priority and a decision was taken not to use the government equity stake as a mechanism to launch, i.e. carry out the restructuring of these companies, but to create conditions through phased sales of government shares for spontaneous (through transactions on the capital market) consolidation of owners' packages of shares, i.e. for increasing the concentration of ownership, which would enhance further restructuring of these private companies.

It turned out, however, that a creation of a concentrated ownership structure, i.e. the establishment of the dominant owner, was neither fast nor efficient, hence after four years these companies are still characterized by dispersed ownership – the ownership structure which is not conducive to restructuring. There are two reasons for such state of affairs. The first one is an inadequate institutional framework of the capital market, resulting in a low volume of trade in shares, mainly due to poor protection of property rights of shareholders, in particular small shareholders.<sup>1</sup> The second is the slowness of the state in selling shares from its portfolio on the capital market, bearing in mind that the sale of these shares would encourage the establishment of the majority owner that has motivation for restructuring.

Furthermore, dispersed ownership enabled the survival of the old management teams of these companies, so that the majority of these companies in the real sector are still managed by these same general managers who had been running those companies before privatization. This finding is very important, because this fact may be hiding part of the explanation of the phenomenon of low intensity restructuring of this group of companies. It is even more important in light of the fact that the current managements have the motivation to prevent any attempt to concentrate share holdings, with the legal arrangements governing company prospectuses, and thus company restructuring which would result from ownership, playing into their hands.

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<sup>1</sup> Moreover, it was noticed that in a number of cases the managements prevent trade in shares on the stock exchange by refusing to sign a prospectus, which is a necessary document for starting trade in shares on the stock exchange.

Generally speaking, one could say that this group of companies in the Serbian real sector has been characterized by a fairly low intensity of restructuring over the past four years. That low intensity can in this case be explained by the dispersed ownership structure (with the existence of insider shares, i.e. shareholders) and by the fact that the managements of the companies have not been changed. These two findings are completely in line with the empirical finding (Djankov and Murrell, 2002) that dispersed ownership dominated by shareholders insiders (those who are employed in the companies) prevents thorough restructuring of a company, as well as that the survival of the old management of a company does not promote its restructuring. Another reason for such result in Serbia can be found in the inherited and widespread self-management mentality, i.e. *Weltanschauung*, which only intensifies the effect of incentives arising from insider shareholding and dispersion of ownership.

### **Companies privatized under the new model**

Group 3 is comprised of companies which are relatively easy for privatization and in whose case privatization is just a precondition, i.e. a prelude to restructuring which is carried out by a new private majority owner of such a company. These companies were first on the list of candidates for privatization under a new model, which started in the latter half of 2001, with first privatized companies in early 2002.

Although the companies in this group had the most intensive restructuring, which is in line with the previously mentioned empirical evidence (that the establishment of a majority private owner and the arrival of a new management step up restructuring), it is certain that the pace of that restructuring was slowed down by specific requests which were put before investors, mainly in relation to investment in social programs and the imposition of an obligation not to fire workers, who are inherited redundant labor, for a specified period of time. These conditions constituted a consequence of political fears of the then government, i.e. its officials, that such retrenchments as a result of restructuring would have a significant negative effect on their popularity ratings, even against the backdrop of relatively high political stability and a strong reform coalition which (for a while) was providing a two-third majority in the parliament.

Pursuant to the above, the restructuring of the companies in group 3, which have not yet been privatized, is fully linked to its fast privatization. There are

no technical or institutional obstacles to such privatization. All the institutions which are necessary have been long built and are quite well established. The problem arose, however, in the first half of 2004, when the new government, for party-political reasons, appointed to the key posts (Privatization Minister and Privatization Agency Director) persons without capacities required for carrying out privatization, but with great capacities to create scandals, since the political motive for such appointments was gaining political popularity on account of alleged abuses in privatization committed by the previous government. Only when it was clear what serious damage was sustained due to a standstill in privatization in terms of erosion of government's credibility, namely that political damage was much greater than (expected) gain, the said problem was solved by replacements of officials, and privatization was resumed. Still, precious time was lost, bearing in mind that without the said standstill, a far larger number of companies would have been privatized by now, thus also restructured.

### **Pre-privatization company restructuring**

The next problem has been and still is related to large socially and state owned companies which could not be privatized through sale, bearing in mind that nobody was interested in buying them on sight. The reasons for this lack of interest could be broadly found on two sides. Firstly, an absence of any business prospects of such companies, which are in a large number of cases conglomerates, i.e. engaged in many different activities, without being specialized in an area where they would have the competitive edge. Furthermore, these companies very often were wrong ("failed") investments from the very start – they were constructed on the basis of investment decisions taken by those who did not have to bear the consequences of these decisions. In some cases of such conglomerates, there are certain plants, i.e. parts of the enterprise (once basic organizations of associated labor), which have some kind of business prospects. Consequently, fragmentation of such companies should be carried out and those units which have some business prospects should be established as separate companies. Other units without any future in business are candidates for bankruptcy and liquidation, in order to privatize their assets, primarily fixed assets, instead of their equity. Of course, in such a division it is necessary, in collaboration with creditors, to allocate liabilities of the company to the units which are formed by its partition.

The second problem were accumulated debts of companies, i.e. their obligations which in many cases were higher than assets and receivables put together – such companies had negative capital. Consequently, it was necessary to resolve the issue of their debts before launching privatization. It turned out that the largest part of liabilities of these companies (in some cases more than 80 percent) was debt to the state. Direct debt, such as tax and contribution arrears, or indirect, such as unpaid utility bills. Still, the bulk of the liabilities of these companies to the government is a consequence of foreign loans for which creditors were issued sovereign (government) guarantees, which have not been repaid. The fate of this part of companies' liabilities from the mentioned group deserves some more attention.

Namely these loans were taken out by domestic real sector companies, domestic banks acted as financial mediators, namely in most of the cases four large banks liquidated in early 2002, and the state issued sovereign guarantees to foreign creditors. Consequently, the state took over all the claims of these banks arising from extension of foreign loans with sovereign guarantees and allocated these claims to the Agency for Bank Rehabilitation, Bankruptcy and Liquidation. Although the liabilities of the state to foreign creditors arising from these loans (in arrears) were considerably reduced on the basis of agreements with the Paris Club creditors (51 percent of government debt was written off in November 2001, while the remaining 15 percent will be written off after successful completion of the Extended Arrangement with the IMF envisaged for end-2005) and the London Club creditors (a write off amounting to 60 percent in total), the state did not write down its claims on its debtors, i.e. the companies which used these loans. In other words, a reduction in the state's liabilities to foreign creditors did not result in a reduction of government's claims on debtors in the real sector.

Two mentioned problems created a need for pre-privatization restructuring of these companies, in order to make their privatization possible at all, that is their sale (at any selling price). The envisaged restructuring implies organizational changes (mostly fragmentation) and resolution of company liabilities. In addition, restructuring can imply also bankruptcy, i.e. liquidation, of parts of these companies (followed by the sale of assets) and cutting employment. Such pre-privatization restructuring (in the unofficial World Bank jargon called "dressing-up the pig") explicitly bans any investment, be it in fixed assets or working capital. It is just light pre-privatization restructuring which is followed by privatization through tender or auction, i.e. by the sale of shares of that company, i.e. its parts, to a new private owner. Therefore, as early

as 2001 a group was formed of 69 companies with around 155,000 employees (those who formally have a work place, that is, an employment booklet).<sup>2</sup>

The above described restructuring, provided that a solution is found for the liabilities of the company, may be also called a substitute for bankruptcy, i.e. liquidation of a company through bankruptcy. One should not completely disregard the possibility that one of the motives for introducing such restructuring lies in the awareness of the shortcomings of the then legal arrangements related to bankruptcy, in particular extremely long duration of bankruptcy proceedings, weaknesses in its implementation and uncertainty with respect to the adoption and implementation of new bankruptcy legislation (which proved to be reasonable, considering that the new bankruptcy legislation, although passed by the Parliament, has not been implemented over the first half of 2005).

However, in the first four years of transition nothing came out of the said restructuring and subsequent privatization of these companies. A mere two companies from the mentioned list had completed pre-privatization restructuring and were sold in early 2005. The question may be asked why there are such delays in the restructuring and privatization of this group of companies.

It is obvious that two main technical problems have arisen in relation to the implementation of thus designed restructuring. The first one is the problem of identification, separation and verification of claims by different creditors on the said companies, taking into account that their arrears are years and decades old. That problem is aggravated by the already mentioned problem of debts to the state, for the write-off of which, conditional or unconditional, irrespective of government policy, in some situations there were no legal grounds. The second problem is a relatively complex and pretty absurd organizational structure of these companies, primarily the cases of socially owned holdings created through the transformation of the so-called complex organizations of associated labor. This second problem is augmented by the engagement of

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<sup>2</sup>The number of such companies varies. So far, since 2001 only two such companies have been privatized, which decreased the initial number of companies under restructuring. Contrary to that, companies which were not initially slated for restructuring, and whose privatization failed after two attempts (nobody offered the initial price), are included into the group for restructuring, as it has been assessed that further attempts at their privatization will not be successful. Hence, the total number of companies slated for restructuring was 75 in March 2005. Moreover, this number of companies should be increased by more than 500 smaller subsidiaries. These companies are in a way hostages of large companies, bearing in mind that the future of subsidiaries, whatever it may be, is linked to the fate of large companies which need to be restructured. The total number of employees in the companies slated for restructuring (including small enterprises and subsidiaries) stands at around 200,000.

foreign advisors, which in certain cases was mandatory, where big multilateral donors provided grants. Foreign consultants, unused to such organizational arrangements, were wasting time searching for the sense where there is no sense, nor has ever been.

However, the key reason for the absence of activity in the field of restructuring of this group of companies lies in the lack of political will to do that. Overstaffing in those companies is the main reason behind the lack of that will. Namely, the restructuring of these companies would inevitably lead to lay-offs of a sizeable number of those presently employed. Whether directly, in the course of pre-privatization restructuring, or indirectly, after privatization, as part of efforts by a new owner to restructure his own company and enhance its economic efficiency. The total number of future retrenchments in restructured companies will vary from company to company, but in general terms, it could be said that these will be older employees, with lower levels of qualifications and relatively limited capacity to acquire new skills and change their work habits. Furthermore, one should bear in mind that a number of such companies in the cities, i.e. regions, where they are located, generate very significant portion of total employment, which is relevant in light of proverbially low labor mobility in Serbia.

In that respect, the restructuring of these companies, i.e. lay-offs of redundant workers, can have negative political consequences – significant falls in political popularity of those taking these decisions and those implementing such restructuring. Therefore, there is a direct incentive to politicians to maintain the inherited redundancies, namely in the case under consideration here, not to carry out pre-privatization restructuring. General managers, i.e. employees' representatives in those companies, being aware of the mentioned incentives related to political popularity, are in a position to blackmail politicians, mostly by demanding a constant flow of, and an increase in, subsidies to such companies, i.e. suspension of any restructuring of such companies.

It could be said that in this manner political equilibrium has been established in the form of balanced subsidies to non-restructured and non-privatized companies, maintenance of redundancies in them and political support which those employees and their families lend to the politicians who are not carrying out restructuring. This finding is in full compliance with the findings of the model of relations between politicians and firms (Shleifer and Vishny, 1994). In the said equilibrium, explicit subsidies are paid to loss-makers (budget item subsidies to non-financial organizations) and soft budget

constraints are made possible. Namely, in addition to direct subsidies, non-payment of utility bills to public enterprises is tolerated, and as for other creditors, the efficiency of collecting claims from socially and state owned companies in Serbia is proverbially low.

An indirect confirmation of the thesis that political equilibrium was established relatively early on, which was not conducive to the real sector restructuring, is a relatively low level of efforts invested in institution building, i.e. in creating institutions and building administrative capacities necessary to carry out pre-privatization restructuring. Namely, in setting up the Privatization Agency, which is, among other things, in charge of the real sector restructuring, far more attention was paid to the building of the Tender and Auction Centers than of the Restructuring Center.

In this manner, a connection empirically verified also in other countries (Djankov and Murrell, 2002), was confirmed in Serbia as well, and that is the connection which exists between soft budget constraints and absence of enterprise restructuring. Moreover, on the basis of domestic experience, there is room for an even firmer conclusion, which reads that without the imposition of hard budget constraints, there are no incentives for the real sector restructuring. In other words, with soft budget constraints in place, the real sector cannot be expected to restructure.

On the example of these companies another empirical finding could be tested (Djankov and Murrell, 2002), which is that foreign trade liberalization and tougher international competition spurs the restructuring of such companies. Namely, it could be said that in Serbia the first year of transition saw liberalization of foreign trade flows, largely due to the elimination of quantitative import restrictions, and to a lesser extent owing to the reduction in customs protection. Nevertheless, such changes did not bring about the restructuring of this group of companies. On that basis, it can be concluded that the imposition of hard budget constraints is a necessary condition for restructuring. Without this condition in place, foreign trade liberalization can not by itself create incentives for restructuring.<sup>3</sup>

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<sup>3</sup>The relation between foreign trade liberalization and hard budget constraints is more complex than it might seem at first sight. Namely, protectionism increases equilibrium prices on the domestic market, which can enable such companies (if they still produce something) to operate without losses by selling their goods on the domestic market, thus also making the component of soft budget constraints lose its relevance. Foreign trade liberalization is cutting prices on the domestic market and forcing the state to (unless it wants them closed down) subsidize such companies. In that respect, foreign trade liberalization produces higher transparency, bearing in mind that explicit subsidies have to be introduced. Clearly foreign trade liberalization is not a sufficient condition for restructuring, but in the case of Serbia it is not clear whether it is even a necessary condition. Namely, even in the

It is obvious that, in principle, political equilibrium was established in Serbia, namely a vicious circle in which there are no incentives to any of the parties to begin the restructuring of the real sector, i.e. of this group of enterprises. However, a question is raised as to the extent to which some of the perceptions underlying the decision-making process are based on reality. On the one hand, the first transition government lasted almost three years, longer than in nearly any East European transition country. Still, it is questionable how justified it would be to link this political result primarily to the non-implementation of the real sector restructuring. Furthermore, the fall of the first Serbian reformist government in 2003 certainly was not a consequence of the restructuring of the real sector, since no such restructuring ever happened. Finally, a question may be asked to which degree the real sector restructuring influences the popularity rating of the government, that is, of the ruling parties, today. Namely, employees in these companies indubitably belong to the losers in transition, so it can be assumed that this part of the electorate turned against the government, that is, against reform policies, a long time ago and that they have long been voting for opposition political parties, in particular those which for sure are not reform-oriented, i.e. whose political programs do not envisage orientation to market economy.

In the long run, political equilibrium is established based on the political popularity (voters' support) which is a result of increased subsidies, versus the political support which is a result of cuts in taxes collected for financing these subsidies.

In Serbia, four years after the beginning of transition, political popularity as a result of increases in subsidies is still far greater than political popularity won on the basis of cuts in the tax burden on the taxpayers. Namely, in present-day Serbia, the number of those who are mindful of their own budget burden is still relatively small. The number of those who live on subsidies, that is, on transfers, is considerably larger. With a rise in wealth, i.e. at an increased level of steady income, the number will also increase of those who define their preferences in politics on the basis of tax burdens, among other things, which political competitors are offering to them. Such a change will bring about the establishment of a new political equilibrium in which there will be no incentives for keeping the redundancies in the real sector. Support to such change can come from a tax reform which would increase the share of direct taxes in total tax revenue at the expense of indirect taxes. Namely, a tax burden based on

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conditions of protectionism many of the 69 companies in this group were not able to cover expenses out of their own revenue, which means that the imposition of hard budget constraints would bring about restructuring, or bankruptcy, even in the absence of foreign trade liberalization.

direct taxes is much easier to notice and a larger number of people will see the connection between increased subsidies and their own increased tax burden.

New private investments, i.e. investments in new plants, generate economic growth and increase the number of voters to whom their own tax burdens matter much more than the subsidies the state is providing and this will inevitably result in the shifting of political equilibrium toward a reduction in subsidies. The problem is, however, in the fact that such a solution takes time and may be jeopardized if interest groups which demand subsidies get well organized.

In the short run, however, help in terms of incentives to scale back subsidies and carry out restructuring of the real sector may come from those who represent the interests of budget balance, and in Serbia that is only the IMF for the time being. When the Serbian parliament adopted the 2004 annual budget providing for a deficit in the amount of around EUR 625 million or around 5 percent of GDP, only the pressure from the IMF managed to force the Government to submit to the Parliament a rebalanced budget with a dramatically decreased budget deficit. Likewise, it is only thanks to the IMF's pressure that the projected deficit in the 2005 annual budget amounts to "a mere" EUR 250 million and allocations for subsidies to non-financial organizations, that is, subsidies to the real sector, are declining. Obviously, against the backdrop of prevailing economic populism and relatively instable ruling coalitions, the IMF is only relevant and credible political force which prevents uncontrolled growth in the budget deficit, i.e. which reduces it to a more or less acceptable level.

### **Public enterprises – restructuring and reform**

Public enterprises were created in Serbia in the early 1990s, on the basis of a concept that these companies, irrespective of the ownership of capital, should be companies performing activities of public interest. However, unrelated to the above concept, these companies were very soon practically transformed into companies with state owned capital, and therefore an equal sign was effectively put between public and state owned companies. These companies were established in the fields which have elements of natural monopolies (electricity, communications and certain types of transport), elements of administrative monopolies (forests, oil industry), but also activities in the field of transport

which do not possess elements of a natural monopoly, and administrative monopoly has not been formally established (air traffic). In addition to the national public enterprises (at the level of Serbia as a whole), which employ around 135,000 people, a large number of public utility companies were established at the level of municipalities, i.e. local communities.

The inherited situation in these companies at the beginning of transition may be assessed as very unfavorable. Firstly, in these companies core and non-core activities have been completely integrated. For example, within EPS, the core activity, such as electricity generation, was integrated with non-core activities auxiliary to the core activity (which are directly linked to the performance of the core activity), such as maintenance of power plants, and non-core activities performed as side activities, such as catering facilities and vacation homes, i.e. hotels. As a result of such organizational structure, in the regime of public enterprises such activities are performed, which do not belong to activities of public interest under any criterion whatsoever. The consequence is that these, commercial, activities within public enterprises are fully protected against market competition, and they cannot be privatized, either. The next consequence of such an organizational structure is a very large number of employees in these companies, i.e. high overstaffing.

In the period prior to transition in Serbia, in the case of a large number of public enterprises the policy of depressed prices was pursued (motives for such a policy will not be discussed). This led to a dramatic decline in the revenue of public enterprises, and in some cases (e.g. electricity), to a rise in consumption of services they provide and higher costs of public enterprises. All that produced sizeable financial losses of public enterprises, which were covered in part by subsidies from the budget, while in part they constituted a quasi-fiscal deficit. The beginning of the public finance reform in Serbia in the course of 2001 converted almost all quasi-fiscal deficits of public enterprises into subsidies. That is how public enterprises came to be the biggest beneficiaries of budget resources, within the item subsidies to the non-financial sector, with the Serbian Railroad Company being the biggest individual beneficiary of these resources.

The absence of any incentive whatsoever for economic efficiency, mostly due to the absence of competition, but also due to the public ownership of capital, contradictory objectives of business operations of public enterprises and the absence of the possibility of bankruptcy (though the new Company Law allows for liquidation of these companies without bankruptcy), led to

very low economic efficiency of these companies, and one of the indicators of that low efficiency is redundant labor. Finally, many of these companies, like, for instance, JAT Airways, were not repaying loans they used to procure fixed assets, and ended up with huge liabilities. Although public enterprises in Serbia are not so 'commercially neglected', as are socially and state owned companies from the list of 69 companies, they certainly require thorough restructuring.

In analyzing the state of affairs in the public enterprise sector, it is necessary to separate two types of restructuring. One is relatively easy restructuring, which could simply imply a change in business policy of these companies. It is beyond doubt that significant changes have been made in that respect, which have first and foremost significantly reduced uncontrolled financial flows in these companies. This restructuring is mainly a consequence of the change of managements which happened with the change of government in late 2000, i.e. early 2001.

As for deeper, organizational, financial and management restructuring of public enterprises, very little has been done there. The only thing that was done was the spinning off of coal mines with underground exploitation, which have become an independent public enterprise, while two enterprises have been set up at the level of Vojvodina for water management and forest exploitation – a change motivated by the policy on Vojvodina's autonomy, and far from any economic rationale, i.e. economically-driven restructuring.

In other words, the absence of restructuring of public enterprises can be almost equalized with the absence of restructuring of large state and socially owned companies, those from the group of 69. It could be said that the reasons are identical. In the case of public enterprises, too, political equilibrium has been established in which explicit subsidies are paid to loss-making companies and they are allowed soft budget constraints, i.e. in which the restructuring of public enterprises is not initiated, all that being geared to garnering political support of employees in these companies. In that sense, the mechanism to destabilize this equilibrium, that is to break the said vicious circle, is the same. It is the elimination of the budget deficit, i.e. budget expenditure cuts.

## FUTURE RESTRUCTURING – WHAT NEEDS TO BE DONE, AND WHAT CAN BE EXPECTED

From the standpoint of successful restructuring of the real sector, it is necessary to make several basic steps.

1. Cancellation (conditional write-off) of debts to the state of heavily indebted companies, in order to privatize them through sales to interested investors. Privatization proceeds should serve as a basis for *pro rata* payments to creditors, namely to replace the bankruptcy estate which is formed in bankruptcies and liquidations of companies. This would establish an ownership structure which would create strong incentives to the restructuring of these companies. The first steps in this direction were made in the first quarter of 2005, when the Government drafted amendments to the Privatization Law, which will create legal grounds for such a procedure. Obligations related to social programs should not be imposed on new owners, as was the case before. Instead, social programs, if necessary, should be dealt with by the state.
2. Fragmentation of large companies is certainly a priority, in order to form units which can be privatized through sales, as well as units which are slated for bankruptcy and liquidation. There is a strong probability that in the process of liability allocation cooperation can be expected early on from creditors who have written off many of these claims, i.e. who have low expected values of these claims.
3. Following the above step is efficient implementation of new bankruptcy legislation, i.e. bankruptcy and liquidation of those companies which cannot be privatized through sales. Their bankruptcies will release significant resources which are currently not used and which will be made available through these bankruptcies to new investors interested in starting business. Therefore, this policy should be combined with the policy of eliminating barriers to the entry of new investors, both at the level of Serbia and at the level of local communities and their considerable powers in this area.
4. It is necessary to additionally accelerate the privatization of those companies in the real sector which are not in need of pre-privatization restructuring. All the institutions necessary for carrying out such privatization have been built and are up-and-running, so that it would require only a strong political impulse from the Government, to demonstrate that privatization is its priority task.

5. Thorough restructuring of public enterprises is necessary. Although the inherited situation, hence the obstacles to restructuring, vary from case to case, there are several recommendations, i.e. guidelines, which are common for all public enterprises. The first step is to spin off non-core activities from public enterprises, i.e. to set up new legal entities for the performance of these activities, with resources they are using at present. Such companies should be very soon exposed to competition and privatized by applying the general model in force.
6. A much more complicated part of restructuring follows, related to the reorganization of the performance of core activities (horizontal and vertical separation), aimed at exposing to competition all those activities which are now performed within public enterprises, and which can be exposed to competition, that is, which are not natural monopolies. The said reorganization should be followed by thorough restructuring of new units based on massive labor shedding. Only after the reorganization, and in some cases also after the restructuring of new units, privatization of these units, i.e. new companies, should be considered, that is, initiated.
7. In parallel to restructuring and privatization of public enterprises regulatory institutions should be built, primarily independent regulatory agencies for regulation of natural monopolies, bearing in mind that certain activities performed by public enterprises belong to natural monopolies. The building of such institutions, in addition to the economic effect, has a significant political effect as well, since it mitigates political resistance to privatization of public enterprises.
8. Finally, the key element related to all these steps is the imposition of hard budget constraints on all the companies. That implies the elimination of explicit subsidies, as well as consistent conduct of bankruptcy proceedings, so that creditors can collect their claims from insolvent, i.e. illiquid, debtors, and consistent observance of contracts, i.e. contract enforcement, so that creditors can collect their claims from solvent debtors.

However, a question can be rightfully ask whether there are political incentives for the implementation of the said steps, i.e. whether it is realistic to expect any activities of the government in that field. An answer to the above question should be sought in the following facts.

1. There is strong pressure from the IMF to restructure the real sector in order to resolve the problems of the budget deficit, i.e. too large public spending, and trade deficit. The budget deficit, i.e. public spending, is

primarily related to public enterprises, and the trade deficit is related to non-restructured and non-privatized socially and state owned companies which cannot export. One should not expect the said pressure from the IMF to abate, it can only be heightened.

2. A change in political constellation can be expected (maybe it has already occurred), in which most of those employed in non-restructured companies (public, state and socially owned) perceive themselves as losers of transition. In that context, they vote in large numbers for those political parties which are against transition and against the establishment of market economy. In other words, in this political constellation, the restructuring of the real sector will not create new political opponents – they already exist, hence there is nothing to lose. Such political development can even lead to the stability of the government which begins the job of real sector restructuring.

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Boško Živković

## Banking Sector Restructuring

### INHERITED SITUATION: SYSTEMIC INSOLVENCY

In the previous decade the banking sector was almost completely devastated: the total assets of banks from the territory of Serbia and Montenegro were reduced from the level of around USD 22 billion in 1989 to around USD 9.5 billion at the end of 1999. The income-bearing assets of the banks fell considerably faster than the total assets: domestic currency loans went down from the level of around USD 17.5 billion at the end of 1989 to USD 0.7 billion at the end of 1999. The reduction of dinar assets is accompanied by the immobilization of the foreign currency components of assets. The collectibility of dinar placements was decreased from the level of around 40-50 in early 90s to 20-30% at the end of 1990s. At the end of 1999 the share of income-bearing assets (interest-bearing assets and analogous components) in the total assets was approximately 13%. Despite the interest rate control, the interest rate margin (difference between the lending and borrowing interest rates) was extremely high. Despite that, the banking sector operated at a loss during the whole decade. The sector's liquidity was low and unstable.

The banking operated, in a political/economic sense, as a redistribution mechanism. It constantly transformed the quantity of money that was small in real terms and decreasing into a "soft loan". Disruptions were quickly and with high multiplier effect transferred from the economy and government to the banking. The main disruption transferred from the environment to the banking activity are large deficits. The quasifiscal deficit, which was primarily created in socially- and state-owned companies (primarily in infrastructural activities), was partially financed by loans granted by commercial banks. The direction of commercial banks' loans towards the financing of quasifiscal deficits presents the main cause of the low loan collectibility. According to the findings of a

questionnaire organized in June 1997, commercial banks regularly collected about 50% of the approved principal and around 60% of accrued interest. After that period, the collectibility rapidly deteriorated. In mid-1998 the rate of principal collection was 20-30%, with only 33% of the accrued interest being collected for the first 6 months of 1998. In the group of large commercial banks, the collection of principal and interest is even weaker. Because of the insolvency of companies-debtors a significant part of loans which was not serviced regularly became, in the total amount or significant percentage, permanently uncollectible. Therefore, the active part of the banking sector in Serbia entered transition with low capacity and very low level of credit interest rates. It was mostly useless. This situation is described by Table 1. The high price and low accessibility of loans inhibited the activity in the real sector.

Table 1. Average weighted interest rates (in % at the annual level)

Description	December 2000	October 2001
Average lending nominal interest rate	77.90	34.98
Average borrowing nominal interest rate	34.627	21.81
Nominal interest margin (at the monthly level)	2.30	0.89
Real lending interest rate	40.94	2.77
Real borrowing interest rate	-0.15	-0.71

Source: NBS, Statistical Bulletin, various issues

Under the described circumstances, rent seeking is almost an inevitable phenomenon. During the 1990s the banking sector was overflowing with rent seekers of different types. A large portion of non-performing loans arose in fact form related party lending.

## OVERVIEW OF MAIN MEASURES AND EVENTS

The main measure in the period after autumn 2000 was the closing (bankruptcy) of more than 25 insolvent banks. The total assets of these banks accounted for almost 2/3 of the assets of the total banking system. The main reason for such a radical decision was the deep banking crisis and low ability of the budget to increase the capital of insolvent banks. Through bankruptcy, mergers and acquisitions the number of banks in Serbia went down from 83 in 2001 to 46 in 2004.

The second key measure was the dismantling of the related party lending system. This phenomenon was almost legal in the previous decade: most non-performing loans were approved to the owners of insolvent banks. In banks which had this imperfect connection the marginalization of the existing owners was conducted. This was done based on a separate law on the Paris and London club of creditors. From July 2002 the Government of the Republic of Serbia initiated the conversion of the banks' debt to the Paris and London club of creditors into the capital of the group of banks which had these debts. The result of this process was a temporary nationalization of a large part of the banking system.

A measure of this type was inevitable for two reasons: the first, debtor banks did not have any possibilities to meet their commitments without greater disruptions, and the second, the corporate structure of banks, inherited from the previous solutions, did not enable efficient management, since the main debtors were at the same time the main shareholders of the banks.

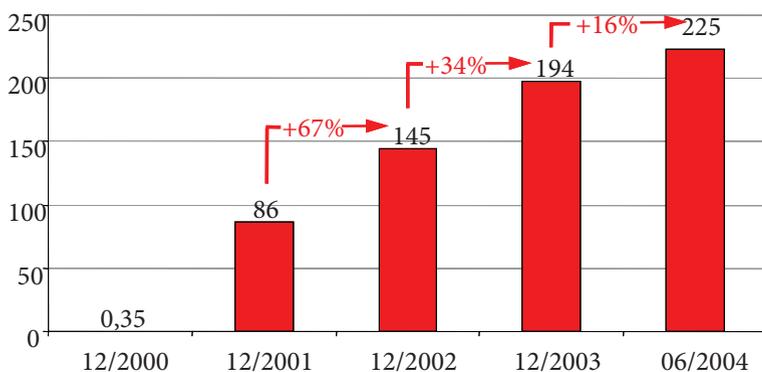
The banking system of Serbia, after the radical structural changes (bankruptcy of large banks, entry of foreign banks in the market, temporary nationalization of some banks under the law on the Paris and London club) is recovering. At the end of 2004 the banking sector of the Republic of Serbia consisted of state-owned banks, domestic private banks and foreign banks. At the end of 2003 domestic banks owned approximately 80% of the total assets and 87% of capital. A rapid expansion of deposits and loans in foreign banks changed the configuration so, after a successful bank privatization in 2005, the banking system is to cease to be dominantly domestically-owned, i.e. state owned.

### MAIN RESULT: RAPID RECOVERY OF CREDIT ACTIVITY

The most important change in the Serbian banking during the past 3-4 years is the rapid growth of credit activity. It is clear that, after the large crisis during the 1990s and ensuing radical therapy, the remaining portion of the banking sector is recovering. Although the credit growth dynamics is slowing down significantly, the fact remains that such a fast recovery is rarely seen, even in the experiences of countries with similar history and prehistory of banking crises.

Despite the fast recovery, the level of credit supply (measured by the total loans/GDP ratio) of the banking system of Serbia remains comparatively small and inefficient. The value of this coefficient is still below 0.20 in this country. For the sake of comparison, already in 2002 the same indicator in Croatia reached 0.456, in Slovenia 0.384, and in Bosnia and Herzegovina 0.216. Therefore, in terms of its capacity and efficiency our banking system is still closer to the banking systems of central Asia, than central Europe. The second important quality of our banking system is its fragmentation. A large number of banks have small capacity. That group of banks is not characterized by pronounced credit activity growth seen in the entire sector.

Figure 1. Total loans of the Serbian banking system (in billions of dinars) and pace of its change (in %), as at the end of the period



Source: Lecture by R. Jelašić, IMQF Postgraduate Program, School of Economics, Belgrade, July 2004

The road to full normalization of this important economic activity is clearly long. A consequence of this finding is the following: for the banking system of Serbia to become comparable with the systems of the neighboring countries it must retain the attained pace of recovery. Is that possible? The following text presents an attempt to answer this question. Let us have a positive preliminary response to this question. The arguments supporting this assumption are as follows.

First: the loan structure is relatively favorable, relative to tradition and inherited situations. At the end of June 2005 the loan structure was traditionally dominated by the corporate sector (77%), and individuals (19%). Loans to the government and other sectors are negligible (2%). Retail loans are posting relatively rapid growth. Their growth causes dispute as it is primarily directed to financing the purchase of cars and durable consumer goods. There is still no cause for concern, because their level, due to low initial values, is still small. In the second quarter of this year the increase in loans to this sector was 7.9 billion dinars. The largest part of that growth referred to long-term loans. A relatively small increase in housing loans of around 1.2 billion dinars can be considered an unfavorable circumstance.<sup>1</sup>

The second important argument in favor of the optimistic assessment is the fact that the loan offer structure is quickly changing in favor of more efficient banks. Unfortunately, the banks which are dominantly or exclusively in foreign ownership are more efficient. They are increasing the loan offer much faster than the banks predominantly in domestic ownership. The banks in foreign ownership currently account for one fifth of the national banking sector, measured by the total assets. Their share in the total number of employees and the total network is probably smaller. This group of banks accounted for more than a half of the total loans (around 57% in 2003). This change in the loan structure will significantly affect the near and distant future of the national banking. If these trends hold out, the competitive edge of "domestic banks" will decrease. The advantages that the banks in foreign ownership have on the credit side will soon turn into a domination on the corporate banking market.

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<sup>1</sup> Other important indicators of the credit portfolio structure are also improving. It is also obvious that after the "clean-up" of insolvent banks from the sector, the process of cleaning up of each bank's assets continued. This was done particularly intensively by the banks in which the swap of government receivables for capital was very extensive. It is realistic to assume that the process of risk asset generation, which was institutionalized by the legalization of the so-called loans to founders or related parties, was placed under control. This means that risk loans will not increase in the future faster than the growth of the total assets. This is an important and far-reaching change in the manner of operation of the banking sector. The result of this process is a more favorable picture of the banking sector risk. Most banks adjusted the basic risk indicators (capital adequacy, large and the largest possible loan, permanent investment ratio) with the required levels already in 2003.

The consequences of this finding are as follows. The first can be formulated as a question: why is this group of banks more efficient than the rest of the system, in particular the “traditional” banking. These banks manage, with relatively scant resources, to quickly increase their income (interest) bearing assets. The conditions for the loan supply expansion are equally favorable for both groups of banks. The main factor which affects both groups of banks is the fact that almost half of foreign currency retail deposits are immobilized by the system of specific “deposit insurance”, and their transfer to the foreign reserves. The credit risk is still relatively high for everyone. A possible answer: this group of banks has obviously found a way to manage credit risks. It seems realistic to assume that it is a good selection of corporate clients, absorbing most of credit increase and generating dinar deposit growth. Competition has obviously been initiated in that market. The advantages of foreign banks are not exclusively interest rates. The quality of services offered by these banks is probably higher. This group of banks also has an important status advantage over the national banking. The probability of related party lending (traditionally speaking - lending to the founders or owners) developing in these banks is negligible. The reason lies not only in the procedures of credit analysis and credit decision-making taken over from parent banks, but also in the fact that lending to hidden related parties is practically impossible, because it would be completely irrational. The ownership over capital is separated from credit decision-making in status terms. The efficiency of management in these banks is measured by a standard indicator - increase in the owner’s wealth.

The third important consequence can be defined as a question: where are most of the assets of the remainder of the banking system allocated? The possible answers are as follows: one part is in old loans that are difficult to collect. The following, however, remains open: what happened with the placements of deposit increase after the renewal of savings? Why do domestic banks slowly increase the supply of loans? Rarities that can be found in balance sheets are of interest. For example, in some banks loans account for only a tenth of their assets. (In this situation a question arises: is such an institution a bank in the strict sense of the word?) The conclusion: the most probable reason of the relatively slow (relative to the first group of banks) recovery of loan supply of this group of banks is the “traditional” form of loan decision-making.

The fourth consequence is related to the near and distant future of the national banking. If these trends continue, the competitive ability of this group of banks will be reduced. The advantages which foreign-owned banks have on the loan side will soon turn into domination in the national, particularly

corporate banking. This process will be accelerated precisely by the open tender on the sale of two medium-sized banks. If the sale of large state-owned banks is not accelerated, this change can, in short term, have as a consequence the (in)efficiency of the procedure of their privatization. (The sale price of those banks greatly depends on their current and potential market share.) In medium and long term this process can lead to the marginalization of the share of the national banking. Leaving aside the value disputes as to which banking is better and more desirable, it should be noted that this process can activate a risk – reopening of a banking crisis. This risk is neither small nor distant: the decrease in the credit activity of large domestic banks can lead to their insolvency. In view of the size of their total assets and their share in the sector structure, this could be an almost insurmountable problem and a trigger of much more serious disruptions. An alternative and less painful solution of such a crisis is the acceleration of concentration in the banking sector.

Finally, the third argument in favor of the optimistic forecast is the high potential of the banking sector growth. This argument is a subject of deepest controversies. The starting assessment is affirmative here as well. The arguments can be historical and logical. From the historical point of view, the sizes of deposits, which essentially determine the credit potential, were in absolute and relative sense (relative to GDP) much larger in the 1970s and 1980s. The current banking system of Serbia only partially and with insufficient efficiency uses the existing deposit potential. In simple terms: it appears that more money is in mattresses than in banks.

This assessment can be proved in exact terms by analyzing the standard defined confidence coefficient (CC) defined by the ratio between the M3 / M1 aggregates<sup>2</sup>). In our country this indicator is still low. (Table 4) In the observed period it fluctuated around 0.4. In normal banking systems this coefficient is higher, sometimes much higher than 1. Unfortunately, during 2003 the reduction of the value of this coefficient is registered.

Table 2. Changes in the coefficient of confidence in the banking system

	December 2000	December 2001	December 2003
$CC(M1/M3)$	0.399	0.468	0.419

Sources: Bankers' Association of Serbia and [www.NBJ.yu](http://www.NBJ.yu)

<sup>2</sup> More details in: E. Zola, *Cost and Effectiveness of Banking Sector Restructuring in Transition Economies*, IMF WP/01/157, October 2001.

The key changes in the value of this coefficient arise from the growth of savings. The maintenance of the savings growth trend is extremely important not only for the efficiency, quality and capacity of the banking sector, but also primarily for the maintenance of the trend of activity recovery in the real sector. For the banking sector recovery dynamics to be maintained, it is necessary to maintain the “heroic” dynamics of savings growth. Problems: the remonetization with dinar monetary aggregates was gradually slowing down since the end of 2002 and its potential was probably exhausted at the end of 2003. The solution lies in the activation of the system of foreign currency savings protection (insurance).

The slowdown of growth dynamics and the low level of utilization of the existing foreign currency savings are the probable causes of slower dynamics of recovery of the banks’ credit activity. For the previous growth of savings to be restored, apart from replacing the current system of “deposit insurance” with a regular one, it is also necessary to resolve the fundamental issues of monetary regulation strategy: the status and use of foreign currency savings and reserve currency in general. A precondition for that is the basic strategy of accession to the European Union and integration in the EMU.

Finally, apart from these controversies, the issue of the size and dynamics of the future bank credit activity growth must be joined by a newly-raised one: could a rapid growth of loans cause inflation?<sup>3</sup> The monetary theory and experience of a large number of countries give sufficient reason for an affirmative answer to this question. That is, in any case, the reason for the existence of regulatory systems restricting the supply of loans. However, the probability of appearance of a crisis in the banking sector, which would quickly translate into monetary instability does not depend only on the dynamics of changes, but also on the **level of credit activity**.<sup>4</sup> An argument of the opposite kind is based on this fact: at low levels of credit supply, the risk of crisis appearance is not high unless the banking system is exposed to severe disruptions, such as related party lending. The reason: the growth of bank loans increases the supply of the real sector, which absorbs the demand this credit increase causes. The dynamics of supply increase mostly depends on the loan purpose. A working capital loan usually leads to a faster increase in supply than in the loan itself. In this country such phenomena are registered in a number of companies. This problem will be dealt with later in a separate section on the transition liquidity trap.

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<sup>3</sup>The issue was opened by Piritta Sorsa, Head of the IMF Mission to Serbia and Montenegro, with regard to the negotiations of the IMF Mission with the Serbian Government. See: *Politika*, 2 October 2004.

<sup>4</sup>Argumentation of this type can be found in: C. Cottarelli, G. Dell Ariccia, I. Vladikova-Hollar, “*Bank Credit Growth to the Private Sector in Central and Eastern Europe and the Balkans*”, IMF Working Paper, WP/03/213

MAIN PROBLEM: INTEREST MARGINS ARE  
DECREASING, BUT REMAIN VERY HIGH

The high costs of ownership, measured by the interest rate margin were a characteristic of the initial phase of transition in almost all countries. Sooner or later those costs were normalized, dominantly under the influence of the market. In the countries in which the credit market was established quickly, the normalization occurred relatively quickly, within 3-5 years.

In the countries in which the market is highly monopolized, the key problem is a low or negative deposit interest rate. It is established as a residual value of the lending interest rate, degree of loan collectibility and bank costs. In the long run this state is unstable, because it prevents the increase in the deposit base of the system.

During 2003 and in particular in the first half of 2004, Serbia saw a significant decrease in the general level of interest rates. Although the fluctuations of interest rates in the first half of 2003 were primarily a reaction to the changes in inflation, their relatively high level was a consequence of the high credit risk and a high level of regulatory costs, i.e. the level of immobilization of the banks' funds (required reserve). In the first half of 2004 the average weighted interest rates on deposits became positive in real terms. The discount rate was still negative in real terms in the first half of 2004. Its regulatory function was marginalized in this manner, if not fully annulled. The National Bank of Serbia conducted the policy of cheap money no one could get to.

The monthly average weighted credit (lending) interest rate fell moderately during 2004, reaching 1.16% in December, or 14.59% at the annual level. The hidden interest rate or, in jargon, the average weighted fee rate<sup>5</sup> collected when a loan is approved registered a decrease in the fourth quarter of 2004 relative to the previous quarter; in December it was 0.37% (0.26% and 0.87% on long-term loans). This hidden form of interest is higher in shorter-term than in longer-term loans: in the first case it is 5.74% of the amount of loan (dominantly consumer ones), and 3.90% of the amount of long-term loans.

The weighted deposit or borrowing interest rate (on total dinar deposits) stagnated in this period. In December 2004 this interest rate amounted to 0.3% or 3.6% annually. The old problem was preserved: these interest rates remained deeply negative. A consequence: dinar savings were practically non-existent. The structure of dinar deposits was dominated by approximately 70%

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<sup>5</sup> Banks in Serbia calculated single lump sum fees. The base is the amount of the approved loan. Collection - immediately upon the approval. The basic reason for the claim that it is hidden interest lies in the fact that official interest and fee are included in the loan price. This practice is regulated by the NBS rules on effective interest rate from the beginning of 2005.

of demand deposits and balances in giro and current accounts. These deposits generate no interest either theoretically or practically: in December 2004 the average weighted interest rate on these types of deposits was 0.08% on a monthly and 0.95% on the annual level. It is assumed that the level of dinar deposits is practically inelastic to the changes in interest rates. The reason: these interest rates are still negative. The proof: in December the average weighted interest rate on term dinar retail deposits was 1.03% a month and 12.86% a year.

This behavior of banks is essentially a rational response to the low level of confidence in the national currency. Even if interest rates on dinar deposits increased radically, it remains open whether that would be profitable, i.e. whether the growth of dinar deposits of this type would significantly increase the deposit potential of the banks?

The second type of behavior can be registered on the foreign currency deposit market. Interest rates on euro deposits do not differ significantly from one bank to another. There is severe competition on that market. Banks have different interest rates both in terms of maturity and size of deposits. The rates on euro savings demand deposits range from 0.7% to 3% annually, while the rates on term deposits maturing in a year vary in a wide range of 1.1% to 5.5%. One type of absurdity: the ranges of longer-term interest rates are smaller: savings deposited on a three-year term vary from 3% to 6%. This absurd situation can be explained easily: banks need short-term deposits more than long-term ones. The reason: loan structure is closer to short-term than to long-term horizon.

Table 3. Interest rates 2002- 2004 (in %, annually)

	Dec 02	Oct 03	Nov 04	Dec 04
Discount rate	9.00	8.50	8.50	8.50
Weighted lending i.r., total	14.81	14.72	15.39	14.59
On short-term bank loans	15.48	14.99	16.08	15.26
On long-term bank loans	10.87	12.86	12.09	9.86
Weighted borrowing i.r., total	2.74	3.72	3.72	3.60
On RS bills	22.71	20.59	21.15	21.25
On NBS bills	11.35	16.54	16.83	16.30

Source: NBS, Economic Review, January 2005

The second important implication of negative interest rates on dinar short-term deposits is that it is practically irrelevant. The credit interest rates of banks are connected with interests on foreign currency deposits. Explanation: although loans are approved in dinars, the repayment has a foreign currency clause in most cases. The old problem remains: intermediation costs are still high.

#### TRANSITION LIQUIDITY TRAP AND THE PROBLEM OF BANKING SECTOR EFFICIENCY

A question arises how, despite radical reform measures in this area, the banking system of Serbia still remains less developed than the banking systems in comparable countries? Apart from the factors located within that sector, another one should be registered. It is generally designated by the term “liquidity trap”. Macroeconomic stability is subordinated to the principle of efficiency and required reserves are extremely high. The effects of these measures on the behavior of the banking sector is not difficult to estimate. The level of credit activity will be lower, and (regulatory) costs of intermediation higher. Generalization: as long as the monetary policy is the basic pillar of stabilization policies in the circumstances of currency substitution (dual-currency system), the central bank has a restrictive effect on the recovery of the banking sector. It must restrict the supply of loans, regardless of whether it acts on the side of demand (retail loans) or supply (financing of working capital).

The experience of other countries, which faced more or less the same problems in the first stages of transition, shows that there are essentially two traps. The first trap was fiscal.<sup>6</sup> It develops in the following manner: the initial production decrease, development of the gray economy, criminalization of the society and rent activities lead to the decrease in fiscal revenue. Revenue reduction cannot be followed by an efficient policy of fiscal expenditure restriction. The budget becomes unbalanced. The government sustains heavy constraints in the battle against recession. A fiscal policy that would stimulate economic activity is not possible. The pressure of the expenditure side of the budget originates from the extensive social infrastructure and the increasing number of unemployed that almost fully rely on the government budget. The fiscal trap slows down economic growth and almost completely blocks anti-recessionary economic policy.

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<sup>6</sup> Identification and definition of the problem was given by J. Kornai. More detail in: Kornai, Janos, “Transformational Recession”, *Highways and Byways*, MIT, 1993.

Serbia has been in the fiscal trap for a long time. Successes in the normalization of public finance are mostly concentrated on the revenue side of the budget. The introduction and efficient implementation of the VAT point to a possibility of getting out of this trap. The basic issues related to such an exit is the reduction of budget expenditure. This is an equally painful and inevitable process, as well as revenue collection increase.

The second important phenomenon following the stabilization policies in all the countries was a liquidity trap. It is particularly deep in Serbia due to the dual-currency character of its monetary system.<sup>7</sup> Until the anchor of stability in medium term is taken over by other monetary policies, the banking system of Serbia will “produce” a relatively low level of credit supply.<sup>8</sup>

The transmission mechanism acts in the following manner: in order to curb inflation, monetary policy must be restrictive.<sup>9</sup> It involves a restriction of growth of the key indicators of money and credit supply.<sup>10</sup> The recovery of credit activity of banks and increase in the quantity of money in circulation are, in this pattern of economic policy, in conflict with the preservation of monetary stability. On the other hand, the severe restriction reduces the level of activity in the real sector. This causal connection has proved to be strong in the countries in transition. The reason: in a situation of general liquidity crisis, without alternative (self-financing and financial markets), companies are left without the working capital.

Companies and households respond to the liquidity crisis permanently generated by this pattern of economic policy in four ways:

- (1) by converting stocks into income: disinvestment, reduction of private foreign currency reserves;
- (2) defaulting;

<sup>7</sup> This phenomenon was analyzed in detail by Guillermo A. Calvo and Fabrizio Coricelli. See: “Output Collapse in Eastern Europe: The Role of Credit”, IMF Working Paper WP/92/64, August 1992.

<sup>8</sup> At the end of 2003 corporate loans amounted to 18.7% of GDP. At the same time this indicator amounted to 42.3% in Bosnia and Herzegovina, 26.6% in Bulgaria, 57.3% in Croatia and 42.7% in Hungary. According to the findings of the World Bank, bank loans are still a marginal source of financing of the economy and account for less than 5% of funds used by companies to finance working capital and new investment.

<sup>9</sup> An example of the activity of this trap is a recent press release of the NBS, which, responding to the increase in prices in May 2005, issued a release stating that “for the purpose of reducing inflationary pressures, ...it undertook measures from its area of competence... the required reserve rate on FOREIGN CURRENCY base has been increased by 5 percentage points to 26%”. Also: the obligation of the NBS to pay interest on allocated FOREIGN CURRENCY reserve of the banks with the exception of the retail FOREIGN CURRENCY savings has been abolished. The NBS will continue to sterilize surplus liquidity through repo operations “and in such a way influence the reduction of domestic demand”. See: [www.nbs.yu](http://www.nbs.yu)

<sup>10</sup> Those levels were a subject of an analysis by the IMF in a recent press release on the occasion of the completion of negotiations with the Government of Serbia.

- (3) reducing wages; and
- (4) borrowing.

All four ways have been used in our practice. The second and the fourth method dominated in the period before 2000. Enormous unsettled commitments and uncollected loans present a proof of that. Today the first and the fourth type of response to insufficient liquidity are active. Foreign currency liquidity reserves, held both by the corporate and the retail sector, can create sufficiently large dinar liquidity at any time which the central bank cannot sterilize efficiently and on time. Monetary policy loses efficiency under these conditions, while the price of such policy, measured by the effects on the financial and real sector becomes extremely high.

The initial liquidity crisis and low level of credit activity caused by restrictive monetary policy and strict fiscal discipline are partly a consequence of two key oversights in this economic policy model. Namely, in the developed economies there is an alternative to banking finance – developed capital market. Overseeing that key fact, in most countries (including Serbia) this economic policy model does not have a strategy that would enable the activation of healthy sources of financing the exit from transition recession. The resistance against this model offered spontaneously both by the retail and corporate sector is neutralizing the effects of monetary restriction by engaging private foreign currency reserves. This is a game with a negative result, in which all three players lose. The problem lies in the fact that the only long-term solution is the elimination of the dual-currency character of the monetary system by acceding to the European Monetary Union, or, which is less likely, designing an alternative economic policy model.

#### CERTAIN ELEMENTS OF DEVELOPMENT STRATEGIES

The basic strategic goal of additional changes in the banking sector is the increase in its capacity (credit supply) and efficiency (reduction of intermediation costs). For this goal to be achievable in medium term it is necessary to resolve in a consistent manner the status of the euro in the national monetary system and increase the level of safety of deposits by adopting a new deposit insurance law.

The first basic strategic goal is to increase the capacity of the banking sector. This goal is not unattainable in medium term, because the banking sector in Serbia has high growth potential. The maintenance of savings growth trend is extremely important not only for the efficiency, quality and capacity of the banking sector, but also, primarily, for the maintenance of the trend of recovery of activities in the real sector.

In order to maintain the dynamics of the banking sector recovery it is necessary to maintain a high dynamics of savings growth. Their growth is gradually slowing down. The solution lies in the activation of the system of protection (insurance) of foreign currency savings. The slowdown of growth dynamics and low level of utilization of the existing foreign currency savings are probable causes of slowdown of bank credit activity recovery. For the previous growth of savings to be restored, it is necessary, apart from the replacement of the current system of “deposit insurance” with a regular one, to resolve the fundamental issues of monetary regulation strategy: the status and use of foreign currency savings and reserve currency in general. A precondition for that is the basic strategy of accession to the European Union and EMU.

The second basic strategic goal is banking efficiency increase and financial intermediation cost reduction. Costs, profit and other parameters of bank efficiency in Serbia have very unfavorable values. The cost ratio for the best banks in Serbia is approximately 2.5 times the comparable values in those countries. For inefficient state banks this ratio is even 10 times higher than the comparable ratios.

An increase in the bank efficiency is a precondition for an increase in the efficiency of financial intermediation in Serbia. For this strategic reconfiguration of the system to be achieved in a short period of time, it is necessary to create conditions of full competition in which more efficient (domestic and foreign) banks would gradually take over the deposits and create loans. Therefore, this activity needs to be consolidated by small banks gradually merging with the large systems. Changes in the banking sector structure can mean either the liquidation of inefficient and small banks or their rapid capital increase and expansion through new strategic investment. Since a significant part of these banks are owed by the state a concept of resolving the issue of banks that cannot be privatized is needed and desirable.

An increase in the level of security of the banking and financial system and a reduction of the level of their risk, should enable their easier integration in European processes and reduce transfer costs. Supervision over the

operation of banks and other financial institutions should be modernized in institutional and technical sense. An increase in the NBS supervisory capacity is possible by implementing a plan for the development of control function and establishment and maintenance of special supervision over state-owned banks. A separate task of bank supervision is to monitor the banks generating a rapid growth of the total assets.

In view of the degree of interconnection between banks, insurance companies and brokerages, experiences of some EU countries that have a single institution for supervision over all financial activities should be considered.

After attaining the desired level of banking system security, it is possible to activate a new channel of financial intermediation – non-bank financial institutions, savings institutions, S&Ls and microcredit institutions. The activation of this system can contribute to an increase in the system's efficiency and increase in the competitiveness on the credit and deposit markets. Putting in place the basis for the development of the non-bank financial institution sector is possible by establishing supervisory capacity in the insurance sector and adopting the strategy of medium-term development of this sector.

Large (relative to GDP) internal debts make the normal operation of the financial system difficult. A part of those debts is concentrated in the relations between companies and banks in bankruptcy. A new law governing bank bankruptcy and liquidation should resolve the status of those debts and the institution managing them. There is also need for an improvement of the legal and institutional framework for bank exit, including a review of the status of the Agency for Bank Rehabilitation and giving greater authority to this agency in the implementation of bank rehabilitation.



Dragor Hiber

## New Economic Legislation

### INTRODUCTION

The creation of a new legislative framework for economic activities is one of the most important initial steps in any transition period. In Serbia, as in other countries in transition, three processes occurred simultaneously:

- Deregulation and liberalization, whose aim is to free economic life from the binds of socialist administration, in order to open up possibilities and realize assumptions for the establishment of a market economy; which meant, for example, abolishing the system of numerous permits and permissions, followed by the liberalization of foreign-trade relations and revoking various laws and sub-legislative acts which had created the possibility for state directives in economic life.
- The introduction and establishment of new institutions, characteristic of a market economy, for example, those which build and regulate a market for security papers, or which regulate markets in those sectors reserved up to now for the state (telecommunications and the energy sector for example).
- The fundamental reform of existing institutions which existed in a certain form in every economic-legal system and which should be transformed into a form corresponding to a market economy

Deregulation and the introduction of new institutions are presented in the analysis of transitional moves in individual sectors. The text which follows presents the processes in the third domain, in the reform and transformation of existing institutions.

Here, a specificity of the transitional processes in Serbia, especially in this domain, should be pointed out. Even as far back as the socialist era, especially

before the collapse of SFRY, in the Yugoslavia of that time, based on the concept of social ownership and self-management and the “socialist production of goods” doctrine, institutions were formed which could be qualified as quasi-market. In terms of form, they were to a considerable degree reminiscent of equivalent institutions in market systems. In essence and the milieu where they were formed, however, they were not.

Due to this, their transformation could have been either easier or more difficult than in other transitional countries of South-Eastern Europe. Easier, since the forms already existed, so resorting to the direct reception of models from developed market systems, or encroaching on (as for example in Hungarian company law) institutions which existed (and what they were like) more than fifty years ago was not necessary. On the other hand, reform could have been (and was) more difficult as the retention and reform of these forms allowed (and still allows) for a long term and more intensive influence of conservative forces and concepts than is desirable. The self-management conscience, i.e. the employees’ wish to decide on everything even in privatised companies is a good example of this.

Three segments which in a wider sense form part of company law, i.e. the legal organization of economic subjects: legislature on economic enterprises, on bankruptcy and the registration of economic subjects have been chosen as examples of these reforms.

Such a selection was made not only because the management method and legal shaping of economic subjects facilitates and reflects the reform processes, but also because legal regulations in this field represent the picture of the influence of legal inheritance on the transition processes.

Namely, while regulations on the organization of economic subjects (the Law on Companies, i.e. the Law on Economic Enterprises) could somehow, as a legal framework, accept transitional processes, bankruptcy legislature (the Law on Assignment, Bankruptcy and Liquidation) and practice are an example of the tough resistance of old structures and old philosophies, while the evolution of regulations on the registration of economic enterprises shows the tendency to add dynamics to economic life and create a clear picture of who the real existing economic subjects are in order to provide interested potential creditors and other partners with more detailed information through a data system registered by applying this law and interconnected data from other registers.

## THE LAW ON ECONOMIC ENTERPRISES

The Law on Economic Enterprises, passed in the autumn of 2004, is the third law regulating company law in accordance with a market economy. The first law of this type (the Law on Companies) was passed in 1989 and was the first step away from the concept of a self-managing company to a market company. Thus, as the basic model of an economic subject, it envisaged a social enterprise and its sub-forms (cooperative enterprises, public enterprises), and only as an exception the so called mixed enterprise (a company in which social property is joined by private) and private enterprises, including two basic forms from modern company law: an enterprise with limited responsibility and a stock company.

Only a few years after this law was passed, the social and economic environment in Serbia changed completely. Certain transitional elements, primarily those connected with leaving the previous system behind, showed the rudimentary regulative solutions of this Law to be inadequate, primarily in the sense of including new, more complex relations in the organization of economic subjects. Judicial practice had many difficulties in solving disputes between company founders and unclear solutions offered the opportunity for malpractice. Due to this, work on the preparation of a new law started very quickly. Its passing was postponed many times and for several years, primarily for ideological reasons, i.e. the lack of readiness on the part of the political and intellectual elite of the time to enter a political and economic transition. The new Law on Companies was passed in 1996 with completely new starting points and is to a great extent the basis on which the new Law on Economic Enterprises passed in 2004 was prepared.

The Law on Companies from 1996 started from a form of organizing economic subjects regardless of the type of ownership of the starting capital, i.e. the legal nature and founding regime (the physical or legal entity in private, state or social ownership). The ideological base for this law was the idea of corporatisation – all economic subjects, even social companies had to be organized into one form of enterprise set out by the law, i.e. in a given time, extended several times, they had to transform into such a form. These forms generally corresponded to those known in comparative company law. Partnerships and companies with limited partnership were planned as companies of individuals, while a stock company and limited joint companies were planned as capital enterprises, though the latter, according to the way

relations between the founders are envisaged was on the boundary between an enterprise of individuals or capital. As well as the principles of corporate organization, the law also contained special rules for a social enterprise, public company and company which employs handicapped people, by regulating, first of all, specificities in the managing method. A special law was later passed on public companies.

The Law on Companies from 1996, based on comparative solutions (mostly French company law), in essence represents a modern company regulative. Conceptually, it could serve as a legal framework for entrance into economic transition. The types of economic subjects it envisaged, the founding systems, the relations between founders, the basic principles of corporate management, and also the legal framework of interconnecting companies in principle satisfied modern standards.

With the acceleration of the transition process, starting from October 2000, and especially after privatization according to the new model began in 2001 and 2002, legal and economic practice highlighted the shortcomings (inadequacies and imperfections) in the Law on Companies from 1996. On one hand, the adopted conception proved to suffer from being extensively normative. Many questions, for example, from the field of corporate management were regulated in too much detail and were too rigid. The lack of flexibility of the adopted solutions restricted economic subjects in effecting complex inter-relations, especially those resulting from the influx of foreign (private) capital in a way that best suits the founders' goals and the character of economic relations. Many of these solutions are lagging behind the technical development made in the last decade (electronic shareholding, i.e. immaterial shares, decision-making via telecommunications etc.). Essentially unimportant questions were regulated in too much detail with the obligation to transfer the solutions from the law into corporate acts (statute, rule book etc.) that lead to the fact that the internal regulations of a company were too detailed, unclear and lacking in transparency.

On the other hand, numerous important issues, characteristic of a developed corporate system remained either unregulated or not adequately regulated, leading to significant controversy and disputes in judicial practice: regulating relations between the ownership and managing function in an economic enterprise and in the managing sphere, relations between the managing board and the director etc. Particularly difficult problems occurred just after insider privatization (according to the model. i.e. the law from

1977) which lead to the significant dispersion of ownership. The question of the rights and obligations of members and shareholders in relation to economic enterprises as well as those between members and shareholders lead to problems of similar intensity in a way that influenced creditor security. Questions of basic capital, its reduction and increase were regulated too rigidly and the general opinion was that the size of the minimum (basic) capital for founding an enterprise with limited responsibility was set too high etc.

Finally, the Law on Companies from 1996 did not adapt easily to new, modern solutions hitherto unknown in the legal system which regulated the capital market. Thus, numerous disagreements, i.e. contradictions occurred between the Law on Companies and those rules which regulated the security paper market, their issue and circulation, taking companies over etc. The solutions set out in the Law on Companies from 1996 were contradictory to other systematic regulations envisaging ownership relations: for example, in relation to the Law on Obligatory Relations the situation where a legal representative (director) of a company signs a contract outside the limits of the authority given to him by internal regulations, for example the Managing Board, is regulated differently and not quite clearly. The question of the validity of such a contract caused many serious disputes which, of course, increased the business risk of all economic subjects and foreign investors in particular.

Due to this, in 2002 the Ministry for Privatisation and Economy decided to set up a working group for the preparation of a new law on economic enterprises. The World Bank supported their work in an expert sense. The new law retained basic conceptual solutions, and to a great extent the systematization of the Law on Companies from 1996 in an attempt to remove all noted deficiencies. Some of these solutions are the result of the desire to harmonize the new law on economic enterprises with European directives relating to the organization of economic enterprises.

As regards the types of economic enterprises, the law omitted the theoretical classification into enterprises of individuals and capital and stood by the standard four-part classification into partnerships, companies with limited partnership, limited joint companies and stock companies. What is new is that the law tried to include and regulate entrepreneurs. For the first time after World War II a difference was made between an open and closed stock company with special, strict rules valid for open stock companies (financial revision, publishing business reports etc.). In the case of an open stock company, the role of the Commission on Security Papers in the procedure of founding an

economic enterprise was emphasized in the function of protecting the interests of both the public and the investor.

The legislator paid special attention to regulations on founding economic enterprises. A contract dominated the founding process, i.e. a founding act for one-member companies, though the principle that internal company acts are regulated in more detail by the Statute is accepted. For relations between founders, especially in the case of a limited joint company a special contract can be made between the founders. For all forms of economic enterprises foundation is significantly easier compared to the previous system. The minimum basic capital is significantly reduced (for limited joint companies); except in the case of an open stock company, the basic capital can be paid in goods and rights, and not money and the value of non-cash deposits can be evaluated by the founders. Furthermore, the law defines and limits the deadlines in which state organs can act in the processes of founding and registering economic enterprises, and passing a deadline is taken as if it has been approved, i.e. registration is then possible.

Significant new items were introduced into the system of corporate management. Firstly, a greater number of regulations are of a dispositional nature, i.e. founders and enterprise members can modify the management system to suit their own needs, i.e. goals. Secondly, the system of corporate management is simplified in all forms of economic enterprises except an open stock company. Thus, in the case of a limited joint company, unless the members defined this differently in the contract, in addition to the member assembly, a director or managing board also run the enterprise and supervision is handed over to an internal reviser or board of revisers instead of the supervisory board. In the case of a stock company, management is divided between the assembly and the management and executive board. Regulations on convoking and the decision making methods of the management bodies (the assembly and managing board) are clearly defined, which was a significant weakness in the existing regulations. Regulations on management responsibility and conflicts of interest are also strictly defined and the system of shareholder protection is significantly improved (possibility to reverse the decisions made by the assembly and managing board, lawsuits by minority shareholders, derivative lawsuits etc.). The goal of all of these regulations is the establishment of a more rational balance between the ownership and management function, a more complete ownership control of economic enterprises and a legally defined management responsibility. Many of these solutions are, to a great extent,

new not only to the old law but also to the legal tradition of Serbia and future practice will show how efficient their application is.

The strengthening of the controlling function of the founder (members, shareholders) through intensifying the authority of the Enterprise Assembly is especially significant in the management system. When dealing with relations between members, in accordance with trends in modern company law, special attention was paid to the protection of minority shareholders with the imperative method of regulation prevailing. This, of course prevents the regulation of this protection with internal company acts at a level below minimum standards, but at the same time risks reduced decision efficiency (“terror of the minority over the majority”).

From the viewpoint of management functions, this law abandoned the idea of defining the methods for the obligatory participation of the employees in the management and co-decision making process of a company. The question of participation is left to be regulated by the Law on Work or other separate regulations.

A significant improvement brought by the Law on Economic Enterprises in relation to the previous law is a detailed and precise regulation of the statutory changes of the enterprise and the interconnection of economic enterprises with capital. Regulating these questions, in the case of statutory changes, the law brings the protection of the creditor’s interests to the forefront. The legal solutions in this domain are almost completely harmonised with EU directives. On the other hand, when dealing with the interconnection of enterprises with capital, restrictions were made in relation to potential misuse, especially on account of minority shareholders or creditors – for example, by forbidding mutual participation in the capital. However, the law did not regulate the contractual interconnection of economic enterprises as the legislator deemed this matter part of trade-contract law, rather than company law. Theoretically observed, this viewpoint can be defended, but one should not forget that in obligation law, Serbia accepted the so-called system of unique regulation, i.e. the regulation of all obligatory relations with a unique Law on Obligatory Relations, so more specifically detailed, even dispositive regulations on contractual connection do not exist in the legal system. Firstly, this solution can de-stimulate the desired interconnection. Secondly, the non-existence of separate regulations makes contractual connection non-transparent which can endanger the interests of third-party economic subjects, minority shareholders and creditors. Thirdly, Serbia does not have an efficient antimonopoly

legislature and the proposed solutions (autumn 2005) are not convincing, so the absence of general legal regulations on contractual connection additionally opens up a space for the creation of damaging integration from the viewpoint of unsettling competitors.

In contrast to the previous law, the Law on Economic Enterprises does not have special regulations referring to social and public companies. Transitional and final regulations envisage the application of previous regulations valid for public and social enterprises and the idea that privatisation is obligatory makes new special regulations superfluous.

At the time when the Law on Economic Enterprises was passed (autumn 2004) the first transition phase was almost over. The legal framework of the modern business market was at least formally in place to a significant degree, i.e. as regards the number of laws. Thus, one of the central questions for the application of the newly passed Law on Economic Enterprises is the harmonization of this law with numerous laws regulating the status and management of economic subjects. It is not only an illustration to name the most important ones: the Law on the Registration of Economic Subjects, the Law on Marketing Securities and other Financial Instruments, the Law on Privatization, the Law on Bankruptcy Proceedings, the Law on Foreign Investments, the Law on Banks, the Law on Insurance Companies, the Law on Investment Funds, the Law on the Protection of Competitors (should be passed), laws on accounting, some process laws (extrajudicial and executive procedures) etc.

Although some of these laws were passed or changed just before passing the Law on Economic Enterprises, it is difficult to talk of the harmonization of this law with other regulations. The impression gained is that the proposal had the idea that the Law on Economic Enterprises is a basic system law, that the choice of key solutions lie in this law and that other connected regulations should be harmonized with those solutions adopted by the Law on Economic Enterprises. Theoretically, this is true, but from the viewpoint of normal and continual business practice and the normal functioning of the legal system this is a textbook example of bad legislative politics. On one hand, serious legal gaps exist until individual regulations are passed or changed – for example, Serbia today has no regulations in the domain of founding and connecting companies or in the field of foreign investments or in the privatization domain, or in the specific field of the protection of competitors which will be a barrier to creation, i.e. abuse of a dominant position, i.e. monopoly. This, besides other

things, leads to sending the wrong signal to investors. On the other hand, the harmonization of laws passed with the Law on Economic Enterprises has started before they have practically been applied, like the Law on the Registration of Economic Subjects. Finally, in some fields the legal framework has continued to be built independently of the newly passed Law on Economic Enterprises, so the creation of special subsystems has continued, even though the concept of the Law on Economic Subjects was that these subsystems, such as banks and insurance companies would be, in principle, regulated by general company laws.

The Law on Economic Enterprises is a complex and detailed law (457 articles) and many of its solutions are new in some significant details. It is understandable that work on such a key legislative act is long and complex. Even though the law was prepared for two years, the impression that can be confirmed by serious arguments is that its preparation was unnecessarily accelerated in the last phase. Thus, in the parliamentary procedure the Cabinet that proposed the Bill accepted and the parliament voted for an unusually large number of amendments a law of this type and of such significance. This could be the consequence of the bill being legally-technically incomplete and interventions by the Cabinet that proposed the Bill were carried out at the last moment through parliamentary procedure. This allows for the possibility of numerous other legal-technical weaknesses and discrepancies when the law is applied which cannot be noted at this moment.

In any case, the preparation and adoption of the new Law on Economic Enterprises represents a significant reform step. In the first place a significantly more modern codex of statutory organization is obtained – the law offers answers to questions and problems which arose in practice in the previous period. Secondly, this law is to a great degree harmonized with the European statutory law and also new trends and solutions adopted by modern national legislatures. Finally, it represents a complete legal framework for the establishment of a new market economy, both in the finalization of the privatization process and its complete end.

However, more than for other systemic laws, one must expect that the application of this law will require not only the adaptation of economic subjects and state institutions, but also the opening of new questions which will have to be answered by changing and adding to the law itself. Experiences of other transitional countries in which regulations on organizing economic subjects were changed several times, show that it is dangerous to take a strict

and inflexible attitude to the adopted codification, but the legislator should be open to the adaptation process and the need to fine tune the legal text. All the more, the application quality and real range of this law will depend on the speed and quality of its harmonization with other connected regulations. Existing experience with delays, confusion and polemics in the preparation of changing rules regulating the market of capital shows all the dangers which can occur in this process.

## THE LAW OF BANKRUPTCY PROCEEDINGS

The law valid until now regulating bankruptcy was the Law on Assignment, Bankruptcy and Liquidation passed at the same time as the first law on business, in 1989. The environment for which this law was prepared was dominant government ownership and self-management. The rules of bankruptcy and liquidation were in accordance with the legal-economic ambience in which many questions in legal and economic life were regulated using illegal methods and legal regulations, even those on bankruptcy only had an instrumental function in implementing political decisions. Thus, the Law on Assignment, Bankruptcy and Liquidation was, with justification, evaluated as being non-applicable to a market economy and was perceived to be a barrier for the establishment of clean and transparent economic-legal relations. The inherited practice in the application of this law, especially total voluntarism in making decisions on starting, leading and completing bankruptcy or liquidation proceedings probably represented this barrier to an even greater degree. Thus, this law primarily served to eliminate those subjects for which the permanent inability to settle their debts (insolvency) was established, from legal life.

As an option in exceptional circumstances (in the assignment procedure) the law predicted that the interests of a creditor of a business heavily in debt could be realized without final debtor elimination. The main legal-regulation weaknesses of the Bankruptcy Law prior to reform are as follows:

- Before the bankruptcy or liquidation proceedings began, a long primary procedure took place. By undertaking such a procedure the courts rarely decided to start bankruptcy proceedings. Bearing in mind the serious consequences of starting bankruptcy proceedings (the loss of the legal

subjectivity of the debtor, the loss of work on the part of all employees, etc.), the courts called on the “general interest” for postponing the decision on starting bankruptcy proceedings, thus enabling the existence of businesses which, objectively speaking, did not have any chance of survival, while the creditors helplessly waited for a change in the court’s stance.

- If the court ruled in favour of starting bankruptcy proceedings, the implementation of the bankruptcy proceedings was entirely in the hands of the court and the bankruptcy manager. The bankruptcy manager did not have any motivation to complete the bankruptcy proceedings quickly or any particular reason to protect the creditor’s interests. The creditor’s role in the bankruptcy or liquidation proceedings was minimized. The rules on converting the debtor’s property into cash did not facilitate an efficient procedure. As a rule, the property lost value or was confiscated and the position of the creditor did not improve after the bankruptcy was set in motion.
- The possibility of assignment depended on the debtor’s good will. The debtor or creditor could start the assignment proceedings only in agreement with the debtor. If the expert report on the material-financial state of the debtor was in favour of an assignment, then an assignment ruling was made if more than half of the creditors eligible to vote voted for it. The law envisaged a very rigid framework, i.e. the assignment method with a postponement of the payment for a year or a 50% reduction in claims. No other assignment modalities were allowed, for example, the postponement of all claims until the reconstruction of the debtor company, and what is of particular importance, those creditors who agreed to an assignment or who were forcibly included in the assignment did not have any legal influence on any restructuring, i.e. on managing the company.
- Liquidation proceedings were envisaged for a company which was not insolvent, but whose work should be brought to a halt by the will of the founders, by missing the deadline, if the company was founded with a deadline, by canceling registration, forbidding work and if “the subject is not organized in accordance with the law” (the law does not contain a definition of a situation where “a subject is not organized in accordance with the law”, where at the same time that is not also the reason for the cancellation of the registration). The regulation in question gave the liquidation court almost unlimited discretion. This possibility had

“interesting” applications, just after the onset of transition, by starting pre-liquidation proceedings referring to “illegal organization” in order to resolve very different relations: from significantly disrupted relations between shareholders, with the unresolved question of the size of the shareholding in the background, to the possibility that the government as the minority shareholder would gain control of the company. Opening pre-liquidation proceedings facilitated receivership, which was used in the case of large companies such as “Mobtel” and “ICN Galenika”.

Based on all of the aforementioned issues, the conclusion can be drawn that neither the legal framework nor the bankruptcy, liquidation and assignment practices satisfied any of the interests which should be met in a market economy. The fact that the new bankruptcy procedure law was passed as late as mid 2004 shows the acuity of the conflict of interests (often wrongly recognized) and also the strength of the remains of self-management logics and the resistance to transition.

Syndicates played a pronounced role in discussions on the future law on bankruptcy proceedings. The syndicate demands were not only an expression of tendencies to obtain the best possible position for the employees of a bankruptcy debtor in a bankruptcy procedure. This was, to a significant degree, achieved by the plan whereby the employees were placed in the second payment order in the creditor payment order immediately after the costs of the bankruptcy proceedings are met and before any government claims based on public income are met. Furthermore, government claims in relation to pension and invalid funds are in the second payment order as they are indirectly to the benefit of the employees. However, the syndicates considered that the employees should be consulted even about controlling the course of the bankruptcy proceedings and especially in the case of carrying out the bankruptcy proceedings by selling off part of the company or selling the company in debt as an entirety, when they should approve the attained price. For the syndicates this was a form of privatisation and not the payment of creditors, and according to this notion the employees as “representatives” of government ownership should be consulted in its “transformation”.

The postponement of passing the Law on Bankruptcy Proceedings was aided by the “transformation” of the Federal Republic of Yugoslavia. According to the Constitution of the FRY, a federal regulation needed to be passed, but in the meantime Montenegro passed its own law and at the time when the draft of the law was prepared, the adoption of the State Constitution of Serbia and

Montenegro was also expected, based on which the bankruptcy issue would fall into the jurisdiction of the member states, i.e. the Republic of Serbia. Finally, the law on bankruptcy was placed on the agenda of the People's Assembly of the Republic of Serbia for the session which ended in the disbanding of the Assembly and the parliamentary elections which were held in December 2003. The government which began its mandate after these elections brought a draft bill before the People's Assembly at one of the following sessions which had not undergone any significant changes from the previous government.

The name itself (the Law on Bankruptcy Proceedings) denotes a new bankruptcy philosophy – this is a law on bankruptcy proceedings which is applied when the debtor is incapable of paying.

Bankruptcy can end in one of two ways: in the bankruptcy of the debtor or his reorganization. Bankruptcy means the payment of creditors by selling off the property of the company in debt which therefore ceases to exist. Reorganization is intended to be the payment of the creditor according to the conditions adopted by the reorganization plan of the company in debt.

From these simple definitions cited in the first article of the law the philosophy of the new bankruptcy proceedings can be seen clearly:

- The reason for starting bankruptcy proceedings is the fact that the debtor is unable to pay
- The goal of the bankruptcy proceedings is the payment of the creditor's claims to the highest possible degree
- The rules of the bankruptcy proceedings are defined in order to attain this goal.

Thus, inevitability can be emphasized as the key innovation in the new bankruptcy system, i.e. the reliability of the criteria based on which the decision to open, i.e. to start bankruptcy proceedings is made. There should be no place for discretionary decisions by the court or any other institution. The creditor brings about the commencement of bankruptcy proceedings by asking the debtor to pay his debt with the result that it cannot be paid (as an exception the debtor himself can declare bankruptcy by ensuring that when the payments should be made he is not able to do so; potentially his goal is to secure timely reorganization, i.e. restructuring which will enable him to become solvent again). It is highly likely that this new item, the inevitability of the bankruptcy proceedings if the conditions set out by law are met, and especially in cases for which pre-bankruptcy proceedings are planned is the reason for the resistance

to adopting the Law on Bankruptcy Proceedings. (It remains to be seen whether the Commercial Courts will faithfully implement this by evaluating whether or not the conditions have been met). In the public, wagers have been laid on the number of government and state companies which will cease to exist after the strict application of the inevitability of bankruptcy rule, which would bring about the formal cessation of employment to a great number of those who are not officially employed.

Another significant innovation is the changed role and status of creditors in the bankruptcy proceedings. They cease to be passive observers of the actions of a bankruptcy judge, bankruptcy council and bankruptcy manager, and instead are active participants on whose decisions the implementation model of the bankruptcy proceedings, its dynamics and finally goal realization, i.e. creditor payment, depend.

Depending on the type of creditor, whether it is a bankruptcy, third-party or security creditor (a bankruptcy creditor is one who in the end receives payment from the debtor's property, a security one has claims which are secured by some real security means entered into the public register and a third-party creditor is one whose assets at the moment the bankruptcy proceedings begin form part of the debtor's property), the law enables him a special role in the process. Bankruptcy creditors play the most significant role, which is realized through special bodies, an assembly and board of creditors (the board is a body elected by the assembly and represents a type of executive organ). The Assembly of Creditors decides on whether bankruptcy will be conducted by means of a procedure leading to bankruptcy or by the reorganisation and continuation of the work of the bankruptcy manager. Creditors, through the Board of Creditors, by giving opinions to the Bankruptcy Manager, participate in decisions on how the property is converted into cash and also in other questions relating to the management of the property until bankruptcy has been completed. The board has a controlling role in relation to the bankruptcy manager with the right to object to his decisions to the Bankruptcy Judge or Council, to propose his dismissal and a replacement and to determine the level of compensation costs and reward for the bankruptcy manager. The board submits any complaints regarding the decisions of the Bankruptcy Judge and Council on behalf of all creditors.

The third new item is the significantly changed status of the bankruptcy manager. A special law (on the Agency for Licensing Bankruptcy Managers) proposed that licensing could only be performed based on a special expert

exam and also supervision of the work of the bankruptcy managers carried out by the agency. A bankruptcy manager has the right to compensation costs and a reward, so he is stimulated to perform his task well and quickly. At the same time he is held responsible for any damages under strict liability rule. A manager can be replaced (changed) during bankruptcy proceedings on the initiative of the creditors. If bankruptcy proceedings are performed on a debtor with majority government or state ownership, a “specialized organization formed according to a special regulation” will perform the role of the bankruptcy manager according to the regulations set out by the Agency for Privatization.

When bankruptcy is commenced, a bankruptcy manager has the authority of the managing organ or the owner in debt. As in the previous system, the bankruptcy manager is under the supervision of the Bankruptcy Judge and Bankruptcy Council, but control by the creditors is also included now, which represents an additional guarantee for his legitimate, conscientious and efficient work.

What is new is the attempt to determine deadlines for individual tasks in the bankruptcy proceedings. In total, according to the given deadlines, bankruptcy proceedings should last between six months and a year.

When converting the debtor’s property into cash, in addition to the sale of assets and property rights, the sale of the debtor as a legal entity or the debtor’s work is also envisaged. The law foresees the application of one of two types of public sale, auction or tender. Only in special cases, under strictly defined conditions and in a limited number of cases is free sale possible (by direct agreement).

As far as reorganization as a form of bankruptcy is concerned, it can be achieved at the proposal of the debtor, the creditors (at least 30%) and the bankruptcy manager and also the owner of 30% of the debtor’s capital. Reorganization means the adoption of a reorganization plan. The procedure involved in the preparation and adoption of the plan can last a maximum of 90 days from the commencement of the bankruptcy proceedings. The elements of the plan are set out by law. The law contains a detailed list of measures which can be adopted and applied with the aim of realizing the plan. In order for a plan to be adopted it is required that most creditors vote for it according to classes (bankruptcy, third-party and security) and payment orders.

The adoption of a regulation plan has the character of a settlement between the creditor and the debtor, the conversion of the claim to cash and

has the strength of an executive document. Bankruptcy is thus formally over, the denotation that the debtor is a bankrupt company is deleted from the register and it continues to function normally (though the plan may predict limited independence, i.e. the participation of bankruptcy subjects and organs in the management of the company). In essence, the end of the bankruptcy proceedings is conditional: if the plan is not realized, bankruptcy proceedings leading to bankruptcy will be reopened.

As a whole, the legislator strived to predict precise rules for every situation and phase of the procedure.

The scope of the new Law on Bankruptcy is still difficult to evaluate. Preparations for its application took a long time, so it can be said to be somewhat late. In principle it represents a serious advance in this transition phase, especially as a pre-condition for a thorough restructuring of the existing real sector in Serbia.

## THE LAW ON THE REGISTRATION OF ECONOMIC SUBJECTS

How the introduction of new subjects into economic (and legal) life is organized is especially important in the initial phases of transition. Not only can Company Law regulations set too high obstacles and barriers for the organization of new economic subjects, but these barriers can also be set on the formal side in the registration procedures.<sup>1</sup>

This does not exhaust the potential importance of this legislation. Public registers on companies and entrepreneurs provide information on the other participants in economic life. Their comprehensiveness, correctness and accuracy are also significant.

Furthermore, obstacles and unnecessary delays can also occur regarding changes in legal subjectivity (mergers, the division and connection of economic companies with capital).

In keeping with the economic and legal philosophy, socialist law was restrictive regarding the introduction of new subjects except for those founded by the state (in the Serbian variant, however, this also included those under government ownership).

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<sup>1</sup>Traditionally in comparative law and in Serbia/Yugoslavia legal subjectivity is gained by registration

Thus, it is perfectly understandable that registration regulations, in a certain way, follow the systematic laws in the field of company law (the Law on Companies, i.e. the Law on Economic Enterprises).

Hence, until recently the procedure of registering a company in Serbia was regulated by regulations drawn up in the pre-transition period (amended and added to later) in the last version of the Law on Registration Procedures in a court register from 1994, the Decree on Registration in a court register from 1997 and the Law on Private Entrepreneurs from 1989.

According to these regulations, the Commercial Court managed the company register according to regulations on extrajudicial procedures, while the municipal government body managed the register of entrepreneurs.

The court ruled on the application of a company to register by evaluating from the application and enclosed documents whether all conditions prescribed for registration had been fulfilled. The legal question asked here, especially after an inspection of commercial court practices, was, what was the role of the court and what was its authority in relation to the content of the submitted founding acts (in the application procedure, according to the Law on Companies from 1996, it was necessary to enclose the company's foundation contract, i.e. a founding act and statute), especially when predicted rules on corporative rule were in question.

In practice the court refused registration if it noticed faults in the composition, authority and relations of company organs which broke the rules of the Law on Companies, though not with a negative decision, but most often with a conclusion, thus a type of decision used for procedure control, de facto asking the founders to remove the noted deficiencies before an eventual decision refused registration.

In some cases, following the logic and principle rules of corporate control, the court would evaluate the suitability of autonomous solutions and not only formal law.

This all concerns the previous control of corporate rules, which albeit formal and sometimes rigid, was undoubtedly useful in the early phase of the development of corporate law in the transitional legal and economic system.

The practice of registration changes is also interesting. A characteristic phenomenon was that individual stockholders, i.e. shareholders in a society with unlimited responsibility, would contest the registration of changes stating that the law, i.e. the statute in the decision-making procedure containing the

change, had been broken. This concerned the content or legal questions for which suites could be filed for contesting the illegal decisions of company organs. Instead of filing these charges, the possibility for raising these questions in the registration procedure was provided and the registration court could decide on these issues, as in the previous question, so that even during the registration of changes procedure *de facto* disputes on property (stocks, shares) disputes, i.e. the ownership structure of an economic society, were conducted.

It is better when these charges are brought autonomously and not camouflaged by registration, not only because of the unjustified delays in the registration procedures.

Despite the ruling the registration procedure in a court register was considered urgent, the general opinion is that it took too long, too many documents were requested with the application, the signature notarization and other formalities were required and the courts acted too formally and rigidly. Any delay in the simplest registration can lead to significant damages. In addition, engagement on registration procedures utilized legal resources required for such long (too long) procedures.

Furthermore, the personnel and technical equipment of commercial courts was (and still is) such that difficulties arose when data on registration needed to be accessed (the register has the character of a public book and every interested party can inspect it, i.e. an extract).

This is why radical regulation changes were made in this field (these regulations were also prepared by the old government and did not come onto the agenda until the People's Assembly was disbanded and they were passed by the new session). Simplicity and speed are the main characteristics, i.e. the goals of the new system.

The new Law on the Registration of Economic Subjects removed the registration tasks out of judicial jurisdiction, transferring them to a special Agency for Economic Registers. This united the organs and regulations for the registration of economic companies and entrepreneurs.

This means that the procedure is not judicial, but a special case of comparative procedures. In this procedure an appeal (decided on by the authorized ministry) is allowed only against those decisions where registration is refused and not against those which accept it.

Registration is performed at the request (application) of the subject who is required to provide all of the necessary documentation required for registration.

The party who considers that the registration violates some interest (for example a stockholder or shareholder who considers that a registered change is against the law or internal acts of the company) can realize this interest only in court, by proving that the decision based on which the registration was completed (for example a decision made by the company's managing body) is illegal. The law then predicts a correction, i.e. the deletion of the registration.

Other, very significant new items brought in by the new system are:

- The urgency of the procedure, by law, is not just an instructive rule. If the registrar (the authorized individual named by the Managing Board of the Agency who performs all registration work, the issuing of excerpts and certificates etc.) does not complete the registration within the regulated time, the registration will be considered complete and the registrar forced to acknowledge it.<sup>2</sup>
- The uniqueness of the register for the whole of Serbia; registers which were kept in commercial courts did not represent an entirety. Now there is one register – independent of the office where the registration was carried out.
- The maintenance of the register in an electronic form facilitating rapid data manipulation.
- Links with other registers containing data on the economic subject.
- The obligation to submit annual reports on business affairs, meaning not only publicity, i.e. the accessibility of this data, but a corresponding legal reaction in the case when reports are not made; it is assumed that this is a result of the fact that the company or entrepreneur had no economic activity so their status will be defined as inactive in the line of duty if a report is not made in two years.

Inactive company status is a special category in the law which illustrates the transitional nature of the law itself and the economy it is regulating. This is the status into which all companies previously registered in commercial courts which do not request transfer into the new register are transferred. Namely, an evaluation was made that (proved right at the start of the application of the law) there are a significant number of companies in Serbia founded by law, which never really started to operate or have de facto stopped and their founders have not commenced a liquidation procedure and deletion from the register.

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<sup>2</sup>This formulation is not the best, for example, when the deadline for an application is met for an application that does not satisfy the conditions

## INSTEAD OF A REFORM BALANCE

Laws organizing the status, foundation and cessation procedures of economic subjects which prove unsuccessful were passed in the fourth year of transition; it was expected, based on the experiences of other countries in transition and due to the nature of the issues they deal with, that this would occur at the start of transition.

It was shown that this “delay” was in part caused by the fact that formal-legal, structures envisaged by pre-transition regulations could serve as the framework for new conditions, i.e. new processes. This primarily refers to the Law on Companies, i.e. Economic Enterprises. Any additions and fine tuning of regulations could wait (necessary interventions concerning public companies were performed earlier).

Thus viewed, the new Law on Economic Enterprises represents a good step forward. However, it must not be forgotten that the system, in a legal sense, is not complete by far. The public debate on some aspects of the legal regulation of the capital market and also the public scandals which occurred when the existing regulations were applied, clearly indicate which questions should urgently be regulated or reformed: the securities market and the role of investment funds. Not only is this market incompletely regulated according to the standards of a market economy, but the influx of a significant participation of private (shareholder) capital in market mechanisms is very slow.

The reform direction is clear. Public scandals which have emerged are linked to the unclear role and position of the state (as the capital owner, regulator, subject of economic politics ready to adjust the interpretation of laws to concrete cases, not respecting owners’ rights etc.). In short, the role of the state should be examined again, particularly the increase in that role in the last years of transition.

In the second part, the “delay” is to a great extent the consequence of resistance to the formation of legal opportunities for the action of market laws. Bankruptcy regulations are a good example. Illusory social and political calm, i.e. its preservation, are the motivation for the postponement of adopting and applying regulations leading to the elimination of the obviously unsuccessful from economic life and the transference of the economic burden resulting from this failure from creditor to debtor.

Thus observed, the passing of the analyzed laws can be evaluated as a transitional step ahead. A real evaluation will, however, ensue when their solutions are put into practice. It is too early for that now.

Dragor Hiber

## The Reform of the Judiciary and Judicial Legislation

### THE INHERITED STATE

The analysis of the inherited state shows that, under the 1990 Constitution, the Serbian law proclaimed the principle of the division of power. The system of the division of power generated the constitutional principle that courts were independent and autonomous in their work. This independence and autonomy were guaranteed by the rule under which judges held a permanent post, as prescribed both by the Constitution and law. The Constitution laid down that the Public Prosecutor's Office was "an independent state authority prosecuting the perpetrators of criminal offences and other deeds punishable by law and applying legal remedies in order to protect constitutionality and legality".

However, the principle of the division of power was not fully applied in the judicial legislation in force at the time, which led to numerous derogations compromising the principle of the independence of judges and courts from other branches of power. However, even that system was gravely breached.

The above was manifested in:

- (a) the manner of the election of judges and court officials, public prosecutors and their deputies, where the legislative branch, namely the parliament and its working bodies, played a decisive role in formal and legal terms, while, in fact, the executive branch (ministries) had the upper hand.
- (b) the manner in which judges were relieved of duty, where the legislative branch had the final word, but with the prior control of the judicial branch, which established reasons for dismissing a judge; in practice, the right of the judicial branch (the Supreme Court General Session) to be the only proposer of the dismissal of judges against their will, was severely

violated, so that politically unsuitable judges were relieved of duty directly by the parliament at the proposal of a parliamentary committee and at the initiative of a ministry.

- (c) the manner of financing, given that courts and judges are financed from the budget, adopted by the parliament at the proposal of the executive branch, and that the financial means are managed by the minister. The material position of courts as institutions and of judges depends on the budget and its distribution.

This dependence was all the bigger in that it also meant, at the time of strained circumstances, privileged financing and rewarding, for example by assigning public flats and granting favourable housing loans to particular judges and prosecutors. This material dependence, including the dependence of the judiciary and judges, had many even subtler forms, a situation in which new financial and political elite played an important role, acting as mediators in allocating resources between the executive branch and judges and the judicial administration, e.g. through organizing (quasi)specialist judicial training seminars, purchasing equipment and decorating premises, etc.

As a logical consequence, judges were influenced by the executive branch of power, i.e. the political elements constituting it, to an extent that can be seen as corruption. This assessment was supported by numerous studies.<sup>1</sup>

The dependence of the judiciary on political power and its bad economic position led to the resignation of many experienced and competent judges. Between 1992 and 1994 some 800 judges (almost 1/3 of all judges) resigned. New judges were recruited as dictated by the political parties, while the establishment of political coalitions forming the executive power meant, among other things, deals on “quotas” in the election and promotion of presiding judges, judges and prosecutors.

The outdated judicial network was yet another factor that contributed to the bad circumstances in the judiciary, the inefficiency of courts and corruption. Special courts existed only in the economic field, while the obsolete system of procedural law and the abuse of that law in ordinary courts, resulted in numerous bottlenecks in the judiciary, which virtually turned the Supreme Court of Serbia into an ordinary court, although its task was to ensure the uniform implementation of the law.

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<sup>1</sup> For more detail see: Begovic, B. et al.: (2001), *Korupcija u Srbiji (The Corruption in Serbia)*, Belgrade: Centar za liberalno-demokratske studije (Centre for Liberal-Democratic Studies).

For this reason, even before the transition (October 2000) the judicial system had been assessed as one of the segments of state authority which needed a radical transformation and the most comprehensive changes.

Immediately before the transition new directions of the judicial reform were formulated:

- “cleansing” the judiciary by legally and constitutionally dismissing those who abused their judicial post or whose professional competence and experience did not guarantee successful discharging of their duties;
- strengthening the independence of the judiciary from other branches of power by implementing various institutional measures, including those aimed at financial independence;
- altering the legal system of electing and dismissing presiding judges, judges and prosecutors, again to strengthen their independence, to reduce the influence of the executive power and follow professional and ethical criteria in their election and promotion instead of political and other criteria;
- ensuring the more efficient and transparent organization of court systems and the technical modernization of courts;
- promoting professional standards and responsibility of other experts participating in court proceedings (clerks and expert associates, lawyers, expert witnesses, etc.).

#### THE LEGAL REFORM OF THE JUDICIARY IN 2001

In 2001, immediately upon the change of government and the beginning of the transition, the first steps were made to restore and reform the judiciary by consistently implementing the old regulations. Firstly, the national parliament abolished the unlawful decisions under which, in the last several years of Milosevic’s rule, judges were relieved of their posts in contravention of the prescribed procedure, (due to their public opposition to electoral frauds and the manipulation of the judiciary); secondly, a great number of presiding judges (who had seriously compromised themselves) were replaced, as they did not hold permanent posts, but had limited mandates.

The legal framework for a more thorough reform of the judiciary was to be established by a set of judicial-organizational laws adopted in the second half of 2001: *the Law on Judges, the Law on Public Prosecution, the Law on the High Judicial Council, the Law on Court Systems and the Law on Seats and Districts of Courts and Public Prosecutor's Offices* (all published in the "Official Gazette of the Republic of Serbia, no. 63/2001).

The very circumstances in which those laws were adopted showed that there was no consensus and, perhaps, no clear strategy of judicial reforms in the pro-reform political block. In other words, the laws were not proposed by the Government or prepared by the competent ministry. Instead, they were proposed by a parliamentary group which, at that moment, although still part of the ruling majority, was about to become the opposition (the Democratic Party of Serbia). The Ministry of Justice, which itself set up a working group to prepare draft laws on the organization of the judiciary, was opposed to the mentioned laws, but they were adopted after all with some minor changes. It was said that they were endorsed by the parties which supported the Government and, in return, the party which proposed the laws, was to vote for the Labour Law, a claim which can be considered truthful.

The basic difference between the draft laws prepared by the Democratic Party of Serbia and those prepared by the working group of the ministry, lied in the continuity issue. While the adopted laws sought to reform the existing judicial system by maintaining the continuity of the institutions and the same personnel, the draft laws of the ministry, i.e. the Government, revealed the intention to achieve discontinuity and to build completely new institutions. Thus, for example, the adopted laws insisted on the permanent post of judges, including the judges holding posts at that time, meaning that judges could not lose their status even if the courts to which they had been elected were abolished, nor could they be transferred to another court against their will. The laws elaborated by the ministry, on the other hand, laid down that upon entering into force of new laws, the old courts were to be abolished and new ones established; hidden behind this was the idea of the discontinuity of judicial posts and reelection of all judges, in order to achieve lustration through a professional and ethical review to be conducted by an independent body, as had been done in some other transitional countries. This concept was, admittedly, never fully developed and there was also a dilemma as to whether it was necessary to link the discontinuity of judicial posts with the change of the constitution. Interestingly enough, this idea can be heard again in the context of discussions on constitutional changes in Serbia, based on the draft

constitution drawn up by the present Government, i.e. the party which opted for continuity<sup>2</sup> at the moment of the adoption of the judicial laws.

Nevertheless, it is quite certain that the new laws introduced a number of novelties that are undoubtedly reform-oriented, the most important of which are:

### **The system of the election and dismissal of judges and public prosecutors**

The mentioned laws (*the Law on Judges, the Law on Public Prosecution, the Law on the High Judicial Council*) envisaged a system based on the model of a *High Judicial Council*, i.e. a concept of an independent and professional body with the exclusive right to propose judges, presiding judges and prosecutors, at the same time keeping the system of the parliamentary election of judges as prescribed by the constitution.

The composition of the Council differs depending on whether it proposes judges or prosecutors. The majority of Council members in the procedure of proposing judges are precisely judges themselves. Thus, the Council has permanent members (the President of the Supreme Court, the Republican Public Prosecutor, the minister of justice, a representative of the Bar Association, a prominent expert elected by the national parliament among three candidates proposed by the Supreme Court), who are always on the Council, and members at invitation (six members are elected by the Supreme Court and two by the Republican Public Prosecutor) depending on whether the Council decides on the election of judges or prosecutors.

This potentially decisive role in proposing judges and prosecutors considerably strengthens their independence from the executive and legislative branch of power. Putting an end to the domination of political power was to ensure that professional criteria prevailed in the election and promotion of judges and prosecutors.

The legal arrangement regarding the dismissal of judges against their will reflects even more clearly the decisive role of the representatives of the judiciary. According to the law, a judge may be dismissed against his will if he has performed his duties unprofessionally and unconscientiously, if he is

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<sup>2</sup> As regards the continuity/discontinuity dilemma see Ivošević, Z. (2002): "Reforma sudstva u Srbiji" (The Reform of the Judiciary in Serbia) in "Zakon o uređenju sudova" (the *Law on Court Systems*), Savremena administracija, Beograd, pages 6-8. See the draft constitution of the Republic of Serbia, D. Hiber, "Dugo putovanje do ustava" (A Long Journey to the Constitution), *Prizma*, June 2004, pages 16-17.

sentenced to prison for a period exceeding six months or if he committed a criminal offence rendering him unsuitable for discharging judicial duties, and if the conditions exist for his retirement. The decision on whether there are reasons for the dismissal of a judge or whether the conditions exist for such dismissal, is made by the Grand Personnel Council, a body consisting of nine judges of the Supreme Court of Serbia. The national parliament is only to confirm that decision.

The dismissal procedure, initiated, as a rule, by presiding judges, guarantees the rights of the person against whom the procedure was initiated, i.e. his right to present counter-arguments challenging the reasons for his dismissal, a practice which turned out to be successful.

### **The material position of judges**

The material position of judges and prosecutors has been institutionally improved; the law guarantees a minimum salary, which, in the original version of the law, was relatively high, so that the salary of a judge of the Supreme Court was brought into line with the salary of a cabinet minister, the salary of the president of the Supreme Court with the salary of the Prime Minister, while the salaries of judges and prosecutors, depending on the level of the court, were 6-10% lower. At one point, a career in the judiciary was even desirable in financial terms.

### **Special courts and new subject matter (instance-related) jurisdiction**

The Law on Court Systems envisages the establishment of a new special court: the *administrative tribunal*. (Under the regulations which were in force at that time, administrative procedures were in the jurisdiction of the Supreme Court of Serbia, and, exceptionally, of the District Court in Belgrade). This was to contribute to relieving the Supreme Court of a great number of frequently banal administrative procedures, but also to increase the efficiency of the judicial protection of citizens against the unlawful acts of the administrative (executive) branch.

Corporate crime courts, specialized for corporate disputes, corporate criminal liability, the execution of decisions in these matters, bankruptcy

procedures and the registration of enterprises<sup>3</sup>, continue to work under the new name of commercial courts.

Additionally, a new kind of second instance court as well as new subject matter jurisdiction or instance-related jurisdiction, were envisaged in order to increase efficiency, shorten the procedure, establish uniform jurisprudence and restore the original role of the Supreme Court – the role of a supreme court of appeal. District courts ceased to be courts of appeal vis-à-vis communal courts, keeping the first instance jurisdiction only for aggravated criminal offences and some kinds of law suits. The second instance jurisdiction (vis-à-vis both communal and district courts) was granted to a newly established court, the *Appellate Court*, which was seated in Belgrade and had departments in Novi Sad, Nis and Kragujevac. Thus, the Supreme Court acts only under extraordinary legal remedies.

### **Institutional guarantees of impartiality and efficiency**

The laws included the adoption of additional institutional guarantees of the judiciary's impartiality and efficiency. The supervisory role of the court administration (presiding judges) was established more clearly, it's right and duty to carry out the regular supervision of prompt and fair judicial proceedings (but, certainly not the right to influence specific cases) as well as supervision over court departments (offices, executive clerks, etc.) The supervisory role of higher courts over lower ones was envisaged in the same way. The judge's responsibility for conscientious and efficient work is increased with his obligation to report to the presiding judge in cases where the case has not been completed within 6 months.

In the case of the prosecutor's office, an attempt was made to clearly define, on one side, the relationship between prosecutors and their deputies, and on the other, the relationship between lower and higher prosecutors. Of special importance here is the manner in which the system of obligatory instructions is defined, which higher prosecutors can, in written form, issue to lower prosecutors in specific cases; written form is here the basis of the clearly located responsibility.

The principle of the incongruousness of the judiciary post with carrying out any other professional work, public services, membership in political

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<sup>3</sup> Insofar as the judicial branch is involved in the registration of enterprises.

parties or any other proceedings which bring the judge's independence, dignity or impartiality into question is also envisaged. A special act regarding this issue was to be adopted by the Supreme Court – even though this act was formally passed, its contents do not correspond to the idea that it should precisely define the cases of the incongruousness of the judiciary post with other posts, because of which its adoption was initially envisaged.

It was considered as of exceptional importance to guarantee the system of the “accidental judge”, i.e. the scheduling of a judge's cases based on criteria which is independent of cases or sides, or anybody's will, and which was established by the court's operating procedure (the operating procedure has adopted the scheduling system according to the time when the case arrives in court). Truly, the law already provided the possibility to deviate from this principle, in the case of the court's overburdening, as well as the possibility of taking a case from a judge who is unjustifiably behind with his caseload. The decision to abandon the accidental schedule is in the hands of the presiding judge, but the additional barrier and controlling mechanism in the use of this possibility was supposed to be presented by the obligation to inform the immediate higher court presiding judge about every exception.

### **The application of and amendments to the law: defective and incomplete reform.**

The judiciary-organisational laws adopted at the end of 2001 were not, from one side, consistently applied – certain institutions envisaged by those laws had not yet been introduced into the legal system.

The most important example of the non application of those laws is the fact that the new organisational scheme of courts had not been established; the deadline for their implementation, which was already rather long, was constantly extended. “The seriousness” with which the establishment of the appellate and administrative tribunal was approached and the preparations for the transfer of cases to those courts could be best seen from the scandal which occurred when the national parliament failed to adopt the law which would extend this deadline on time, thus Serbia entered the year 2004 literally without second instance courts. District courts lost this jurisdiction and appellate ones were not established. The problem was resolved with the help of the Constitutional Court by the further postponement of the implementation of this part of the law.

Even the establishment of the High Judicial Council was delayed because the Supreme Court's proposal for the Council member who is elected by the national parliament was also delayed.

On the other side, and more importantly, many of the newly adopted decisions were essentially disputed by the various participants, in the very name of the (fundamental) reform of the judiciary. The central issue, at least on the surface, was the appointment and dismissal of judges and prosecutors; many dilemmas were refracted through this issue. The solution according to which the High Judicial Council proposes the appointment and the Great Personnel Council the dismissal of judges was not questioned in principle. The adopted decision was one of the variations of comparative-legal known models, often accepted in countries in transition.<sup>4</sup>

Namely, soon after the beginning of the implementation of this system (and the implementation, as it was mentioned, was delayed because the appointment of the permanent Council members was also delayed according to legal regulations), clashes of interests between the judicial on the one side, and the legislative and executive branches on the other, emerged. After a series of proposals from the High Judicial Council failed to be accepted by the national parliament, the amendments to the law provided the national parliament with the right, in the case of the non acceptance of the Council's proposal, to appoint one of the candidates who fulfilled the conditions and had applied for the position, but had not been proposed by the Council. This meant, of course, that not only was the Council's role of exclusive proposer stopped, but in fact the nucleus of authorisation for the appointment of judges was returned to other administrative branches. This amendment was later declared unconstitutional.

Furthermore, the right to propose the presiding judges from the High Council's jurisdiction was also excluded and was passed firstly to the national parliament's competent committee, and then following the declaration of this regulation as non-constitutional, to the special body where representatives from the legislative and executive branch of power dominated so that this decision was also abolished on the grounds of being unconstitutional.

On evaluating the constitutionality of the reduction in the High Judicial Council's jurisdiction, the Constitutional Court assumed the position that this represented a violation of the independence of the judiciary as guaranteed by the Constitution. (Truly, this court, which forms part of the same personnel

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<sup>4</sup> See V. Rakić-Vodinečić and others, *Pravosudni savet (Judiciary Council)*, Institut za uporedno pravo (the Institute for Comparative Law), Belgrade, 2003, page 7

structure, did not consider that the same independence guaranteed by the unchanged constitutional decree, was violated during the former legal regime in which the authorised parliamentary committee had the exclusive right to propose the holders of judiciary posts.) However, regardless of the Constitutional Court's legally controversial rationale, because the Constitution itself envisages that the national parliament elect and dismiss judges, the return of the nucleus of authorisation to the controlled legislative branch, carried out by the executive branch, undoubtedly presented a step backwards and the return to the previous model which was rightly criticised and discarded.

On the other side, the supporters of restricting the jurisdiction of the High Judicial Council, in which the holders of judiciary posts predominate, cited the fact that the personnel structure of the judiciary had not changed in regard to the pre-transitional period, and that the *communis opinio* was that this structure was very bad. Since the structure of the High Judicial Council reflects the structure of the judiciary itself, it is understandable, they emphasised, that the structure of proposals for the appointment of judges, all the more for proposals for judge posts in higher courts and for presiding judges was in fact the continuation of the status quo, the confirmation and reproduction of the judiciary from the previous, pre-transitional period, and hence a barrier to reform. Those judges elected by political criteria, insufficiently skilled party obedient, judges discredited in election scandals and political trials, cannot be participants in the process of creating a new, democratic professional judiciary.

No matter what the basis for those arguments and even without their comparative evaluation, it can easily be concluded that in addition to facing two concepts of reform, the scene was also pervaded with the struggle for dominance in the process of making judicial appointments, which implicates the preponderance of other criteria, both political and pragmatic over purely professional criteria. Even more, this meant the negation of the independence of the judiciary: this kind of control over making judicial appointments meant the opening of possibilities for extended control over those appointed, i.e. those aspiring to be appointed, i.e. institutional corruption. In short, those who make decisions about appointments, in other words about promotions, hold the lever of influence over those who have been appointed and all other contenders. This proves, among other things, the lack of sufficient potential for reform, i.e. the real readiness for the reform of both the representatives of executive and judicial branches of power.

A similar situation, facing two opposing “concepts” of judiciary reform, also emerged in the implementation of regulations regarding the dismissal of judges.

According to regulations drawn up in October 2000, proposals for the dismissal of the holders of judicial posts were determined by the Supreme Court General Session. This regulation was evaded in the case of the dismissal of those judges who opposed the electoral theft in 1996, who later went on to become activists in the Judges Association, the professional association of judges whose work was put out of action by the regime before 2000 through their refusal to register the Association. Entrusting the establishment of proposals (reasons) for dismissal to the , the body which is made up of Supreme Court judges, instead of to the General Session, the collegiums of all Supreme Court judges, does not essentially change the concept. It was most likely that the idea was that it would be hardly feasible to achieve a majority who would vote for the dismissal of those judges who had been discredited the most, since the Supreme Court, as the top of the pyramid, pronouncedly suffers from those flaws which are characteristic of the judiciary in general. Reaching this level in the judiciary hierarchy was only possible by using those means which were most criticised. If the intention was the conservation of the inherited state, it seems that this was achieved: by the end of the year 2003 the proposed the dismissal of only three judges for performing their duties unconscientiously and unprofessionally, which fully contradicts existing data regarding the quality and efficiency of the courts’ work, the trust which citizens place in the judiciary and the evaluation of the level of corruption etc.

If not formally, the system was essentially brought into question by the amendment which transferred the appointment of the Council’s members from the ranks of all judges to the national parliament. This meant that the parliament directly took over the decisive role in the control of the conditions (reasons) for dismissal. This amendment was also disputed by the Constitutional Court, thus the original system was reinstated. However, legal confusion ensued since for some time there was no legal body to implement the appropriate procedure. Among other things, this confusion resulted in dismissal proceedings practically not being brought at all (until the end of 2003, apart from cases of retirement and release from duties on personal demands, there were only three dismissals).

At the same time, the executive branch, and also part of the public, continuously brought up the issue of the lustration of the existing judicial cadre,

allowing for, at one moment, the possibility of making amendments to the Law on Judges, primarily linking such a move with the so called electoral thefts and rigging of political trials. (This amendment was also declared unconstitutional). It thus came about that, on the whole, despite prevailing appraisals about insufficient expertise, poor work and disorganisation, inefficiency and even corruption, the judge and prosecutor cadre inherited from the pre-transitional period has not essentially changed. Moreover, amidst the confusion of amendments, constitutional control, suspensions from the Constitutional Court and the repeal of regulations, the Supreme Court Collegiums brought the decision not to apply the unconditional decree of obligatory retirement of judges after the fulfilment of legal conditions, citing the position that, before the passing of this law, the retirement age was extended in accordance with the (general) Law of Employment based on the ruling of the presiding judge, contrary to special regulations.

As regards the prosecutor's office, the situation was somewhat specific. In the legal system and the Serbian Constitution, the Prosecutor's Office is characterised by independence but not autonomy. The most important dilemmas (or conflicts) during the passing of a law or later during its subsequent application and amendments, related to the position, mandate and type of appointment, i.e. the selection of deputy prosecutors. Firstly, in the first version of the law, the permanence of their post was reduced in that their mandate was limited to eight years, and their appointment was transferred from parliament to the High Judicial Council. At one point, with the amendments to the Law on Public Prosecution, the jurisdiction for the appointment of deputy prosecutors was transferred to the Government, which probably destroyed the balance between the development of the institution of the prosecutor's office as a judicial body and the fact that this institution is not fully autonomous to lead specific prosecuting policy.

The appraisal of the existing confrontation between the judicial and political branches in the establishment of a certain kind of control over the judiciary, can be confirmed by another fact: in four years, each of the four top posts at the head of the judiciary were held by four different people (the Serbian Supreme Court presiding judge or acting presiding judge and the Republican Public Prosecutor or acting public prosecutor).

In the three years since it was adopted, there were other novelties too, introduced through amendments and appendixes to the initially adopted judicial-organisational laws or through special laws.

One particularly significant innovation was the introduction of special departments (including the Belgrade District Court and the Serbian Supreme Court) for organised crimes and war crimes. Special prosecutors were introduced and appointed in the same fields. This solution was also the subject of dispute, with the argument that this is a disturbance of the regular judiciary system, which is unnecessary, unacceptable and inappropriate for a legal state.

Public debate about the status and justification of the existence of the special department for organised crime, in which the senior representatives of the executive and judicial branches participated, is characterised by excessively direct political argumentation with regard to the judiciary problematic, at times relying too much on specific trials which were conducted in this department, which has certainly not contributed to strengthening the judiciary's position, especially in this segment.

The Supervisory Board was also introduced, the body with jurisdiction to investigate complaints about illegal and delayed court proceedings.

The institutionalisation of the centre for the professional training of judges, which was originally established as part of the Judges Association can be counted as one of the fundamentally useful innovations. The fact that transition means numerous, rapid and detailed changes in legislature makes the issue of professional training one of the central issues in the reform of the judiciary. The further development of the training system within the judiciary is expected and along with the reform of the qualifying examination for judges and, of course, university law education, this could be very useful.

It could be concluded that the frequent and numerous changes to adopted judiciary laws, including the return to the original versions and the non-appliance of some adopted solutions as well as the sharp public polemics between judicial and executive branch officials, are a clear indicator of the relative failure of the reform of the judiciary, the lack of clear strategic determination and even the existence of an insufficiently strong resolve for reform.

At the same time, the appraisal of the situation within the judiciary from senior officials within both the executive and judicial branches, remains very unsatisfactory, regardless of how sincere they were or whether they were attempting to avoid their own responsibility for the current state. They are confirmed by the empirical data of excessively long proceedings, corruption and other scandals and legal insecurity stands out as the factor which influences the unsatisfactory efficiency of economic reforms.

## COURT PROCEEDING LEGISLATURE

For a modern, fair and independent judiciary, based on the principles of the rule of law and the respect for human rights, not only are changes to the judicial-organisational system of importance, but also proceedings regulations too.

The first phase of the reform of court legislature, and also some of the classical institutions of substantive law, can be linked to the preparation and accession of Serbia (the Federal Republic of Yugoslavia, ... Serbia and Montenegro) to the European Council system and the European Human Rights Charter.

*Criminal proceedings* were the first to be reformed. The most significant innovation in the new Law on Criminal Proceedings was the reduction in the so called police temporary custody and the right of the arrested individual to have access in that phase to an expert defence lawyer as well as the stricter establishment of regulations regarding temporary custody.

The law also attempted to adapt to the times and to modern technological challenges, for instance the controlled introduction of new sources of evidence including evidence gathered by, approved in advance, wiretapping.

Even though in general this was a modern law, its implementation brought some of its solutions into question. Therefore, the efforts to insure the right of the defendant to an efficient trial (prompt justice), in accordance with the European Human Rights Charter and the Strasbourg Court's jurisprudence, among other things, was achieved through the absolute limitation of the temporary arrest period. If the verdict is not reached and sentencing passed before the end of the legally regulated maximum period, the defendant has to be released to defend himself while on bail. It was not just that, because of the lack of corresponding transitional regulations, but also because of its incorrect interpretation (this issue was the subject of scandal and polemics between judicial and executive branches), the adoption of this law led to the release of a number of criminals accused of the most serious criminal acts against whom the proceedings went on long after the time limit had expired in the previous period, but it was also shown that the inefficient Serbian judiciary is rarely able to keep to the predicted time limits. Therefore, the maximum time for temporary confinement was extended, especially for cases of organised crime.

The litigation proceedings, whose solutions were also criticised for being archaic and not relevant to modern needs, were changed in the last years of the

period in question. The aim of the largest number of newly adopted solutions was, almost certainly, to prevent the abuse of the power of attorney which led to the dragging out of lawsuits; the general opinion was that on average trials lasted for unjustifiably long periods, which makes the legal protection of property rights extremely inefficient. The repercussions of such a situation on the economy, i.e. economic growth, are obvious.

It is not possible to evaluate the scope of the adopted changes because of the short period since their implementation. It seems that they will largely depend on the court's readiness to place efficiency at the forefront, and proceedings regulations are not the only condition for that.

From the most significant innovations the first efforts to ensure the concentration of the litigation materials could be set aside, which included the obligation of all parties to present all facts and evidence during the initial proceedings operations, the charges and the response to charges. The possibility for the later presentation of new facts is strictly limited; the opinion is that this will discipline all parties and prevent the unnecessary dragging out of court proceedings. It should be said that this means that a new higher level of expertise will be required to lead the litigation, i.e. it will increase the importance of engaging an expert proxy (this was, however, obligatory only in exceptional circumstances). The possibility for requesting the judge's disqualification was also restricted, which was used and abused a great deal in the function of dragging out litigation. Finally and potentially the most important as regards efficiency, was restricting the possibility for the appellate courts to repeal the original ruling and to return the case to the court of original jurisdiction for a repeat ruling. If a complaint is also submitted against the ruling of the new court of original jurisdiction, the appellate court is obliged to solve the case in an appropriate way. However, the question remains as to what extent this is harmonised with the expected position and organisation of the future appellate court.

For the same reasons (inefficiency), (civil) enforcement proceedings have also been reformed. Characteristic new institutions, aimed at the more efficient protection of contracts and properties, are, for instance, for economic issues, shortened enforcement proceedings: if the claim is documented with the appropriate written documentation, the possibility of direct enforcement proceedings is envisaged without any prior litigation, and the debtor in those proceedings can dispute the implementation of enforcement only with evidence which literally contests the documentation.

New enforcement means and subjects, relevant to the market economy (enforcement on shares of stocks, shares in limited liability companies, securities etc.) have been introduced and the enforcement procedure on bank accounts has been amended.

Of particular importance is the fact that time limits during which the court is obliged to carry out certain enforcement operations (with the possibility of sanctions for any violations) is determined and shortened by law.

It is also still too early to evaluate the scope of the new items in the new Law on Enforcement Proceedings because, among other things, the implementation of some of the previously adopted regulations on which some forms of enforcement depend has not yet been secured (for instance, the register of securities on movable property, the completed register of securities, the functioning of the Agency for Enforcement Claims etc.).

Some other measures have also been introduced in the “unburdening” of the courts in the attempt to improve the courts’ efficiency. Therefore, some records which were traditionally under the courts’ jurisdiction in our law have been removed from their jurisdiction.

In first place was the continuation of the project according to which, through the replacement of the land-registry system with the so called system of uniformed registry, i.e. real estate registry, the land registry was to be transferred from courts and entrusted to certain administrative (geodesist) bodies.

The registry of economic subjects (companies) is no longer within the jurisdiction of commercial courts either, but of a separate specialised agency.

Such a reduction in jurisdiction and along with that the scope of work, will certainly exert a positive influence on the courts’ work, but what remains is the question as to whether the jurisdictions (tasks) themselves will suffer after being taken over by less qualified bodies.

The same function – the unburdening of the judiciary – is shared by the institutionalisation of peaceful, out of court settlements envisaged by the Law on Mediation for litigation proceedings and the Law on Out of Court Settlements for labour disputes.

## THE BALANCE OF REFORMS

In the decade which preceded transition the judiciary, which by definition could hardly manage to respond to the new demands and needs since it was basically established as a socialistic one, was completely devastated. Personnel ruined by poor cadre selection and an impoverished and frightened judiciary became nothing but the appendage of the executive branch. Judges were the executors of the first confirmed election theft in 1996, which even Milosevic had to admit by annulling it with the special law for election results which was “established” by the judges. Such a judiciary was susceptible to general and institutional corruption and was ready to execute the political elite’s direct orders. It was used for the legal cover and protection of the grey privatisation and the squander of public and state property, smuggling, crime and some of the most serious politically motivated crimes. However, such as it was, it did express a certain resistance and vitality, especially when a number of judges, at the cost of being crudely expelled from the judiciary, opposed the abuse of the judiciary in election theft.

The necessity for reforms was clear, the same as the final goal: an independent, expert, fair and efficient judiciary. The legal principles, which should be transformed into laws thus offering the most direct route to the desired target, were mostly known.

The objective difficulty in projecting reforms was presented by the fact that the contradiction between the principles on which a good judiciary is founded and the existing state was obvious. Therefore, for instance, a certain legal security for judges, some of the models where judges hold permanent posts, is not only the constitutional principle of the current constitutional system, but also an important guarantee of independence; the same model (permanent post) was protecting (and protected) also those who not only seriously violated professional and ethical standards, but did not inspire confidence that they would be able to respond to new demands.

Furthermore, the reforms should have been multilateral, with the aim of resolving both trivial and serious issues, such as elementary financial issues, the fulfilment of elementary needs for the modern functioning of courts or prosecutor’s offices, such as computers (and people trained to use them), premises etc. Two disastrous figures show the importance of providing at least the bare minimum of resources. Trials are being postponed because jurors fail to turn up because they have not received the minimum compensation for

their work, and investigations are not completed because the courts do not have the finances to make the down payments for essential, more expensive expertise.

The reforms should have started with the adoption of the new judicial laws. It is obvious that their proposals are characteristic not only of a lack of coordination, but also the lack of any previously adopted strategy.

Although any basic criticism cannot be formally directed at the adopted laws, the very lack of a strategy is probably the reason why it was impossible to gather efficient reform forces around the reforms themselves (through the implementation of the laws).

There was also resistance from both the judiciary, apart from other things, because many people were worried about their positions, and the executive branch, not only because they thought that the laws and the tempo of reforms had been forced on them, but also because they considered that the domination of the concept of preserving continuity imposed a reform project which did not offer sufficiently profound changes. Through the implementation of the new laws, the political branch, in relation to the judiciary, had to be practically unconditionally stripped of its power and was unwilling to accept that, considering themselves as a more reliable guarantee for reforms than the judiciary itself. Therefore, the resistance to reforms came from all sides; the *status quo* was *de facto* maintained in many judicial systems and often changes to judicial laws only introduced additional insecurity. In such a milieu even those steps forward which were made remained without effect after some time.

In the last years and months, the executive branch have often violated explicit legal regulations, as was the case with the earnings policy; for a long time the salaries in the judiciary were not brought in line with those in the executive branch as was predicted by law, and the reaction to that problem was a change of law, by which judges are made equal to clerks in the state administration.

On the other side, the results, quality and efficiency of the judiciary have not essentially changed – in other words, the reforms have not brought about any real results. Some indicators, some scandals which have emerged lead us to draw the conclusion that the reform of the judiciary is without any results at all.

Hence we come to the most important evaluation regarding the balance of reforms: the processes are (again) at the beginning. That implicates the

preparation of a new strategy and standing behind it and the creation of a pro-reform majority both within the judiciary and outside it.

As part of any future constitutional changes, a new, balanced response to the issue of discontinuity should be found.



Boško Živković

## Financial Market Reform

### MARKET FORMATION AND OPERATION: BASIC CONTROVERSY

Although the Belgrade Stock Exchange is the first stock exchange re-established in Eastern Europe after the Second World War (1989), the question whether Serbia has a proper financial market still remains open. From 1990 to the beginning of 2002 the Stock Exchange lingered as an organization without institutions or proper rules of conduct. At one moment, in order to survive, the Stock Exchange itself engaged in trading in short-term securities. This form of deformity is probably rarely seen anywhere.

During 2002 a significant change occurred: the capital market began to operate. The main assets (instruments) are shares issued in the privatization process under the 1997 Law. Already during 2002 the volume increased several times over the previous period. A smaller part of volume is the frozen foreign currency deposit bonds of the Republic of Serbia. At the end of 2002 the total market capitalization reached around 40 billion dinars or 634 million euros. In March 2004 the market capitalization reached 203 billion dinars. This level is relatively (compared to the comparable countries) high and amounts to 28 percent of GDP.

However, already from October 2003 and throughout 2004 the volume on the stock exchange went down. This development was expected, but not in such a short period of time and with such intensity. The main reason for the emptying of the market is its basic imperfections. The Serbian financial market practically does not know the primary issues of corporate instruments. (The market of short-term commercial paper was mostly in the grey area and could not survive for long.) The consequence: the financial market is at this moment the mechanism of concentration of ownership over shares distributed in the process of mass privatization during 2000 and 2001. This fundamental

market deformity, which is basically determined by the imperfections of the mass privatization model can be seen in other countries as well. It, however, causes two types of consequences.

The first type of consequences is related to the functioning of the market itself. It is becoming empty. After share ownership concentration is achieved, the volume is reduced and shares are practically withdrawn from the stock exchange. In the elementary definition the financial market in Serbia is used for purposes quite contrary from the standard ones. Instead of being used for companies *going public* it is used for *going private*. Moreover, this process is continued in the conditions involving low information and price efficiency. It is estimated that in such circumstances the market undervalues shares, which additionally accelerates the process of its emptying, increasing the risk of full retardation.

The second group of consequences refers to the market regulation. In the circumstances when it becomes a redistribution mechanism, there is an increased risk of “regulator capturing”, i.e. its discriminatory behavior in favor of one and against another group of players. The reason for the formulation of this estimate is the fact that the trade in the highest quality securities has mostly been transferred to OTC methods of trading. The main cause: emptying of the market is caused not only by the market concentration, but also by the regulator’s behavior. The volume of share trading went down because of intensive OTC trading due to the takeover market activation in the conditions of drastic underregulation under the Law on Market of Securities and Other Financial Instruments from November 2002, which came into effect in October 2003. The second important fact: with different regulatory norms government bonds have practically been withdrawn from the stock exchange. Foreign currency deposits bonds are directly traded between the banks.

## MARKET SEGMENTS

Market evolution during the last four years has been unsteady. The evidence of such unsteadiness is the brief description of operation of its basic segments.

**The corporate bond market** is of low liquidity and non-transparent. In the period until 2003 this market operated mostly with short-term corporate

commercial paper. The primary market of long-term corporate bonds has not been established yet. The Stock Exchange still has no such securities at the official listing.

**The basic corporate securities traded are privatization shares.** Dominant sellers are individuals who received these shares free of charge in the procedure of mass privatization. The dominant buyers are de facto taking over these companies. For that reason the financial market is predominantly a corporate market, rather than a share market. There are no new issues of shares that would be used for the financing of companies. Thus, the capital market in Serbia is still not an important mechanism of financing of the corporate sector. The lack of transparency of this market (problems of going public and prospectus quality) is a consequence of the attempts of the current management to maintain unofficial control in such companies or to establish official control of the majority owner.

In October 2004 the Stock Exchange activated a special segment of the so-called **continuous share trading**. This measure should affect the evolution of the national market by reversing the process of its emptying. The reserves towards the early activation of this market are based on the argument that liquidity can be created by speculative demand. The second type of reserve refers to the ability of the market to discover the fair price. (There is a series of evidence demonstrating that the markets in transition are generally speaking not price efficient. This primarily refers to the existence of possibility of price manipulation.) The permitted daily price fluctuations are relatively high. The liquidity of this market is exhibiting an upward trend.

**Foreign currency deposit bonds** are liquid and have attractive yields. Although they are not directly convertible, they can be used for the purchase of corporate shares in privatization. Their introduction in stock exchange trading (September 2002) significantly affected the level of market capitalization and its liquidity. This security will be an important part of the total volume of trading in a relatively long period in the future, because the issue value is relatively high (4.2 billion euros), with satisfactory liquidity. (This security is traded continuously.) The yields of these bonds were relatively high at the beginning of the operation of the market. In time they were gradually normalized at the 7-10% range at the annual level. The bond market is segmented. There are three basic markets. The first market is within the banks. The banks convert deposits into bonds. At conversion the owners have a right of choice: conversion or payment in cash. At this market, the discount applied when paying frozen

foreign currency deposits in cash, is very deep in real terms. Information asymmetry, which partly originates from the complicated procedure of registration and trade, results in the owners of FX savings passbooks often accepting the offer of banks for the purchase of bonds at a relatively low price. The second market is formed between the banks. The prices on this market are not public. It seems realistic to assume that most of trading is conducted on this market. The main players on the supply side are banks which have the largest number of depositors. On this market capital gains from the first market are realized. The third and probably the smallest in terms of volume is the Stock Exchange.

**The money market** in Serbia is still shallow and undeveloped. The basic problems in its operation are relatively high interest rates and high level of required reserves of the National Bank of Serbia. The level of interest rates on short-term borrowing is very high. Attempting to normalize the structure of interest rates, in January 2005 the NBS organized the first repo auctions. Their volume is still not so large as to substitute more significantly the system of required reserves. In the given conditions, until repo operations become a mass instrument of monetary regulation, the required reserves will remain the basic instrument of system liquidity control. The expected result of activation of these operations is the normalization of interest rates. The attempt to discover the lowest (non-risk) interest rate by the auctions of Treasury bills of the Republic of Serbia was not successful. The interest rate at which the government bills were sold was above the interest rates on the NBS bills, in the range between 3 and 6 percentage points. The yield rates in this market varied regardless of the basic fundamental factors and, generally speaking, remained at a very high level. In some situations these rates were higher than the commercial ones. The demand for these securities is concentrated on a few highly liquid banks, and the price of money which the government obtained in this way is very high. The NBS repo operations have a chance of engaging much greater demand and discovering the base interest rate in the system in the conditions involving greater competition. This would lead to a revival of the money market and its gradual normalization.

During December 2004 the **Belgrade Stock Exchange Index** was established under the official name of *BELEXfm*. The basic characteristics of this index are determined by the qualities of the market itself. There is no official listing on the Belgrade Stock Exchange, with a relatively small number of shares being continuously traded. For that reason, the composite index concept was selected,

measuring changes in the prices of all shares on the so-called free stock exchange market. The index is, in the statistical sense, descriptive, not an investment index. This characteristic of the index is a consequence of a relatively small depth and low liquidity of the share market. The index weighting is based on market capitalization, with the weight of each index component being limited to maximum 10%. The index is not adjusted for dividend payout or number of free float shares, which means that it is not protected from price disruptions regularly arising due to dividend payout. Price weighting is performed based on capitalization or the number of shares of each issuer which are included in the free stock exchange market. Preference shares or ordinary non-voting shares are not included in the number of shares included in the index basket. In order to prevent any single share from having a dominant share in the index basket, the number of shares with which it can participate in the index basket is limited. The weight is limited in the following manner: first the market capitalization of each issuer whose shares are included in the index basket is calculated, followed by the calculation of the weight of each share in the index basket.

#### IMPERFECTIONS OF THE CORPORATE CONTROL MARKET

The corporate control market (takeover market) was activated in October 2003 amidst low protection of minority shareholders, codified in the Company Law. The second important circumstance: the regulation of the company takeover process in the Law on Security Market was vague and particularly discriminatory in favor of the takeover bidder. This is what led to the expected deformities of this market. Public scandals, discreditation of regulatory bodies, powerful vested interests which were latent on the market appeared in more drastic forms. The key deformities of this market are the following.

The best companies privatized under the 1997 Privatization Law with the low level of protection of minority owners are exposed to the greatest takeover risk. There are practically no takeovers of other types of companies. Takeover subjects were mostly from the so-called horizontal line: companies engaged in the same or similar activity. A stronger presence of investment funds and conglomerates has been detected lately.

An inversion of this market's function is registered here: instead of the sanitary role (predators, takeover bidders eliminate from the corporate structure

inefficient companies and managers), here the basic function is the formation of rents (obtaining monopoly) or high capital gains. For that reason the process of company takeover in Serbia bears all the characteristics of early transition: inefficient institutions, accelerated concentration of ownership and low level of minority owner protection.

Takeover is realized amidst low price efficiency of the market. The basic causes of low price efficiency of this market are systemic: the general level of share price is lower than in the comparable countries. The low price efficiency results in a low value of the price/book value ratio. The consequence: the risk of hostile takeover, in the circumstances of combined activity of these factors, increases. This deformity allows the national corporate control market to be described as discriminatory in favor of the takeover bidder. The current market configuration allows the activation of this procedure even in the case when the share price is unknown.

The basic cause of the accelerated takeover market expansion is the instability of ownership structure created by the 1997 Privatization Law. This quality of dispersed ownership is registered in all the cases in which the countries in transition applied it. Typical examples of this type are Russia and the Czech Republic.

The undervaluation of companies on this market is a consequence of fundamental imbalance between the supply of and demand for privatization shares. The supply on the takeover market underwent an upward deformation. The deformation of supply is a consequence of the low level of income and weak protection of minority shareholders. The share yield is usually not in any way dependent on the amount of net corporate profit. For that reason, a large number of shareholders of this type strive to sell their assets. On the demand side is the takeover bidder or bidders. Other potential owners (individual and institutional investors) do not buy shares of the target company because the level of investor protection is low. The reason: the owner who took over the company may legally hide the profit or transfer it into his other company (firm "tunneling").

The second group of factors are legal and regulatory inconsistencies. The takeover bidder is not obligated to buy out all the shareholders. It is enough for him to take over 51% of voting shares. Since there is no legal obligation of public unconditional offer for the purchase of the remaining shares at the price of the controlling package takeover, the remaining shares usually become worthless very soon. Neither is the other basic laws governing this issue

complete, coherent or consistent. These regulatory imperfections practically give the management unlimited power: it can “tunnel” the firm, reduce the value of its assets and adopt most of the decisions against the classic rules of property protection. On the other hand, the Law on Securities Market treats all joint-stock companies as public, in such a way unnecessarily increasing the takeover risk.

Takeover often occurs as the market’s punishment against the management expropriating the property of its own owners. In most dramatic takeover cases non-standard behaviors of managers can be registered, practically abolishing or significantly restricting the owners’ rights. The Law on Securities Market did not regulate the normal takeover defense procedure. For that reason the mass moral hazard arises: the management, if it cannot take over the company itself, works for the benefit of the takeover bidder, rather than its own principal. This situation results in the worst possible outcome. Share prices fail to reach their real value even during the takeover. Everyone loses: the owners, the management and the state alike.

On the Serbian corporate control market almost all forms of takeover are present. From the purchase of initial packages on the secondary market to the purchase of the companies in bankruptcy. Recently, the takeover through a public offer has become particularly topical. The second important phenomenon in the past few months since the Law on Securities Market came into effect has been the strong presence of investment funds from the countries of the so-called tax haven. In the near future the mechanism of mass takeover of companies in bankruptcy is likely to be activated.

The phenomenon of takeover itself is not disputed. It is today a world trend and presents one of the basic channels of restructuring of modern economies. What is problematic in this phenomenon in this country?

Experiences with joint-stock company takeover in Serbia so far show that this procedure is usually followed by a massive threatening of property rights of the existing owners. This practice can compromise the financial market in the long run.

After the takeover, the new owner frequently conducts the mass operation of expropriation against the remaining shareholders through the capital increase operation. This is done particularly frequently by domestic owners. The issue price of new issue shares is much lower than the real and last realized market price, or the share price at which the takeover was conducted. The preemption right to new issue shares is usually first eliminated. These decisions

are adopted by the shareholders' meeting without particular resistance because they (employees and pensioners) do not have a possibility to purchase new issue shares. Since our legislation does not regulate the secondary trade in this right, it is, under such circumstances, practically worthless. The result of this operation is a drastic reduction of the share price. (Cases have been registered where, due to these operations, the price of shares went down to barely 10% of the price at which the joint-stock company was taken over.)

If the new owner is a financial or institutional investor it is not possible to expect additional investment in companies taken over as is the case in takeovers by strategic investors. The basic strategy of a financial investor is to acquire capital gains. He takes over a company which is evidently undervalued and achieves appropriate result with relatively small cost restructuring and management change. The presence of these investors, in particular funds from "tax havens" has lately increased. Domestic investors of this type are in a less favorable position, because the adoption of the law on investment funds has been delayed for already a few years.

Finally, in the present form the takeover market is discriminatory. Takeover transactions as they are conducted currently in this country negatively affect everyone involved except the takeover bidder. Small owners who do not accept the takeover bid, cannot, under the existing conditions, protect the property rights. They were also previously affected by the management's failure to observe property rights.

The government and its Share Fund are particularly affected. Since the moment when the Law on Securities Market came into effect, no significant sale of the minority packages has taken place. If it fails to join the takeover bid, the government mostly shares the fate of the remaining small shareholders and suffers losses. The legislative reaction to this phenomenon was wrong. The Share Fund is given the rights of ordinary share holders. The solution lies in the adoption of a standard law on takeover.

#### Strategy of market development and existing regulations

The key issue of strategy of capital market development is the issue of its survival. Other countries with mass privatization programs faced this problem as well. After "the high tide" of sale, which is essentially a normal reaction of the owner to the level of risk and yield of these shares, low tide sets in. The number of listed shares is decreased, the trade volume goes down and there are no new emissions.

For the market to survive and make sense it is necessary to develop those of its basic functions. The basic (strategic) goal of the financial market's development is to make it capable of performing its basic function – financing of the corporate sector. For the financial market to evolve gradually from the currently dominant mechanism of property rights redistribution, the mechanism of financing the corporate sector should be fundamentally rearranged.

The Law on the Market of Securities and Other Financial Instruments was adopted at the federal level in November 2002. This law jeopardizes the basic principles of shareholders' property protection. A new law or radical amendments to the existing law must eliminate the conflict with elementary standards of market regulation.

As long as this Law is in force it is not possible to establish the basic function of the market, because it did not successfully solve the problem of a company going public through a public share offer. Furthermore, the Law does not enable the protection of the market's integrity, because it does not recognize the concept of related parties. This shortcoming led in some cases to the discreditation of the regulatory bodies and a collapse of the market. Namely, pairs or groups of related parties (issuers, banks, financial auditors, brokers, etc.) can cause a series of disruptions on the market from the deformation of the price of a stock exchange transaction to the manipulations in public placements of securities.

The second important area of necessary and desirable changes is the area of takeovers. In this area the laws do not precisely define the procedure, supervision over and obligation of the takeover bidder. The need for regulating this area is undisputed, regardless of whether this will be done by a separate takeover law or amendment to the Law on Securities Market. The desirable solution is the adoption of a new takeover law.

At the end of 2004 the Law on Economic Entities was adopted. The Law dedicates particular attention to public corporations or publicly-held joint-stock companies. The expected result of the implementation of these solutions is a reduction of the risk of investment in the real sector and, in medium term, enabling the real sector to acquire additional capital not only through the banking system but also through the financial market. The achievement of this strategic goal does not depend only on the solutions in this law. Equally important are the laws governing the financial markets. The development of the capital market requires an improvement of management of joint-stock

companies, in particular the improvement of the protection of minority shareholders. The basis for the evolution of regulations according to the EU standards and OECD principles of corporate governance is provided by the Law on Economic Entities. National corporate governance principles based on these standards should be defined.

Parallel with risk reduction, which would result from amending the basic laws, it is also possible to activate new sources of demand on the financial market. The simultaneous development of these processes enables the deepening of the market and increase in its liquidity. Without institutional and portfolio investors the capital market cannot be expected to grow quickly. For that reason, the law on investment funds and investment companies should be adopted.

Apart from the basic laws, there is also need for a separate law on mortgage-backed securities. That law would enable the issuing of low-risk securities backed by mortgages

A strategically important goal could also be the reinforcement of the supervisory function on the financial markets. It is necessary to redefine the competences of the Securities Commission and increase its actual regulatory and supervisory capacity by defining its status as an indisputably independent regulatory body. The Commission must have actual ability to exercise its authority in particular in the area of efficient supervision of participants and processes on the market. The second important area in which the supervisory capacity of the Commission should be increased is the introduction of adequate reporting based on the IFRS and IOSCO principles. Namely, the procedure of company going public by issuing securities on the primary market and protection of minority shareholders can be raised to a significantly higher level.

These goals can be achieved either by reinforcing the existing institution (Securities Commission), or forming a new institution for supervision of all financial activities (banking, insurance, financial market). In view of the experiences of other countries, a possibility of establishing a new institution for integrated supervision over all financial activities which would be de facto and institutionally independent both from the executive power and from the market participants, should also be considered.

In the area of international and regional cooperation it is possible to reinforce the national financial market by continuing and intensifying cooperation within the IOSCO. Serbia is a full member of this international

association of regulatory bodies for securities. This cooperation can improve the quality of national regulations and raise the supervision capacity of the national regulatory body.

The next important goal is the reinforcement of self-regulatory bodies and professional associations enabling an increase in market discipline and improvement of ethic standards of professions, increase in the level of professional knowledge and skills and creation of trust of the investment and general public in institutions.



Boško Mijatović

## Reform of the Labor Market and Labor Relations

### THE SITUATION UNTIL 2001

#### **Situation on the labor market**

The 1990s were the years of crisis in every respect – not only economic but also political. The break-up of Yugoslavia brought with it wars in which Serbia did not formally participate, but its material and financial engagement was clearly visible. UN trade and economic sanctions were an additional burden. If one adds to it the negative effects of the administrative socialist economic system, the result is a very unfavorable picture of economic and social trends during this decade.

During the 1990s, economic trends were exceptionally unfavorable – from the sharp decline of the domestic product, real value of wages, pensions and all personal income, through plummeting employment and growing unemployment, to the flourishing grey economy, criminalization of economic life and the society as a whole, etc.

The total employment fell by 200,000 from 1991 to 2000, i.e. from 2.2 to 2.0 million. The basic contribution to the adverse employment trends came from the sector of state and socially owned companies (including mixed), where employment dropped by more than half a million, from 2.1 to 1.6 million. This constant downward trend was a proof of the failure of the formal sector not only to increase employment and engage the available labor force, but also to maintain the current employment level. The private sector increased employment by more than 300,000, but did not manage to make up for the fall in the state/socially owned sector.

The reasons for such dynamics of employment lie in the economic activity trends. The decrease in the domestic product of the formal sector was accompanied by a decrease in employment, although at a slower pace. This difference in the speed of decline caused a large rise in the number of surplus employees (hidden unemployment), i.e. those employees who did not contribute to the production of goods or services. The exact assessment of the employee surplus for 2000 did not exist, but it is certain that the surplus exceeded one third of the total number of employees in socially and state owned sector. Such processes are the result of the government policy of preventing employee layoffs, i.e. transferring the social policy from the state to companies. The reduction in the number of employees during this decade is the result of the natural outflow due to retirement, employment in the private sector or emigration.

The private sector had a positive employment dynamics, but the opportunities for a faster development of this sector and greater employment by the same were not utilized. Economic policy usually favored „large scale“ economy at the expense of the autochthonous private sector, which slowed down its development. On the other hand, the private sector avoided high taxes and contributions hiring employees without registering them, which reduced the growth of formal employment.

At the same time, registered unemployment was on the rise, to increase between 1991 and 2000 from 522,000 to 723,000. These figures hardly reflected true employment trends, since the registering with the labor market completely lost the character it should have: namely, many of the unemployed who were actually looking for a job stopped registering with employment bureaus since there was no hope that they would find a job that way; on the other hand, those who were not really looking for a job registered to obtain benefits the status of the formally unemployed entailed (health insurance, child allowance, etc.). The duration of unemployment was very long. According to the labor force survey, in 1996 the average duration of waiting for a job was 47.2 months, and about 4/5 of the unemployed waited for employment for more than one year.<sup>1</sup> Thus, unemployment in Serbia was a long-term and permanent category: few people left the category of the unemployed. Unemployment in Serbia was definitely exacerbated by the inflow of refugees from Croatia and B&H, and then from Kosovo and Metohia. According to the 1996 census they

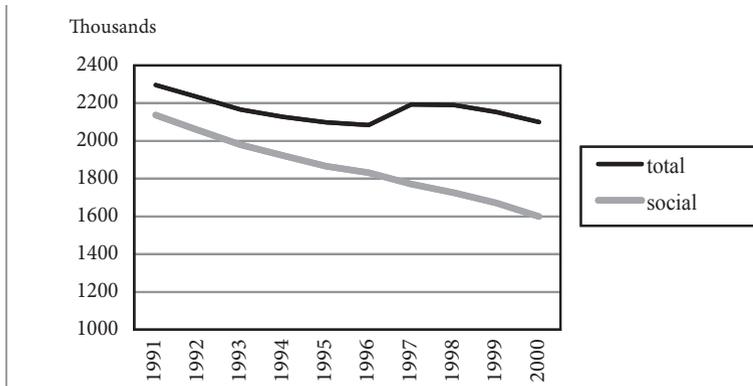
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<sup>1</sup>G. Krstić and B. Stojanović – *Osnove reforme tržišta rada u Srbiji*, (Basic Reforms of the Labor Market in Serbia), CLDS and EI, 2001, p. 30

numbered, not including the refugees from Kosovo and Metohia, six hundred thousand.<sup>2</sup>

The movements in registered employment during the nineties are shown in the following graph:

Figure 1. Formal employment



During the 1990s Serbia experienced a strong upswing of grey economy. Many people who did not formally earn enough to provide an adequate living – the unemployed, employed, pensioners, housewives, etc. – took up jobs in the grey economy sector to provide themselves and their families at least mere subsistence. The causes of the above were numerous: overly restrictive government regulations, excessive taxes, wars, sanctions, blocked transition, weaknesses of government bodies, etc. Generally speaking, grey economy is certainly inferior in terms of economic efficiency compared to the formal sector, but in the given circumstances it proved to be a more vital part of the overall economy.

The empirical studies of the grey economy of Yugoslavia from 1997<sup>3</sup>, confirmed the assessment on its size and significance in the life of the population. On the basis of the survey (3,000 respondents) it was concluded

<sup>2</sup> *Census of Refugees and other War Affected Persons in the Federal Republic of Yugoslavia*, UNHCR, Commissioner for Refugees of the Republic of Serbia, Commissioner for Displaced Persons of the Republic of Montenegro, Belgrade, 1996.

<sup>3</sup> *Analiza sive ekonomije u SR Jugoslaviji sa procenama za 1997. godinu i preporukama za nje-nu legalizaciju (The Analysis of the Grey Economy in FR Yugoslavia with Estimates for 1997 and Recommendations for its Legalization)*, Ekonomski Institut, Beograd, 1998.

that as many as 2.3 million people were involved in the grey economic activities and that slightly over a half of this number was made up of the individuals who had jobs in the formal sector, which is the evidence of their low income. The earnings of the grey economy participants per hour were higher than the earnings in the formal sector by half.

### **The normative labor relations system 2000**

During the 1990s, certain labor legislation reforms were introduced (labor relations laws were passed in 1991 and 1996), but they mostly involved formal adjustment to market economy in little or least important domains. For instance, collective bargaining was introduced, but it was controlled by the state to such an extent that it was reduced to mere form and was a continuation of legal regulation, very much like government decrees.

These changes of the labor legislation were a part of a very slow transition from the socialist towards the market system. The foundations of transition were laid in 1990, but, later on, there occurred some retrograde processes, so that the economic life proceeded in the institutional interspace between these two forms. Privatization began, but by the end of the decade less than five percent of capital was privatized; prices were still under government control; legal labor, capital, money or foreign currency markets were stifled or did not exist; companies were more like welfare centers than profit centers, etc.

Towards the end of 2000, and until the adoption of the new Labor Law in 2001, the labor relations system was based on the 1996 Labor Relations Law. The foundation of the labor legislation was the federal labor relations law, while the republic one supplemented it with more detail. However, the federal law was detailed enough, so some provisions repeated in both laws. An important addition to this law was the Law on Labor Relations within Government Bodies, which protected this category of the employed and practically made dismissing them impossible, except in the case of clearly proved disciplinary offences. The novelty in the new system was greater reliance on collective bargaining agreements, and also the elimination of many previous detailed provisions from the text of the law and their transfer to collective bargaining agreements.

From the economic point of view, the most important provisions of a labor law are those related to the hiring and firing of employees, types of employment, manner of determining wages, collective bargaining, employee benefits, etc.

**The hiring of employees** faced considerable procedural and formal requirements. First, as a rule, the vacancy had to be filled by means of public announcement, with all the accompanying procedures (selection committee, supervisory body, etc.), which complicated and lengthened the procedure. Secondly, for each position there was, in accordance with the legal requirements, a job plan with the necessary qualifications, which significantly and frequently narrowed unnecessarily the scope of candidates for hiring. Such an approach to hiring is justified in the system in which the private ownership of companies does not dominate or exist, but social or state ownership dominates, and the legislator rightfully believes the only way of curbing nepotism and corruption is the setting of a wide scope of the most objective selection criteria and procedures possible. However, in the system which is becoming a market system, the obstacles to free recruitment of employees by owners or managers selected by them become counterproductive and impede a normal and inexpensive flow of staff expansion or renewal.

**Firing** for economic reasons was almost a mission impossible. First, although the law provided for the possibility of dismissing employees due to organizational, economic or technological reasons, during the most part of the nineties, a decree was in force banning employee layoffs during the UN sanctions against Serbia, with the so-called forced leaves to which were sent employees for whom there was no work; besides, there was a direct legal ban on dismissing certain categories of employees (veterans etc.) Secondly, the political atmosphere during this decade was completely against the layoffs, which, due to the domination of party state over economy, automatically meant that company directors completely avoided layoffs. In other words, even when it was possible, there were no layoffs for fear of government reaction. And, thirdly, the costs of possible layoff, stipulated in the Law on Labor Relations, were exceptionally high, and amounted to 24-36 employee wages, in the form of a single redundancy pay. What was even more unfavorable, those high costs of the adjusting of the labor force to the necessary level were supposed to be borne by the companies which, as a rule, were in a bad situation and which were supposed to be saved by restructuring, including the reduction of employee number, from the impending bankruptcy.

In such combined conditions, there were no layoffs for the purposes of adjustment of labor force to the changed circumstances. The only way of labor force reduction was the natural outflow due to retirement or the employee's leaving his/her job willingly, which for most of the companies was too slow a process.

This lack of possibility to lay off the labor force affected the companies' behavior: instead of legal employment there was mass grey employment or employment through youth employment cooperatives, by means of service contracts, temporary work and similar legal and illegal techniques of avoiding full employment. That is how restrictive legislation produced its opposite – the shift of employment from formal to grey and quasi-formal arrangements.

While new employment managed somehow to avoid restrictive rules and reach companies, it was not possible to reduce the existing employment to the right measure. Therefore, in many companies there was a large employee surplus, i.e. a great number of employees did not contribute to the production and the financial result of the company. Estimates (although unreliable) of the surplus ranged between a third and more than a half, and that is supported by the fact that lately, new owners of privatized companies have very often offered incentives to a considerable part of the labor force (usually 30-40% of the total employees, even more) to leave the company voluntarily.

**Collective bargaining** was contemplated as an unavoidable and centralized system. Unavoidable, because the obligation of collective bargaining is stipulated, although it goes against the logic of collective bargaining and against the rules of the International Labor Organization on the freedom of collective bargaining. Centralized, because there was an applicable rule that everybody had to comply with the provisions of the “higher” collective bargaining agreement, even if they did not conclude “their own” collective bargaining agreement. In other words, it was sufficient that the all-powerful Government of Serbia conclude the republic collective bargaining agreement with its faithful political allies, the Independent Trade Union and the Chamber of Trade and Industry of Serbia and that all companies were obliged to apply it, regardless of whether it suited them or what they thought of it.

The main victim of the system of collective bargaining designed in such a manner was the setting of wages, which was, thus, transferred from companies to collective agreements. “The basic price of labor”, as the minimum price for the simplest work, as well as the prices of labor for other employee categories were most often set at a level much higher than the market one, and most often could not be paid out, since companies could not bear such high labor costs. The party state tolerated such company behavior since in this manner it got propaganda points as a declared protector of employee interests, but since it also laid down high taxes and contributions on the minimum base of such unrealistically determined wages. By doing so the state additionally encouraged employers to satisfy their demand for labor force on the informal market.

**Flexible employment forms** were hardly provided for in the law, and only as specificity and an exception to the rule. And the rule was permanent full-time employment, which certainly does not suit the market economy, but which strengthens employees' social security.

**Various benefits** were stipulated by the law: paid leave (minimum 18 days, not including Saturdays), holiday and meal allowances and the cost of transport to the place of work, part of the sick leave costs, etc, were considerable additional cost for the companies, and a significant part of employee income, especially for those with lower wages.

### **Social aspects of labor legislation and policy**

Socially and state owned companies in Serbia in the 1990s were increasingly turning into welfare centers for employees, and were less and less production and profit centers. The economic crisis uncovered this change of character of Serbian companies, but, although less visible, it had itself contributed to the crisis. Namely, when one considers more closely the normative character of labor relations at the time as well as the state policy in this and other areas, one can easily notice that the welfare function of the state was to a great extent transferred to companies, with mostly adverse effects. Let us take a closer look:

1. job security, i.e. the impossibility for a company to lay-off an employee and thus try to reduce costs;
2. collective "bargaining" in favor of employees;
3. wage egalitarianism;
4. different financial and material benefits from company funds (the above mentioned ones stipulated by the law and those received through the trade union);
5. prescribing of low selling prices, by which the state protected the employees' standard of living, without compensation to companies for losses sustained;
6. lack of implementation of bankruptcy legislation,
7. melting away of capital in favor of wages and due to low prices of the basic foodstuffs and utility services, etc.

In this manner, the state tried to make the survival of (a part of) the citizens at the time of economic crisis easier, but at a considerable economic and social cost. The economic cost was reflected in the ruin of many companies which could not sustain the burden of the social policy imposed on them, and the social cost was reflected in a considerable neglect of a large part of the population in Serbia – all those who were not employed. The bad situation of the neglected citizens was further exacerbated by the bad management of the state's social programs, intended for all citizens: therefore, the payments out of a small welfare program for the poor (both in terms of the number of people and the amount of welfare) were more than 24 months late towards the end of 2000; on the other hand, only the employed citizens had the right to a somewhat better child allowance program.

The care for the employees was also reflected in a very favorable system of compensations and insurance in the case they were to lose their jobs due to objective reasons (bankruptcy or the like). These unemployed persons had the right to a cash compensation and pension and disability and health insurance in the period of receiving the compensation. The cash compensation amounted to 70% of their net wages in the last month of employment, and the period in which they received payments lasted up to 24 months, while those with over 30 years of service had the right to compensation until they found another job or become entitled under the law to old-age pension. Of course, the other unemployed persons (i.e. those who were looking for their first job and those who voluntarily terminated employment) did not have such favorable rights. The basic division was into the employed and the unemployed: the employed had jobs and the accompanying benefits, while the unemployed were pushed to the margins, with very bleak prospects. Among the latter prevailed the young and educated, who responded to the deterioration of living conditions by emigrating.

The welfare approach to employment and hiring during the 1990s produced the expected results during the worsening of the economic crisis: the wages plunged in real terms (by more than a half) and, thus, took on the burden of adjustment to the lower domestic product. On the other hand, in capitalist economies the adjustment to the crisis is made by the reduction of the level of employment, leaving the companies in a healthier state, and the crisis is, therefore, less deep.

## LEGISLATIVE CHANGES 2001-2005

### **Introduction**

The process of the true transition of Serbian economy, which commenced the beginning of 2001, inevitably affected labor legislation. True capitalist economy is definitely not possible with the labor relations law containing strong socialist elements of employee protection. For the foreign investments to arrive in Serbia, especially in the form of privatization investments which the Serbian Government seriously counted on, it was necessary to radically change labor legislation at the very beginning of this wave of transition. Because it is hard to believe that the investment in the Serbian economy not only by foreign but also by local investors would be of a larger scope if numerous impediments from the applicable Law on Labor Relations were to remain.

The new Labor Law was passed in December 2001. It was an important step on the reform path and was passed after an exciting political struggle. It was followed by the Employment Law from 2003, which was supposed to provide a necessary level of protection from unemployment and to ensure that the active employment measures are implemented through the National Employment Service.

At a more general level, the strategy of the DOS's Government of Serbia was a combination of the following elements:

1. a relatively liberal labor law which increased the flexibility of the labor market, which, in turn, was supposed to increase the attractiveness of doing business in Serbia;
2. alleviating the tax and contribution burden on the wages, which was supposed to increase the attractiveness of new employment and to encourage the legalization of employees in the grey economy;
3. active employment measures which, with government support, were meant to encourage new employment; and
4. relatively generous social programs for those who lose their jobs or agree to willingly leave their companies (under the Employment Law, from the Transition Fund and from the funds of the buyers of privatized companies)

The idea was to enable through 1, 2 and 3 a long-term rise in employment, and to absorb some of the short-term problems. Increased fiscal costs for the implementation of this strategy could be covered from donations and privatization proceeds.

## **Labor Law from 2001**

### *Introduction*

The whole of 2001 was spent in the preparation and passing of the Labor Law. Since the Ministry of Labor and Employment did not have sufficient expert capacities for the drafting of the law, foreign experts were engaged, too, under the leadership of the World Bank. The Minister, Dragan Milovanovic, was a staunch advocate of the reform.

In the autumn of 2001 political obstacles to the draft law built up. The Confederation of Autonomous Trade Unions of Serbia (SSSS) led a strong action against the draft, demanded to participate as a partner in the drafting of the law, proposed anti-reform amendments to the proposal, and at the time the law was being passed in the Parliament, organized an unsuccessful general strike. The Association of Free and Independent Trade Unions (ASNS) of Minister Milovanovic supported the draft while the Nezavisnost Trade Union Confederation (UGS Nezavisnost) was somewhat indecisive, not willing to join either the Government or the SSSS. The SSSS had three goals: first, to secure mandatory collective bargaining at all levels, from the state to the company level; second, to make layoffs as hard as possible; and third, to ensure through the law the largest possible role for the trade unions in the relations between employers and employees. If these demands had been accepted there would hardly have been anything left of the free negotiations between employers and workers, and thus of the labor market.

Another important difficulty appeared in the party field. The break-up of DOS coalition was so far advanced that the passing of the Labor Law was threatened. Since DSS indicated that it was not happy with the proposal, a political deal was struck in which DSS was promised the passing of the (corrected) judiciary laws proposed by them if they voted for the Labor Law. And that is what happened.

*Basic solutions*

One of the important questions the proponent was faced with, which to a great extent predetermined other solutions, was the following: how to encompass in one labor law to such different sectors as the state/socially owned and private? That is, whether to opt for equal solutions for all employees or to differentiate them according to sector? For example, is it good to also give the right to lay off workers to the directors of socially owned companies, who are not accountable to an unbiased owner, but are either accountable to no one or to the biased political parties? Whether and where to make compromises? The Government opted for one law with equal rules, considering the fact that the privatization process was beginning and that all socially-owned and many state-owned companies would be privately owned in the foreseeable future. This solution certainly makes sense, but it brought – as could be seen after a time – many difficulties, since its basic assumption (the one about fast privatization) did not materialize, since, as we can see, privatization is not over, not even half of it, four years from its commencement. Perhaps it would have been better to provide in the law somewhat different solutions for the two sectors, with the socially owned companies or those with mixed ownership shifting to the regime stipulated for the private sector after privatization. That is because the path taken resulted in a lot of compromises, solutions that were adopted primarily for the purposes of protecting employees in the socially owned sector prior to and during privatization, but which do not suit the private sector and the market economy.

Generally, the basic dilemma in designing the Labor Law was : *freedom of negotiation* or *state regulation*, that is, *the labor market flexibility* or *employee protection*. In essence it is the choice between economic and social motives in designing the law: the economic ones speak in favor of the freedom of negotiation, based on the respect for the labor market, while the social ones aim at the highest possible protection of the employees from the risks (and gains) the labor market brings to the workers.

Employers, on the one hand, most often favor market regulation of their employee relations, i.e., the freest possible negotiation of all the relevant factors (nature of employment, wages and other conditions) with employees, as well as the least possible costs the state imposes or may impose (taxes and contributions, legal obligations of the company towards its employees, the simplest possible procedures, efficient adjudication, etc.). Such relatively liberal labor relations systems truly foster the development of economic activity, and

even, usually, provide for a higher level of employment than alternative, more tightly regulated ones aimed at the maintenance of employment.

Employees, on the other hand, often prefer job security and wage stability, especially during the times of high unemployment and transition changes. Trade unions always support them and the state usually shows understanding for such demands and regulates labor relations favoring security, wages and other employee benefits. In the countries where labor relations are more broadly regulated (like in many EU members) unemployment is usually high. It is similar in many countries in transition, but the question here is whether it is primarily the consequence of labor legislation (similar to the one in the EU) or the difficulties of building and functioning of a new economic system.

In the area of labor relations, not only in Serbia but also in other countries, social and political considerations are opposed to economic ones and the result is a *trade-off* between job security and level of employment, i.e. the higher the security the lower the employment, and vice versa. Individual countries have resolved this dilemma differently: liberally in the USA, for instance, with the domination of contract over legislation; by broad legislative protection of jobs in Germany and Italy, for example. However, the European Union realized that the restrictive solutions in labor legislation in many member countries make the European economy less competitive and dynamic than others (e.g. USA), and adopted, through the 2000 Lisbon Agenda, proclaiming the goal of making the EU the most competitive economy in the world by 2010, a program of labor legislation reform in a more liberal direction, which has been gradually implemented, but not fast enough (the Koch's report, end of 2004).

The most important issues reflecting the character of a labor law are: the hiring and firing procedures, employee benefits, collective bargaining and prescription of wages, etc. If the hiring and firing procedure is simple and inexpensive for the company, if the wages and other benefits are not precisely regulated by the law but left to collective bargaining, which, in turn, is not mandatory, we can speak of a liberal labor relations regime. If, however, hiring is complex and firing even more so, if many employee rights are defined by the law, and collective bargaining thus emptied of any content and then made practically mandatory, obviously, social and protection motivation dominate the legislation. procedure.

Let us look at the basic solutions in the 2001 Labor Law.

**Hiring** was simplified compared to previous solutions. there is no longer a legal obligation to recruit employees by means of public announcement, which

made the process long and costly. Now, there is a reasonable basic assumption that an (private) employer knows best how to obtain the best workers and that he does not need a tutor in the form of government legislation. The Labor Law provides only for the basic employment conditions (minimum 15 years of age and that such labor does not threaten the employee's health, morality and education), but all other conditions for a particular job are defined by the employer (qualifications, years of experience, etc.).

The Law, apart from the classic form of permanent full-time employment, also provided for flexible forms of work, such as temporary and part-time employment. These solutions widened the choice of both the individual and the employer, and the wrong interventionist idea of strict limitation of flexible forms of work in order to force the employers to hire full time permanent employees, was discarded. A reasonable opinion prevailed that the unemployed will benefit more from flexible employment forms, although this may mean less work and earnings per person, but for more people, than not so effective pressure on the employers to do something that does not suit them (full-time employment).

**Termination of employment by the employer.** This part of the law underwent the greatest changes. It is true that the principle that the employer can dismiss an employee only for a justified cause was still retained, which limits the freedom of contract, and involves the court as the place where it is finally determined whether the cause was justified or not. However, such justified causes are formulated in the Law quite broadly, and they, too, are basically interpreted by the employer (at least in the first instance), so that they do not pose a serious functional obstacle to the dismissal of employees.

There are three basic groups of causes for possible dismissal:

1. if the employee violates the rules;
2. if it is established that the employee does not perform adequately, that is, that he does not possess the necessary knowledge and skills to do the job;
3. if due to technological, economic or organizational changes, the need for a particular job no longer exists.

#1 – The novelty here is that the law does not impose the procedure of determining the violation, as was the case in the previous law with the disciplinary committee, but it leaves to the employer the right to establish the facts, based on a reasonable assumption that it is not in the employer's interest to rid himself a good employee this way.

#2 – The right to dismiss an employee who does not perform satisfactorily must also be an inalienable right of the employer. That is because such an employee is a hindrance to the efficient functioning of the firm and it is only natural that the direct way of dismissing him be defined.

The labor law, however, stipulates the obligation of the employer to pay severance pay to such an employee, the amount of which depends on the years of service and the amount of the wages up to that moment. Namely, the severance pay ranges from one to 2 ½ employee's wages for each year of service with the present employer. This severance pay was drastically reduced compared to the previous law, under which it amounted from 24 to 36 monthly wages, but it is not clear why it was retained in the first place. Namely, it is unclear why an employer should have any obligation to pay anything to a bad or insufficiently good worker; if the basic prerequisite of the employment contract – the one about the good performance of work by the employee – was not met, it is natural that the contract should be terminated by the employer but without any compensation for the employee. If the state wants to assist such an individual, it should pay the severance pay itself, from the budget. Of course, it is clear why such solution was included in the law: to discourage layoffs and thus reduce social tensions during transition. Such socio-political reason is hard to support from the economic, and even the moral point of view, considering that it grants the right to financial compensation to the person who does perform his job properly.

#3 – The employer may also terminate the contract of the employee if, due to technological, economic and organizational changes, the need for his services no longer exists. This is, therefore, the way in which the employer can reduce the labor force in the company, i.e. adjust it to the real needs. However, the law sets two limits to the employer who has more than fifty employees.

Firstly, he must attempt to solve the problem of redundant employees before laying them off. If he intends to lay off less than 10% of the labor force, it is sufficient that he attempts to provide the employee with another position. Since this obligation was broadly defined, it did not pose a true obstacle for less than 10% of the labor force.

A somewhat more complex procedure was stipulated for the layoff of more than 10% of all employees. In such a case a redundancy program must be prepared, which may contain the change of position, assignment to another employer, retraining, etc, which is carried out in cooperation with the National

Employment Service. If such measures are unsuccessful, which happens as a rule, the particular employees are laid off and the problem remains with the National Employment Service.

Secondly, and more seriously, the law stipulates the employer's obligation to pay to the employee who is losing his job the redundancy pay ranging from the amount of two to five monthly wages of the said employee, depending on the total years of service. This provisions, too, is neither economically sensible (since it makes the so much needed restructuring of the company harder) nor morally justified (since one cannot see why the employer/company owner should finance social policy). There is still that old socio-political consideration.

**Privatization and the reduction of the labor force<sup>4</sup>.** One of the important components of the privatization program in Serbia is the care for the destiny of redundant employees in privatized companies. Namely, in the process of the decision-making on to whom a company will be sold ( in tender privatization) the social program criterion was one of the basic three criteria (apart from the selling price and the amount of the investment program). This criterion usually meant the commitment not to lay off employees in the following few years, and/or the obligation to pay the agreed (and defined in the social program) redundancy payments for those employees who agree to voluntarily leave the company during this period. Similarly, in the companies sold through auction, the privatization program and the draft agreement include the ban on lay-offs in the following few years, as well as the amount of redundancy payment (usually 200 € per year of service) for those who will willingly leave the company. This was the way to attempt, as was declared, to reduce the so-called social cost of transition, or indirectly, (some) employees were bribed into accepting privatization.

What were the effects of such an approach? It led to the direct reduction of the price of the company being privatized. Because it makes no difference to the buyer what form the payment takes:

1. the full amount he is ready to pay for the company to the state budget (through the selling price of he firm), but with no cost for the layoff of the redundant workers, or
2. a part of the amount he is ready to pay to the budget, and the other to the excess employees, so that they leave the company.

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<sup>4</sup>The points related to privatization and the Transition Fund are not related to the Labor Law, but, since they are linked to layoffs, they certainly belong here.

The buyer, of course, is only interested in the total acquisition and restructuring costs, and not their structure. An the state decided to give up one part of its revenue, in the form of compensation, to the employees who are going to lose their jobs. the idea is that these employees either find a way to initiate a private business, or, at least for a while, to have some means of livelihoods.

#### Frame 1

Philip Morris, the buyer of the Duvanska Industrija Nis - DIN (Nis Tobacco Industry), offered redundancy payments to the DIN employees in the autumn of 2004, according to the social program from the privatization time. The management estimated that it is less expensive than to have a large surplus of employees on the payroll for another four years and pay them wages. Of 2,400 employees, 1,650 accepted the offer and left DIN. The total Philip Morris's cost was a US\$ 100 million, and the employees who left the company received US\$ 65 thousand on average, i.e. between US\$ 10 and 100 thousand. In this way the state lost US\$ 100 million, since that is the difference in the price Philip Morris was prepared to pay in the privatization DIN in the situation when it was left to it to resolve the issue of redundant employees and the alternative situation in which the rules of privatization would not oblige it to retain the present level of employment for the following five years. The question remains whether it is good for the state to give up US\$ 100 million in order to improve the situation of only 1,650 workers, and whether it is fair that at the expense of the state certain individuals gain up to US\$ 100 thousand for the loss of job<sup>5</sup>.

BAT, the buyer of the Duvanska Industrija Vranje – DIN (Vranje Tobacco Industry) did not opt for the reduction of the number of employees and payment of redundancy pays, but intends to increase production and thus employ the whole workforce. Many DIV employees are probably sorry that they are not employed with the neighboring DIN.

**The so-called Transition Fund** is a special social protection program, intended for larger companies being restructured or placed under bankruptcy.<sup>6</sup> The Government of Serbia usually pays from it lump sums to employees who

<sup>5</sup> The year before almost all DIN employees, in their capacity of minority shareholders, sold their shares to Philip Morris for about US\$ 90 million.

<sup>6</sup> This program was created as the result of political pressure exerted by large companies, and its legality is disputable even though in 2002 the Government adopted the so-called Social Program, which was supposed to formalize the spending of these budget funds

are willingly or forcedly left jobless, most often 100 € for each year of service. In 2002, 57,000 employees were paid off in this manner, for which CSD 7 billion were spent. This is, in fact, the option which those people whose employment is terminated may choose instead of the regular unemployment benefit, and the idea is to provide, even with a modest sum, some initial investment into a small private business. The experience shows that this does not happen very often, but that the money is spent for self-support for several months. Informal at the beginning, this program was formalized in 2002 through the so-called Social Program. In 2005, CSD 5 billion from the budget were earmarked for these purposes.

**Collective bargaining** between employees and employers should to a great extent regulate employee wages and other more important employment conditions.

Under the 2001 Labor Law, collective bargaining between employers and trade unions is mandatory "... the participants ... shall be obligated to negotiate". If the negotiations do not go well, the arbitration body must be formed by mutual agreement, but its decisions need not be binding. Such a solution is not in full harmony with the principle of free collective bargaining, since it, at least partly, loses the character of free negotiations if it is, firstly, mandatory, and, secondly, if the arbitration is mandatory. The only thing missing is that the arbitration body's decision is binding, to have the collective bargaining system, at least in terms of effects, similar to that from the times past. However, what is important is that the situation when the collective bargaining agreement is not reached, remains a possibility: collective bargaining – in order to truly be free – must be given a chance to fail and not to produce the collective bargaining agreement, at least for a while.

The improvement in comparison to the previous solutions is also the fact that the general collective bargaining agreement (for the whole of Serbia) and the social collective bargaining agreement (for a smaller territory or a group) bind only those employers who are the members of the association which signed these agreements, and not everybody else as well. Up to 2001, both general and special agreements directly bound all employers.

The provision from the Law stipulating that the Labor Minister may decide, if he assesses that there is a justified interest, that the general or individual collective agreements or individual provisions thereof apply also to those employers who did not participate in the conclusion of the collective bargaining agreement, is not a good solution. This possibility exists in practice

in some European countries, but one cannot see the need for this system to be applied in Serbia. Quite the opposite would be good: that it is made possible through free contracts for the companies and employee representatives to adapt employment contracts to their own preferences and specific conditions in individual companies.

The provision of the Labor Law reading that until new collective bargaining agreements are concluded the old ones, from Milosević's time will apply, is a very conservative one. These collective bargaining agreements can hardly be considered legitimate, since they were concluded between the representatives of the party state and party trade unions, and as such, should not be in force at all in the new environment. It would be better if upon the passing of the Labor Law all collective bargaining agreements had become invalid, and had to be concluded again, after new collective bargaining. However, in the majority of Serbian companies these old collective bargaining agreements are still in force, regardless of whether they are applied or not. It would be better if the Labor Law had stipulated that upon the enactment thereof all current collective bargaining agreements were to become invalid and that the new ones could be adopted in accordance with the new labor relations system.

Generally, the normative system of collective bargaining did not function as contemplated in the Labor Law. And in the part it was functioning it would hardly get a passing mark. The major trends are as follows:

- in some companies the old collective bargaining agreements were not complied with, either because there were not sufficient funds for compliance, or because they do not fit with the new conditions, or because the management, feeling stronger than the employees or the trade unions, did not honor them.
- in some companies the trade union was strong and managed, after strikes, to achieve not only the compliance with the provisions of the old collective bargaining agreements favorable for the employees, but also additional benefits,
- there is a relatively small number of new collective bargaining agreements, which is not the evidence of the satisfaction with the current ones, but of the unstable and/or unclear situations in these companies, problems in communication between the two sides, as well as immaturity of industrial relations in Serbia,
- in Serbia, there is a clear problem of the representativeness of the collective bargaining actors at a higher level: two trade unions are formally

representative (SSSS and Nezavisnost), the third currently is not (ASNS), while, really, no employer association is representative, and therefore the collective bargaining at the level of Serbia or large regions is not possible; in many companies, especially the smaller ones, there is a problem of trade union representativeness, since the trade union organization is either non-existent or weak and inactive.

In summary, in Serbia, the compliance with the inadequate collective bargaining rules was weak on the part of the stakeholders who consciously relied on the fact that neither their partners in the company nor the state would stand in their way.

Since the *determination of wages*, in normative terms, is the basic task of the collective bargaining effort, it is obvious that, in Serbia, they are not determined through collective bargaining agreements. according to anecdotal evidence, since proper research has not been conducted, one could cautiously conclude that the wages are determined:

- in the sector of socially-owned and mixed (not fully privatized) companies as well as in the previous times: according to the available resources of the company with marked solidarity,
- in the autochthonous private sector, which mostly comprises small companies: by owner's decision, i.e. in accordance with the local labor market, and
- in large privatized companies: often according to collective bargaining agreement, after tough negotiations (and with strikes) between the company trade unions and management.

**Minimum wages** – The Labor law stipulated the minimum wage, as a social measure which should protect the worst paid workers. it is determined semi-annually by the Government of the Republic of Serbia and the representative trade unions and employer associations.<sup>7</sup>

While the 1996 Labor Relations Law set the minimum wage in a simple way – at 35% of the average wage – the 2001 Labor Law stipulated that it be determined according to the cost of living, needs, labor market situations and development of Serbia. Such flexible criteria turned the system of setting the minimum wage into constant haggling, where the trade unions demand as much

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<sup>7</sup>The question is whether the Employers' Associations of Serbia is a representative employer association, because since the summer of 2004 it is practically unknown which management group represents the organization. It was not certain even in the previous period whether this Association represented a relevant number of employers. It seems as of the governments and trade unions need an employer organisation for procedural reasons, so they condone it.

as possible, the government offers less, and the final outcome is somewhere in between. A witness to the above is the ratio of minimum to average wage in Serbia: from 35% towards the end of 2001, through 43% in January 2002, to 47% in January 2005.

Despite all the understanding for the care of the social position of the poorest, even when it is exclusively motivated by political reasons, it is not good that the minimum wage practically equals a half of the average wage in Serbia. too high a minimum wage must!) either lead to non-compliance with the regulations, which has been a custom in Serbia all these years, 2) or, if the regulation is complied with, to lead to the increase of wages of a part of unqualified workers, but also to the rise in labor costs and the reduction of the job positions for unqualified workers, and thus rise in the overall unemployment.

#### *General assessment of the Labor Law*

The 2001 Labor Law was a large improvement in comparison to the previous Law on Labor Relations from 1996. the improvement of labor legislations is visible in all areas – from the simplification of hiring and firing, through more flexible relations within the company to a more liberal collective bargaining system. the basic philosophy of the law – to regulate the basics and toe leave the rest to the companies and collective bargaining – was good. There is no doubt that the Labor Law from 2001 was great step forward from the previous solutions. But this was neither hard to achieve, since previous legislation was so restrictive that it was easy to bring positive novelties, nor does it mean in itself that this law is exceptionally good, at least from the economic point of view. The 2001 Law, nevertheless, belongs to the category of laws common in market and transitional economies.

The main weakness of this law stems from its striving towards political compromise. That is, although liberal to some extent, this Labor Law gives concessions, for the purposes of political compromise, at the level of principle: it does not promote the idea of free contractual relations between employers and employees, but accepts the philosophy of the state regulation of industrial relations for the purposes of employee protection, and then attempts to mitigate the regulation in detail. For example, it prescribes mandatory collective bargaining, although not the obligation to reach agreement. Or, it stipulates that the employer may dismiss the employee only for a justified cause, and then

attempts with flexible formulations to expand the freedom it has just restricted. This apparently pragmatic approach – in which you accept wrong philosophy for the sake of compromise, and then derogate the compromise by allegedly clever tactics – can hardly produce good results over a long term. Because, wrong philosophy sooner or later comes to the forefront, for instance, by the parliament correcting technical weaknesses of the law and ensuring that the ruling philosophy is respected.

This law was rated somewhat more favorably by the World Bank saying that this law “provided more flexibility in both the hiring and firing of workers ... These changes are the basis for the efficient reallocation of labor so as to increase productivity of existing and new enterprises.”<sup>8</sup> Or, the law “creates the scope for enhanced labor mobility and job creation by simplifying the process of hiring and terminating employees and by reducing labor costs”<sup>9</sup>. The Foreign Investors Council in Serbia (FIC) goes even further, and almost fervently claims that “the new law is very free-market oriented and comes as a response to the major economic and social changes that call for more flexibility in the labor market”<sup>10</sup>. A more balanced and accurate evaluation of this Labor Law was given by the consulting firm PriceWaterhouseCoopers which says that “the Law does not privilege either employer or employees and it enhances functioning of the labor market”<sup>11</sup>

In sum, the 2001 Labor Law had both strengths and weaknesses. Its basic weakness was that it was too European and the basic strength was that it was not fully European.

## **Employment Law**

The Employment Law was changed in 2001, and in July 2003 a new one was enacted, under the name of the Law on Employment and Unemployment Insurance, riding on the last wave of the reform laws of Zoran Zivkovic's Government. They basically regulate two important things: first, unemployment

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<sup>8</sup> *Serbia and Montenegro, Republic of Serbia, An Agenda for Economic growth and Employment*, World Bank, December 6, 2004, p. 114

<sup>9</sup> *Serbia and Montenegro, Recent Progress on Structural Reforms*, World Bank, November 16, 2003, p. 5

<sup>10</sup> *Proposal for Improvement of the Investment Climate in Serbia*, Foreign Investment Council, Belgrade, 2005, p. 24

<sup>11</sup> *Doing Business and Investing in Serbia*, PriceWaterhouseCoopers, 2004, p. 43

insurance, with employee rights and manner of financing, and, second, the system of active policy of employment by the state.

**Unemployment insurance** aims at assisting an individual who has lost his job without his fault, through the payment of unemployment benefits during a certain period of time, to look for and find an appropriate job, without a significant loss of income.

Towards the end of 1990s the minimum unemployment benefit was 50% of the average monthly wage in the Republic and there was no upper limit. Those who received the benefit were entitled to 70% of their last wage plus 2% for each year of work experience. This was really a generous formula, especially for those with high wages and many years of service: they could obtain a benefit that was higher than their last wage! Such a generous system was possible because the number of beneficiaries was exceptionally low, since the job security was high and the number of those who lost their jobs was very modest.

At the beginning of 2001 the system changes: the computation formula is corrected and now the benefit amounts to 60% of own wage plus 2% for each year of work experience. There is also a corrective, so that the benefit cannot be less than 40% and more than 80% of the average wage in Serbia. The period during which the benefit is to be received ranges from 3 and 24 months, depending on the years of service of a particular person. A single payment of the whole benefit is allowed if the individual commits to start a private business with these funds.

As from July 2003, the cash unemployment benefit amounts to 60% of the employee's last wage in the first three months, and then 50%. The benefit may not be lower than minimum wage, nor higher than the average wage in Serbia. The length of the period of 3 to 24 months is retained, as well as the right to a single benefit payment in the case of self-employment.

Less generous unemployment benefits were inevitable and the result of two concerns:

1. the expectation of a significant rise in the beneficiaries during transition and layoffs of redundant employees during the restructuring of the economy, with the corresponding adverse financial consequences
2. fear that the policy of generous benefits over a long period of time would discourage beneficiaries from seeking employment.

However, even at this level the benefits in Serbia are above average for a country in transition, and there are considerable difficulties in financing them.

Namely, at the beginning of 2005, the delay in the payment of unemployment benefits is six months and rising, which does not speak favorably of the care of the state for the unemployed or of the respect of their legal rights.

The number of the unemployment benefit recipients increased from 46 thousand in December 2000, to 79 thousand in December 2002, and to 85 thousand in December 2003. It is still low, considering that the total unemployment stands at least at 500 thousand (according to the labor force survey) or about 900 thousand at most (according to the National Employment Service records). This number is not much higher only because many people who lose jobs in large companies in restructuring or bankruptcy do not apply for the benefit, but opt for another program aimed at the unemployed, as more favorable – single payment from the Social Program, or the Transition Fund.

**Active employment policy** is treated well and in a modern manner by the Law. The problems arise in its operationalization: neither are there funds for active employment measures, nor does the National Employment Service operate at a sufficiently high level.

The obligation of financing a rising number of unemployment benefits very efficiently empties the National Employment Service's budget, so that very little is left for other programs. That is why in the last several years only 1 % of the Serbian BDP is allocated for these purposes, which is insufficient for more serious results. Therefore, the measures implemented are mainly the cheapest ones, such as the mediation in employment and education for employment, and to a lesser extent to adult education. Such low amounts allocated for active measures begs a question as to whether the state has any serious intention of pursuing the active employment policy or is skeptical as to its efficiency.

Such possible skepticism on the part of the state would be well founded, since active employment measures usually yield poor results, both in Serbia and other countries. They are mostly a political response of the Government to a significant problem of unemployment, undertaken without much hope in the positive outcome. International empirical research indicates inefficiency of most active employment policy measures in terms of costs and benefits. It seems that only a small number of measures may yield positive effects on the rise in employment in accordance with the cost-benefit principle, such as the mediation in employment and education of the unemployed.<sup>12</sup> Therefore the policy of active employment programs which is, reluctantly pursued in Serbia, may be positively evaluated: the National Employment Service practices

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<sup>12</sup> See: *Impact of Active Labor Market Programs: New Evidence of Evaluations with Particular Attention to Developing and Transition Countries*, World Bank, 2004

only those measures that are considered to be the only effective ones – adult education and mediation in employment.

Moreover, the weaknesses of the National Employment Service are considerable. Its institutional capacity building in accordance with the Employment Law is not complete. Its staff is not numerous enough. There is also a problem of skills of a part of its employees for doing their jobs. A particular problem is the lack of the modern IT equipment, which slows down the work and results in lower efficiency- then monitoring and evaluation of the undertaken active employment policy measures does not exist, which results in the lack of knowledge on the effects of such measures, and renders impossible the fine tuning of the active policy instruments according to the efficiency level of each of them. A special problem poses the lack of any vaguely reliable estimates of the future needs of the economy in terms of workers by profile/ trade, which restricts the educational component of the National Employment Service activities<sup>13</sup>.

### **Social dialogue**

The idea of the social dialogue of important actors in a society as a method of making important social decisions has constantly been around in the last few years. All the time it has been advocated by the trade union representatives and shied away by the members of the Serbian Government. Employer representatives are reserved but passive.

The fundamental idea lying behind the advocacy of social dialogue in our country is the idea of the possibility to achieve social harmony if major players are reasonable and act in good faith. Then, the representatives of employees and employers could find the best solution in agreement with the executive branch of the government, starting from their own interests, needs and capacities.

In a standard liberal democratic system, and Serbia inevitably strives for such a system, decisions are basically made in two ways. Firstly, on the market, by free contract entered into by free citizens on the basis of supply and demand, on their private affairs in the economic field. Secondly, in parliament, on the affairs that must be dealt with collectively.

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<sup>13</sup> For more detail see: *Forum o najvažnijim merama i preprekama za povećanje zapošljavanja, Finalni izveštaj*, (Forum on the Most Important Measures of and Obstacles to the Employment Growth, Final Report) CLDS, 9 March 2005

The idea of a social dialogue as the decision-making form is opposed to both the market and the democracy. To the market, since the social dialogue, dealing with affairs that belong to the individual, tries to replace the market and change the outcomes of its operation. To democracy, since the stakeholder groups discuss the affairs that belong in the Parliament (laws, etc.), trying to reduce it to an auxiliary body which would implement the previously reached agreements. And that would in turn be totally opposite to the idea of citizen/people sovereignty and the concept of parliamentary democracy.

Social dialogue lacks democratic legitimacy of the participants, since they (apart from the Government) are mostly self-proclaimed, i.e. no one gave them, through proper elections, the right to decide on behalf of the real or imaginary members. It lacks the precisely determined scope and decision-making procedure. On the other hand, both the market and the parliament are based on the clear and full powers to decide on detailed regulation of both the contract and property (the market) and parliamentary work, and to ensure that the decisions are enforced (courts, executive bodies, etc.). from this standpoint, the social dialogue which should produce important decisions turn out to be a very controversial idea, since no one knows who and with what rights participates, what is the subject matter of the decision-making process, how the decisions are made and who ensures decision s enforcement. If some effort were invested and the above questions regulated in detail, the result would be somewhat unexpected – we would get a class defined, corporate state, which is a well known and long ago discarded idea of the foundation of the state on the agreement between classes.

A nicely devised dialogue of interest groups, on the other hand, very easily turns into fighting between lobbies for immediate material and status gains for the participants through the abuse of state. Moreover, it is very hard to distinguish between the “true” social dialogue and the lobbying for own interests. And lobbying is the simple struggle for redistribution of profits and fixed income, which, when it is in full swing, ruins the productive sphere of the society.

Another type of the social dialogue – informative and consultative – may be useful, but it requires that all participants agree on the type of the dialogue held and on the unacceptability of imposing own ideas and interests on the others, and especially on the Serbian Assembly. I believe that the purpose of the social dialogue should not be the making of binding decisions, since it would mean not only the marginalization of market freedoms and parliamentary

democracy, but also of economic development. And that would be to high a price for a controversial institution.

The first Socio-Economic Council was established by the agreement between the government, trade Unions and the Employers' Association in August 2001, but the Council soon, due to the differences which emerged over the proposed Labor Law and the withdrawal of the UGS Nezavisnot, ceased its activities. It was restored in April 2002, but it died down due to the lack of agreement between participants on the role and scope of activity of the Council. Prime Minister Djindjic used the idea of the social dialogue for propaganda purposes, and nothing serious was (being) done.

The Government of the Prime Minister Kostunica proposed and the Assembly accepted the Law on the Socio-Economic Council, but that did not produce any more serious work either. The Law itself does not indicate specifically the scope of activity of the Socio-Economic Council, so one cannot tell what kind of the social dialogue the legislator had in mind. The practice will tell, then.

### **2005 Labor Law**

Two leading trade unions in Serbia were displeased with the 2001 Labor Law and in the following period led a tough propaganda campaign against it, claiming that the pendulum swung too much to the employer's side to the detriment of employees, and that it needs balancing out. When, in forming the government of Vojislav Kostunica, Slobodan Lalovic, a trade union activist became the Minister of Labor, the time came for this law to be changed in the direction advocated by the trade unions.

The first draft appeared in the summer of 2004, and expressed a trade unions' candid opinion as to what a labor law should be like. According to other views (the World Bank, four employer associations, some economic ministers, economic experts) it was absolutely unacceptable. In further dialogue many weaknesses have been mitigated, but the marked social-trade unionist orientation was preserved, at the expense of the employer's rights and freedoms. The Law was adopted, after the disallowed text corrections and repeated vote in the Parliament in March 2005.

Let us see what are the novelties in this law compared to the one from 2001. The novelty in this law is the chapter on additional employee rights

during the bankruptcy procedure. The employees who have claims against the company in which they worked, and which is under bankruptcy, under the provisions of the Labor Law gained the opportunity to collect part of their claims outside and prior to the bankruptcy proceedings itself, regardless of the fate of the bankrupt's estate. Their claims are taken over by the newly established Solidarity Fund, who pays them in advance. Who finances it? The Republic of Serbia budget. Considering that the Bankruptcy Law itself stipulates the priority payment of a part of the employee's claims, these provisions of the Labor Law must be understood as providing for additional and faster exercised employee rights.

Is this a good solution? On the one hand, arguments in its favor may be found: unlike the classic capitalist economy, in which employee claims against the company in which they are employed cannot be more than a monthly gross wages, in Serbia in transition, such claims could be multi-annual, and there is sense, from the social reasons, to enhance and speed up the payment of a part of these claims. On the other hand, the above problem is temporary and there is no sense in adopting a solution which will be in force in future, when the situation has stabilized, to address a temporary problem. Moreover, it is not clear why the taxpayers, which definitely include some poor people, should finance the payment of private claims of private persons against private companies. Because, budget financing of debts in bankruptcy is just that: interfering with government coffers with private financial relations.

There is also a new chapter on status changes, which prescribes that the new employer is obliged to apply for one more year the collective agreement or operating rules of the former employer for the employees taken over by him. It is obvious that the idea was to protect the employees from the risk of wage reduction upon the status change, but the question is why disregard the possibility that the collective agreement of the new employer may be more favorable than the old one. Secondly, it hardly make sense to impose on employer the internal document (collective bargaining agreement) of another company and another employer. If nothing else, this provision will to some extent and in some circumstances discourage status changes, which cannot be good news for the employed either.

Wishing to improve the position of the employed at the expense of the employer as much as possible, in many provisions old figures were replaced by more favorable ones or the provisions of the general socialist collective agreement from 1997 were introduced in the law. That is how the minimum

annual holiday increased from 218 to 20 days, paid leaves (for birth or death in the family, etc.) from 5 to 7 days, the provisions on the increased wages (for working on public holidays, at night or overtime) were taken from the collective agreement, the redundancy/severance pay was also raised to one third of the wages per year of employment (for redundant employees) and 1 to 4 wages (for individual dismissals), the threshold for the obligation of preparing the program to address redundancies was lowered, the limit for temporary employment was reduced from 3 to one year, etc. Under the new law, the employer must, and in the old law he “could”, pay the retirement allowance of minimum three average wages and cover the costs of his or his family member’s funeral! There is no doubt that these changes increase labor costs, and that they will reflect adversely both on employment or on other employee income.

There were no significant changes regarding the termination of employment: the philosophy of justified cause for dismissal was retained (dissatisfactory performance, breach of rules, the need for the employee no longer exists), as well as the special treatment of redundant employees. The procedures are now very complicated, allegedly to protect the employees, but perhaps, to give the chance of weaker jurists and non-jurists in small and medium enterprises to make a procedural mistake and to have the termination reversed by the court, with damages for the employee.

There are no big changes in collective bargaining. All participants are still obligated to negotiate, but they do not have to form an arbitration body, so there is no obligation to have a collective agreement and the whole deal may fail. The provisions of the general and special collective bargaining agreements still directly apply on all the employers who are members of the signatory associations. The novelty is that the minister may, for justified reasons, exempt some employers or associations from the application of the collective agreements in the part related to wages.

The wages chapter looks a lot like those dating twenty years back: it is filled with criteria, value of work, equality, rulebooks, different wage components, past work, cost compensation, etc.

All in all, this law did not essentially change the character of industrial relations in Serbia, but the labor market regulation is more inflexible, and labor costs for employers have significantly increased. The idea that during transition employees need as much protection as possible prevailed in this government and in this Assembly, which is not only unfavorable for the future course of

transition and investment, but also leaves the uncertainty as to whether the restriction introduced because of transition are there to stay. Because, rules once introduced, especially when they particularly favor one important group, are hard to change even when the real reasons are very strong.

### **The role of IFI's and donors**

The donors' role in the creation of labor legislation and institutional building was considerable. Of special importance has been and still is the engagement of the World Bank, which dominates among donors in terms of experts and strategy. Namely, the World Bank is given the lead by the donor community in the areas which have key impact on poverty, and labor relations and employment definitely do.

The most important role of the World Bank is its influence on the design and implementation of structural reforms. It does so by means of its own expertise, which is obviously very precious for the countries in transition and developing countries, and by attaching formal conditions of conducting certain reforms as the prerequisite for the loan approval.

In designing, and also drafting, the 2001 Labor Law and 2003 Employment Law, foreign experts had a significant role since the expert capacities of the Ministry of Labor and Employment were relatively limited. In drafting the 2005 Labor Law, expert assistance to the Ministry was given by local trade unions, and the World Bank tried and partly succeeded in removing from the draft the exaggerations which abounded in the first drafts. The main arguments it tacitly used was the (future) SOSAC, i.e. the structural adjustment loan.

## LABOR MARKET TRENDS

### **Introduction**

Globally speaking, the situation on the labor market in Serbia is not favorable. Its basic characteristics are high unemployment, long-term reduction of employment and considerable number of surplus employees in the formal

sector, inflexible formal labor market, large grey economy, relatively low wages, which are all manifestations of serious deviations both on the labor market and the overall economic system.

Four basic categories on the labor market in Serbia are the formally employed, the redundant, those active in the grey economy and the (formally) unemployed. There are overlaps between these categories: part of the employed in the formal economy is also active in the grey one, and part of them are redundant; part of the formally unemployed is also active in the grey sector. The causes of such overlaps are numerous, but we will mention only the basic ones. Firstly, many of those employed in the formal economy have an interest to work in the grey economy as well to increase their otherwise modest income, and there are opportunities for it because many companies do not yet operate at full capacity or no at all. Secondly, a part of the formally employed are redundant in their companies, and remained there from the previous times. Thirdly, many of those who work exclusively in the grey sector, or under short-term agreements in the formal sector, remain registered with the National Employment Service, for the benefits the status of the unemployed brings (health care, child allowances, etc.) due to these overlaps, and the weaknesses of official statistics, there are dilemmas related to the basic labor market figures – employment and unemployment, average wage, and they depend on the definitions used and the methodology of calculation.

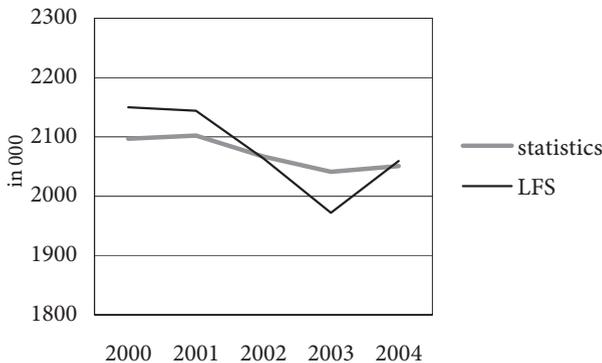
## **Employment**

At the time of transition it is usual for the employment to be one of the first victims of structural changes during the first years, and, therefore, the subject of the greatest concerns of the Government and the Parliament. The fall in employment in the first stages is probably natural, since the process of the destruction of the old, uneconomical jobs is usually faster than the creation of new jobs, especially if the opening position is far away from the economically rational (balanced market). Thus the unemployment levels in the East European countries in transition rose fast in the first few years of transition, although more slowly than the drop in the GDP, to gradually fall in later phases, together with the restoration of the economic activity on the reformed bases. However, even today, fifteen years from the beginning of transition, the labor market situation there is not satisfactory: in the East European countries and the

ex-USSR countries the number of redundant employees is high, due to insufficient company restructuring.<sup>14</sup>

In Serbia, as shown on graph 2, formal employment during the period 2000-2004<sup>15</sup> did not plummet, like in other countries, but was mostly stagnant, with slight decline in the last few years.

Figure 2. Employment



Sources: Labor Force Survey, Republic Statistics Office (RZS), various years; Statistical Yearbook of Serbia, RZS, various years

There are three main causes for it:

- first, Serbia did not witness a (considerable) fall in the GDP in these years, so the fall in employment was not necessary; moreover, Serbia witnessed a significant GDP growth during these years, as a result of the economic recovery in the period after the 1999 air raids, lifting the strict confining measures from the time of Milosevic, and inflow of aid and other foreign capital; Serbia entered the second wave of transition, the one we are following, with (deformed) market economy, and not with the centrally planned one, as was the case with most countries in transition, so the structural breakdown was not very big,
- secondly, privatization was not particularly fast during the first years of this period, so the relieving of companies from the burden of excess

<sup>14</sup> *Labor Markets in Europe and Central Asia: Towards Creating More and Better Jobs*, World Bank, November 2004.

<sup>15</sup> Employment trends are displayed on the basis of two sources of data: Labor Force Survey and regular statistics. The differences between them are not great, neither in level nor in trend.

employees, which is the most direct and most important method of reducing formal employment in Serbia, was not considerable; the obligation of the company buyer to provide hefty redundancy payments to the employees who agree to leave the company, being expensive, dissuaded a part of owners from trying to reduce the workforce and, thus, certainly contributed to it;

- thirdly, the implementation of the new bankruptcy legislation, which could reduce formal employment, did not start yet (until spring 2005).

One may notice that the increase of employment in the autochthonous private sector was not mentioned among the important factors, which does not mean that it does not exist – it is just not particularly high. Therefore, the following very beneficial mechanism is not work in Serbia: many jobs are lost in the privatized companies which were overburdened with redundant employees, but the loss is compensated by a fast growth of employment in the new private sector; that means that, unless the growth in the new private sector accelerates, we may witness, in future, a considerable drop in formal employment – when the restructuring is in full swing and when the companies start shedding excessive workforce. Slow growth of new companies is the consequence of insufficiently favorable investment climate, i.e. not only slow transition and regulatory and economic and political weaknesses, but also political causes (the issues of the state's borders, Hague Tribunal, etc.).

In Serbia, basically, the following trends in overall employment are present:

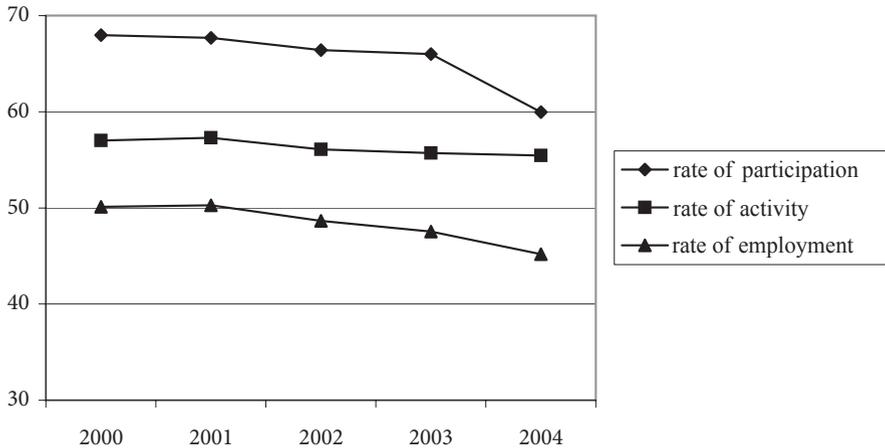
- companies from the previous socially owned sector are slowly shedding redundant employees, so the employment in this sector is falling;
- the GDP growth increases the demand for the workforce, which leads to the rise in employment in the new private sector, and which is reducing the redundancies in the former socially-owned sector;
- grey economy is gradually shrinking (the activity shifts to the formal sector) although it is still considerable.

The results of such trends are slight fall in formal employment in the last few years. Job loss in Serbia is, as in many other countries in transition, still faster than the job creation. Employment is growing.

However, apart from those who are formally employed, there are many other individuals who work and earn money, such as farmers, participants in the grey economy, temporarily active, etc. They number about 1 million, which

means that those who work and are “employed” according to the definition of the International Labor Organization number about 3 million (2 million of the formally employed and 1 million of others).<sup>16</sup>

Figure 3. Rates



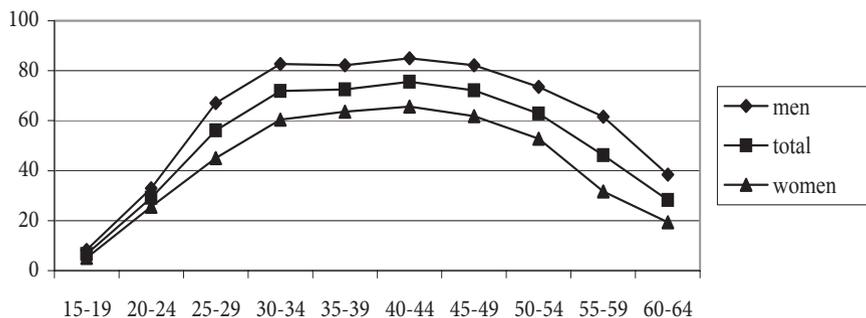
During the years under observation, all relevant rates were edging down: the rate of participation (share of the employed and the unemployed in the working age population), rate of activity (share of the employed and the unemployed in the population aged 15 or above) and rate of employment (share of the employed in the population aged 15 or above). The reasons are multiple. First: gradual reduction of employment and increase of unemployment. Second: gradual passivization of the unemployed, i.e. the abandoning of the status of the unemployed on the part of those who lost hope that they would ever find a job.<sup>17</sup> These trends match the processes in other countries in transition too, but in Serbia, the values are (were) higher in the previous years owing to the delay in transition and/or company restructuring.

The movements in the rate of employment in five-year age cohorts is shown in Figure 4.

<sup>16</sup> See Labor Force Survey, Republic Statistics Office (RZS), various years

<sup>17</sup> Third: In 2004, the methodology of Labor Force Surveys was changed.

Figure 4. Employment rates (in %)



It is noticeable that the employment rate between the ages of 30 and 49, when it is maximal, reaches only about three quarters, which means that every fourth inhabitant of Serbia from these most productive cohorts does not work, which is certainly too many. There is a considerable difference between men and women: while the rate of employment of men in the above cohorts exceeds 80%, in women it barely exceeds 60%. Similarly, the overall rate of employment for men for the ages 15-64 is 63.2% and for women it is 44.1%.

There are no good estimates of the level of redundancies in Serbia, but it is certain that it is a large figure. It is supported by the fact that new owners of privatized companies often give an offer to a large number of the workforce (20-40%) to leave the company voluntarily accompanied by a stimulating financial offer. In the companies which have not yet begun the privatization process, including companies with huge losses and state owned companies, it is certain that the surplus workforce is even larger. This will only deepen the problem of unemployment. As was the case with many countries in transition, the shrinking of economic activity in Serbia in the 1990s<sup>18</sup> was now followed by an appropriate reduction of employment, but a steep decline of real wages, which left the addressing of the redundancy problems to the future.

The share of self-employed in the total number of employees is very low – about 5% and much lower than in the advanced countries in transition (over 10%) and the developed countries (OECD about 15%). The causes of the above are a relatively low level of SME development and high level of grey (informal) employment in them. Similarly, Serbia has a very low share of flexible employment forms (part-time, temporary employment), which makes up about 1% of total employment. And flexible forms could be important

<sup>18</sup> Due to other, and not transition related reasons.

channel for the employment of women and youth. Who are particularly threatened by unemployment<sup>19</sup>.

The employment in the grey economy is very high: in 2002, the ratio between employment in formal and grey economy was 70 to 30% according to the Standard of Living Survey<sup>20</sup>. Such a high percentage of those active in the grey economy speaks of the failure of the state to reduce grey economy through milder fiscal policy, liberalization of economic regulations, and control mechanisms (repression).

There formal employment structure underwent the changes usual for a country in transition: reduced share of employment in agriculture, mining and industry, from 39.0% in 2000 to 36.3% in 2003, in favor of the services sector<sup>21</sup>. The smaller share of these sectors, in particular the industry, was not caused by fast increase in productivity and efficiency of the industry and Serbia's shift towards the post-industrial society, but by the failure of many companies to maintain their market share in the presence of competition. This deindustrialization process was followed by a surge in the share of those services that are market oriented.

In the first half of 2005, the process of employment reduction began at last in the public administration and public enterprises. The International Monetary Fund gave its strong contribution to this process. In many institutions and companies – from the Army and health care to EPS and the Railways – employees were offered severance packages in return for their leaving their jobs. The Army offered 12 gross wages, Belgrade Airport 15 average gross wages, Zastava Arms 300 EUR per year of service, Yugoslav Airlines 250 EUR per year of service, the railways and the PTT 200 EUR per year of service, etc.

There are a few problems with this system. First, the offer applies to all employees, so in some companies and institutions it may be noticed that the needed employees (qualified and good workers) leave, while those who are not necessary (administrative staff, and poor performers) stay. Secondly, these offers are often directed at older employees, those who are near retirement, which means that the gain in the reduction of employment will be short-term – several years – since they would, even without the program, retire in the near future. Thus, the financial gain from the reduction of the labor force is temporary and modest. And, thirdly, the offered redundancy payments are often not well

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<sup>19</sup> *Serbia and Montenegro, Republic of Serbia, An Agenda for Economic growth and Employment*, World Bank, December 6, 2004

<sup>20</sup> See: *Poverty Reduction Strategy Paper*, the Republic of Serbia Government, 2003

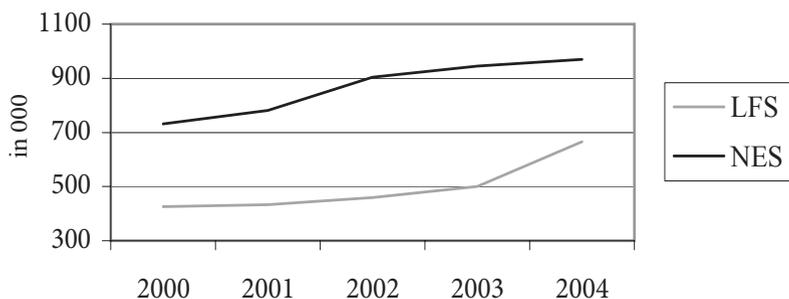
<sup>21</sup> Labor Force Survey (LFS), various years, share of the total number of employees in these sectors is higher, owing to agriculture

balanced, or well suited, meaning that they do not meet employee expectations and do not result in the number of those who want to leave the company being more or less equal to the estimated number of surplus employees: thus, in Yugoslav Airlines too few, while in PTT too many employees applied.

## Unemployment

The first years of this transition wave in Serbia were characterized by a noticeable growth of unemployment, whether it be measured according to the Labor Force Survey (LFS), or the National Employment Service (NSZ).

Figure 5. Unemployment



Sources: LFS and NES, various years

Note: in July 2004 the NSZ methodology was changed, so the number of the jobless in December 2004 fell from 969.9 to 830.6 thousand; this change is not shown in this graph for consistency purposes

As may be seen, two relevant source of data on the level of unemployment in Serbia give materially different results. It is usually considered that the NSZ data overestimate the actual unemployment, since there exist strong incentives for the individuals who work in the informal sector, i.e. who are not jobless, to register with the National Employment Service: health care, right to various welfare benefits, etc. on the other hand, one may say that the Labor Force Survey data underestimate unemployment, since even those people who work only one hour per week are considered employed. It would probably be the most accurate to consider these two measures of unemployment the bottom and top limit of actual unemployment in Serbia.

The corresponding unemployment rates are shown in Table 1

Table 1. Unemployment rates

	2000	2001	2002	2003	2004
NES*	25.6	26.8	29.0	31.7	31.7
LFS**	12.1	12.2	13.3	14.6	18.5

\* The rate was calculated as the ratio between the number of the unemployed and the sum of employed and the unemployed.

\*\* The rate was calculated as the ratio of the unemployed and the active population

It is obvious that the unemployment problem in Serbia has been worsening in the last few years, together with the increase in the number of the unemployed and the decrease in the number of the employed. In terms of the unemployment level, Serbia belongs to the most unfavorable group of countries in transition (with Macedonia, Poland and Slovakia), while it exceeds by far OECD and EU countries. What is the worst of all, Serbia has not finished its economic restructuring phase and has not entered the phase of accelerated growth so that it can expect that there will be no further increases in unemployment, but the worsening of the situation is not only possible but highly likely.

The duration of unemployment is very long: in 2002 it reached 47 months on average

Table 2. Unemployed by length of unemployment (in %)

years	2000	2001	2002	2003
under 1	18.2	26.6	25.7	24.7
1-3	32.2	27.5	31.9	33.6
3-8	31.6	27.1	25.5	25.0
over 8	18.0	18.7	16.9	16.8

Source: LFS, various years

Compared to previous years, the share of the jobless who have not had a job for less than a year has increased (to about a quarter), but unemployment is still a long-term situation: three quarters of the jobless have not had a job for

over a year, and 1 in 6 has been unemployed for more than 8 years. In OECD countries, this ratios are quite the opposite: about three quarters of the jobless have not had a job for less than a year, which means that the flexibility of the labor market there is much stronger, as are the chances of the unemployed to find a new job fast.

According to the LFS, in 2002 women experienced a somewhat higher than average rate of employment (14% compared to men 9%), and the people with secondary education, including technical (14%). The lowest unemployment rates are among those who have no education (3%) and those with a university degree (6%). The young (up to the age of 24) are particularly affected by unemployment, and the unemployment rate among them is three times as high as the average rate<sup>22</sup>.

## Skills

There is a prevailing opinion in Serbia that our labor force is educated and very well qualified, and that it is a comparative advantage of Serbia. However, a large part of it is not true. There are many problems: the skill of the employed and the unemployed are often obsolete since they refer to obsolete technologies, which is the consequence of the technological stagnation of the Serbian economy; the education system is obsolete and produces workers with the occupations that are very often unnecessary (a half of the secondary vocational schools' capacities produce unnecessary occupational profiles; adult education is at a low level and does not provide the necessary knowledge innovation to either the employed or the unemployed, etc.

The reform of the secondary education is ready, but it is just not implemented due to the conceptual differences, resistance by many teachers who would possibly lose their jobs, insufficient cooperation between the Ministry of Education and the National Employment Service, etc. Recently, an inter-ministerial group for the reform of the secondary education was formed (including the National Employment Service), and the outcome of its work remains to be seen.

The state of the adult training system is quite bad. The old training system through the so-called People's Universities is long, not to be replaced with a better one. A small number of companies (only one third) participates in such

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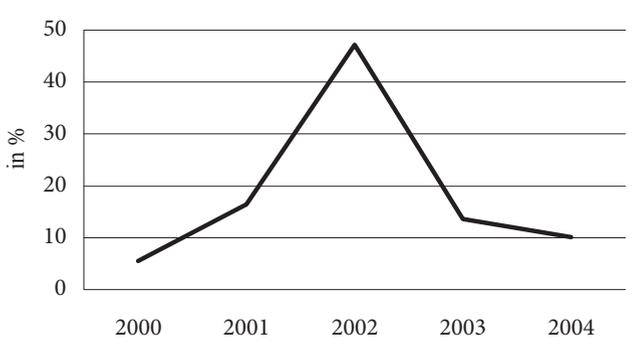
<sup>22</sup> *Serbia and Montenegro, Republic of Serbia, An Agenda for Economic growth and Employment*, World Bank, December 6, 2004

programs; the National Employment Service has limited resources available and organizes programs of limited reach (computer literacy, foreign languages); the Ministry of Education can train adults and with what curricula, what certificate do they obtained, etc. Part of the gap is filled by the private sector, but the problem of the lack of the certificates recognized by the state limits its reach.

### Wages

During the transition period, average nominal wage in Serbia grew very fast. When the nominal growth is adjusted for the cost of living index it can be seen that even the real growth of wages was high between 2001 and 2004 (Figure 6) with the explosion in 2002.

Figure 6. Wage trends – real growth



The accelerated pace of the wages in 2001 and 2002 by 16.4 and exceptionally high 47.2 percent respectively is the consequence of certain production activation, but, even more so, a significant inflow from the funds from abroad in the form of aid, loans and privatization proceeds.

Such fast growth of wages corresponded to the optimistic expectations of the population about the fast resolution of socio-economic problems with the change of Government. Such expectations were encouraged by DOS before elections, and afterwards tried to meet. What is even more important is that international financiers, led by the World Bank and the EU, agreed with the rise

of the individual income for two reasons: first, to pull the production by the increase in domestic demand, and, secondly, so that the general public better accepts the transition. That is why they were ready to provide the appropriate financial support to Serbia.

In 2003 and 2004 the real wage growth considerably slowed down, although it was still in the high regions between 10% and 15% of annual growth. This slowdown was mostly the consequence of the lower inflow of foreign capital and the impossibility to provide faster growth from domestic sources.

The wage growth contributed to the growth of personal spending of the general public, although they make up only one third of the total population income<sup>23</sup>. However, the wage growth did not manage to boost domestic production to the desired extent, since the increased purchasing power of the population was for the most part materialized in the purchases of imported goods, which led to the worsening of the trade balance.

Lately salaries in the public sector and their accelerated growth pose a special problem. It threatens not only the budget balance, i.e. increases the budget deficit, but also the internal and external macroeconomic balance.<sup>24</sup> Namely, the monopolistic character of many public sector activities is obvious, not only in infrastructure, utilities and related activities, but also in education or health care, as well as the use of such monopolistic position by the employee trade unions. Strikes, from educational workers to Yugoslav Airlines employees, as well as threatened strikes, are a common phenomenon and a political problem which is hard for any government to solve. The government of Zoran Djindjić tried to regulate the wages in the public sector in the uniform manner and under the uniform criteria, but it proved to be impossible due to the existing wage differences and strong resistance for them to be done away with.

#### GENERAL ASSESSMENT OF THE CHANGES SO FAR AND THE PROPOSALS FOR THE IMPROVEMENT OF LABOR LEGISLATION

The labor market in Serbia experienced considerable changes in the last four years, i.e. in the second wave of transition. The changes are material,

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<sup>23</sup> Other major items are pensions, natural consumption, income from agriculture, etc. See: *Siromaštvo i reforma institucija podrške siromašnima (Poverty and the Reform of the Institutions Supporting the Poor)*, Ministry for Social Affairs and CLDS, 2003, p. 69.

<sup>24</sup> See: *Serbia and Montenegro, Fourth Review Under Extended Arrangement (EA)*, International Monetary Fund, November 30, 2004.

both in institutions that make up the framework for this market, and in the fundamental characteristics and trends on the market itself.

The labor and employment legislation reform was thorough in the period 2001-2003. The 2001 Labor Law, despite the compromises made, was a good basis for the transition of the Serbian economy and the creation and efficient operation of new companies. It brought a considerable dose of the labor market flexibility, which is so badly needed by a country in transition in which both the economy and the companies should be restructured towards a significantly different environment and set of incentives.

The Employment Law from 2003 enabled the modernization of the state employment policy. However the results are not great, or satisfactory, due to the lack of funds for larger scale programs of active employment policy and a longer process of the improvement of the National Employment Service.

Labor market trends are not favorable. Employment is slowly declining, or stagnating at best, while the unemployment is growing. What is unfavorable is the fact that the corporate restructuring, including the reduction of the workforce, is still ongoing, so that the current trends will continue in the years to follow. It is equally unfavorable that the investment environment in Serbia mostly unattractive, and the expansion of the new companies sector is modest, with adverse effects on employment.

The basic challenge with regard to the labor market has been and still is the creation of an efficient market which should reallocate the workers from the grey economy to the formal sector, and from the companies with redundancies to others, enhance the incentives for the employees to look for a job, retain labor costs within the moderate range, and bring to individuals (especially from the vulnerable groups) social security, as much as possible.

The improvement of labor legislation is one of the elements of the policy of the labor market performance upgrading. To make this market more flexible, facilitate corporate restructuring and meeting the labor demand with supply, it is necessary to correct or change several solutions in the labor legislation of Serbia:

- significantly reduce the regulation of the labor market and enhance the role of contractual relations between the employer and the employee; increased flexibility can only result in increased employment,
- transfer from the Labor Law to Collective bargaining agreements many employee benefits (holidays, leaves, increased wages, compensation of

costs, etc.), since in that manner the specificities of individual companies are better catered for,

- eliminate the rule calling for a justified cause for the termination of employment, i.e. leave it both the employer and the employee the full freedom to terminate the employment contract, in accordance with the contract itself,
- eliminate the legal obligation of the employer to pay severance/redundancy pay upon termination of employment; the social policy should not be financed by employers but by the state,
- eliminate the special system of employee claim settlement in bankruptcy,
- eliminate the validity of old documents with the new employer in the case of status changes,
- simplify many procedures prescribed by the 2005 law, etc.

The reformed labor legislation would contribute to the improvement of the business and investment environment, and, finally, to the rise in the number of jobs, which should be the basic orientation of the state policy.

Moreover, the issue of how and to what extent the state can boost and enable the increase in investments in human capital, i.e. the skills of both the employed and unemployed is an important one.

Gordana Matković

## Reform of Pension and Disability System

### LEGACY OF THE PAST - THE MOST IMPORTANT CHARACTERISTICS AND WEAKNESSES OF THE SYSTEM

As in most other countries, the pension and disability system in Serbia is partially based on the pay-as-you-go financing of pensions. Compulsory insurance in Serbia encompasses employees, employers, the self-employed and farmers, and their insurance is organized within three separate funds.

At the end of 2000 in Serbia there were 1.5 million pensioners, over 1.2 million in the employee fund, with the average pension of 2000 dinars (around EUR 30). Two thirds of pensioners received below-average pensions. At the same time, the average pension amounted to over 90% of the average wage,<sup>1</sup> with the share of pension expenditure in GDP reaching almost 15%.

At the same time large debts were inherited in the system. In the employee fund the so-called “large debt” was inherited in the amount of 2.5 monthly expenses for pensions and pension payment lag of almost two months, while the payment lag in the farmers fund was 23 months.

Difficulties in financing pensions in Serbia arose already in mid-80s and culminated at the time of economic decline during the 90s. A reduction of the number of employees, evasion of contribution payment and widespread gray economy led to a reduction of the number of insured persons. On the other hand, due to the population ageing, as well as very liberal retirement requirements, the number of pensioners rose continually. Over the years pension financing required increasingly “creative” measures, since pensioners presented an important electorate, leaning towards the then regime.

The adjustment of the pension-disability system was conducted in several manners. First of all, by changing the indexation system and increasing the

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<sup>1</sup> For pensions paid for the corresponding month

contribution rate, which was as much as 32% at the end of 2000. However, pension expenditure “reduction” was achieved by not paying all 12 pensions a year, illegal reduction of pensions during 1994-1995 (when the “large” debt to pensioners was created), paying pensions in the form of electricity vouchers, depreciation of all receipts through inflation, in particular hyperinflation in 1993, etc.

The 1990s crisis led to a clear demonstration of both positive and negative characteristics of the pay-as-you-go method of pension financing.

The basic advantage of the pay-as-you-go financing system is that it prevents the “savings for old age” from losing its value in the market and in extraordinary circumstances, which can happen to capitalized pension funds. It is quite certain that war years, hyperinflation and “unreliable investment” would have left capitalized funds completely without assets and disappeared, like foreign currency savings, for example.

On the other hand, the main shortcoming of the pay-as-you-go financing system is its increasingly difficult operation in the conditions when the number of insured persons is decreasing relative to the number of pensioners. Since in 2000 this ratio in the Serbian employee fund came down to only 1.26, (1.26 employees per 1 pensioner), this weakness of the pay-as-you-go financing system is clearly demonstrated.

The inherited situation, however, was not the only reason for the preparation of the Serbian pension and disability system reforms.

From a long-term perspective, Serbia is facing a process of pronounced population ageing. In these circumstances the unfavorable ratio between the potential contributors and pensions cannot be a short-term phenomenon and will not be eliminated by economic development and progress. Similar demographic movements present the main driver of pension system reforms in developed countries as well.

Apart from that, the rapid growth of the pensioners’ number was not only a result of population ageing, but also of very liberal retirement requirements and exercising different rights. The once established retirement age was never changed, despite the longer life expectancy, reduction of the importance of physical labor and change in the economic structure. The right to disability pension was often exercised without meeting the basic requirements that would point to actual disability, with a significant presence of corruption in the last decade. Liberal retirement requirements were partially a result of a policy aimed at resolving the issue of unemployment and redundancies (the

so-called administrative pensions). Apart from that, there were institutes in the system that enabled early retirement, such as early pension and purchase of the remaining years of service, or were too liberal, such as the right to work with shorter working hours, disability occurrence risk and others, which implied the supplementing of employees' wages from the resources of the pension fund.

Furthermore, certain other solutions and illogicalities in the system, as well as numerous irregularities during the 90s, resulted in a very high replacement rate (ratio between the last wage and the first pension). For the employees who retired during 2001 with full pensionable service, pensions were on average higher than wages.<sup>2</sup>

## REFORM STEPS

The first moves after the October 5 changes were directed towards the stabilization of the system and establishment of regular pension payments. Pension payment was among the government's priorities and remained as such throughout all four years of transition. Since October 2000 to date pensioners have been paid 12 pensions every year. Payment regularity was not achieved only in the farmer fund.

At the same time, soon after the establishment of the new Republic government at the beginning of 2001, the preparation of reforms began. An important part of the reforms was also communication with the public, in particular the trade unions and pensioner associations, on the unsustainability of the system and necessity of change of the legal framework.

Strategic commitments were defined and decisions adopted on reform steps and pace. It was decided that changes of the existing pension and disability insurance system would be swiftly introduced and legal amendments proposed which would ensure the sustainability of the financing system. Like in other countries in transition, the government explored possibilities for the system reform to be designed in such a way as not to rely only on the pay-as-you-go pension financing as the only pillar of the system, but also to introduce the second and the third pillar. The second pillar entails the introduction of the compulsory additional insurance for younger insured persons, while the third

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<sup>2</sup>In view of the fact that the average pension was 90% of the average wage, where the average pension includes disability and survivor's pension, as well as pensions of those who did not have full years of service.

pillar provides for voluntary pension insurance. The idea of rapid introduction of the second pillar was rejected, primarily due to high transition costs, underdevelopment of the financial markets in Serbia, as well as insufficiently persuasive advantages of its introduction in other countries. It was accepted that instead of the second, after the reform of the first pillar, regulations would be prepared for the definition of the voluntary third pillar of pension and disability insurance.<sup>3</sup> A working group for legal amendments was soon established.

Parallel with the work on reforms, other activities were initiated for the purpose of contributing to savings in the system. First the previous practice of borrowing the missing funds in the pension fund from the banks was discontinued, which signified annual savings of over 500 million dinars related to interest. Order was introduced in the procurement system, exchange of data with relevant municipal registry departments in order to interrupt payments to deceased pensioners,<sup>4</sup> and during 2002 fight against corruption was initiated in the disability pension system (change of the retirement procedure, cutting the ring of perpetrators and fund employees, doctors and intermediaries with the assistance of the police).

With the amendments to the tax laws already in mid-2001 different receipts of employees on which taxes and contributions had not been paid ("hot" meal allowance, vacation allowance) were included in the wage. In such a way, one of the channels for contribution payment avoidance was cut and payment base extended. On the other hand, by the decision of the government and management boards of the pension funds in mid-2001 the contribution rates were reduced from 32 to 19.6%.<sup>5</sup> At the same time the contribution rates for health insurance and unemployment insurance were also reduced. The total contribution and tax burden on net wages went down from 110 to less than 70%. This reduction was to provide an incentive for an exit from the gray economy and employment and reduce the wage burden to the level in other countries in transition. The pension fund deficit increased in such a way to over 30% of total assets, with the missing funds being paid from the budget.

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<sup>3</sup> G. Matković – *Social Sector Reforms*, in "Reform Strategy", CLDS, Belgrade, 2001

<sup>4</sup> Comparison of data with the relatively outdated base of the Ministry of the Interior showed that 500 pensions are paid after the beneficiary's death, in some case for more than 10 years, or they were paid without a reduction to the deceased's survivors - it is estimated that in such a way annual savings amounted to 5-10 million.

<sup>5</sup> Although the effects of these measures were never evaluated, it is a fact that in the conditions of predominantly socially- and state-owned economy contribution reduction primarily led to wage increase (which rose by over 40% in real terms in 2002), which resulted in a significant increase in real pensions.

After 2001 the level of contribution rate was changed another two times, and legally fixed at 22% by the recently adopted law on contributions.

At the end of 2002 the return of the so-called large debt to pensioners was initiated. This debt is to be fully repaid by June 2006.

## LEGAL AMENDMENTS

Reforms of the first pillar of the pension and disability system in Serbia were conducted in two steps. Since until the adoption of the Constitutional Charter in early 2003 the pension issue was regulated at the federal level, first the federal law was amended in December 2001. The Government of Serbia formulated and officially submitted the proposed amendments to this law to the federal level, insisting on legal amendments despite the opposition of Montenegrin representatives in the federal government.

From the aspect of the financial consolidation of the system, two most important changes from 2001 were the extension of the retirement age and change in pension indexation.

The retirement age was increased by 3 years, from 55 to 58 years for women and 60 to 63 for men. At the same time the minimum retirement age was changed from 50 to 53. In such a way Serbia caught up with other countries in transition which initiated these changes earlier, but mostly opted for gradual change of the retirement age.

The second important change implied a transition from pension indexation to wages to pension indexation to the combination of wage and cost-of-living increase. In this way pensions were prevented from growing too fast, which was unsustainable due to the deficit in the pension fund.

Furthermore, during these legal amendments the uniform amount of the minimum pension was guaranteed (20% of the average wage) instead of multiple minimum pensions, varying depending on the length of pensionable service. Some entitlements were abolished, as for example the disability occurrence risk and employment and retraining under special terms.

Further changes were introduced in the first pillar when the competence for the pension system was brought down to the Republic level with the adoption

of the Constitutional Charter. The new pension and disability insurance law was adopted in April 2003.

The goal of the changes were as follows: establishment of firmer bonds between the level of pension and paid contributions, more just, stimulating and simpler manner of calculating pensions, more even distribution of burden between contributors (expansion of insured persons' coverage), reduction of overly liberal and redistributive elements in the system, creation of incentives for longer participation of older workers and opening of possibilities for voluntary insurance.

One of the most important changes in the law refers to the introduction of the new formula for pension calculation, based on points<sup>6</sup> and extending the calculation period to all years of service. This kind of calculation system enables a firmer connection between the level of pension and contributions paid in, because it takes into account all the years during which contributions were paid in, eliminating the favoring of those with significant career advancement or significantly higher wage only in one part of their work history. This method also increases and determines more precisely the difference in the amount of pension depending on the number of years of service, and for over 40 years of service it increases the amount of pension. One of the important characteristics of the new system of calculation is the reduction of difference in pensions between pensioners with the same work history, regardless of the moment they retire.

The new method of calculation of pensions provides incentives and is important in curbing the gray economy, because it increases the importance of the amount of contributions paid in, regardless of whether the contributor is at the beginning of his working years or about to retire. Because of these characteristics the method of "personal points" is also particularly important in the conditions of self-employment expansion.

Legal amendments also extended the coverage of compulsory pension insurance. The obligatory payment of contributions for author's and short-term service contracts was introduced, as well as for the work via youth and student employment agencies, except for those below the age of 27 attending regular schooling. In the previous period work through contracts and youth and student employment agencies was also a widespread method of avoiding the payment of contributions. The law also introduced a possibility for everyone who wishes to pay in contributions to be able to do so, regardless of their employment/

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<sup>6</sup> Personal points, the average value of points calculated for each year of service presenting the ratio between the individual's average wage and average wage of all employees.

ownership status. The method of calculation of pensions for special categories, with rights to beneficiary years of services was also reformed, becoming more explicit and less privileged.

Important changes were also introduced in the area of disability pensions. The concept of determining disability according to general disability was introduced instead of the disability to perform their own job, and a regular review of disability pensions was envisaged. The right to benefit due to reduced work ability was abolished and benefits for the existing beneficiaries of II and III category of disability were restricted.

Changes in farmers' insurance were supposed to resolve, at least partially, the vicious circle of non-payment of contributions and deficit in the farmer fund. Instead of the previous solution whereby all members of farming household were mandatorily insured, which presented a significant burden for multi-member farming households, obligatory insurance of only one household member was introduced. It was prescribed that those who accumulated debts did not have to meet their debts from the previous period, but that period would not be included in the pensionable service. Apart from that, the base and contribution rate were equalized with the lowest base and rate in other funds.

Legal amendments were accompanied by intensive communication, primarily with employees' trade unions, with numerous presentations of new solutions and discussions with competent committees. The amendments were officially adopted by the Economic-Social Council by all three largest trade unions.

According to the assessment of the World Bank "bold changes in the pension system in Serbia, implemented on two occasions, during 2001 and 2003 are among the most important achievements in the overall reform program".<sup>7</sup>

In the second half of 2003 work began on the preparation of the law on voluntary insurance, for which it is expected that it would soon go before the Republic parliament.

The World Bank team participated in designing the reform strategy. Within the concrete work on reforms, its experts were mostly involved in the preparation of voluntary insurance. On the whole, this cooperation can be assessed as positive, with respect for arguments on both sides and attempts of the Bank to open possible options, and not to impose them.

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<sup>7</sup> *Serbia and Montenegro, Recent Progress on Structural Reforms*, World Bank, November 2003, p. 22

## OMISSIONS AND/OR FURTHER NECESSARY REFORM STEPS

As can be seen from the example of developed countries, the pension and disability system based on the pay-as-you-go financing principle, passes through constant reforms. One of the methods in which the system, in the conditions involving ageing population and deterioration of relations between those who potentially contribute and those who receive pensions could operate, is its constant changing, adjustment of the amount of pensions and raising of retirement requirements. This, however, is not simple due to political reasons, in view of the fact that the increasingly numerous elderly population presents a large electorate.

Some effects of the pension and disability system reforms in Serbia can be illustrated by the data according to which in 2004 the reduction of the number of disability pensioners was initiated, the total number of pensioners in the employee fund went down by 54 thousands, the replacement rate went down to 66%, in 2004 over 3 billion dinars were collected from contributions on work conducted through youth and student employment agencies and contracts, and payments were initiated for voluntary insurance (for the so-called extended and additional insurance over billion dinars were paid in). In 2004 the average pension reached around EUR 130, and relative to 2000 the real growth of pensions is over 85%.

Because of large inertia characterizing the pension and disability system, low employment and widespread gray economy, the effects of reforms are relatively slow and insufficient for a more complete financial stabilization of the system. The share of pension expenditure<sup>8</sup> has in the past few years stabilized at approximately 11.6% of GDP, while the deficit for pension payments<sup>9</sup> went down from 3.2% in 2002 to 2.4% in 2004.<sup>10</sup>

Optimistically speaking, in medium term, the pension financing problem will be alleviated by employment increase and gray economy reduction. In longer term, however, the problems related to population ageing remain. For that reason in the future there is likely to be a further increase in the retirement age, in particular for women, change in pension indexation, further entitlement

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<sup>8</sup> It is necessary to differentiate between the expenditure for pensions and expenditure of the pension fund, which, apart from pensions, include care and assistance to elderly and disabled persons, health care of pensioners, administrative costs, foreign exchange differences and interest on the loan from the Fund for Development, etc.

<sup>9</sup> It is also necessary to differentiate between the transfers from the budget and the deficit. The transfers from the budget include the legal obligations of the budget to pay higher contributions for the contributors with accelerated calculation of years of service, payment of the old debt to pensioners, etc.

<sup>10</sup> J. Bajec and K. Stanić – *The Serbian Pension System Assessment*, draft, 2005

review.<sup>11</sup> In longer term, the pressure can also be reduced by the introduction of additional insurance pillars. Any new consideration of the introduction of the second pillar should be based on a careful evaluation of experiences of other countries in transition, but only after Serbia is able to bear the transition costs of its introduction.

One of the important changes in short term can be expected in the area of fund consolidation. Namely, Serbia is the only country in the region which continues to have three separate pension and disability funds. In mid-2004 the Government of Serbia adopted a decision on consolidation, which is to be conducted first at the administrative, and then at the financial level. There is no dilemma that the employee fund and the self-employed fund should become a single fund. A barrier to their integration are debts in the employee fund, which still pays pensions with an almost two-month delay. A barrier for this part of consolidation is also the resistance among the insured from the self-employed fund and their desire to use “surplus” assets of this fund, which are a result of its favorable age structure (5:1) for business loans.

A dilemma, however, remains related to the integration of the farmer fund to the integrated pension fund and general review of the compulsory nature of pension and disability insurance of farmers. Namely, with the adoption of the 2003 law, there was hope that the incentives provided by the law would stimulate regular payment of contributions and reduce the deficit in this fund. This did not happen, inter alia because the control of contribution payments was not strengthened simultaneously. On the other hand, there is widespread belief among some farmers that voluntary insurance is a better solution. In the event of accepting that option, the government budget would have to take over the complete financing of over 214 thousand pensioners from this fund and define separate/different solutions in the area of social assistance to old farmers.

The planned improvement of the IT system and reorganization of the registry records of the insured, with the technical assistance of the World Bank, should contribute to the improvement of the system as a whole, but also enable easier control of contributions.

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<sup>11</sup> More in B. Mijatović et al. - *Improvement of the Socio-Economic Position of the Elderly in Serbia*, Economics Institute, Belgrade, 2004



Gordana Matković and Snežana Simić

## The Social Infrastructure Reform

Gordana Matković

SOCIAL WELFARE REFORM

### **Inherited situation**

Poverty in Yugoslavia dramatically increased during the 1990s, the middle class was disappearing, the number of poor doubled with an increasingly rising number of people just above the poverty line. According to the national criteria, measured in relation to the income per consumer unit, over one third or nearly 2.8 million inhabitants of Serbia were below the poverty line in 2000.<sup>1</sup> The collapse of the economy and dramatic decrease of the GDP, which was halved during the 1990s, certainly had its decisive impact on the increase of poverty. Due to irregular payments or non-payment of salaries, collapse of the “socialist giants”, delays or non-payment of social assistance and pensions, poor functioning of health care and the necessity to pay for previously “free of charge” services, pushed many households below the poverty line.

Under such conditions, the social policy was pursued primarily through direct subsidizing of unsuccessful enterprises, on the one hand, and prescribing low prices of basic products and services (bread, milk, cooking oil, sugar, electricity, rent), on the other. At the same time, the minimum safety nets were practically destroyed. Social welfare (cash) benefits, such as child allowances, were more than two years delayed, and other allowances (social assistance – MOP and carers’ allowances) between 26 and 32 months. Debts were also incurred in the system of pension and disability insurance, veteran disability insurance, and the accommodation in the social welfare (residential) institutions was paid irregularly ... Huge delays in payments, as well as devalued and low amounts of social assistance also caused a great fall in the number of beneficiaries of

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<sup>1</sup> G. Krstic - *The Profile of Poverty in Serbia*, in “Poverty and Reform of Financial Support to the Poor”, The Ministry of Social Affairs and CLDS, Belgrade 2003, p. 23

certain entitlements.<sup>2</sup> Additionally, the lack of funds caused the permanent deterioration of living conditions in homes for the children without parental care, in homes for the elderly and other residential institutions. Underpaid, left on their own and most often not in a position to render the elementary assistance, the social welfare employees lost their motivation for work, and the level and quality of the services considerably worsened.

The the dis-functional social welfare system caused the poorest groups to become highly dependent on international humanitarian aid. Numerous non-governmental organizations, supported by international funding in the field of social protection, started to operate introducing new methods of work and new forms of social welfare services. The lack of cooperation between the NGO sector and the social welfare system made it impossible to introduce the innovations into the system and impeded the development and sustainability of social protection.

### **Pace of the reforms**

Immediately after the changes of October 5, the activities in the field of the social protection followed the double-track course.

The first activities were practically **crises management**, directed towards stabilizing the system. These activities consisted of: repayment of the debts accrued over a number years, establishment of regular payments of social welfare benefits, improvement of the conditions in residential institutions, etc. By the end of 2003, all debts for social assistance were settled: for child allowances, social (cash) assistance (MOP), carer's allowance, as well as the debts for veteran disability allowances. Donor funds were used for paying debts previously accumulated in the system, while the government committed to reinstate a regular payment of entitlements. That regularity in payment of current liabilities was established, as early as during 2001. Simultaneously the so-called One off Fund was established at the republic level, through which, during the first two years, additional donors' and budgetary funds were channelled towards the poorest and the most vulnerable.<sup>3</sup>

The coordination of donors' humanitarian aid was established, especially in the area of interventions related to the improvement of living conditions

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<sup>2</sup> In 2000, in far more unfavourable situation, the number of beneficiaries was cut by half compared to the beginning of 1990s

<sup>3</sup> Several times additional payments (double amounts) of social assistance have been paid in order to improve the conditions of the most vulnerable entitled persons, as fast as possible.

in residential (social welfare) institutions. During the first year, considerable donors' funds were used for the procurement of food and medications for these institutions, as well as durable consumer goods, indispensable accessories and equipment, PCs, etc. The most affected residential institutions were reconstructed completely. A number of collective centres (CCs) for refugees and IDPs (internally displaced persons) was also reconstructed and, since mainly elderly people stayed in them, they were converted into the homes for the elderly and formally introduced as a part of the social welfare system.

The other part of the activity was aimed at the **formulation of reforms** within the system. First, strategic goals in social protection were defined<sup>4</sup>, (expert) working groups to deal with reforms were established and many national and regional conferences were held in order to reach professional consensus on reforms.<sup>5</sup>

The principles of social protection development were formulated, based on the transformed role of the state, on sound financing and greater responsibility of the individual to provide security for him/herself and his/her family.<sup>6</sup>

The transformed role of the state implies the decrease/discontinuation of subsidies to enterprises and therefore the withdrawal of social policy from enterprises. This transformation also implies not only decreasing subsidies for basic products and services, but also decentralization, meaning that the state should not be the sole financier, organizer and service provider in the social sphere.

An important principle was also the rationalization of the funds and sustainability of social protection implying that the rights must be adjusted to the financial capacities of the society and state aid must be available to everyone in the same way and aimed at those really vulnerable.

The principle of greater responsibility of an individual to provide security for him/herself and his/her family attaches greater importance to the active measures of social policy and those measures in the field of the social protection which would not encourage long-term or even multi-generational dependence on the state's social welfare.

From these basic postulates it follows that the changes in the **area of social welfare benefits** should be directed to the establishment of the unique absolute poverty line for the entire territory of Serbia, the real value of which

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<sup>4</sup> G. Matkovic - *The Reforms of the Social Sector*, in "The Strategy of Reforms", CLDS, 2001

<sup>5</sup> In 2001, 5 regional conferences were held which were followed by published bulletins about the reforms in the social protection.

<sup>6</sup> B. Mijatovic - *The Principles of a New Social Policy*, in "The Strategy of Reforms", CLDS, 2001, p. 63

will be maintained by indexing with the costs of living, together with the permanent access to entitlements and improved targeting of the beneficiaries. In order to analyse the weaknesses of the current system and prepare the changes and get the best possible picture of the standard of living and poverty, a Living Standard Measurement Survey - LSMS was initiated and carried out in mid-2002 on the sample of more than 6300 households and on another 500 households depending on social welfare assistance.

On the other hand, for the purposes of budget planning, the changes of the welfare criteria were piloted with the aid of donors' funds. On the basis of the adjusted criteria, a new beneficiary list was established. These "new" beneficiaries received social welfare assistance from the donor funds (DFID and the World Bank).

In the area of social welfare services the changes should have moved towards decentralization, deinstitutionalization (transformation of institutions) and development of alternative forms of social care, incorporation of the non-governmental (NGO) sector in the service provision through cooperation/partnership of all participants that may offer both active and passive social protection measures at the central and local levels. Thus, the changes were supposed to ensure the availability of services, their designing according to the needs of the beneficiaries and the opportunity to choose.

The implementation of the reforms in the area of services was carried out through two mechanisms: reform projects and special funds to finance the projects at local level.

In 2002, the work on many **reform oriented projects** began: the strategy of foster care development (the instructions for programme implementation, regional employee training, preparation of training curriculum for foster care families, establishing of regional networks, launching national, regional and local campaigns, adjustment of foster care allowances, preliminary changes of the relevant legislation), the transformation of institutions (analysing the possibilities of institutions beginning to render alternative social services - opening of day-care centres for persons with disabilities, creating regional centres for foster care, shelters, "half way houses" in the process of decreasing the number of institutionalised beneficiaries<sup>7</sup>), the development of integrated social protection at local level (the analysis of the situation and capacity

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<sup>7</sup>Half-way homes are intended for the young who at the age of 18, upon finishing their schools, under compulsion of law, leave the homes for children without parental care or foster families. Quite often without any job or with a low pay, they suddenly appear with no institutional or any other support. Half-way homes are in fact a transitional solution between the home/foster home and fully independent life.

building, along with launching pilot programmes in five municipalities for the joint action of protection from violence, abuse, juvenile delinquency, care of children without parental care and children in conflict with law) and the development of standards of professional work, procedures and protocols in social care centres and certain areas, too (the protocols on protection of violence, the change of operation of the commissions for the categorization of children with special needs, human trafficking, etc.).

The **mechanisms** for the development of alternative social protection services and changes at the local level, as well as for the incorporation of non-governmental sector in providing services include the Fund for Financing Associations of Disabled Persons (2002), and the Social Innovation Fund – SIF (2003). Both funds represent **mechanisms for the decentralization and reform of the system**, since they finance the projects at local level and new alternative services which are not part of the system or are not sufficiently developed. Also, both mechanisms encourage the partnership of governmental and non-governmental sectors giving priority to joint projects and encouraging transfer of good practice. The standard projects, financed through these two projects, are: day care centres for children with disabilities, half-way houses, home care, development of local protocols and action plans to fight violence, inclusion projects for disabled persons, day care centres for Roma children... Over 300 local projects were financed in the course of two or three years of these two funds' operation.

### **The statutory changes and strategic documents**

At the beginning of 2002, the **Law on Financial Support to Families with Children** was enacted. One of the basic features of this law is clear differentiation between the social policy and population policy measures. According to former solutions,<sup>8</sup> the amount of the child allowance differed depending on the order of the child's birth, and children of higher order of birth exercised a universal right in the areas with a low birth rate. The new law defines the child allowance as the social policy measure, the universal right to the child allowance is abolished, the amount of the allowance is equal for all children, and better targeting of the poor is provided by more precise

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<sup>8</sup>The Law about Social Care on Children, Official Gazette, No. 42/92, 29/93, 53/93, 67/93, 28/94, 47/94, 48/94, 25/96 i 29/01)

definition of income and property, while considering eligibility.<sup>9</sup> The families with children with disabilities and single parents, foster parents and guardians, are put in a favourable position by the new law in order to encourage protection of children without parental care outside institutions.

The law also eliminated regional differences in criteria, establishing a uniform threshold for the entire territory of Serbia, provided maintenance of real value of allowances (through indexing of welfare and thresholds with the costs of living) and as much as possible provided the continued access to this benefit.<sup>10</sup> Parents' allowance – one-off allowance at the time of the child's birth - was introduced as a special measure to encourage more childbearing. The new law stipulated a stricter penal policy towards employers and responsible persons if they issue false certificates of income to the applicant for child allowance, and towards responsible persons in municipal and/or city administration in the case of their misapplication of the funds for benefits payments.

**The Amendments to the Law on Social Protection and Social Security of the Citizens** were prepared as early as the end of 2002, but they were adopted only in mid-2004. As the former one, this law, too, eliminated the differences between municipalities in the eligibility criteria for social welfare assistance and introduced a uniform absolute poverty line at the republic level, ensuring maintenance of the real value of benefits by way of indexing with the costs of living and continued access to entitlements. The legislative changes established new, a somewhat more realistic equivalency scale, and the use of the benefits for employable beneficiaries was limited to 6 months in a calendar year. Also, the amount for the carer's allowance for old and disabled persons was considerably increased, thus decreasing the difference in the amount paid through the pension and disability plan. Certain legal criteria for foster families were defined, and the concept of professional foster care was introduced, too, although limited only to the employees who may lose their jobs in the process of deinstitutionalization. As an initial step for a different treatment of the beneficiaries, their representatives were incorporated into the governing bodies of the social protection institutions.

In 2003, the **Family Code** was also prepared, which was recently adopted (February 2005). In terms of the social protection system, particularly important innovations in this law are reflected, primarily, in the changed role

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<sup>9</sup> According to the new legal solutions while establishing the financial situation of a family, all incomes, savings and property will be taken into consideration, not only wages and pensions.

<sup>10</sup> At the same time, the change of the procedure in payment enabled budget savings of over 200 million CSD per year.

of the centres for social work (CSR) in the area of the family legal protection, introduction of pluralism of services and in the definition and formulation of protection measures against domestic violence.

**The Poverty Reduction Strategy Paper (PRSP)**<sup>11</sup> was adopted towards the end of 2003 as a document that analysed the role of some priority sectors (employment, education, health care, social protection, environment, etc.) and the position of certain affected groups (refugees and displaced persons, the Roma, women, children, etc.) through perspective of transition and economic development effects to poverty. The implementation of the strategy in these areas is underway, together with monitoring and evaluation and efforts to achieve the coordination of the measures and activities envisaged by the strategy with the European integration processes.

### **The shortcomings and/or further required reform steps**

During the first four years of transition poverty in Serbia was considerably reduced. According to the criterion of income per consumer unit the share of the poor fell to 14.5%, and according to the criterion of consumption, more appropriate for countries in transition, to about 10.6%.<sup>12</sup> The real growth of salaries, pensions and other income in real terms put many households above the poverty line, reducing poverty in urban areas in the first place. However, the density of households just above the poverty line remained significant, indicating that even relatively minor aggravation of the standard of living may jeopardize a relatively large part of the population. If the poverty line were raised by 25%, the number of the poor would double.<sup>13</sup> The unemployed and undereducated make up the most vulnerable group, and, at the level of households, the households with a large number of members and elderly households with only one bread winner are particularly threatened. The poorest live in villages and in less developed regions. Besides, the Roma, refugees and displaced persons, and disabled persons are exceptionally vulnerable groups that cannot even be covered by general surveys.

Reestablishment of the minimum safety nets almost certainly alleviated the position of the poorest. As the researches in 2002 on the basis of LSMS indicates, the social welfare in Serbia is well targeted, even better than in

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<sup>11</sup> *The Poverty Reduction Strategy Paper*, the Government of the Republic of Serbia, 2003

<sup>12</sup> G. Krstic - *The Profile of Poverty in Serbia*, in "The Poverty and Reform of Financial Support to the Poor", Ministry of Social Affairs and CLDS, 2003, p. 23

<sup>13</sup> *The Poverty Reduction Strategy Paper*, the Government of the Republic of Serbia, 2003, p. 9

other countries of the region and represents comparatively important part of consumption of the poor, much higher than other transfers.<sup>14</sup> The analysis of the previous results of the survey carried out in 2003, indicates the improvement of targeting children's allowances after the enactment of the new law.<sup>15</sup> The following can be indicated as the basic **shortcomings in the area of benefits**: very low coverage by social assistance,<sup>16</sup> low cash benefits amounts and inadequate equivalency scale favouring small households. The Amendments to the Law on Social Protection and Social Security of Citizens made some positive steps in ensuring social security of citizens in relation to all the above weaknesses. It is necessary to further extend this most efficient social transfer after the analysis of the effects of these changes and providing for the adequate budget funds in the next period.<sup>17</sup> However, the degree of its extension depends on the administrative capacity of local CSRs, too. In this field, it is also necessary to consider proposals for relocation of the part of the work concerning collection of documents to municipalities which administrate child allowances. Also, while considering possibilities to extend the coverage of the social welfare assistance, it is necessary to have in mind that the same may cause considerable "leakage" of budgetary funds, unless grey economy is reduced at the same time

Moreover, since the research studies reveal that more than the half of the poor, who do not receive social assistance, are in fact not **informed** about their rights and entitlements or do not know how to apply to exercise the rights,<sup>18</sup> a more active role of all the participants in the social protection is necessary in this area, as well as the cooperation with other participants at central and local level. Many problems in the area of the social protection are inter-ministerial by nature and require establishing connections with the education, health care and employment sectors. This is even more important if the emphasis in social policy should be laid on active measures.

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<sup>14</sup> B. Milanovic - *The Social Transfers; Inequality*, in "The Poverty and Reform of Financial Support to the Poor", Ministry of Social Affairs and CLDS, 2003, p. 51

<sup>15</sup> G. Krstic - *The Poverty in Serbia in 2003 and Analysis of Children's Allowances*, internal document of the Ministry of Social Affairs, 2004

<sup>16</sup> According to the study of the World Bank on the poverty in Serbia, the basic problem with welfare benefits is not targeting but the error of "exclusion", i.e. insufficient coverage of the poor. World Bank "Serbia and Montenegro Poverty Assessment", Vol II, p. 137

<sup>17</sup> For some proposals for further changes see B. Mijatovic - "The Proposal of Reforms of Financial support to the Poor" in "The Poverty and Reform of Financial Support to the Poor", Ministry of Social Affairs and CLDS, 2003, pp 111-128

<sup>18</sup> B. Milanovic - *The Social Transfers; Inequality*, in "The Poverty and Reform of Financial Support to the Poor", Ministry of Social Affairs and CLDS, 2003, p. 61

In the previous four years, the system of support to **persons with disability** was not sufficiently analysed and changed, especially in the area of benefits, same being comparatively low and different in various parts of the system (social welfare, pension and disability insurance and protection of veterans). Nevertheless, certain improvements were made in changing attitudes and raising awareness about human rights of persons with disabilities, need for tolerance, the right to inclusion and participation, and especially in terms of quality and fostering of certain services at local level. The national strategy for persons with disability, currently underway, should also answer these questions, among other things.

In the area of reforming the system of social **services**, more decisive actions towards deinstitutionalization and transformation of institutions. At the same time, re-categorization of the social welfare (residential) institutions and re-categorization of beneficiaries have not begun yet, because, among other things, a professional consensus on overcoming classical “categorization” and establishment of categories based on needs has not been established yet. As for the further reform of the social services, it is of particular importance to analyse the results of the reform projects and pilot programmes through the Social Innovation Fund (SIF) in order to further improve the social protection legislation on the basis of such knowledge. In this context, it is also necessary to analyse the restrictions and possibilities of further decentralization with the utmost care.

The insufficiently developed **control** mechanisms at central level make further advancement of the social protection impossible, and also represent an obstacle to continuing the process of decentralization. Its establishment and strengthening will also cut down the problem of corruption and misuse in the system, which were not the focus of engagement in the previous period.

Finally, as well as in the other sections of the social sector, one of the challenges in social protection will also be “**placing the beneficiary in the centre of the system**” and, in this context, the change of views of the actors rendering services in this area. It seems that placing a student in the centre of the education reform, or, for example, a patient in the centre of the health care system will be far simpler. In other words, in principle, the beneficiaries of the social protection are not the interest group, they are often excluded from participation processes, they have no access to the power centres and cannot articulate their demands. This is certainly one of the reasons why in 2000, speaking in relative terms, the largest state debts inherited were to the beneficiaries of the social protection were. Different attitude of the state towards

those who need assistance, and the change of attitudes and behaviours of the employees in social protection departments, is a long-term process which can hardly be achieved through changes in legislation,<sup>19</sup> and will require a great number of different instruments and incentives, as well as the education of professionals and the general public.<sup>20</sup>

### **The role of international institutions and donations**

As may have been expected, in the first two years of the transition, the donations in the social welfare sector were considerable<sup>21</sup> to decrease with the withdrawal humanitarian aid and greater orientation to development projects and programmes. Most of the donors tried to follow the activities of the Government and respond to the requirements defined at the donor's conferences.

Of international organizations, the World Bank played the most prominent role. The cooperation with the World Bank was positive as a whole. The expert team of the bank rendered support to the Government, placing its expert capacities at its disposal, acknowledging professional arguments, specificities of Serbia, without imposing solutions prepared in advance.

On the whole, the basic shortcoming was insufficient mutual coordination of donors who presented far too great demands to the state that, objectively, does not have sufficient capacities for international cooperation.

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<sup>19</sup> V. Bosnjak - "Social Services / the Heart of Social Protection Reform", internal document of the Ministry of Social Affairs, p. 7

<sup>20</sup> Due to these reasons, all reform projects also cover educational packages for professionals, and enactment and beginning of the implementation of new solutions provided for by laws and bylaws are also followed by training process.

<sup>21</sup> In the past period, the biggest donors in the area of social protection were the Government of Norway, the Government of Italy, the Government of the Great Britain, the Government of Switzerland, the World Food Programme, ECHO, UNICEF, UNHCR. UNDP also assisted in capacity building of the Ministry of Social Affairs.

Snezana Simic

## THE REFORM OF THE HEALTH CARE SYSTEM

### **The inherited health care system**

In the last decade of the 20th century in the Republic of Serbia, there was a policy of maintaining all the capacities and employees in the health care system, as well as all the rights to health regulated by law in the hope of economic recovery and possible preservation of all the resources without greater social perturbations. Since in the meantime the socio-economic situation in the country dramatically worsened, the health care system adjusted to the newly appeared changes in a disorganized manner, together with the falling of fixed assets (buildings and equipment) into disrepair, the lack of medicines and medical supplies, drastic decrease of the quality of health services and their use, informal payments and corruption, transfer of patients and part of equipment from the state to the private health care sector and resulting deteriorating health of the population.

The characteristic features of the health care system used to be and still are to a great extent: a well developed network of health institutions, the population extremely favourably covered with health care personnel and hospital beds, fragmentation of health services with the introduction of a series of clinical specialities, formalized approach to the health promotion and prevention of illness, lack of motivation to work and low professional satisfaction of medical staff. Low productivity, inefficiency and uneven quality of health services rendered to the population are the consequence of such conditions.

Despite considerable funds allocated to health care from the gross domestic product from the government sector, and the total costs evaluated at up to 10% of GDP, this system is faced with constant financing problems. The proceeds of the Republic Health Insurance Fund are not sufficient for servicing all the rights due to the low GDP level, developed informal sector, inherited debts, inadequate collection of contributions as a consequence of financial indiscipline, undeveloped insurance information system and administrative weaknesses. The funds from the Republic budget financing the health care of refugees, internally displaced and unemployed persons, although increased during the past years, are still insufficient.

The discrepancy between a wide scope of rights and their affordability, jeopardize the basic principles of the system operation. Access to health care services is limited by considerable payments out of the beneficiaries' pockets, especially for the poor and other vulnerable groups (the elderly, the disabled, the Roma, refugees and internally displaced persons). In the study on the evaluation of poverty in Serbia, conducted in 2003, more than 3% of the population stated high costs of health care services and lack of insurance as basic reasons of the decreased access to health services.

While analysing the state of health of the population, the high share of cardiovascular and malignant diseases in the death structure is indicative of wide presence of behavioural risk factors (smoking, alcohol, obesity, improper nutrition, physical inactivity) and the environment (polluted air, water and soil). High-risk behaviour is most common in adults, especially men and vulnerable population groups. These causes of death are known as preventable, i.e. premature mortality since they can be successfully prevented by health promotion and preventive measures and activities.

### **The legislative framework of the reform**

The basic documents, representing the basis for the implementation of the reform in the health care system, have been adopted. The **Health Policy in Serbia** document was created out of the need to define the basic goals and directions of health care development. The Government adopted it in February 2002 and it has seven goals referring to the following: protection and improvement of the state of health of the population, fair and equal approach to health care, placing beneficiaries (patients) in the centre of the health care system, achieving financial and institutional sustainability of the system, improvement of efficiency and quality of work together with the definition of special national programmes concerning employees, network of institutions, evaluation of health technologies and improvement of medical supplies, defining the role of the private sector and advancement of staff base in the health care system.

The appearance of international partners imposed a need to define a clear vision of the system development. **The Vision of the Health Care System in Serbia** has been formulated with the participation of all key stakeholders in the health care system - the team from the Ministry of Health, including

the minister, the representative of the Republic Health Insurance Fund and the Health Care Institute of the Republic of Serbia and contains nine leading principles. The general vision of the health sector takes several assumptions as a starting point:

- The future health care system in Serbia will be developed from the existing capacities and inherited tradition;
- In future, the principle of solidarity will be the most important decision-making and finding solutions, to always be respected at all levels. The health care beneficiary must always be in the centre of attention of those who make decisions at the political, administrative and professional level, and of health care providers;
- Although the goal must be the directing of all necessary resources to the provision of the best possible health care, in the following years the development has to consider financial restrictions conditioned by the economic potential of the country. Open discussions must be held about this fact, both in political institutions and in the public;
- During the next decade, the controlled change from the present system should lead to such a system in which the joint activity of public and private sectors in rendering health care services, will provide the population with the health care system which will, within the effective organization and actual resources, ensure equal access to the basic package of health services. Such services will be based on modern technology and modern scientific methods, backed by effective prevention and promotional activities.

The working version of the **Strategy of the Health Care System Reform in the Republic of Serbia until 2015** with the action plan is based on the previous documents and, together with them, it is presented in the publication of the Ministry of Health “**Better Health for Everyone in the Third Millennium**”. This strategy set the platform for the activities in the health sector with the priorities defined on the basis of the evaluation and analysis of the state of health of the population. The set priorities in the reform of the health care system are: the reduction of preventable illnesses and premature mortality of the population, the coordination of health insurance rights with the financial capabilities of the population and creation of modern, sustainable, decentralized and transparent health care system.

In the meantime, drafts of several specific strategies in the health care system have been prepared - the Strategy of Providing Sufficient Quantities of Safe Blood, the Tobacco Control Strategy, the Safe Food Strategy and the Public

Health Strategy, while the National AIDS Combating Strategy had already been adopted by the Government.

One of the systemic laws - the Law on Medicines and Medical Devices, drafted in cooperation with the European experts and harmonized with the requirements of EU, has been adopted (Official Gazette of Republic of Serbia, number 84/2004), while the proposals of the other two systemic laws (the Law on Health Care and the Law on Chambers of Health Care Workers) are in the parliamentary procedure. The Law on Health Insurance underwent the public hearing procedure and, in September, it will be proposed to the Government of the Republic of Serbia. Apart from the above, the Law on Protection of the Population against Contagious Diseases and the Law on Sanitary Inspection have been adopted, too.

### **The past reform changes**

The reform of the health care system was delayed after the events in October 2000 in comparison to the other social sub-systems and practically started in 2002. During these three years, decent conditions of work in the health care system with sufficient most important equipment and consumables were achieved. However, medical workers themselves, their motivation and professional satisfaction have not changed a great deal and a longer period of time will be needed for these changes.

The health care institutions were equipped with modern equipment, reconstruction and refurbishment of premises in some twenty general hospitals and many out-patient clinics have started, 150 ambulance cars have been bought, and clinical centres have been equipped with diagnostic equipment of the state of the art technology. There is a better supply of medicines and medical supplies and, at the same time, measures for rationalization of consumption were applied, especially medicines by establishing a “positive list of medicines” and introduction of the information system for the monitoring of their.

About twenty guidebooks of good clinical practice for the most common diseases and conditions, appearing at the level of primary and secondary health care, were developed. They serve as protocols for physicians in their work and enable a considerable rationalization of resources.

The mechanisms of respecting the rights of patients have been advanced by introducing a representative for the protection of patients' rights of (the so-

called “patient’s lawyer”) at the level of health care institutions and at the level of the Ministry of Health and by defining a procedure to be undertaken in case of infringement of these rights.

In the draft Law on Health Care there is a separate section with precisely defined rights to health and rights of patients based on the European Charter of Patients’ Rights.

The explanation on the improvement of quality of the health services work defined the quality performance indicators at the level of health care institutions, making appointments for diagnostic procedures has been introduced and the waiting lists for expensive interventions, by which the access of the population to these services has been improved. The investigation of the level of satisfaction of beneficiaries with the work of health centres was conducted and the results of these efforts are available the public and they will be used while concluding contracts on services and programmes with the Republic Health Insurance Fund.

A restrictive granting of approvals for specializations has been introduced in order to reduce the fragmented structure and narrow specialization in the health care system. New standards of population coverage with medical staff and hospital beds have been defined, as well as new performance standards. The assessment of the surplus number of employees in the health care system is underway, as well as looking for the most suitable models to decrease their number.

Numerous national programmes and campaigns are underway and their aim is the promotion of health and prevention of diseases and disorders - the National Anti-Smoking Campaign and the National Campaign for the Prevention of Cardiovascular Diseases. The guidebooks for preventive health services are being prepared and programmes and projects for early discovery of diseases - especially malignant diseases, have been strengthened.

### **The international partners in the reform of the health care system**

During this period, the most important partner in the reform of the health care system has been the EU through the European Agency for Reconstruction. It financially supported about ten major projects in the amount of about 90 million Euros. The Project of Medication Management, the Project of Preparing Good Clinical Practice Guidebooks, the Support to the Public Health in the

Republic of Serbia, including the foundation of the School of Public Health, the Strengthening of Preventive Health Care Services, the Development of the Health Care Information System, the Project of the Supply of Sufficient Quantities of Safe Blood, the Project of Reconstruction of 20 General Hospitals in Serbia and several smaller ones - the Burden of Diseases and Injuries in Serbia and the Assessment of the Health Care Service.

The World Bank is financing the "Health Care" project which covers the reconstruction of health care centres in four pilot regions: Vranje, Kraljevo, Valjevo and Zrenjanin. This year the International Committee of Red Cross will finalize a successful pilot project of the basic health services in the municipality of Kraljevo, and the Canadian Agency for Development started the second round of aid in the Balkans aimed at the reform of the primary health care and improvement of the reproductive health of the young. The funds for combating HIV/AIDS and introduction of the Directly Observed Therapies (DOTs) for tuberculosis have been obtained from the UN Global Fund. Bilateral aid from many countries is important, too, especially from the Norwegian Government in education in emergency medicine and development of the information system for monitoring the consumption of medicines, donations of the Japanese Government in the equipment of high technological value to the clinical centres, as well as the aid from China, also in the equipment of high technological value. It is important to mention that there is coordination at the level of ministries of health between the partners, so the projects are not duplicated and the results are jointly evaluated.

### **Future activities in the reform of the health care system**

Considering that the most significant aspects of the reforms of all social sub-systems, and the health care system, too, is the reform of financing, it is important to emphasise that this aspect of the reform of the health care system is considerably delayed, mainly due to the initial inertia and lack of readiness of the Republic Health Insurance Fund to undertake the reforms. The change in the method of financing of service providers from the financing of the structure (institutions and personnel) to the financing of outcomes and performance is the process still awaiting us. It was envisaged that the results of the pilot project of the basic health care services in Kraljevo, introducing capitation (paying physicians in primary health care according to the list of the patients who selected him/her), will be extended to the entire system in 2006.

The best way of financing hospitals has not been chosen yet, and the consultant of the World Bank, currently engaged, has a task to propose a model appropriate for our country. The solutions range from the so-called prospective budgeting of hospitals to the introduction of the diagnostically related groups (DRGs) as isoresource categories with the costs defined for each group of diseases.

One of the problems in the implementation of the health care system reforms is the capacity and the staff which did not increase greatly, but not decreased either, during 2001, and they are not in harmony with the financial capabilities of the country. Apart from considerable investments in the health care system during the past several years, the productivity, efficiency and quality of work of the health service were not increased as a result. At the request of the MMF, the Action Plan for the Rationalization of Capacities and Staff is underway and it will define new standards for population coverage with hospital beds and medical care staff, and new standards of performance. On the basis of same, in the period until 2010, the number of beds in hospitals for acute hospitalisation will be decreased (15%) and in the hospitals for the treatment of chronic diseases and conditions (10%), the number of medical doctors in specialized consultative departments in health care clinics and hospitals will be decreased (6%), as well as the number of administrative and technical staff (17%). Some departments, such as occupational medicine and dentistry will be considerably reduced. Rehabilitation centres and pharmaceutical activity are considered for privatisation.

The position of the private health sector is not properly solved and it has been developing in an unorganised manner without proper legislation and control, and currently, it presents (financially) a powerful lobby that requires an equal status in the health care system, which is impossible to establish due to limited financial capabilities of the Insurance Fund and surplus of capacities and staff in the public sector. One of the solutions, already accepted, is to incorporate certain service providers from the private sector which will have to conclude contracts with the Insurance Fund (so-called public/private mix).

And, finally, it is necessary to emphasise that the important aspects of the health care system reform of, such as financing reform (insurance), constant improvement of quality of work, accreditation of health institutions and programmes, licensing of medical workers and assessment of health technologies, depend on the adoption of new systemic laws for which there has been no consensus so far. Although a part of preparations to introduce these, for our situation, new concepts, has already been carried out, the preparation itself requires proper legal solutions not existing in the current laws.



Boris Begović and Milica Đilas<sup>1</sup>

## International Relations

### INTRODUCTION

The 1990s were quite certainly a decade in which Serbia's, i.e. FR Yugoslavia's relations with the world were at their all-time low, with the country's position being the most unfavorable in its recent history. This was a period of wars for the heritage of the SFRY, foreign political isolation and the United Nations sanctions against FR Yugoslavia, NATO air strikes, an economic and social crisis, political authoritarianism etc.

After the democratic changes in October 2000, prospects opened up for a radical improvement of Serbia's relations with the world and its inclusion in international institutions and structures of integration. The population's expectations in this regard were exceptionally high, especially concerning the positive effects of such integration on the standard of living. The new authorities were doing very little to manage these expectations. It soon transpired that a considerable part of the obstacles to full integration in the international community had not been eliminated. For example, the issue of relations with the Hague Tribunal, i.e. the fulfillment of its requests made Serbia's foreign political position increasingly difficult and represented the crucial obstacle to the process of successful integration in international trends.

### DRAWING CLOSER TO THE EUROPEAN UNION

There is no doubt that Serbia's first partner on the road to full integration in the international community is the European Union, so that any review of

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<sup>1</sup> Even though this is a joint paper of the two mentioned authors, the veritable division of work which existed in the writing of this chapter should be mentioned. Boris Begović covered sections Integration into International Financial and Economic Institutions and Evaluation of Integration into the International Community and Milica Đilas the rest of it.

Serbia's international relations should start with a review of how close Serbia has drawn to the European Union, i.e. to the stabilization and association process. Before October 2000, the relations of Serbia, or better to say of FR Yugoslavia with the European Union boiled down to accepting assistance for democratization, independent media and humanitarian assistance, since any other forms of economic cooperation were banned by the sanctions. Following the democratic changes in Serbia, however, the isolation was lifted and, at the Zagreb summit in November 2000, the FRY became a full member of the Stabilization and Association Process (SAP), this representing the framework for association which the EU had offered to countries of the western Balkan region – Croatia, Bosnia-Herzegovina, Macedonia, Albania and FRY/Serbia and Montenegro (SCG). The promotion of relations with the EU, with membership being the final goal, became the new authorities' foreign policy priority. In view of the fact that drawing closer to the EU found itself at the top of the list of political priorities, but also that, following a ten-year period of isolation, integration into the EU enjoyed a high degree of support among the citizens, one was to expect faster progress towards the establishment of contractual relations with this international organization than was really the case. It was only in April 2005 that Serbia and Montenegro's Feasibility Study was approved, meaning that the start of talks on the Stabilization and Association Agreement can be expected in the autumn of 2005, and the actual signing of the Agreement in spring at the earliest, or more likely in the autumn of the following year. The following analysis will endeavor to review the reasons for the slow realization of the process of integration into Europe.

### **Serbia and SCG in the stabilization and association process**

The Stabilization and Association Process (SAP) was conceived as an approach to countries of South-Eastern Europe (Western Balkans) offering the entire region the prospect of membership in EU, but also enabling each individual country to advance faster if it meets the envisaged conditions. The conditions are defined in a similar manner – as a set of conditions applying to all countries, with the addition of specific conditions for countries that had been conflict. The most important common conditions are, essentially, the criteria defined at the **European Council** in Copenhagen in 1993, which also applied to the countries of Central and Eastern Europe that had already joined the EU, including: the stability of institutions guaranteeing the respect of human and

minority rights and democratic principles and the rule of law, a functional market economy, as well as the ability to assume obligations stemming from membership. The attention of all SEE countries was additionally drawn to the necessity of regional cooperation, as well as the need for devotedness to the resolution of open question in a peaceful and constructive manner. For those countries that had experienced conflicts which ended with the signing of peace agreements, envisaged is the respect of all obligations stemming from them. In the case of SCG, this means the Erdut, Dayton-Paris and Kumanovo agreements, but also the obligation to cooperate with the Hague Tribunal set out in them. Such an approach by the EU demonstrates the desire for the region to improve as a whole and for all the states in it to become stable and democratically-oriented, economically prosperous, directed towards regional cooperation and dialogue and without the desire to resolve open questions through armed conflicts.

Serbia, i.e. FR Yugoslavia/SCG, has made large steps towards the fulfillment of the conditions set by the SAP. Political life in the country has normalized, even though it soon became clear that the elimination of certain repressive laws adopted in the previous period (Law on the University, Media Law) would require the building of new, strong and legitimate, legal and other institutions, which required time.

In the sphere of economic reforms, a whole series of resolute moves were made and were positively assessed in European and world economic and financial circles. Macroeconomic stabilization was achieved surprisingly fast, as well as the liberalization of prices and foreign trade, comprehensive economic reforms were launched with the goal of improving the technical, legal and institutional presuppositions for attracting foreign investments and achieving sound economic growth.

As regards regional cooperation, the FRY became a factor of stability in the region and an active participant in the search for solutions for the existing problems, instead of being, like before, someone who “produces” new problems. The relations with former Yugoslav republics have been established and/or upgraded to a higher diplomatic level, the process of resolving open issues has been launched (like, for instance, the issue of the succession of SFR Yugoslavia), as was the process of active participation in regional initiatives and organizations.

The progress achieved in economic and political reforms led to the establishment of a Consultative Working Group, a working body characteristic

of the first phase of SAP and consisting of representatives of the FRY government (as well as the governments of Serbia and Montenegro) and representatives of the European Commission. The first meeting was held on July 23, 2001 and, in the following year, another four meetings took place at which the progress achieved in certain fields was discussed. After each meeting, the Commission published its recommendations, stating what else needed to be done in the observed field in order for the reform process to succeed. After the fifth meeting of the Consultative Working Group, held in July 2002, the mechanism was interrupted due to our side's expectation that a positive assessment of the Feasibility Study would follow soon and would open the door for talks on the Stabilization and Association Agreement. Since events did not take such a course, technical talks were reinitiated in July 2003 in the form of an Advanced Permanent Dialogue and, before the final approval of the Feasibility Study in March 2005, as many as six meetings of this working body were held.

Despite the fact that significant steps were made, the process of drawing closer to the EU soon encountered a deadlock. There are two reasons for such a course of developments – the obligation to cooperate with the Hague Tribunal and the relations between Serbia and Montenegro in the joint state – first in the FRY, and then, after the redefinition of relations, the signing of the Belgrade Agreement and then also the adoption of the Constitutional Charter, in the state union of SCG as well. Unlike the US, which laid emphasis primarily on cooperation with the Hague Tribunal, the EU insisted equally, if not more, on an agreement between Serbia and Montenegro on the manner in which the joint state would function. The reason for this was simple – the goal of the improvement of relations with the EU is to regulate contractual relations through the signing of a Stabilization and Association Agreement, whose provisions largely deal with the establishment of a free trade zone between FRY/SCG and the EU. In order to enter such a relationship, the EU, simply speaking, wants to know on which terrain the game will be played – on the terrain of the joint state, which implies a clear agreement on the division of competencies between the level of the joint state and its members, or, if there is a customs border between Serbia and Montenegro, on the separate terrains of the republics. Furthermore, the redefinition of the relations between Serbia and Montenegro, achieved through the Belgrade Agreement, was a political project supported by the EU, so it is understandable that the consistent implementation of the agreement would be important for this organization's credibility, primarily for those actors, like the high representative for the foreign and security policy, Javier Solana, who mediated in the conclusion of the Agreement.

At the beginning of the transition process, the ruling coalition in Montenegro did not participate in the federal government, nor did it consider binding the decisions which would be taken by such a government, in which Montenegro was represented by the opposition political bloc. Such a situation very soon became an obstacle to the promotion of relations with the EU, and the agreement on the redefinition of mutual relations was expected to contribute to the overcoming of the problem. It transpired, however, that the Constitutional Charter also failed to provide a satisfactory answer to Brussels' question as to who on the other side is responsible for doing the work within the SAP and on which territory will a possible Agreement be applied. True, the problem of the non-recognition of the government was overcome – official Podgorica is participating in institutions established by the Constitutional Charter, but this was not the case with the problem of different economic systems, i.e. policies, and the attitude to their harmonization. While official Belgrade, with the support of Brussels, insisted on the Charter containing provisions on the free flow of goods, services, people and capital on the territory of SCG, official Podgorica claimed that the market was not, i.e. that it should not be unified, but rather joint, and that there was no cause for the European Union to exert pressure for the full harmonization of the economic systems, i.e. the policies to be carried out. Nevertheless, efforts were made to resolve the created situation through the adoption of an Action Plan for the harmonization of the economic systems of Serbia and Montenegro which harmonized the customs rates for 93% of the products, with the exception of a certain number of agricultural products. These problems proved to be an insurmountable problem – while there is no political need in Montenegro to apply high customs duties in order to protect farmers, as there are none, Serbia has around 500,000 farmers' households, i.e. around two million people, due to which the Serbian government, for the purpose of acquiring the political support of that part of the population, has a completely different attitude to the issue of lowering customs barriers.<sup>2</sup>

The Action Plan is adopted by the parliaments of Serbia and Montenegro and, it is only in the third attempt, due to the inability to form a quorum, that

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<sup>2</sup>In this regard, the partial interests linked to the foreign trade regime are much better articulated in Montenegro. Namely, non-tariff barriers (based on quantitative restrictions) suit the realization of such interests to a far greater extent. Since such restrictions lead to the growth of the equilibrium price on the domestic market, the possession of an import permit which is, of course, issued in a non-transparent and non-competitive manner, makes it possible to keep considerable rent for oneself. Such a system of non-tariff barriers and the allocation of permits also prevents any new entry, this enabling the maintenance of such rent. The relatively small number of those who collect such rent makes it possible for them to organize well and articulate their interests well, so as to master the process of formulating the relevant economic policies, i.e. to bear influence on those taking decisions on these policies. It is for this reason that the „harmonization“ did not succeed.

the parliament of the state union of SCG adopted it. This was sufficient for the European Commission to start, in September 2003, work on the Feasibility Study, presuming that an agreement on the harmonization of customs barriers for the remaining products would soon be reached. It soon became clear that a final agreement would be difficult to achieve, not only because of the different economic and political interests of Serbia and Montenegro in regard to the issue of the harmonization of agricultural products, but also because of the fact that early parliamentary elections were called in Serbia in December 2003, and that the government was not formed before March 2004. This meant that, until that time, the Montenegrin government had no partner for talks on resolving this problem – such a constellation perfectly suited official Podgorica which did not wish to resolve this problem in the first place. Since the new government could not (or did not want to) offer a solution that would be accepted by both the Montenegrin side and the EU and, thus, unblock the process of European integration, the EU took upon itself to resolve the problem and in October 2004, allowed SCG the “twin track” approach for association with the EU. This, essentially, implies the possibility for Serbia and Montenegro separately to negotiate on economic issues and no further conditions for the full harmonization of the two republics’ economic systems. As an indicator of the fact that it remains devoted to the idea of a joint state, the EU will sign with SCG one Stabilization and Association Agreement, with two protocols that will contain economic issues, while the political issues would be reviewed in the joint part. Such an approach enabled the continuation of the process of integration to the extent to which it was halted by the lack of harmonization between the Serbian and Montenegrin economic policies, and it produced the first positive results already in March 2005, when the Textile Agreement between the EU and Serbia was signed.

Nevertheless, prior to the approval of the Feasibility Study it was necessary to resolve yet another problem – the problem of direct elections for the parliament of the state union of SCG, which were to take place in February 2005 under the Law on the Implementation of the Constitutional Charter. Much before the deadline for the holding of the elections, it became clear that there was no political will in Montenegro to have them organized, while there was no united answer to this problem in Serbia. The attempt to resolve the problem through the postponement of the elections for a year, during which period a referendum on independence would be held in Montenegro, failed in December 2004. The deadline for the holding of elections passed without any agreement on how to overcome this obstacle, which created a situation

in which deputies whose mandate had, essentially, expired found themselves in the SCG parliament in March. As the approval of the Feasibility Study was becoming certain, there was a growing need to find a solution to this problem, which was preventing the EU Commission from concluding in the Study that the rule of law existed in SCG. Finally, on April 7 an agreement was reached on a change of the Constitutional Charter which linked the holding of elections for the parliament of the state union to the holding of elections in Serbia and Montenegro, respectively, and which the public learned about only two days before it was signed. Less than a week later, on April 12, the Feasibility Study was approved.

The standstill in the process of promoting relations with the European Union did not, however, occur only because of the non-harmonized relations between Serbia and Montenegro in the joint state, but also because of unsatisfactory cooperation with the Tribunal in The Hague (International Criminal Tribunal for the Former Yugoslavia – ICTY). From the start of SAP, the obligation of cooperating with the Hague Tribunal was clearly set out among the criteria whose fulfillment was important for drawing closer to the EU. Even though cooperation proceeded sporadically and without a legal framework until the spring of 2002, the European Union did not suspend, or threaten to suspend either the macro-financial assistance forwarded to FRY, or the funds from the CARDS program, nor did it stop the technical dialogue being conducted within the Consultative Working Group. The only “threat” the EU addressed to the FRY in regard to the fulfillment of its obligations towards the Hague Tribunal concerned the holding of the donors conference in Brussels in June 2001 – while the US made its participation in the conference conditional on the extradition of Slobodan Milosevic to the Tribunal, the EU did not call into question its participation, but made it clear that it would promise funds at the conference itself, but that they would be given to the FRY only when the former Yugoslav president is extradited to the Tribunal. Such a stand of the EU regarding cooperation with the Hague Tribunal essentially did not differ from the US stand – the difference could more or less be described as a difference between a “good cop” and a “bad cop” – while the US constantly kept exerting pressure for this cooperation to be established, threatening with the suspension of assistance, the EU made it clear, without threatening to suspend current cooperation, that the fulfillment of obligations towards the Tribunal would be the key condition for further steps on the road to the establishment of contractual relations with the EU.

The extent to which cooperation with the Hague Tribunal is a crucial precondition for the EU became clear the moment when the EU Commission started working on the Feasibility Study for the first time, i.e. in the autumn of 2003. After the parliament of the state union adopted the Action Plan for the harmonization of the economic systems of Serbia and Montenegro, the European Commission started working on the Study, in the belief (which was insufficiently based on facts) that, while the Study was being drawn up, the economic systems, i.e. the policies of Serbia and Montenegro would be fully harmonized. Not only did this expectation prove to be wrong, but even at the moment when the Study was to be published – in March 2004 – the issue of cooperation with the Hague Tribunal was raised once again. Namely, in December 2003, indictments were issued against four generals of the SCG Army and the police, and until the moment when the Study was to be published their appearance in The Hague did not look very probable. For this reason, and because of the inability to carry out economic harmonization between Serbia and Montenegro, the drawing up of the Study was postponed, in expectation of the resolution of these two problems. While the problem of harmonization was resolved with the adoption of the twin-track approach in October 2004, cooperation with the Hague Tribunal was established only later. Until the publishing of the Study in April 2005, 12 indictees voluntarily surrendered to the Tribunal, the funds of ICTY fugitives were frozen and good cooperation was established between the Tribunal's Office of the Prosecutor and the Special War Crimes Court. With the Serbian government's guarantees being accepted, a number of indictees have been released pending trial.<sup>3</sup> However, until the moment the Study was published, it was not known whether this would be sufficient for it to be approved, because General Pavkovic, one of the four generals indicted in December 2003, had not been extradited to the Tribunal, nor were, allegedly, his whereabouts known at the time when the Study was published.<sup>4</sup> The confirmation of the approval by the EU Council of Ministers came after General Pavkovic's arrival in Scheveningen, and the start of the talks has been scheduled for October 2005, although the Study itself explicitly says that the talks could be suspended if the non-fulfillment of conditions continues.

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<sup>3</sup>First of all, in December 2004, Jovica Stanišić and Franko Simatović, then in April 2005 Vladimir Lazarević, Milan Milutinović, Nikola Šainović and Dragoljub Ojdanić.

<sup>4</sup>It is certain that high-ranking officials of the European Commission, i.e. of the EU had received credible assurances that this problem would be resolved in a satisfactory manner, i.e. within a satisfactory deadline. The assurance truly proved to be credible.

### **Foreign trade cooperation with the EU**

This part of the text will restrict itself to an analysis of foreign trade with the EU after October 2000, primarily because of the fact that the essence of the Stabilization and Association Agreement lies in the establishment of a free trade zone between SCG and the EU, after the transitional period agreed on in the talks. This means that a vast majority of the Agreement's provisions, around 80%, will be devoted precisely to foreign trade.

The inclusion of FRY in SAP in November 2000 also meant our country's inclusion in a liberalized regime of preferentials for the entire region, which came into force on December 1, 2000. These, so called exceptional trade measures were granted for a period of five years and they imply the right to export to the EU without customs duties and quantitative restrictions on all our products, with the exception of certain categories of textile and food products which can be exported to the EU without customs duties or reduced customs duties only within a quantity quota. After May 2004, the preferential treatment of our exports was expanded to include the 10 new EU member countries.

The renewal of trade cooperation and the use of EU preferentials produced their first results already in 2001, when the growth rate of exports to the EU was 25.0%, in 2002 it was 13.3% and in 2003 it was around 20%, while the growth rate of imports in 2001 was 27.9%, in 2002 it was 43%, and in 2003 it was 31%. Between 2001 and 2003, exports and imports to and from the EU registered very high growth rates which were, true, partly the result of the non-existence of trade with the EU in the period of the sanctions and isolation. True, noticeable was a faster growth of imports than exports, this leading to the increase in the existing trade deficit.

This situation was contributed to by the fact that, in the period between May 2003 and August 2004, the preferential treatment of exports of our sugar to the EU was suspended, primarily because of the excessive exports of sugar whose origin could not be determined with certainty, and then also because of the lack of adequate legal and institutional procedures for the issuing of certificates on the origin of goods, which the "sugar affair" clearly pointed to. For this reason, in January 2004, the European Commission issued a warning to its importers to pay additional attention to the origin of goods being imported from SCG, which quite certainly had a discouraging effect on cooperation. After a detailed investigation into the routes of the sugar that had been exported from Serbia in the preceding period, as well as the establishment of a supervision system

and the issuing of certificates on the origin of the goods, harmonized with the requests of the European Commission, the preferentials were reinstated. The direct consequence of the re-approval of sugar preferentials was the growth of exports of this product, and consequently of overall commodity exports to the EU in 2004, by 40% compared to the preceding year. Imports of goods from the EU in 2004 grew by 46% compared to the preceding year. The trade deficit with the EU in 2004 was as much as 4.117 billion USD and it was larger than the deficit in 2001 by as much as 246%.

Obstacles to a major growth of exports are primarily the low quality of domestic products, the production inefficiency of domestic plants and the non-diversified production structure, the lack of effective mechanisms for the favorable insuring of export credits, but also the long procedures for the establishment of administrative and technical cooperation for exports of agricultural and food products by the EU, as well as high quality standards and high standards of consumer protection and health protection on the EU market. The development of institutions that are to contribute to the fulfillment of these requests was, for a long time, the subject of internal institutional problems and conflicts of competencies between the state union and the member states. The “twin track” model made the situation clearer by determining that the economic sphere fell within the competency of Serbia, i.e. Montenegro, this also enabling the establishment, i.e. the faster reform of all institutions necessary for the promotion of economic cooperation with the EU. The result of such an approach is also the signing of an Agreement on trading with textile products between Serbia and the EU, which lifted all quantity restrictions on exports of our textile to the EU. By signing the Agreement with Serbia, the EU abandoned its three-year long attempt to sign such an agreement at the level of the state union, which was prevented by the inability to establish institutions that would assume international obligations for the entire territory of SCG.

## INTEGRATION INTO INTERNATIONAL FINANCIAL AND ECONOMIC INSTITUTIONS

### Previous activities and results

Even though the largest part of the activities towards integration into international institutions proceeded simultaneously and although there existed important links among these institutions, it is more suitable at the analytical level to analyze each of these institutions and Serbia's relations with it individually.<sup>5</sup> In this sense, only the most important international financial and economic institutions will be reviewed.

### International Monetary Fund

The renewal of membership in the IMF in the autumn of 2000 was the first step towards Serbia's integration into international financial institutions. The renewal of membership and the preparation of the first *Stand by* arrangement with the IMF was made conditional by this institution on certain elements of the economic policy, primarily the abolition of the dual exchange rate, i.e. the establishment of a single exchange rate, more or less determined by the market, and endeavors to eliminate the quasi-fiscal deficit, as well as the settlement of Serbia's outstanding financial obligations towards the Fund.

In June 2001, the first *Stand by* arrangement with the IMF worth 136 million USD was approved. Part of these obligations which Serbia accepted within the arrangement concerned the maintenance of the envisaged macroeconomic proportions, but the IMF strongly stimulated structural reforms, primarily in the financial (banking) sector. During the realization of the arrangement, the IMF insisted on the need to liquidate four large banks which accounted for 80% of the assets of the then domestic banking sector, but whose total placements were contaminated. The liquidation of these banks, carried out in January 2002, apart from having a beneficial effect on the development of the domestic financial sector, also enabled the successful execution of the *Stand by* arrangement.

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<sup>5</sup> Further in the text it is exclusively the position of Serbia in these structures of integration that is observed, regardless of the fact that membership itself is linked to the state union of Serbia and Montenegro, i.e. FR Yugoslavia that preceded it.

In 2001, i.e. during the *Stand by* arrangement, the IMF was a kind of representative of Serbia's at international conferences, i.e. at financial negotiations. This included the presentation of credible assessments of the Serbian economy's macroeconomic stability, which had a large effect on decisions at donors' conferences, to the extent to which the donors' decisions were economically, i.e. non-politically motivated. Furthermore, the IMF made the basic projection of the country's foreign indebtedness and an analysis of the possibilities for servicing the foreign debt which represented the basis for the decisions of the Paris Club of creditors. With the results of this projection, the IMF strongly supported a considerable write-off of our foreign debt.

In May 2002, an extended (*EFF*) arrangement with the IMF was concluded. Two elements of the IMF's policy are of the greatest importance for transition in Serbia. The first one is the refusal to accept the Serbian budget for 2004 with a deficit of 625 million EUR. Even though Serbian officials insisted that it was impossible to reduce the deficit, the IMF's relentless policy and the stipulation of the execution of the arrangement with the reduction of the budget deficit led to a revision of the budget for 2004 and the forming of a budget for 2005 with a moderate budget deficit. The second element is the IMF's policy in the first half of 2005: the IMF's conditions in this period are directed towards the restructuring of the real sector in Serbia which is viewed as the source of the budgetary and foreign trade deficit. It is obvious that, in recent time, the IMF turned to the microeconomic causes of the chronic macroeconomic disproportions in Serbia.

### **World Bank**

The restoration of Serbia's membership in the World Bank was linked to two main issues. First was the issue of settling the outstanding obligations, since the due, i.e. outstanding obligations of FR Yugoslavia on the whole were around 1.760 million USD in 2001. The World Bank Statute does not allow a write-off of claims, i.e. the forgiving of debts, so that the question of an arrangement that would regulate outstanding obligations was raised. This was all the more so since there is no possibility of the World Bank granting new loans to a member country if it has outstanding obligations towards the Bank from previous loans. This problem was resolved with the World Bank granting FR Yugoslavia a consolidation loan, which consolidated all the due obligations, and the deadlines for their execution were moved into the future.

The consolidation loan has a 30-year repayment period and interest rates at the level of the standard loans of the International Bank for Reconstruction and Development (IBRD). This financial operation was the third operation of the kind in the World Bank's history (after the consolidation of the obligations of Bangladesh and Bosnia-Herzegovina).

The second important issue was the issue of the status: whether to acquire membership of the International Development Association (IDA) or of the International Bank for Reconstruction and Development (IBRD). Membership of IDA ensures loans under concession terms, meaning terms more favorable than those on the market: practically interest-free loans with a very favorable repayment period for the debtor. However, the scope of the funds that can be received under these conditions is extremely limited, since the funds are obtained from the budgets of the World Bank's most developed member countries (the G7 group of countries). Membership in IBRD can ensure a larger amount of funds, but which are borrowed under higher interest rates, i.e. rates based on the interest rates which the World Bank pays on the capital market when obtaining them. The decision of the authorities at the time was to request, i.e. to obtain an IDA status and this decision was taken on the basis of the assessment that the state's priority was a generous write-off of the foreign debt to the Paris Club of creditors. Namely, there were credible assurances that without the IDA status (reserved for the most under-developed countries of the world) it is not possible to receive a write-off of the debt to the state's creditors that would be close to the so-called Naples terms (67% write-off).<sup>6</sup>

The first problem with such a decision and its realization was the small amount of funds that were at the disposal for borrowing. Thus, in the first three-year arrangement with the World Bank (which was completed in 2004) envisaged was the borrowing of a total of 540 million USD under IDA terms. In the current arrangement with the World Bank, which represents the borrowing of funds under mixed terms (part of the funds are being borrowed under IDA, and part under IBRD terms), only 225 million USD will be borrowed under IDA conditions. This inflow of capital from the World Bank should be compared to the outflow of capital for the payment of interests to the World Bank for the consolidation loan. The total amount of the obligations based on this interest is up to 100 million USD annually (depending on the LIBOR trends). This means that, in the first three years, the net inflow of capital from

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<sup>6</sup>The acquisition of an IDA status, i.e. membership, is linked to certain conditions concerning the level of development measured by the GDP per capita. Namely 895 USD *per capita* was the ceiling, so that a country above that GDP level could not become an IDA member. A creative calculation of our country's GDP at that moment produced satisfactory results.

the World Bank was only around 80 million USD annually. In the following period, the inflow of funds under IDA terms will not be sufficient even for the repayment of interests on the consolidation loan.<sup>7</sup>

Furthermore, part of the outflow of capital for the payment of interests on the consolidation loan (somewhere over 20 million USD annually) is for the servicing of the portion of that loan that concerns the unpaid credits for investments in Kosovo.<sup>8</sup> In other words, the Kosovo debt is included in our debt to the World Bank, so that interest on this part of the debt is also being paid. These obligations are being serviced from the budget. However, Kosovo is not participating at all in the servicing of these obligations. This has created an economically and politically illogical situation in which the one who is servicing the obligations from his own budget (at this moment this boils down to the payment of interests, but the repayment of the principal is to ensue as of 2007) cannot collect taxes in the region that had generated those obligations. UNMIK and its patrons objected to any kind of alternative solution, so that in the political game that followed, their political weight, regardless of the lack of arguments, proved to be much larger than that of Serbia.

As far as the World Bank's engagement is concerned, in the first years of new membership it focused on advisory and technical assistance to the new authorities in the transition. This assistance was valuable, since the World Bank, as an institution, had accumulated and systematized the ten-year experiences of countries in transition. This especially refers to the process of specific institutional building like, for example the one concerning the realization of privatization.

The start of the World Bank's financial engagement in Serbia was very ambitious in the sphere of financing projects, i.e. primarily projects for the promotion of the state policy, such as the financing of the establishment of an agency for insuring export credits, the modernization of the customs service, so as to accelerate the flow of goods across the border etc. However, the realization of such projects proved to proceed very slowly, and in certain cases the realization of projects was totally halted, so that by the beginning of 2005 only one such project was implemented. This points to our country's very

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<sup>7</sup> Even though there were attempts to increase the amount of funds for our country, this was strongly opposed by France. Namely, IDA funds also come from the French budget, and the French government wants to use these funds to increase the benevolent attitude of African countries which fall under the French sphere of interest. France has no such ambitions in the Balkans. For this reason, quite clear was the motivation of France (which was even against the awarding of the IDA status to our country) to limit the granting of IDA funds to Serbia, so that there would be more for its clients in Africa.

<sup>8</sup> Kosovo's total debt within the consolidation loan is 404 million USD (around 23% of the principal).

small administrative capacity, i.e. the small ability of the state administration to accept specific-purpose (project) funds and to realize projects financed in such a manner. This is the result of the fact that there is a very small number of people in the state administration who are capable of managing the implementation of such projects, as well as the inadequate organization and lack of stimuli for the state administration to work on such an implementation.

In view of the above mentioned, the World Bank very soon moved to the financing of budgetary support to our country, through the granting of loans for structural adjustment. This method of work can be implemented much easier since the state, i.e. the government, is expected to make certain reform moves, these expectations are presented to officials, and when the reform moves are realized, financial assistance is also realized, i.e. the funds are paid into the budget. The World Bank's increasing orientation towards such a method of work points to the already mentioned small administrative capacity of Serbia to receive other forms of financial support, but also a lack of confidence in the authorities' commitment to reform policies, since loans for structural adjustment are disbursed exclusively after the state makes the envisaged reform moves, like, for instance, the adoption of a law with certain reform solutions.

Quite interesting is an unexpected effect of the World Bank's engagement, together with the engagement of the IMF. Namely, both financial institutions are paying attention to the supervision and reduction of the subsidies which companies in the real sector receive from the budget, this prompting these companies to use, instead of transparent subsidies, other, non-transparent funds to enlarge their overall income, i.e. to cover the wage bill and (at least partially) their financial losses.

### **European Bank for Reconstruction and Development (EBRD)**

Membership in the European Bank for Reconstruction and Development (EBRD) was realized very quickly, since there were no outstanding obligations (arrears) towards this financial institution. The financial problem that appeared was the payment of capital, but this was quickly resolved with a Swiss state interest-free bridging loan.

The start of activities by the EBRD, as a dynamic financial institution, far closer to commercial banks than other international financial institutions,

which considers itself to be a bank of the private sector, was marked by various results. Very soon a new bank (Micro Finance, later ProCredit) was formed for the financing of small private business undertakings, and it is operating very successfully. Contrary to this, the idea about a facility for the financing of the working capital of large (non-privatized or partially privatized) companies was not successful and a very small part of the envisaged funds were disbursed (only 2 million out of the envisaged 60 million EUR). This idea represented an innovation in the EBRD's business operations, since it had previously not been applied, i.e. tested anywhere. The creative thinking of bankers, as well as the creativity of business people in general, sometimes leads to business failures. It seems that one of the reasons for such an outcome was also the overestimated potentials of the existing large companies in Serbia to generate rich and constant money flows based on exports.

Due to this failure (and not only for this reason), in the first phase of its engagement in Serbia the EBRD turned to loans for financing the rehabilitation of the infrastructure (railways, the electric power industry, the road sector, the municipal infrastructure sector etc.), with the obtainment of sovereign guarantees, which can only very indirectly be characterized as support to the private sector. It is important to mention that loans of this type were also granted to local communities, and in the case of some of them (like Belgrade, for instance), no sovereign guarantees were requested.

In time, the EBRD kept getting into the swing, so that this bank's present operations are mostly directed towards the financing of more or less private companies, both directly (in the case of large companies), and indirectly, through local banks (mostly foreign owned ones), in the case of smaller companies. In that sense, the share of loans for financing the infrastructure considerably dropped, although programs of support to the local, i.e. utilities infrastructure have been retained.

### **European Investment Bank**

In the case of relations between Serbia and the European Investment Bank (EIB) the issue of membership in this bank was not raised (EIB members are exclusively EU member states), but rather of the renewal of its operations on the territory of Serbia. In this sense, the EIB set as a condition the immediate settlement of all arrears, i.e. the payment of all the installments of previously

received loans which had fallen due, together with the entire incurred interest, before requests for new credits are even taken into consideration. In this regard, the EIB offered no mechanism for resolving this problem, but adopted a defensive and relentless attitude – first pay your obligations, then we will cooperate.

The offer to resolve this problem came from the European Commission, i.e. an EU body. Within the arrangement for macro-financial assistance, the European Commission granted a loan with which the outstanding obligations to the EIB were paid. In other words, the due obligations towards the EIB were transformed into obligations towards the EU. After the resolution of the problem of outstanding obligations, the EIB started its activities in its traditional fields such as the financing of the energy and transport infrastructure, primarily the rehabilitation of the existing infrastructure, with some construction of new facilities, at both the national level and the level of individual (larger) local communities. All the loans granted by the EIB are loans for which sovereign guarantees are requested.

### **Bilateral donors**

Even though it represents a multilateral organization, the EU can be described in this context as the most important bilateral donor, i.e. the donor from whose sources the largest support had arrived. EU donations can be classified into two groups: macro-financial assistance and the CARDS program.

Macro-financial assistance consists of a combination of grants (non-returnable payments) and loans intended as budgetary support, i.e. these funds pour into the budget without any directing (*earmarking*) of the supervision of their purposeful spending. In other words, there are no restrictive conditions for the use of these funds. The provision of macro-financial assistance is made conditional on certain macroeconomic policies and their implementation.

The CARDS program is envisaged by the Stabilization and Association Process as a program of support to the reforms and economic development of South-East European countries (the Western Balkans) and it consists of a whole series of projects which imply the financing of investment programs and of technical assistance. Each year, a list of such projects is harmonized with the government of the country receiving the funds, although the donor, i.e.

the European Commission on behalf of the EU, has the final say in this. The donor formulates the initial list, true in direct contacts with representatives of the authorities, but also according to his own priorities and an assessment of the situation in the field, and the final version of the list of these projects differs relatively little from its initial version.

Namely, in the case of the CARDS program the donor has quite firm ideas about the priorities that should be financed. Furthermore, the donor has quite certain concepts regarding the manner in which part of these funds should be spent. For example, in the case of projects of institutional building, clearly defined are the concepts of the institutions whose building, i.e. development is advocated by the donor. For this reason, one can say that along with the funds, certain concepts are also introduced. This can be explained by the fact that CARDS is essentially defined as strategic support to the Stabilization and Association Process, which is why assistance from this program is intended for the realization of the goals and mechanisms defined by the Process, meaning by the EU. As the country advances on its road towards stabilization and association, assistance is increasingly directed precisely towards those reforms and the building of institutions necessary to fulfill the obligations that would originate from the signing of the Stabilization and Association Agreement. The problem is, however, that, due to the lack of a political agreement within Serbia, there is no domestic «ownership» over the processes of European integration, but rather the process mostly boils down to the fulfillment of conditions set from the outside. Another restriction is also the unclear division of competencies in regard to the coordination of the CARDS program, which largely reflects the general picture of the lack of a clear division of competencies in regard to the process of European integration. At the level of Serbia, the CARDS program is being coordinated by the Unit for developmental assistance within the Serbian ministry of internal economic relations, which requires exceptionally good cooperation with the Serbian government's office for association with the EU, as the coordinator of the entire process of integration and thus also an actor acquainted with the priorities of the Association Process, but also all the responsible ministries, as actors that use assistance and implement the reforms which are crucial for the success of the integration process. At the level of the state union, the CARDS program is coordinated by the SCG ministry of international economic relations, while appearing as the coordinator in the sphere of European integration is the SCG Office for association with the EU. It is clear that there are so many actors and levels that coordination is crucial in order to present clearly defined priorities to the donor. The problem is,

however, that on the side of the Serbian authorities, i.e. the side of the demand for donations and projects there was no clear concept as to what it is that Serbia wants, i.e. what are the institutions and policies that suit our conditions and this period of reforms. Therefore, the authorities were not prepared to try to be an equal partner of the EU, i.e. to engage in a serious debate on the priorities. Due to this imbalance of forces the assistance offered by the EU (and many other large donors) was defined by the donor himself (*supply driven*), i.e. the financing of many projects was based on the supply, much more than on the demand.

The CARDS programs, since it is conceived as financial support to the Stabilization and Association Process, is used not only by Serbia and Montenegro, but also by the other participants in the Process – Macedonia, Croatia, Bosnia-Herzegovina and Albania. While this program in Croatia and Bosnia-Herzegovina is managed by delegations of the European Commission in those countries (with the tendency, especially in Croatia, of increasing management by the beneficiaries themselves), the funds from the CARDS program in Serbia and Montenegro, in Kosovo and Macedonia are managed by the European Agency for Reconstruction (EAR), which was primarily founded for the purpose of assisting reconstruction in Kosovo, after which its activities were extended to Serbia and Montenegro and Macedonia. It was decided to set up a very complex procedure for the selection of the beneficiaries of the funds, i.e. the one who will implement the project, in order to prevent possible fraud. Such a complex procedure inevitably slowed down the inflow of the already approved donations, i.e. the implementation of the corresponding programs. Such delays can have very unfavorable effects. Furthermore, when competing for the provision of consultative services the participation of companies from the EU territory was necessary, whereby a certain service became free of charge from the standpoint of its user, while the funds «returned» to the EU. The separation of the user and the payer, especially if the user is not vitally interested in that service (which is the case with projects based on the supply, and not on the demand), can have negative effects on the quality of the rendered service. Appearing as an additional restriction is also the fact that the European Agency for Reconstruction does not manage the funds that arrive in the country on the basis of regional CARDS projects such as, for instance, the regional CARDS project in the spheres of visas, asylums and migration. Such projects are managed by the European Commission, so that the “surplus” of protagonists on the SCG side is also coupled by a multiplication of actors and

the need for their good coordination and cooperation also on the side of the donor, i.e. the European Union.

It is quite certain that the amount of the donations and the method of their implementation are fully in accordance with the conditions set by the Stabilization and Association Process, this implying conditions of a political, economic and administrative nature which were discussed in greater detail in the part of the text devoted to relations between the SCG and the European Union. The question remains open as to whether the effects of such an engagement could have been larger. This is all the more so since there was no strong setting of political conditions in the implementation of the CARDS program, as is the case with the Stabilization and Association Process with the EU.

US assistance is implemented by the responsible American state aid agency, USAID, which has developed a very rich and diversified program of support to the reform in Serbia. In this regard, political conditions have been very strongly set (primarily concerning cooperation with the Hague Tribunal) for the implementation of that program, whereby the set conditions have nothing to do with the program itself, i.e. with the course of the reforms in Serbia. The setting of conditions for the provision of assistance is linked to American internal political reasons, which concern the relations between the legislative and executive authorities. In this regard, the US legislative authorities have precedence in the creation of political pressures on Serbia.

Such an example of the setting of political conditions is also the donors' conference held in Brussels in June 2001 and the strong pressure for Slobodan Milosevic to be extradited to the Hague Tribunal. It is only after the American administration received credible assurances that Mr. Milosevic would be extradited to the Tribunal, that it took the decision for the American delegation to participate in the Conference, to undertake to offer assistance in the amount of 175 million USD and, which was of special importance, to stimulate other countries to assist Serbia.

There exist very important small donors, whose support is not linked to any kind of political, or even economic (reform) conditions. Among these donors, one should quite certainly mention Switzerland, with which very good relations have been developed since the very start of the return to international financial institutions, in the field of financial diplomacy. Namely, FR Yugoslavia chose to be a member of the Swiss constituency in all international financial institutions, which prompted the Swiss government to offer significant support

in international financial institutions, as well as financial support to the reform policies, especially in the field of international finances.

### **Paris Club**

The settlement of the foreign debt to the state's creditors, i.e. creditors rallied within the Paris Club, was one of the main priorities of the state policy in the first year of transition (the total amount of the long-term debt to these creditors was around 4.5 billion USD, while the short-term debt was around 500 million USD). It was estimated that the level of the encountered state debt (which was not serviced during the 1990s at all, so it has been considerably enlarged by capitalized interests) represented the kind of burden that could not lead to a drastic drop in economic growth and to a moratorium on the servicing of the foreign debt, with all the negative consequences of such a moratorium. In accordance with this, one of the state policy's main goals in the sphere of international finances was to obtain the so-called Naples terms for settling the debt to the Paris Club credits (which imply a write-off of 67% of the debt) and a comparable treatment by the London Club credits (club of commercial creditors).

In that sense, chosen was also the strategy of joining the World Bank as IDA member, so as to create conditions for a generous debt write-off, i.e. for obtaining the so-called Naples terms. The financial diplomacy that was conducted in the preparatory phase was based on the strong support offered to our request by the US, whose financial authorities agreed to be our representative, i.e. the representative of our request to the Paris Club. Such a decision by the American authorities should be viewed in the context of the very good relations between the two countries in the second half of 2001, following the extradition of Slobodan Milosevic to the Hague Tribunal at the end of June that year. Furthermore, very good financial and legal advisors were chosen, and engaged were also certain lobbyists, close to the American financial authorities, as well as the financial authorities of the world's most developed countries (the biggest creditors).

The final phase of the talks took place in November 2001 in Paris and they produced a non-standard solution, i.e. non-standard terms for the write-off and rescheduling of the remainder of the debt, very close to the so-called Naples terms. Namely, the terms were such that 51% of the debt was written off

immediately upon the conclusion of the agreement, the next 15% was frozen and is supposed to be written off following the completion of the extended arrangement with the IMF, i.e. its successful execution (in 2005), while the remained of the debt would be repaid over of period of 22 years, with a six-year grace period.<sup>9</sup> Such terms for a write-off, i.e. for settling the debt to non-commercial creditors are usual only for highly indebted and poor African countries, while among European countries comparable terms for the write-off and restructuring of the debt was received only by Bosnia-Herzegovina.

On the one hand, such an outcome of the talks with creditors of the Paris Club can be assessed as successful, in view of the relative reduction of the debt, i.e. the reduction of the country's overall burden and the moving of this burden into the future. Such a success was the result of the country's relatively high reputation in the world in 2001 and the convincing actions by the US as a powerful representative, but probably also the good preparations for these talks. On the other hand, there remains the fact that a large part of the written off debt represented incurred interests resulting from the non-servicing of this debt in the 1990s, when Serbia, even if it had wanted to, could not have serviced these obligations due to the international financial sanctions that were imposed in 1992. Moreover, there is also the problem of the Kosovo debt, since the rescheduled part of the debt which will start being repaid, i.e. the interests that are already being paid, also include the state debt allocated to Kosovo. Like in the case of the consolidated loan from the World Bank, here too Serbia will be repaying these obligations from its own budget, but without collecting any kind of tax revenues in Kosovo.

The agreement with the Paris Club was followed by a relatively long-lasting and technically complex signing of bilateral agreements with the Club's creditor countries. This created the conditions for obtaining new credits, i.e. primarily for the engagement of these countries' state agencies in insuring export credits, which stimulates trade with those states.

### **London Club**

The final talks with the London Club started, without thorough preparations, only two weeks after the successful completion of the talks with the Paris Club, in an atmosphere of large domestic support and popularity

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<sup>9</sup>With these minimal, but still formal deviations from the Naples conditions, the Paris Club probably wanted to protect itself from the case of Serbia (FR Yugoslavia) being proclaimed a precedent which some other, larger debtors, could use as the basis for requesting the same treatment.

generated by the reached agreement. This largely indicates that the decision to start final talks with the London Club was motivated by the winning of cheap political points, and not by the completion of an important state job.<sup>10</sup>

All this was accompanied by quite poor preparations for the talks, since the issue of connected persons had not been resolved, nor were stands coordinated with the creditors on the total amount of the debt (the so-called reconciliation), i.e. on the amount which Serbia really owes, especially after the arrangements concluded with the London Club of creditors by certain former Yugoslav republics. Furthermore, not much attention was paid to the fact that the country's political rating was not of too great an importance for commercial creditors, who are exclusively interested in the yield they will achieve on the remainder of their claims.

Unsuccessful moves, the use of tactics, procrastination and the like continued over a period of more than two years, which showed that the London Club of creditors was ready to wait and that they believed that time was on their side. When this became clear, and also when the new governor of the National Bank of Serbia (NBS) arrived, serious talks started only in 2004 and were conducted this time in a completely different manner, this also meaning far from the public eye and without statements to the press. The public was informed about the talks only when they were completed, in June 2004, with an agreement that brought a write-off of 62% of the total debt (the total debt was 2,700 million USD), while the remained would be repaid within a period of twenty years.

Such an outcome can be described as a success, since the terms can be compared to the terms of the write-off obtained from the Paris Club. Even more important is the fact that, with this agreement, Serbia acquired an international credit rating, which practically opened the road for borrowing the necessary capital on the world market under reasonable interest rates (premiums on the risk).

### **World Trade Organization**

A request for admission to the World Trade Organization (WTO) was submitted in January 2001 along with the submission of requests for admission

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<sup>10</sup> Just before leaving for the first round of the final talks, the negotiators competed in their statements to the press about how much of a debt write-off they would request and obtain, i.e. how much money they will "leave the creditors short of", so that these figures even went up to over 70%, which is a larger write-off than in the case of the non-commercial creditors of the Paris Club. No one likes to be publicly humiliated, and powerful private creditors are no different than other people in this respect.

or for the renewal of membership in almost all the international financial and economic institutions. Accession to the WTO started with the submission of the Memorandum on the present situation, i.e. a memorandum describing the candidate country's foreign trade regime.

The problem with the admission that occurred was of a political and technical nature. Namely, the memorandum is submitted by an internationally recognized state, and that state (FR Yugoslavia at the time) consisted of two states with completely different foreign trade regimes: Serbia, which abolished in 2001 non-tariff barriers (quantitative restrictions) and based protection on relatively high customs duties, and Montenegro, which was doing the exact opposite. Not even after the redefinition of relations between Serbia and Montenegro and the adoption of the Constitutional Charter did the situation improve in the sense of establishing a single market. After spending more than a year on attempts to harmonize the economic systems of Serbia and Montenegro, primarily for the purpose of achieving progress on the road to European structures of integration, in October 2004 the European Union adopted the „twin track“ approach, essentially enabling Serbia and Montenegro separately to negotiate on economic issues. Such a stand by the European Union also led to a changed way of thinking in the World Trade Organization, whose General Council adopted on February 15, 2005 (after SCG withdrew, in December 2004, its earlier request for membership, and Serbia and Montenegro at the same time submitted separate requests for membership) the decision to initiate the procedure for admitting the Republic of Serbia to this organization and it formed a special working group for the talks. In line with such a decision, at the beginning of March 2005, the Serbian government adopted and addressed to the WTO a Memorandum on the trade regime of the Republic of Serbia, which opened up political problems, but technical problems as well.<sup>11</sup> All this was coupled with dilemmas and uncertainty regarding the survival of the joint state of Serbia and Montenegro. That uncertainty and dilemmas are still present, with increasingly strong centrifugal forces in action. In line with this, international institutions kept increasingly adopting the „twin track“ principle, providing Serbia with the possibility of having independent access to these institutions. According to this, Serbia independently presented a new memorandum on the present situation in January 2005. It is assessed that, now, when the major problem is resolved, Serbia would become a WTO member in 2008.

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<sup>11</sup> One of the discussed solutions was for Montenegro's foreign trade regime to be described in the annex to that memorandum on the present situation. The implementation of this solution was obstructed by the total lack of cooperation on the part of the Montenegrin authorities.

It is quite certain that there had so far been no strong political stimuli for joining the WTO, i.e. that the authorities so far viewed this accession as something that can hardly bring political points. Quite the contrary, this accession means the obligation of the further liberalization of foreign trade and of increasing competition on the domestic market, and this does not bring political points, especially not in connection with the restructuring of the real sector. In view of the fact that accession to the WTO also leads to a reduction of barriers for our exports to the member countries (practically all the important countries of the world), it is obvious that exporters in Serbia are not organized as well as are producers whose goal is to sell goods on the domestic market.

### **Analysis of the integration into international financial and economic institutions achieved so far**

Generally speaking, with the start of the transition in Serbia, the new authorities had strong political motives to work towards integration in international financial and economic institutions. These political factors should be sought in several facts. First of all, the country had been isolated over a period of ten years and it had practically been excluded from world economic and financial trends. Emergence from this isolation and re-integration into the world were quite certainly the desire of a majority of the population in Serbia at the start of the transition. Secondly, initial steps in integration meant a large inflow of funds, mostly donations, which also had a major political value and it directly reflected on the growth of the standard of living. In view of this, there were significant political motives in favor of such integration. Finally, in the first year of transition, due to the mentioned reasons, it was very difficult to conceive any kind of political attack on integration into the world, i.e. into international institutions, or any rhetoric of the kind, so that, initially, there were no political parties that were publicly against such integration.

International financial and economic institutions themselves, for their part, are mostly facilitating this job, since it was in their interest to resolve the problem of membership for Serbia which had been isolated for so long and without any possibility of being internationally supervised. The acquisition or renewal of membership enables, albeit indirect, supervision of the policies being applied in Serbia and it reduces the uncertainty which the international factor faces. In line with this, sometimes truly creative solutions were found for overcoming technical problems on the road to membership.

In time, especially after the first year of international integration and the declining of the obvious political value of this integration as a contrast to isolation (which is slowly being forgotten more and more), political opponents to the country's international integration started appearing. This change was not the result of a change in the constellation of direct partial, i.e. group interests and their articulation in the process of public choice, but it was more of an ideological struggle, between mondialists and patriots, i.e. those who, for ideological reasons are advocates, or opponents of Serbia's integration into the world. The constant requests of the Hague Tribunal, the immoderate rhetoric of the Tribunal's officials and its legal inefficiency have strengthened the political forces in Serbia against international integration.

Some politics of interest groups, i.e. some decision-making within the framework public choice, can be encountered in jobs directly linked to the foreign trade regime, i.e. the protection of domestic producers, which mostly refers to accession to the WTO, the harmonization of the economic policies with Montenegro and the Stabilization and Association Process.

Finally, relations with international financial and economic institutions were sometimes used as a means for a party and pre-election battle. For example, during the 2003 election campaign, sovereign guarantees for the EIB loan for financing the utilities infrastructure in Belgrade were not issued (adopted), because this was the way certain political parties fought against the party that was in power in Belgrade at the time, with the explanation that the issuing of sovereign guarantees increased the state's indebtedness.

### **Integration into other international organizations**

At the moment when economic and political transition was launched, FRY was not a member of the major international universal or regional organizations, primarily because of insistence on the stand that it was the legal successor of SFRY, which was contrary to the generally accepted stand that the SFRY disintegrated into five successor states, and also because of the non-democratic internal circumstances and the restoring to the policy of the use of force in the region. After the presidential elections in FRY in September 2000, and then also the parliamentary elections in Serbia in December of the same year, power was taken by a heterogeneous, but essentially democratic and pro-European coalition, rallied within the Democratic Opposition of Serbia

which accepted the position of the FRY as one of the five equal successors of the FRY, this having created the conditions for the renewal of membership in international organizations, i.e. for applying for membership in those organizations which the SFRY had never been a member of.

### **Renewal of United Nations membership**

In response to the submission of an application for membership, forwarded on October 27 by the FRY president, in Resolution 1326 of October 21 2000, the United Nations Security Council recommended to the General Assembly to accept the FRY as a member of this organization. Only a day later, at a session of the UN General Assembly session, the FRY was the last out of the five legal successors of the FRY to become a member of the United Nations. This resolved the FRY's eight-year long unclear status in the UN which started with the disintegration of the FRY and the creation of independent states. Namely, the FRY was called on to request admission to the UN, but Belgrade kept refusing to do so, referring to its legal continuity with the SFRY, which Croatia and BiH contested. The situation was partially resolved with the decisions of the General Assembly and the Security Council to enable the FRY to be present at the UN, but without the right to vote in this organization's bodies and commissions.

At the time of the acquisition of membership in this universal international organization, under way before the International Court of Justice, as a UN body, were proceedings instituted by Croatia and Bosnia-Herzegovina against the FRY on the basis of a lawsuit for genocide, as well as the proceedings which the FRY was conducting against eight NATO countries based on a lawsuit for the unlawful use of force during the NATO air strikes in 1999. All these proceedings take as a point of departure the fact that, in the previous period, the FRY was a UN member, and, therefore, a signatory of the Statute of the International Court and the Convention on Genocide. The admission of FRY as a new UN member country on November 1, 2000, shed new light on the disputes before the International Court of Justice. In accordance with this, on April 24, 2001, the FRY submitted a request for a revision of the Court's decision to proclaim itself authorized in the case of the lawsuit filed by BiH against FRY, emphasizing precisely the FRY's admission to the UN as a new fact. The request was rejected in February 2003 as unacceptable. In December 2004, the Court decided that it had no authority over the proceedings based

on the lawsuit of FRY/SCG against eight NATO member countries, since the FRY was not a UN member in the mentioned period, so that based on these grounds, or any other grounds, it could not appear as a side in the dispute before the highest UN legal institution. It remains to be seen how this decision will reflect on other proceedings being conducted before the Court, primarily on the lawsuit filed by BiH, since it was precisely the expectation that the Court would proclaim itself unauthorized for the reasons set out by FRY/SCG in the suits filed against our country by BiH and Croatia, that was the basis for the perseverance in the charges against eight NATO member states, despite the fact that the withdrawal of the charges was, as we will later see, one of the conditions for the country's admission to Partnership for Peace.

### **Renewal of membership in the Organization for Security and Cooperation in Europe (OSCE)**

The FRY was admitted to the OSCE on November 10, 2000, when FRY President Vojislav Kostunica signed the basic OSCE documents and ceremonially swore to accept all its provisions and obligations. The extent to which the FRY's international position deteriorated in the period between 1992 and 2000 is perhaps best illustrated precisely by the fact that the FRY was the only country ever to be excluded from the OSCE. Therefore, admission in this organization best marks the end of the FRY's political degradation, since membership in the OSCE is, as a rule, open to all non-problematic European states, so one can freely say that the absence of membership is a much stronger negative status symbol than admission is of a politically prestigious significance.

With the FRY's consent and encouragement, an OSCE Mission was formed in Belgrade in March 2001, which is when the previously established long-standing missions in Kosovo, Sandzak and Vojvodina were formally closed down (the OSCE Mission in Kosovo was established in July 1999). The Mission's mandate and structure are such that it offers assistance and cooperation in all the main OSCE areas, such as the establishment and functioning of democracy, the rule of law, the promotion of human rights, including the rights of minorities, the transformation of the media, the promotion of the application of confidence and security military measures, including the democratization of the army, adjustment to the economic standards of a market economy and so on.

Even though there is no direct formal connection between membership in the OSCE and accession to certain other European organizations, participation and acting within this organization can have a certain impact, primarily a positive one, on the possibility of joining other European organizations such as the Council of Europe or Partnership for Peace. The closest is the link between the essence and nature of the obligations in the Council of Europe and the OSCE, primarily because of the fact that the main goal of both organizations is the promotion and protection of human rights and the realization of democratic principles. In that sense, the OSCE secretary general and the Council of Europe secretary general exchanged letters in February 2001 on the importance of cooperation between these two organizations in the FRY/SCG.

### **Admission to the Council of Europe**

The FRY applied for membership in the Council of Europe (CoE) soon after the democratic changes in Serbia, on November 9, 2000, and on November 22, the CoE Committee of Ministers initiated the procedure for admission, requesting the opinion of the CoE Parliamentary Assembly. This was the second time that the FRY applied for membership in this organization – back in 1998, the then government submitted a request for admission the debate on which was postponed, based on the decision of the CoE Committee of Ministers. Membership in this oldest and, according to its system for the protection and promotion of human rights, most prestigious European organization is conditional on the acceptance of the principles of the rule of law and the basic freedoms of all persons falling within the jurisdiction of the member state, but also the ability to fulfill all the obligations stemming from membership. Two requests which the FRY filed at different periods of time, show the extent to which both elements are important – and they also show that the state is willing to accept the obligations, and capable of doing so. Namely, the request filed during the Milosevic regime was rejected due to the „lack of seriousness and credibility“ in regard to the will of the then authorities to fulfill their obligations, while the request submitted after the democratic changes waited long for a positive answer, mostly because of suspicion regarding the ability to meet the obligations which membership implies.

The general conditions for membership of the CoE in the case of FRY implied, primarily, the holding of elections that would be assessed as free and fair, expressed readiness to accept the European Convention on the Basic Rights

and Freedoms, cooperation with the Hague Tribunal, the opening of dialogue with other CoE member countries and candidate states, including the states created on the territory of the former SFRY, as well as the necessity of respecting the standards for the protection of minorities and national groups with the acceptance of the Framework Convention on the Protection of Minorities. The FRY made huge steps towards the fulfillment of these conditions. The effects leading towards the establishment and strengthening of the democratic practice in the country were positively assessed, as was the conducting of a peaceful and constructive foreign policy. Of special importance was the peaceful resolution of the crisis in southern Serbia at the end of 2000 and the beginning of 2001, then the establishment and development of relations with neighboring states created on the territory of the former SFRY, and the launching of cooperation with the Hague Tribunal.

On the basis of a positive assessment of the invested efforts, at the beginning of 2001, the FRY acquired the status of a special guest in the CoE Parliamentary Assembly, as well as the special guest status within the **Congress of Local and Regional Authorities in Europe**. The FRY also acquired the status of an associate member in the expert **CoE Commission for Law-based Democracy (the Venice Commission)**. Adopted was the mandate and established was the CoE Mission for FRY, with CoE offices in Belgrade and Podgorica, while constant and intensive cooperation was established between the CoE and FRY, which was especially intensive in the sphere of achieving compatibility with conditions for membership in the CoE and its human rights standards.

Despite the approval of the made reform steps, it transpired that the CoE considered them insufficient, because the decision on admission, announced for April 2002, when BiH was admitted, was postponed for September the same year, but was not taken because April the following year. As the most important reason that prompted the decision to postpone the FRY's admission mentioned was the unstable political and legal position of the federal state, which was to assume the obligations stemming from membership. In that sense, the adoption of the Constitutional Charter of the joint state of Serbia and Montenegro became a precondition for a positive decision of the CoE Committee of Ministers on FRY's admission to this organization. The responsible committees of the CoE Parliamentary Assembly (the Committee on legal affairs and human rights and the Committee on political affairs) in June 2002 adopted the reports of their rapporteurs on the FRY and set the conditions that it needed to fulfill following admission. In September, the Parliamentary Assembly adopted a positive Opinion on the admission of FRY

to the CoE. Apart from the adoption of the Constitutional Charter and the establishment of the state union of Serbia and Montenegro, there is no doubt that the assassination of Serbian prime minister Zoran Djindjic on March 12 also had an effect on the Committee of Ministers' decision of March 26. Fear that this event could jeopardize the reform course which Serbia had been following since October 2000, eliminated even the last obstacle to SCG's membership in the CoE and considerably accelerated the decision of the Committee of Ministers in the procedural sense. This created a paradoxical situation in which SCG became a member of the CoE, an organization known primarily for its system of the protection and promotion of human rights, on April 3, 2003, at a moment when certain rights were restricted by the state of emergency imposed in Serbia after the assassination of prime minister Djindjic.

By joining the Council of Europe SCG also assumed a whole series of obligations which it had to fulfill, and which primarily concerned the respect of human rights and they can, actually, be observed as obligations not towards the international community, but towards the citizens of SCG. Some of these obligations have already been met (the ratification of the European Convention on the Protection of Human Rights and Basic Freedoms, the signing and ratification of the European Convention to Prevent Torture and other Cruel, Inhumane and Degrading Treatment or Punishment, etc), but work continued on the full realization of the assumed obligations. For the purpose of ensuring the full implementation of the obligations, a supervision procedure is carried out towards SCG, by both the CoE Parliamentary Assembly and the Council of Ministers. The full realization of obligations stemming from membership in the CoE also became a condition set by the European Union in the context of meeting the criteria requiring the stability of the institutions guaranteeing the realization of human and minority rights and democratic principles, as well as the rule of law.

### **Application for membership in Partnership for Peace**

The Partnership for Peace (PfP) program is NATO's most important initiative directed towards the strengthening of trust and cooperation among the NATO member countries and other countries in the Euroatlantic region for the purpose developing and strengthening stability and security in Europe. Even though the main task of PfP is cooperation in the sphere of defense, the

program is primarily of a political nature and represents a very important factor in Europe's security environment.

The Partnership for Peace program is individual and specific for each state. In accordance with its sovereign rights and national interests and needs, each country determines the essence of partnership cooperation. Practically all the states in the Euroatlantic area have today accepted membership in PfP. All the states in the immediate vicinity of SCG, except BiH, are either members of NATO or of PfP, with the desire of being admitted to NATO. In order to join to program it is necessary to obtain the consent of NATO, which assesses the readiness of the candidate states on the basis of its own standards and criteria and only then does it invite a candidate country to join it.

The process of the FRY's inclusion in PfP was initiated by a decision of the Supreme Defense Council in April 2002, to recommend to the federal government to launch the process. On the basis of the federal government's authorization, the then foreign minister, Goran Svilanovic, forwarded a letter of intent to the NATO secretary general and informed the responsible federal parliament committee about the decision to initiate the procedure for the FRY to join PfP. In his response, the NATO secretary general applauded the efforts being made by the FRY in regard to issues of importance for inclusion in PfP, but he also emphasized the conditions that needed to be fulfilled for the acquisition of membership. They primarily include cooperation with the Hague Tribunal, support to the implementation of UN Security Council Resolution 1244 and the Dayton/Paris agreement, as well as the withdrawal of the FRY's lawsuit against eight NATO members before the International Court of Justice. All these conditions are still valid today, with the exception of the last one – with the decision of the International Court of Justice to proclaim itself unauthorized for the lawsuit filed by the FRY against eight NATO member countries for the unlawful use of force during the air strikes in 1999 (see the part of the text devoted to the UN), the need for the lawsuit to be withdrawn ceased. Mentioned as the most important condition is full cooperation with the Hague Tribunal, which also implies the extradition of General Mladic, for whose presence in the SCG the governments of Serbia and Montenegro claim that there is no proof, but also the respect of the signed peace agreements, with the increasingly frequent emphasis of the promotion of relations between the authorities in Belgrade and Pristina in the context of possible future talks on the final status of Kosovo.

The adoption of the Defense Strategy of the state union of Serbia and Montenegro in November 2004 once again confirmed the country's orientation

in favor of joining the PfP program, while the decision on membership in NATO is left to the democratic will of the citizens, i.e. to a referendum. Even though the holding of a referendum prior to admission to NATO is a practice in all countries, there is an additional need for this in our country because of the NATO air campaign in 1999, due to which current support among the public for membership in NATO is much smaller than support for membership in PfP.

### **The international community's policy of setting conditions**

When reviewing the policy of setting conditions which has been applied by the international community so far in the previous course of the transition, one should observe separately the political conditions and the conditions linked to economic policies and institutional reforms.

When speaking of the setting of political conditions after the launching of the process of political and economic transition, one must bear in mind the fact that, until October 5, 2000, there was a regime of sanctions imposed against Serbia, one that was regulated by the law, by both UN Security Council resolutions (ban on arms trading in March 1998) and on a bilateral basis by certain countries or groups of countries – the economic sanctions which the Contact Group countries (except Russia) introduced against Serbia, the US president's executive order blocking all the property of the FRY government in the US and banning new investments in the FRY, expanded by a new one, banning all imports and exports between the US and FRY, then the ban imposed by the US Congress on granting any kind of financial assistance to Serbia, except assistance for democratization, the freezing of the funds of the FRY and Serbian government in the EU countries, as well as the ban on new investments (later expanded to include a ban on exports of goods, services and technologies that can be used for the repair of the infrastructure or equipment damaged in the NATO air strikes). The ban on the sale of oil was also in force, while the blocking of funds was expanded to include approximately 800 individuals on the visa-ban list, as persons connected with the Milosevic regime. Ten years of the setting of political conditions which was applied in the course of the 1990s obviously left a trade on the policy which the international community applied towards Serbia after the democratic changes – both because of the established picture about Serbia and its citizens, for the change of which it will take time

and perseverance on the reform course, and because of inertia, which can very often be a powerful factor in the definition of policies.

After the October change of the regime, most economic restrictions were immediately abolished – the European Union lifted without delay all the sanctions against the FRY except those against former president Milosevic and persons close to him (the embargo on oil imports and the flight ban in the FRY were immediately abolished, but it took some time for the other sanctions to be lifted), while the US lifted the ban on oil imports and on flights to and from the FRY, it allowed financial transactions and the opening of new accounts in the US, as well as American investments in the FRY, but without fully withdrawing the previously introduced executive decrees. Nevertheless, the restrictions on granting economic assistance by the US remained in force, since they became an integral part of the law on the awarding of assistance, and as such, they became a permanent instrument of the setting of political conditions for economic assistance. The economic, as well as political relations with the EU which, in the long run, represent a major source for setting conditions to the SCG, since the promotion of relations with this organization is Serbia's priority orientation, are defined by the Stabilization and Association Process, so they will be reviewed within the analysis of the position of FRY/SCG in this regional instrument of the European Union.

The first concrete opportunity for changing the US policy of setting conditions was on March 31, 2001, as the date envisaged by the Law on awarding assistance to foreign states for the fiscal year of 2001 for the US administration to certify that Serbia had met the conditions set by this Law. They include: cooperation with the Hague Tribunal, improvement in the sphere of human rights and a reform of the judiciary, as well as the termination of financial, political, security and every other support to Republika Srpska. By the deadline envisaged by the law, any process that could be verified was totally lacking in the sphere of cooperation with the Hague Tribunal (ICTY).<sup>12</sup> Faced with the US intransigent stand regarding the ICTY, in the night between March 31 and April 1, the authorities in Belgrade arrested Slobodan Milosevic and took him to the Central Prison in Belgrade where, two days later, he was charged with corruption and abuse of office. This was sufficient for the US administration to certify that Serbia had fulfilled all the conditions envisaged by the Law on awarding economic assistance and for Serbia to qualify for another 100 million dollars worth of assistance. The next three months were characterized by pressure on Belgrade to extradite Milosevic to the Hague Tribunal. The issue

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<sup>12</sup> Only Blagoje Simić, former officer of the Republika Srpska police, charged with ethnic cleansing in Bosanski Šamac, left for The Hague, following his voluntary surrender.

of extradition and cooperation with the Tribunal in general awoke the already existing differences between President Kostunica and Serbian Prime Minister Djindjic, this complicating the creation of political support for cooperation, but also for the successful proceeding of economic and political reforms in general. As the donors' conference scheduled for June 29 was approaching, it became clear that the US would not participate in it unless Milosevic was in The Hague by then, and that the EU would participate, but would not give the promised funds if cooperation with the ICTY was lacking. In the light of these facts, the Serbian government assumed responsibility and extradited Milosevic to the Tribunal in the evening of June 18, thus ensuring the success of the donors' conference which was held the next day in Brussels.

However, similar conditions were envisaged for economic assistance in 2002 as was the case with the preceding year, which meant the need for a new certification by the administration on March 31, 2002. As progress failed to be made again, the certification was postponed, and American representatives, in both the International Monetary Fund and the World Bank voted against the credits granted to Serbia in this period. Their objection, however, was passive – they did not actively lobby against the granting of funds to Serbia and it was clear that at issue were political reasons, i.e. that the US law obliged them to act in such a manner. The situation, however, changed in regard to acceptance of cooperation with the Tribunal as an obligation that must be carried out – the Law on cooperation with the Hague Tribunal was adopted on April 11, 2002 and indictees started voluntarily surrendering, which made it possible for the US administration to certify that Serbia was fulfilling its obligations and that it, thus, qualified for a new tranche of economic assistance and active support in international financial organizations. At the same time, however, with the renewal of the certification, it was stressed that American pressure would continue until the Tribunal's Office of the Prosecutor is provided with full access to SCG archives and until General Mladic is brought to justice.

Less than two months without American certification in 2002 were actually the only period of the formal denial of support until March 31, 2004. Meanwhile, in May 2003, the US president's executive decrees imposing emergency measures against the SFRY were abolished and all similar decrees were withdrawn, as a result of the progress achieved in the political and economic transition and due to the strong resoluteness in persevering on the road of reforms demonstrated by the country's leaders. In November 2003, the status of normal trade relations with SCG, abolished back in 1992, was renewed. This additionally emphasized US support for the reform processes

in the country<sup>13</sup> On March 31, 2004, US Secretary of State Powell said that Serbia did not meet the criteria envisaged by the Law on granting assistance to foreign states in 2004, i.e. that it was not cooperating with the Hague Tribunal, which meant that the unused portion of assistance for that year (16 million US dollars) would not be able to arrive in Serbia. The Law on granting assistance for the fiscal year of 2004 mentioned for the first time, along with full cooperation with the Hague Tribunal, also the arrest of General Mladic. In January 2005, the continuation of non-cooperation led to even more dramatic measures: 10 million dollars worth of assistance for the fiscal year of 2005 were frozen, even before certification, which, due to the belatedness of the legislation regulating the granting of assistance to foreign countries, is not accepted before May 31 this year. Apart from the freezing of these funds, an additional 73 million US dollars were redirected from assistance envisaged for the government to organizations and programs which are not managed by the government. Soon after the US introduced partial sanctions, the Serbian government's intention to fulfill its obligation towards the Hague Tribunal became clear. A large number of indictees (12 from Serbia and 2 from Republika Srpska) voluntarily surrendered to the Tribunal, thus qualifying for receiving the Serbian government's guarantees for being released pending trial. The number of remaining fugitives is nine, and they include General Mladic. The funds of ICTY fugitives were frozen and good cooperation was established between the ICTY's Office of the Prosecutor and the Special Court for War Crimes, this opening up the possibility for this court to take over certain cases.

As regards the direct conditions set by international financial institutions during the first four years of transition, these conditions were always of an economic, i.e. reform nature, and never of a political nature. In other words, the conditions were linked to the nature of relations with the corresponding institution. In accordance with this, they were the subject of talks between representatives of both sides, like, for instance, the IMF's conditions concerning concrete macroeconomic policies to which the domestic authorities agreed and they demonstrated this by signing memorandums on understanding.

Even though the political conditions set by the US also included the threat that they would vote against arrangements with international financial institutions (primarily with the IMF and World Bank), these threats never came true, and even when they did, as could be seen in the previous text, they were very clearly motivated by political reasons, but not by the desire not to offer economic assistance to SCG. Although US representatives voted against

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<sup>13</sup> In view of the modest scope of trade between Serbia and the US, and especially the modest scope of Serbian exports, this move was primarily of a symbolical, i.e. political significance.

the arrangements, they did not lobby among representatives of other countries to vote against as well, but rather made it clear that they voting was determined by internal political reasons, this being a clear signal to other countries that they should not vote against the arrangements.

The policy of setting conditions, which the international community carried out after the democratic changes in Serbia in October 2000, mostly focused on two issues – the issue of cooperation with the Hague Tribunal, which was dominant, and the issue of relations between Serbia and Montenegro in the joint state. The condition to define the relations between Serbia and Montenegro in the joint state was largely prompted by the desire to receive a correct answer to the question of who is responsible for the fulfillment of obligations that would result from contractual relations with a certain international organization, be at issue membership (Council of Europe) or the Stabilization and Association Agreement (European Union). However, despite this practical motive, part of this setting of conditions was prompted by the desire to preserve the credibility of the EU, i.e. to avoid the „humiliation“ of the high representative for the foreign and security policy, who mediated in finding a solution for the relations between Belgrade and Podgorica.

The situation is somewhat different regarding the conditions that concern unhindered cooperation with the Hague Tribunal, and which can be viewed at least on two levels. The first one, just like the issue of Serbia and Montenegro, is functional and it concerns the question of how other contractual obligations would be fulfilled if the legal obligation of cooperation with the Tribunal is not respected. Nevertheless, the this motive is not excessively convincing, especially when one sees how big a political attention is devoted to this issue. Such heavy „political artillery“ is not used for achieving something that is only of an instrumental value. The second concerns the promotion of certain values that are considered crucial for the cohesion and identity of the present-day international community, and which would be disrupted by agreement to the non-punishment of serious violations of international humanitarian law committed in the war conflict over the previous decade. Of course, one should not exclude the existence of certain other political motives, but the further review of these motives would exceed the needs of this paper.

When observing the policy of setting conditions applied by the international community, one can say that, in the case of Serbia, it was largely efficient, i.e. that it prompted the authorities in Belgrade to fulfill certain obligations towards the Tribunal. Of course, very important for this fact is

also the condition-setting applied by the European Union, regardless of the differences in the manner in which the conditions are set, since this creates unity among all the factors of importance for the success of transition in SCG. Another thing that must be noticed in regard to the setting of conditions by the US is the absence of a general legal framework, which would offer predictability to the setting of these conditions and would make it possible for this policy to be understood in Serbia as the promotion of certain values, instead of the simple implementation of certain conditions towards Serbia and Montenegro. The conditions that are defined at the annual level (through US legislative bodies regulating the granting of assistance to foreign states) and the addition of new ones often seems like the placing of a „mobile target“, and does not originate, as is the case with the conditions set by the European Union, from a clearly defined approach to a certain group of countries with similar political security and economic problems. Apart from the fact that a legal framework is lacking, one should also emphasize the role of Congress - since the conditions are incorporated into the legislation regulating the granting of assistance to foreign states, and which is adopted by Congress, of great importance is the possible influence that could be borne on Congress by members of the media, international non-governmental organizations and the public opinion in general, as well as groups for exerting pressure, which aspire towards the realization of certain political goals. In the case of the condition-setting applied by the European Union, it is the European Commission that decides whether or not the conditions have been fulfilled, and it does this on the basis of a report of its mission in that country, regular annual reports, technical talks with the government and representatives of the civil society in a certain country. And finally, even though, among bilateral donors, the US is the motor of the policy of condition-setting, much more important on a long term basis is, nevertheless, the setting of conditions by the EU. More than an understanding that the EU offers Serbia much larger funds than the US, such a stand is primarily the result of the fact that drawing closer to the EU is not only the SCG's foreign policy priority, but it is also, precisely through the implementation of the policy of setting conditions, the „inciter“ of perseverance on the road to political and economic reforms. In view of this fact and the previous progress achieved in cooperation with the Hague Tribunal, the US setting of conditions would probably not be sufficient if the EU pressure had not gone in the same direction as well.

Regardless of the nature of the condition-setting, it is necessary to point out that the answer to the question as to whether it was effective in the case of

FRY/SCG, as least from the standpoint of operative goals, could be positive. Without the international community's pressure concerning cooperation with the Hague Tribunal, it is unlikely that indictees would have been extradited, especially in this number. Somewhat less successful was the pressure directed towards the redefinition of relations between Serbia and Montenegro – under the pressure of the EU, the Belgrade Agreement was reached, i.e. imposed, but further pressure by the EU and the Council of Europe did not result in a functional state, but rather the European Union gave in and, speaking in the language of SCG politicians, „accepted the specificities of the state union“, having offered the twin-track approach, i.e. separate talks on economic issues for Serbia and Montenegro.

No matter how successful condition-setting may seem, the question being asked is to what extent did it essentially manage to prompt the promotion of certain values, and to contribute to the establishment of equal partnership relations with the international community to which we are aspiring. For example, there are opinions that the pressure that was applied did lead to extraditions, but not to a comprehensive reexamination of the events from the previous period and the role of Serbia in them. Simply speaking, the perception has been created that it is necessary to fulfill certain conditions, without an essential understanding of why this is being done, except for the need to continue with integration into international organizations. The truthfulness of the previous conclusion is best illustrated by the change of the Constitutional Charter for the purpose of having the Feasibility Study approved: as of the end of February deputies with no mandate sat in the SCG parliament, without this provoking a debate on the non-existence of the rule of law and the illegitimacy of the decisions being taken by this body. The decision to change the Charter was made public two days before it was signed, without any public debate, without much thought being given to the fate of the state union and with the understanding that this is being done in order to create the conditions for the Study to be approved.

The responsibility for such a situation lies with the actors in the SCG, but in the international community as well. The actors in SCG missed the opportunity to work on the resolution of problems of crucial importance for the future of our society without pressures from the international community. International organizations, for their part, missed the chance to react in a more positive manner to the first steps from this side, so as gradually to turn the SCG into a responsible, equal partner. Instead, the naked policy of exerting pressure continued, which did not allow the authorities in SCG to show the

citizens that a cooperative attitude led to a change in the international factors' stands, and not only to new conditions. Perhaps the best example is admission to the Council of Europe which, if it had taken place earlier, would have quite certainly been a positive sign for both the authorities and the citizens in SCG. One could not say that essential progress had been achieved in the economic and political reforms in the period between autumn 2002 and spring 2003, when we were finally admitted to this organization, but the death of prime minister Djindjic, which gave rise to fear that the situation in Serbia would deteriorate, resulted in the awareness that it was better to include SCG into the CoE and thus to show that the previous results were appreciated and supported, and also to acquire, through the obligations that needed to be fulfilled following admission, the possibility of overseeing the further development of the situation in the country.

It was precisely fear of a possibility deterioration of the situation that led to an understanding in international organizations that it was necessary to support the reform steps that were being taken in SCG, even when there is awareness that a lot more needed to be done. This could explain the more flexible attitude of international organizations towards the government of Prime Minister Kostunica – the guarantees of this government were accepted and six ICTY indictees were released pending trial, even though the obligations towards the Hague Tribunal had not been met. Something similar applies to the European Union which, after long insistence on the full harmonization of the economic systems of Serbia and Montenegro, which was an obstacle to the approval of the Study at the time when cooperation with the Hague Tribunal was not specified as a problem, enabled separate talks on economic issues through the twin-track approach. These positive signals lent support to the position of the government in the country and opened up space for it to make new moves which will accelerate the country's international integration.

### **Evaluation of integration into the international community achieved so far**

The previous course of Serbia's integration into the international community can be evaluated from a number of aspects. The simplest and, in a way, the most superficial approach is quite certainly the viewing of the flow of money, i.e. the total net inflow as a result of the process of integration into the international community.

Table 1. Realized grants and credits (in millions of €)

Year	Grant	Concession credits	Total
2000	187	0	187
2001	593	270	863
2002	554	263	818
2003	430	288	717
2004	144	431	575
<b>Total</b>	<b>1,907</b>	<b>1,252</b>	<b>3,160</b>

Table 2. Structure of the inflow of funds  
(grants and credits, in millions of €)

Year	2000	2001	2002	2003	2004	Total
International financial institutions	0	33	244	253	407	937
European Union	43	472	315	222	22	1,074
Bilateral arrangements	144	357	259	242	146	1,149
<b>Total</b>	<b>187</b>	<b>863</b>	<b>818</b>	<b>717</b>	<b>575</b>	<b>3,160</b>

The large inflow of funds from abroad in the period after the autumn of 2000 made it possible for our standard of living immediately to be above anything which exclusively domestic productivity would enable. It is for this reason that the average net wages in Serbia are still somewhat above the average net wages in countries that are to enter the EU in less than two years (Romania and Bulgaria). Such a standard of living can, in principle, be encouraging for a radical economic reform, primarily the restructuring of the real sector. However, in conditions of the population's enormous expectations, inadequate management of these expectations and the absence of a radical break with the philosophy of workers' self-management, in which the worker-managers constantly keep requesting higher salaries believing that they were entitled to them, this advantage has simply not been made use of until now.

Serbia's crucial problem lies in the fact that there is no national consensus in regard to international relations, i.e. the strategic national goal in this area. Even though accession to the EU is, nominally, sometimes stated as such a goal, there are obviously very significant differences among the leading political

forces over this issue. This is all the more so since an understanding of what it is that admission to the EU actually means is still not wide-spread in Serbia. It is precisely on the basis of this lack of information that party-political games are being played. Namely, public opinion polls show that a large part of the population (almost  $\frac{3}{4}$ ) support the idea of joining the EU. However, it has transpired that a large portion of this population which supports accession to the EU sees this accession primarily as benefits that will come from it, predominantly in the sense of a higher standard of living. Very little thought is given to all the changes that need to be made in order to achieve a higher standard of living in a market economy.

It is precisely on the lack of this link that many political party see the possibility of increasing their popularity by referring to the idea of European integration, on the one hand, but without doing anything to change these ideas, on the other, especially not in regard to the economic reform which is to introduce a market economy, a firm budget restriction, limited and strictly controlled subsidies and an effective protection of private ownership rights.

Nevertheless, the large popularity of the idea of European integration and the still expressed desire of the EU to be actively included in the reform processes in Serbia which are to lead to full membership in the Union offers certain advantages. In conditions in which there is no strong, consistent and sustainable driving force for the economic and political reforms in the country, integration into the EU can become precisely such a force. Namely, if accession to the EU is made conditional on well and precisely specified requests in regard to the economic and institutional reform, such reforms can obtain their driving force, which Serbia obviously lacks at this moment. Therefore, the reform moves which inevitably lead to a drop in the political rating of the government, i.e. the ruling parties, can be politically justified by the need to integrate into the EU, which is still a dominant political value, and the non-flexibility of the foreign partners.

Furthermore, the authorities' devotion to the project of integration into the EU, due to its large political value, can also serve as a mechanism which will be used to demonstrate to all the sides and to domestic partners devotedness to certain policies, i.e. constancy in their implementation, which is especially important from the aspect of the confidence of private (foreign and domestic) investors. In the case of the EU, two preconditions are necessary for this. The first one is the precise definition of policies expected of Serbia, which can partly be expected in the future Stabilization and Association Agreement,

although this agreement encompasses only a smaller part of reform economic policies, i.e. elements of an institutional reform. The second is the resoluteness of the EU itself to continue along the road of supporting Serbia's integration into the EU. This second precondition could come under a question mark after the latest debate on the future of the EU, following the admission of 10 new members in 2004, the failure of the referendum in France and the Netherlands, and the mood of the public in the EU countries opposing the admission of new members.<sup>14</sup>

A similar mechanism is also the political will to maintain good relations with the IMF and, as part of this, successfully to complete the existing arrangement, whose completion is to lead to the write-off of the remaining 15% of the debt to the creditors of the Paris Club. In this sense, certain reform moves represent the government's obligation towards this international financial institution, so that certain difficult decisions can be presented to the domestic electorate in this manner.

In this sense, devotion to further integration into the international community (political and financial) represents a signal of the government's resolve to implement certain macroeconomic policies, i.e. to carry out the necessary reform moves, which is very important when foreign investors are deciding to invest in our country, i.e. when domestic private investors are thinking about embarking upon investments. This offers credibility to certain economic policies, i.e. to the authorities' devotion to these economic policies and their consistent implementation, i.e. it increases the likelihood of a change of power not leading to a change of the economic policy.

A certain problem regarding international relations, especially in the sphere of integration in international economic and financial structures, is also the insufficient domestic capacity to follow this integration, primarily the lack of administrative capacities. This is the result of the insufficient number of competent people, insufficient level of training for jobs of this type and insufficient stimulation for training and for attracting new, adequate personnel for jobs in the state administration. An indicator of the insufficient administrative capacities of this type are the unexpectedly poor results of the financing of World Bank projects, such as those focusing on the modernization of the customs service.

The result of this lack of administrative capacities, i.e. human capital allocated in state services, is also the fact that international institutions, i.e.

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<sup>14</sup> According to the results of public opinion polls in the EU15 countries, only 40% support the membership of Serbia and Montenegro in the EU.

foreign partners are in the position to impose an agenda, since the domestic side is simply not an equal interlocutor. For this reason, imposed have been not only certain solutions, but also reform topics, especially in the sense of defining the priorities.

Finally, one can say that the domestic consensus on the need for integration into the world, which existed at the beginning of the transition process, has disappeared in time and that a division of society is appearing and, apart from the component of interests, it also has an important ideological component. This is the result of the fact that the political forces which was are, out of their own interests and for ideological reasons, against integration, had calmed down for a certain period of time, only subsequently to return to the political scene, with more or less modified interest-related i.e. pure ideological xenophobia.

In all this, so far there has been no high degree of the articulation of private interests as public ones in the process of our integration into the international community, except in those cases in which such integration was linked to the foreign trade regime, primarily the regime of imports, i.e. the regime of the protection of domestic production.

As regards the guidelines for the future of Serbia's integration into the international community and the impact of this integration on the transition process in the country, one could take as a point of departure the fact that, at this moment (and in some foreseeable future as well), association with the EU is the main driving force of our reform. The harmonization of laws and the adequate regulation of the institutional framework represents the main elements of this reform. This concept leads to the resolution of several problems since the reform then presents itself as both a political need and as a value, even an instrumental one in the sense of realizing the basic value called European integration. Of course, at issue here is not the notion that the EU institutional framework is an ideal one and that the policies being implemented are optimal. There is no doubt that there is too much state interventionism in the EU, too much regulation and discretionary decisions of supra-national authorities which are practically answerable to no one. The separation of authorities and responsibilities never produced good results. The space for a free market, unhindered individuals and entrepreneurial initiative is narrowing down. However, drawing closer and finally integration into the EU makes it possible to obtain a clear and consistent regulatory framework with (in many solutions) decades-long experience in implementation, so that there is no need to invent hot water. Moreover, in conditions in which there

is still a strong political majority in favor of European integration, it is within the framework of this integration that it is possible politically to push through many changes under the motto „We must do this if we want to enter Europe“. Nevertheless, space for domestic creativity does exist, primarily in the manner of implementing such reforms, its dynamics and priorities.

A priority on the domestic plane is quite certainly the creation of a competent state administration, a nucleus which will be able to communicate on a more or less equal footing with representatives of international political, financial and economic institutions. Without such an administration Serbia will simply not be able to impose its own interest in the field of international relations.

This leads probably to Serbia's biggest problem, not only from the standpoint of international relations and further integration into the international community, but also from the aspect of the success of transition on the whole. At issue are the limited human resources which Serbia disposes of: a small number of competent people. Even if good and promising people are successfully attracted to the state administration by adequate benefits, this means that the private sector will be left without such people. Nevertheless, it seems that the biggest problem of present-day Serbia is the equilibrium allocation of the very limited resources called smart people.



Slobodan Samardžić

## Basic Issues of the State

### CONSTITUTIONAL ORGANIZATION OF SERBIA

Serbia stands as a unique example of transitional country in which changes across the state, society and economy keep taking place without relevant constitutional changes in the background. Some transitional countries, and successful ones, have not completely revised their constitutions after the fall of the old regimes, but they rather changed some parts of their old constitutions – mainly those which were necessary to enable establishment of political pluralism and parliamentary systems. It was only later that those countries, their institutions strengthened, engaged in implementation of changes in other domains (Hungary and Poland are typical examples of such approach). However, a great majority of those countries did carry out complete revision of their respective constitutions immediately following the establishment of political pluralism, or immediately after their first free elections.

It is a widely known fact that transition-wise, Serbia lags behind by at least ten years. The reasons for this delay are also well known. It is more difficult, however, to grasp the reasons why, five years after the political changes, Serbia has done nothing to change a single article of its constitution, the one designed by the former regime that had practically identified itself with it.

#### **The period immediately following the changes – absence of constitutional policy**

There were several underlying such constitutional situation in Serbia after the October 2000. All those reasons, as we shall explain in short, proved to be stronger than the explicitly stressed intentions of the opposition to put the

final touch to the overturning of the undemocratic regime by implementing a thorough constitutional change. When the political change had already been made, the constitutional enthusiasm of revolutionary kind dried up in the sand of everyday problems, and shortly after that, the political agreement among the winning parties disappeared. Still, the question is what the reasons for the delay were.

Firstly, the existing constitution was, in some of its parts, applicable in the newly generated situation. The part concerning the organization of government that was based on the constitutional principle of power division guaranteed normatively some kind of rationalized parliamentary system which could, together with the provisions of constitutionality and legality also normatively stated in the constitution, offer an acceptable solution for the period of transition. Whereas in Poland and Hungary there was an urgent need to change their constitutions regarding those provisions in the name of constitutional democracy, there was no such need in Serbia. Under such constitutional provisions, Serbia went to parliamentary elections twice already (in December 2000 and three years after that) and to presidential elections three times. For the presidential elections, however, the legislator did intervene (in 2004), since there had been no constitutional provision in case of failure to elect president, which had happened two times before (in the autumn of 2003).

The second reason for this pragmatic forgetfulness about constitutional changes resided outside of Serbia, in the unresolved issue of the two-member federation, with Montenegro's unexpected disloyalty to the federation in the post-Milosevic period. The ruling political agents in Serbia were genuinely inclined to resolve the federation issue in a fair and constitutional way, only to constitutionally organize their republic as constitutional residue soon after. Owing to a serious constitutional crisis of the federation, the process lasted until February 2003, when the Constitutional Charter of Serbia and Montenegro was finally adopted.

Alongside the federation crisis, another political crisis unfolded in Serbia itself. It first jeopardized and then entirely eliminated any possibility of strategic coordination and agreement among the new opponents that grew out of the once united forces of change. That phenomenon can be taken as the third important reason behind the lack of any successful constitutional policy in Serbia. At that level (the level of constitutional policy), the divisions within the then ruling coalition could be observed when the first initiative to change

Serbian constitution was put forward. That initiative (in April 2003) suffered a massive contradiction. It concerned the actual procedure of passing a new constitution. On the one hand, a decision was made to instigate a constitutional break (discontinuity), i.e. to establish a new procedure by legislation (therefore, not constitutionally). The intention was to revive the already torn ties with the revolutionary situation, in which the legitimacy of such a maneuver would have been taken for granted. On the other hand, the whole new procedure only relied on a series of simple majorities guaranteed by the parliament structure, the parliament being the body that was to turn into the sole constitution maker. Thus: the Law on the Procedure to Change the Constitution (May 2003) was passed by the majority of all MPs in the Serbian Parliament; the structure of the newly formed Constitution Committee mirrored the party structure of the Parliament; all decisions made by the Committee were passed by the majority of its members, even the unfulfilled decision on the proposed draft; finally, the parliament was also supposed to adopt the proposed draft by the majority of its members. The above mentioned paradox showed itself in the fact that the presupposed revolutionary will of the majority, that was the only means for justifying the constitutional break, got to be simulated in a series of illegitimate parliamentary majorities in order to achieve such a far-fetched aim. The revolutionary constitution was supposed to be passed by the Parliament in a procedure normally used to pass systemic laws. The ruling parties lapsed into this paradox primarily owing to their divisions. The smaller fraction, that became the opposition, could not provide a comfortable majority in the Parliament any more in order to pass the decisions that would legitimize the constitutional break. The irresolvable issue of squaring the circle befell the remaining tight majority in the Parliament – they were to keep, even renew, the legitimacy of the constitutional break and do so by means of minimal majority.

It is necessary, though, to mention yet another reason that caused the absence of an adequate and focused constitutional policy in Serbia during the rule of its first transition government. It is the phenomenon that could be called ‘reformist practicality’. In the daily array of huge reformist enterprises – macroeconomic policies, privatization, foreign aid, donations and loans, sector reforms and all, the institutional bearings was lost. What missed was simultaneous building (or rather, reform) of the systemic frame that would provide support and adequate control for the ever-growing weight of the reforms. Without any changes in the domains of public administration and the judiciary, numerous reform laws were but a torrent that flooded over

the river-bed. If we add to that the chaotic parliamentary situation and the absence of systemic decentralization, then it becomes clearer why rational administration of power was impossible. Whether the lack of constitutional changes was the cause or the consequence of such a state of affairs remains to be more deeply analyzed. However, what is likely is that the spontaneous spirit of reformist practicality had neither ear for nor real interest in bringing forth a new constitution. On the contrary, from its standing-point of churning reforms, that spirit viewed it as unnecessary waste of energy and time.

### **Renewing constitutional policy under changed conditions**

After the first transitional government's failure to bring forth a new constitution, the second government (that took over on 4<sup>th</sup> March 2004) made this issue its priority. By the end of March 2004, the Parliament passed the decision on starting the procedure to create and adopt a new constitution for Serbia. The Parliament also authorized its Committee for Constitutional Matters to prepare a draft. Several months later, the Government drafted its own proposal and directed it to the Committee as "a possible view of new constitutional solutions for Serbia, that could be used by the Committee...as basis for drafting a new constitution for the Republic of Serbia" (quoted from the accompanying comment).

Several points can be observed here. Firstly, the constitutional procedure to change the constitution was re-established (Art.132 and 133 of the existing Constitution), which means that the matter was brought back into the domain of constitutional continuity. )In the meantime, the Law on the Procedure to Change the Constitution was put out of force as unconstitutional by the Serbian Constitutional Court). However, that, given the content of the above mentioned Articles of the Constitution, requires the policy of constitutional consensus and not the policy of constitutional differentiation, which is, as a rule, an act of political arbitration. The presently valid procedure to change the constitution assumes acceptance by a two-third majority in the Parliament (in two instances of voting) and the acceptance by a half of the total electoral body, as necessary requirements to adopt constitution. Such a procedure practically imposes the constitutional policy of consensus that, as a rule, begins among the parliamentary parties and then spreads into a broader social consensus. In other words, instead of the revolutionary constitutional policy, we now have, so to say, a regular constitutional policy.

The fact that the parliamentary decision on making a new constitution was passed by a qualified majority provided for the legality of the steps to be taken in this matter. The above mentioned Government's Draft Proposal made an effort to meet the future consensus, as it subsumed parts of a number of proposals made in the period 2001 - 2003. At one moment, it seemed possible to fulfill two tasks in one go. First, to adopt the constitution as soon as possible, which was a general requirement of the second reforms wave; then to fulfill the requirements concerning the policy of stabilization and joining the EU stated in all the annual reports of the European Committee, as well as the strictly formal requirement on the necessity to harmonize the constitutions of the member-states stated by the Law on Constitutional Charter of Serbia and Montenegro (Art.20.2). The second task was to make and pass the Constitution following an extraordinarily demanding procedure.

The problem sprang up at the procedure level, not on the level of negotiating the text of the draft. At one point, the subcommittee of the Constitutional Committee was presented with a completed draft proposal (by the President of the Republic and the Democratic Party), which assumes a different procedure to pass a new constitution. The draft actually represents an initiative to summon a constitution assembly as new and authentic constitution-making body. The initial consensus was thus disturbed and the whole procedure entered a blind alley.

At this moment, the main problem is the fact that the constitutional issue has become a political issue, just one of many current political disputes in the country. At the end of the day, it is an objective risk of the negotiation policy. Such a policy cannot step out of the daily political arguments, primarily between the political parties. The question remains whether the parties would find strength to rise above these daily political clashes to prevent this issue disappear in the melting pot of daily politics. It is quite certain that the importance and urgent need to create a new constitution demand that the political parties invest such an effort and show higher degree of political responsibility.

### **Choice of constitutional solutions for Serbia**

When the two existing drafts presented to the parliamentary Subcommittee are compared, marked similarities and minor differences can be noted. (The case is not the same with many draft proposals coming from the non-governmental

sector or from individuals.) That fact clearly tells us, provided there was an elaborately coordinated constitutional procedure (which was believed to have been achieved until recently), that Serbia could have its constitution fairly soon. We shall not, however, discuss the contents of these two drafts at this point, but the deep dilemma of constitutional choices for Serbia. We shall also limit our discussion to the issues of material constitution, bearing in mind that the procedure of making and passing the constitution represents an authentic constitutional choice in itself.

Choice of constitution in a country that has gone deep into the transformation processes is neither an act of will nor of chance. (Constitutional) choice is not actually a matter of choice. If anyone holding political authority and/or power tried to impose an example constitution, (i.e. a constitution that follows an existing pattern) – that would be an act of utmost political voluntarism. It should not be particularly stressed that a constitution is not (merely) a written document, but, above all, a legitimate (generally accepted) frame for overall management of a society and its state. In a situation when there is a politically articulated and accepted need to transform the society and the state, a new constitution, that should provide a legal frame and secure the direction of such transformation, should also fulfill two basic criteria: firstly, it should be rooted into the lasting structural features of that society, and secondly, it must direct that concrete society (not some abstract one) towards the desired changes and prescribe the best normative and institutional mechanisms to that purpose.

Talking of Serbian constitution, it is clear that it has to undergo a thorough and complete reshaping. In principle, it is possible to achieve that in a few steps of constitutional revision, but if there is public agreement on the need for its total change (and such agreement exists in Serbia) then such a change should be implemented.

Following the line of constitutional parts, we shall try to sketch the elements of constitutional choices for Serbia:

- a) *Constitutional principles (basic provisions)*. In this symbolic and declarative part of the constitution it is necessary to establish specific balance (that would be valid for Serbia itself) between the universal principles of modern constitutionalism (such as respect for fundamental rights, power of law, civil sovereignty, power division, secular character of state) on the one hand, and the specific principles of Serbian statehood tradition (preservation of state continuity, symbols of state, language and script in

public usage) on the other. It is indispensable that inner consensus be achieved on these matters not only between the political parties, but with the representatives of ethnic minorities, i.e. different ethnic communities in Serbia.

- b) *Fundamental rights and freedoms.* In this part it is necessary to apply the usual constitutional standard of modern and contemporary constitutionalism both in the area of rights and freedoms and in that of constitutional guarantees for their practicing. Special attention should be paid to the hierarchy of immediate constitutional protection of fundamental rights and freedoms and additional legal regulations if needed. It is also necessary to accept the constitutional principle of immediate applicability of human and ethnic rights guaranteed by the international law.

This specific feature of our constitutional system to guarantee and protect fundamental rights and freedoms is represented in the category of ethnic minority rights. They should be part of the whole system of rights, but in the constitution they should be defined in a specific way, alongside basic human rights. According to the draft proposal, those rights should be defined as rights of the members of specific ethnic communities living in Serbia, and not as rights of specific collective entities. Apart from that, their constitutional expression should be both positive - the right to preserve ethnic identity and to practice privileges of public life - and negative - any form of discrimination must be forbidden.

- c) *Economic organization.* This part of the constitution should define the foundations of the economic organization of Serbia. From the viewpoint of defining constitutional norms, it should be based on economic liberties (liberty to work and found companies, as well as the principle of market competition, free flow of goods, capital, workforce and services). Apart from that, it is also necessary to define basic economic institutes (property, market, competition) and institutions (national bank, financial court). The basics of public finances - budget, income, revenue and expenditure, public debt - should also be constitutional regulated in accord with the provided system of decentralized public administration (therefore, on the respective levels of republic, province, city and municipality).

Having in mind the need for strategic reform of the economy on liberal principles, it is not advisable that the state take over large responsibilities in the area of specific social rights and policies. For this particular purpose, it would be enough to underline (among others) the principle of social justice. In the specific conditions of transition, the state will definitely

have to face and deal with numerous social issues, but this domain of its activities is not necessary to regulate by strict constitutional provisions; legal regulations based on the principle of social justice and some specific social rights are quite sufficient for that purpose.

It is quite obvious that here we are talking a normative and general, but still precise and concise constitutional definition of the economic organization of Serbia. It reflects a commitment that economic life should be run by those who participate in it, without being excessively normative, especially not on the constitution level.

- d) *Administration organization.* Serbia must create for itself a system of administration that will be the function of democratic governance of the country throughout a long-term process of transformation. In this part of the constitution, the requirement that constitutional solutions must take care of lasting features of the present situation should probably be the most dominant. One of such features is the coalition structure of the government, which is a result of the still unstable party system in the country. Comparative practice shows that the most stable political systems are those in which governments are formed by a single party, and in case of coalitions, then two-party governments are sufficient for political stability. As a rule, governments formed by three or more parties are not stable. Serbia is facing exactly that kind of situation, and it will probably do so for a longer period of time.

The most convenient administration system under such (lasting) circumstances is the presidential-parliamentary system. Serbia is under no condition in a position to introduce a presidential system that would be both democratic and operative at the same time. Even a semi-presidential system (like the one in France) would present Serbia with a challenge of prevalent amount of power in the hands of one party-leader who would be the president of state, which could easily turn into usurpation of power in likely crises. Due to its lasting political circumstances, Serbia must have a mechanism of balanced legislative and executive power built into its system. How is that to be constitutionally achieved?

The existing political pluralism in Serbia cannot provide for a clear relation between the government majority and oppositional minority on a long-term basis. Being such a complex coalition structure, the government will incessantly strive to maintain its parliamentary majority, and will, therefore, have to make constant concessions to smaller parties within itself. Smaller parties will, consequently, get a greater specific weight then,

which is not favorable for regular political activity. In regard of that, the opposition will always have smaller government parties up their sleeve, and be in position to put all sorts of conditions to the government. That is, the government can easily fall on the basis of an *ad hoc* silent alliance between the opposition and one of the smaller parties. However, viewing it from the system's angle, that does not solve the problem of weak government, as in such circumstances the parliament is not strong either. If the government did fall by some chance, the coalition structure in itself would not guarantee a different situation even after new (extraordinary) elections, as the situation would just repeat itself in the mandate of some other government. The point is that the issue of lasting balance cannot be resolved on the level of parliament-government relation.

A systemic solution can only be the constitutional introduction of a stronger president of state. The constitution must, therefore, equip him/her with the tools to use in mediating between the parliament and the government in cases of crises. First of all, the president of the state must have legitimacy and authority of the state organ elected in direct elections. That would enable the president to address the parliament (and therefore the nation) when he/she considers it necessary, as the nation's (and the parliament's) immediate representative organ. Then, he/she must have the right to veto the laws passed by the parliament; this right should be reinforced by a provision on a more qualified majority in the instance of repeated voting on such laws. Finally, the president of the state should have the right to directly influence appointment of one-third of the Constitutional Court judges. Such tools would give the president sufficient constitutional authority to influence the relation between the government and the parliament in critical situations. This kind of authority is smaller than that of the president in semi-presidential systems (in which the government acts quite independently of the president), but it is also large enough to make the president able mediator in the state.

In Serbia, the above presented solution may function only if the president is sufficiently neutral political figure. If politically biased, that would be fatal for the constitutional purpose of his/her position, regardless of whether his/her bias would flick the tip of the scales towards the government or the opposition. At this point we face a grave problem, as such personalities are hard to find, in Serbia and in more mature European democracies alike. The only constitutional provision that could prevent that would be a clear clause stating that the president during his/her mandate must not perform any other political function.

In this part we dwelled mostly on the problem of organizing the administrative system in general, and that is the relation between legislative and executive power. As a rule, judiciary power has a smaller part at this point. However, the most important thing for democratic judiciary acting in accordance with law is its independence of the other two, which can be more easily achieved if the constitution and the system are in balance, as well as politics and political practice.

- e) *Territorial organization of administration.* Although uniform as a state (and that is a principle that should be particularly stressed in the constitution preambles), Serbia should strive towards functional decentralization of power administration. It is possible and even desirable to do so in a way which guarantees its sustainability and efficiency on the levels lower than the central one. The constitution should list possible levels of decentralization - such as province-region, city and municipality- but it should also establish clear requirements to be met in applying a general model of decentralization. Regarding the province – region issue, the constitution should guarantee Vojvodina its territorially autonomous status, as it should define the specific status of Kosovo and Metohija. The constitution can also allow for establishment of that kind of autonomy in other parts of Serbia, but under strictly democratic procedure and in conditions of economic sustainability. The same principle should be applied when city status is to be acquired. Finally, the municipal level of power administration should have features of modern local self-governed community that practically aids the citizens to fulfill their immediate interests.
- f) *The principles of constitutionality and legality.* This part of the constitution immediately and completely guarantees the constitutional principle of the rule of law. Serbia, like most contemporary constitutional democracies, should implement the principle of constitutional judiciary control of constitutionality and legality. For that matter, the role of Constitutional Court should be defined as clearly as possible, as it could be crucial for establishing the rule of law and democracy.
- g) *Changing constitution.* The experience of changing the existing constitution of Serbia points to the need that revision clauses of the future constitution be less restrictive than those of the present one. The new constitution should not be ideal and therefore inflexible, according to the intentions of its makers. It is quite realistic to expect that the process of general

transformation will require certain changes in some constitutional provisions.

On the other hand, the procedure to change the constitution would necessarily have to be to a certain degree stricter than the procedure of changing important (systemic) laws. If we assume that changing such laws would require at least a simple parliamentary majority, then changing the constitution would require a qualified two-third majority and a facultative referendum. Apart from that, the referendum majority would require a half (plus one) of positive votes, provided that a half (plus one) of the electoral body of Serbia consumes the right to vote.

### **Conclusion**

Serbia should establish a new constitutional organization as soon as possible. It actually depends on the politicians and their decision to carry on with the already initiated changes; otherwise, the whole remains in a deadlock. The years that have passed since the very beginning of the changes cannot be considered dramatically lost for the constitutional issue, although they have not yielded results. Being that often topical in the public life of Serbia, this issue has spontaneously led to some mutual understanding regarding this delicate constitutional matter. Two authoritative draft proposals lying in front of the Constitutional Subcommittee are not in any way exclusive, as is the case with some proposals from the non-governmental sector. The many similarities in their contents, especially in some key parts, resulted from the fact that various constitutional ambitions calmed down and got to the point where they realistically reflect what is real and objectively possible.

It is quite interesting that such understanding concerning the matters of constitutional contents does not have a matching counterpart in the matters of procedure. The two approaches are still very distinct. That is, however, more of a reflection of their positions in the political life of Serbia (those of the government and the opposition, i.e. the Government and the President of the Republic in cohabitation) than a matter of essential differences concerning the procedural issue. Still, if consensus figures as the way to settle this (or any other fundamental) dispute, then, the attitude that all parties are in the right should be accepted. The solution is hidden in a general agreement, and the road to success leads through negotiations. The goal is nothing less than a new constitution. Political loyalty to this goal is checked by the acceptance of the

procedure itself, i.e. the political methodology for achieving the set aim. This implies also a negative, but logical conclusion: if the goal is not reached, all participating parties will be responsible.

## RELATIONS BETWEEN SERBIA AND MONTENEGRO AND THE FUTURE OF THE STATE UNION

Almost five years after the democratic changes, Serbia and Montenegro have not managed to get the common state to function. At first that may appear odd, as until October 2000 there had been a general opinion that Milosević's undemocratic regime was the only impediment to that. After the political change in Serbia, the Democratic Party of Socialists, the ruling party in Montenegro, switched over completely to the policy of acquiring state independence. For that purpose, it entered a coalition with the independence-oriented Social-democratic Party after the extraordinary elections in April 2001, as it was left without its previous coalition partner, the federation-oriented People's Party.

As the majority of political parties in Serbia both politically and through their programs favor some kind of state connections between Serbia and Montenegro, the main reason that this issue still remains unresolved is in Montenegro itself. If the orientation toward independence were obvious and dominant in the smaller state, Serbia would not be in the way in any respect. However, the fact that Montenegro has been almost evenly split between the two options for the last five years prevents Serbia from taking a neutral attitude towards the issue. Not even the European Union, that had taken part in arranging the temporary union between Serbia and Montenegro, has remained neutral. At this point, we shall analyze the creation, functioning and future prospects of this provisional state.

### **Transition shadowed by the state issue**

The present solution in the shape of state union is negatively functional in the actual conditions. It is there to prevent even worse solutions that might crop up owing to the lack of democratic, in this case consensual assumptions. This negative functionality is the result of mediation by the European Union to help

create the state union and its Constitutional Charter. Although this document contains a number of positive projections for development and functioning of the state union, with time they have gradually lost their practical significance, since one of the two partners – Montenegro, that is – has systematically worked against them. For that reason, what has become obvious is the European Union's bare motif *to maintain the safety status quo in Montenegro and in the region*, the motif which had underlain the readiness to mediate in the making of the state union. A fragile peace is better than any overt conflict that appears inevitable should far-reaching decisions, such as proclaiming independence, be made without a basic political consensus. In short, the European Union can be much more efficient and successful in mediating and leading the region by means of its integration policy than by its policy of *post festum* intervention, for which it has no adequate institutions and strength.

The Constitution Charter of Serbia and Montenegro came into power in February 2003. Before that, Serbia and Montenegro were formally federal members of the two-member federation established in 1992. Montenegro had not applied any decisions of the federation organs until the Constitution Charter (practically since 1999), except in special cases of defense policy and when accepting international help or various financial arrangements made through the federation. Therefore, the decisions passed by the federal government practically affected only Serbia. The absurdity of the situation was even enhanced by the fact that those decisions were made also by the Montenegrin representatives, who represented only the Montenegrin opposition in the federal administration. The Constitutional Charter at least helped overcome this rather unusual political and legal situation.

The Constitutional Charter is, in any way, a transitional constitutional document. It defines the **status**, **aims**, **jurisdiction** and **means** of the state union as specific a construct as it is.

- 1) As for the **status**, Serbia and Montenegro are defined in a usual constitutional way as “one entity by the international law” (Art.14.1), holding all the rights and obligations implied by such international status in today's globalized world.

All other constitutional features of the state union reflect its specific and transitional character.

- 2) The **aims** of the union, beside general values of human rights, reflect particular functional reasons for establishing such a state union, and those are its faster and more efficient stepping into the space of European

integrations (Art.3, particularly lines 3, 4 and 6). The final aim is as follows: Serbia and Montenegro will maintain their mutual functional relations (common market, harmonizing regulations and practices with European standards, creating a real market economy) following the model of European integrations and will simultaneously work toward leading the state union into tangible integration relations with the European Union. The two features that follow, namely those related to the jurisdiction and finances of the state union, point to the narrow maneuvering space that the Constitutional Charter leaves to the state union itself, i.e. its organs.

- 3) Two things catch the eye when looking at the **jurisdictions** of the state union, and they are characteristic of confederate organizations: a) the state union has only the jurisdictions vested in it by the constitution, or the jurisdictions directly delegated by the member states (Art.17.1.2.); in other words, it does not possess the general jurisdiction to assign jurisdictions, as is the case in all federations); b) the inventory of the jurisdictions constitutionally assigned to the state is but very moderate (cf. Art.19).
- 4) A typically confederate arrangement has been applied in the part concerning the **means**, i.e. the institutes of the state union and their authority. Such an arrangement is constitutionally provided for either by the parity structure of the institutes) The Council of Ministers and The Court of Serbia and Montenegro), or by the principle of delegate agreement, which is the case with the decision-making procedure in the Parliament of Serbia and Montenegro. In this way, the state union does not have its own authentic organs, but it rather has the organs which are actually those of the member states raised to the level of the state union.

In short, the whole constitutional construct rests on a *bona fide* attitude that the ruling majorities of the member states have toward the aims and jurisdictions of the state union. If the constitutionally confirmed possibility of stepping out of the state union is added (by either one or both of the member states – Art.60) then the picture of its temporary character is complete.

The two-and-a-half-year existence of the state union reveals two opposing strategies towards its constitutionally projected function. For the official Montenegro, it represents the last obstacle to be jumped over on the road to independence. For Serbia (and here we shall not use the word 'official', because the government and the opposition agree entirely over it, unlike Montenegro), the state union represents a form, which should fulfill its constitutional role in

order to become comprehensive and functional enough to enter the process of European integrations. Such confronting strategies have resulted, as a rule, in different attitudes towards the responsibilities implied in the Constitutional Charter. Here are two examples to illustrate it:

**Example 1 – gradual harmonization of economic systems.** Since the creation of common market is one of the projected aims of the state union, it has become necessary to devise mechanisms and instruments to harmonize the two systems. In order to achieve that, the Action Plan to harmonize the economic systems of Serbia and Montenegro was put together. The Plan assumed gradual balancing of the two foreign trade and customs policies. The very procedure to adopt the Action Plan was characteristic of the nature of the state union. It was adopted by all three parliaments (two republic parliaments and in the Parliament of Serbia and Montenegro) in exactly the same way in which the Constitutional Charter itself was adopted (in September 2003). The Action Plan was not complete, since an exception had been made for some 56 so-called ‘delicate’ products, on whose exclusion Montenegro had insisted. Finally, when after a full year Montenegro did not apply the document, it was clear that it had no intention of meeting the stated obligations.

**Example 2 – direct elections for the Parliament of Serbia and Montenegro.** According to the Constitutional Charter (Art.20.4), two years following the first (indirect) elections, the MPs for the Parliament of Serbia and Montenegro are to be elected in direct elections. The elections were supposed to have been organized in February 2005, but were not, as Montenegro refused to carry the elections out.

It is quite clear from these two examples that the official Montenegro has adopted the tactics to obstruct the functioning of the state union, not hesitating even to violate the Constitutional Charter and other binding regulations. In both above mentioned cases, it was Serbia and European Union that acted in a synchronized way to save the state union arrangement. In the first case, it was done by introducing the ‘double tracks’ accession policy, which postpones the formation of the common market until the implementation of the Agreement on stabilization and accession (under the condition that the Agreement be ever made). In the second case, the problem was solved by the initiative to amend the Art.20.4 of the Constitutional Charter.

Still, in spite of such interventions, it clearly shows that the state union does not even function within its concrete constitutional jurisdictions, let alone at the level of aims that are set in its founding document. If one of the

two union members constantly keeps obstructing the union, and there are no neutral internal mechanisms that would force that member to stick to the rules, then such a union can hardly survive.

However, the case of Serbia and Montenegro is even more complex than could be perceived in a superficial glance. The already used word 'obstruction' well describes the phenomenon we are talking about. There is an organized and well-planned political activity going on in Montenegro, which does not allow functioning of the state union at the level of its jurisdictions, an even less at the level of its aims. The calculation behind it is but simple: since independence is the main political project of the ruling parties, and since there is no comfortable majority of the electoral body to support it, it is necessary to engage all means to prevent the alternative project, i.e. the functioning of the state union. The active political disturbance of its functioning is then presented as its structural problem, or, as it is readily called, the 'the structural flaw'.

Naturally, any political party or group is entitled to active struggling to promote its political program in the public eye, especially those parties in power, that have on their (legal) disposal various state means to achieve that aim. However, the Montenegrin case is different. Its government violates the very rules it has created in this political game. Such doing meets no sanctions that would protect the right of the state union and that would penalize its violation. (The Court of Serbia and Montenegro is both politically and procedurally unfit for such action). From such a situation, it may be implied that Montenegro is a sovereign state. However, even if it is, it has become so in an illegal, i.e. counter-legal way, by violating the right that had been backed up by the authority of the European Union. If the state union does not have proper judiciary protection, it could then have efficient political protection by the only real authority behind it, and that is the European Union. That brings us back to the fundamental question of why the EU had backed up the creation of the state union.

### **The future of the state union**

Despite its modest jurisdictions and even more modest means to implement them, it is the state union that the European Union addresses, especially within the framework of its integration policy. As it is well known, agreements of this kind (the agreement on stabilization and accession) may be

made only by internationally recognized states. The State Union of Serbia and Montenegro undoubtedly possesses this capability, viewed from the angle of international law. What actually is a problem of Serbia and Montenegro is the misbalance between its international legal ability and internal legal deprivation that is manifested in its inability to implement such a complex international agreement. If there is a 'structural flaw' in the Constitutional Charter, it is the above mentioned misbalance. In such a constitutional context, only political obstruction is needed to jeopardize the whole structure.

With two concrete examples, we have shown how 'the day was saved'. The European Union suggested an innovative solution – the 'double tracks' mechanism to be implemented in the agreement consisting of one common and two separate parts. The criterion for division follows the line of jurisdiction division between the state union and the member states, which practically means that the lion's share of the agreement content will be regulated in the parallel agreement parts. What it would look like still remains to be seen and the chances for a positive outcome are realistic. How it will be implemented remains hidden in the uncertain political future of the State Union of Serbia and Montenegro. In this respect, the agreement has to fulfill one more requirement – it has to subsequently stabilize the only internationally legal partner of the European Union in this matter, and that is the state union. Within the agreement, this is exclusively the domain of a specific agreement policy, and not the usual domain of its legal, economic and integrations-oriented senses. Since the European Union generally acts in favor of the state union, this agreement is the only means that it has on its disposal. The European reasoning is as follows: if the agreement is made not only with the real legal partner, but also the two quasi legal partners – the member states – then the agreement has to be implemented. In that phase, the two member states, the real masters of the agreement in the matter of partnership with the EU, will be forced not only to get closer to each other (which they failed to do by means of the above mentioned Action Plan), but they will also have to transfer some of their jurisdictions to the state union and consequently reinforce it. This process would have to be irreversible and it would last until the state union becomes a formal international subject capable of self-governing.

It goes without saying that such an agreement policy leads to the fulfillment of both essential and by-product aim – and that is the adaptation of Montenegro. It is reckoned that any obstructive policy on the part of Montenegrin government would have to be abandoned, and even the right to referendum on independence would have to go out. Those two tactic means

are simply not in tune with the agreement, in fact they are quite contradictory to its main sense. Indeed, from the viewpoint of such EU policy, it remains unclear why anyone would be running away from the open doors to the EU, especially the one whose proclaimed aim is to join the EU.

This issue is, however, loaded with excessive normative ambitions. Why would joining the EU integrations framework be the highest normative aim of one's public policy? It is not important here what is said about this – what matters is the behavior of the participants. If Montenegro starts a campaign on the independence referendum, that is planned to take place at the time when the negotiations on stabilization and accession agreement should be in their final phase, then it means that independence is a higher priority for Montenegro than the European integrations. This priority may be endangered by the success of the agreement, so these two matters take entirely conflicting positions. If it were not the case, the referendum idea would be abandoned or at least postponed until the agreement is made and its implementation initialized. In this latter case, there would be room for to apply the so-called Czechoslovakian model of state separation. However, the political background of that 'model', that practically enabled the implementation of it, was entirely different from that in Serbia and Montenegro. In Czechoslovakia there was a political consensus not only between the member states but within each one of them, so the separation could not have any bad consequences, either internally or externally. Therefore, that could hardly represent a 'model', it was simply an individual case.

It is absolutely clear that the case of Serbia and Montenegro is different. What is important at this moment is that the EU spotted the problem and decided to mediate.<sup>1\*</sup> The EU did not do in order to facilitate Serbia and Montenegro's joining the European integrations, as that was primarily a matter of their own commitment. The European Union did for safety reasons, in order to help preserve delicate peace in the region. Those reasons, at that time, appeared more important than others – economic, developmental, integrative - and justifiably so. There is neither economic development nor integrations where wars are waged.

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<sup>1</sup>The story of how the EU entered the picture is interesting. It happened immediately after yet one more failure of the then governments of FRY and the two republics to reach agreement concerning the reform of the federation (in 2001). The Montenegrin negotiators insisted on independence and subsequent alliance between the two independent states. When the then President of the federative state announced that the negotiations failed and that Montenegro should resolve the problem by referendum (end of October 2001), the EU soon reacted by offering mediation. In practice, that initiative prevented the Montenegrin referendum from happening.

Still, the EU entered the whole process in a way that was available to it and accordingly equipped. It used the prospective of gradual integration as the means, which opened up new windows not only for Serbia and Montenegro, but for all states in the region. It is reckoned that the integration processes – both regional and European – are conversely proportionate to disintegration processes by secession. Not because the EU would consider newly formed states in the Balkans illegitimate, but because in the Balkans there has never been any agreement, only disputes, conflicts and ultimately wars. When wars do break out, the EU has no means on its disposal to mediate successfully, and, therefore, until elementary conditions for peace are created, the EU withdraws into the background.

In short, the future of Serbia and Montenegro, not only as the existing state union but as a functional state, practically depends on two mutually related things: that the inner reforms be a priority and that the EU persist on its agreement policy.

#### SOLVING THE KOSOVO AND METOHITJA ISSUE

The Kosovo and Metohitja problem has been there for a long time and it is quite likely that Serbia, together with the international community and the political participants within the province, will have to deal with it for a considerable time in the future (and, in the international sense, Serbia and Montenegro as well). In a synchronic cut, the problem may be presented as a conflict of irreconcilable interests – the interests of Serbia to keep the province within some internal legal arrangement on the one hand, and the Albanian majority's interests to tear off the Kosovo territory from Serbia and establish an independent state on the other. The Kosovo reality, since 1999, has been essentially marked by the international protectorate instigated by the United Nations.

The above described state of affairs in Kosovo and Metohitja were already there at the time of political change and the beginning of systemic transformations in Serbia (autumn 2000). The fact that the former regime did not solve the problem of Albanian secessionism, but had additionally radicalized it, as well as the presence of the international troops and civilian missions in the province gave the new government an opportunity to address the problem in

a way that comprised modern safety, diplomatic and democratic mechanisms. A major test of such an approach suddenly cropped up immediately following the establishment of the new government. The Albanian rebellion in three South-Serbian communities (not in Kosovo and Metohija) was supposed to repeat the mid-nineties scenario carried out by the so-called Kosovo Liberation Army. The Serbian and FRY governments managed to calm the problem and put it back into the context of peaceful negotiations and therefore evade a conflict of the nineties kind. The success, however, although recognized by the international community, did not persuade the international protector to allow the reformist government of Serbia to participate directly in the Kosovo and Metohija problem solving.

### **Period 1999 – 2005**

Although the political forces that came into power in Serbia after October 2000 were democratic and pro-European, the international representatives' (civilian - UNMIK and military - KFOR) attitude towards them changed slowly and peripherally. At that time, the temporary institutions of self-government were not yet established in Kosovo and Metohija, and international mediators evaded to use the democratic change in Belgrade in any way that could lead towards the establishment of institutions to boost mutual confidence building and towards their efficient functioning. From the time when the UN mission was established in Kosovo and Metohija in June 1999 to the autumn of 2000, there were events and changes that reached the scale of ethnic cleansing of the Serbian community. Out of 250000 exiled people, there were around 170000 Serbs, or almost two thirds of the Serbian population that had lived in Kosovo until June 1999. Their property – houses, flats, land - was either usurped or devastated. Precise records kept by the Serbian Orthodox Church show that 112 religious monuments, such as churches, monasteries, graveyards were either destroyed or considerably damaged. What was going on was only the Albanian revenge because of the former regime, but also a planned action to expel the population of other nations, religions and cultures (not only Serbs, but the Roma and Ashkali as well) to fulfill the idea of ethnically clean and independent Kosovo.

The International mission's mandate was defined by the UN Resolution No. 1244, but that mandate was heavily influenced by the Albanian majority

pressure to create legal prerequisites for independence. Just as a reminder, let us list the five key elements of the UN document:

- 1) international civil and military administration is introduced in Kosovo and Metohija;
- 2) sovereignty and territorial integrity of FRY (today's Serbia and Montenegro) is guaranteed;
- 3) the international administration's task is to enable stabilization of general conditions in the province, especially to secure basic human and civil rights and preservation of the multiethnic character of the province;
- 4) the international administration is to aid formation of temporary institutions of self-government;
- 5) after these basic tasks are fulfilled, the future status of Kosovo and Metohija will be defined.

The situation in the field, however, was not governed by the Resolution 1244 provisions, but by the actions of Albanian leaders geared towards factual secession of the province from Serbia and by the opportunism of international mission, especially the UNMIK, which was very convenient for the Albanian side. As early as in the first year of the international mission's mandate, a particular amalgam of the international and domestic administrations (exclusively Albanian) was formed, that led to the establishment of a *fait-accomplie* state. Evading essential cooperation with the new government in Serbia was but an expected consequence of such a situation. The most persuasive example is offered by the way in which a general legal frame for the constitution of temporary institutions in Kosovo and Metohija was made, the so-called Constitutional Frame for Temporary Self-Government, which entirely lacked reliable institutional protection for the Serbian community, and instead established a mechanism of classical majority democracy. In the atmosphere of general political-ethnic polarization, this mechanism actually prevented the Serbs from efficient presentation and implementation of Serbian interests within the temporary institutions, above all in the parliament and government. The fact that not one amendment suggested by the Serbian representatives in the Kosmet parliament in the past two years was accepted, gives a true picture of the situation.

To what extent, however, the cooperation between UNMIK and the new reformist government in Serbia could have resulted in gradual stabilization and confidence building among the participants in the Kosovo situation can be

illustrated by the only serious attempt at such cooperation. In November 2001, the first document on mutual implementation of the UN Resolution 1244 was signed by the government in Belgrade, represented by the Coordination Centre for Kosovo and Metohija, and UNMIK. The domain of cooperation covered the practical issues important for the Serbian community living in Kosovo, such as education, health care, traffic and communications and safety. The mechanisms to resolve those issues were established, and they included the Albanian representatives, i.e. the representatives of the temporary institutions. Relying on that agreement, the Kosovo Serbs agreed to participate in the first parliamentary elections in Kosovo, to elect their MPs and enter the government. UNMIK's abandoning of the agreement and the Serbian MPs' failure to achieve any progress in improving the Serbian position in the province led the Serbian collation "Return" to leave the parliament and the government and adopt the policy of civilian disobedience. That happened by the end of December 2003. The Albanian violent attack on Serbs in March 2004 showed the Kosovo Serbs, Belgrade and the international community that the multiethnic Kosovo was an unsustainable concept in the existing international mission regime. It entered the crisis which lasts until this day.

### **The existing efforts to solve the problem**

The most serious problem in Kosovo and Metohija is the implementation of human rights. Bad public administration and inefficient judiciary are the problems that directly influence the poor state of human rights in ethnic communities in Kosovo, especially the Serbian one. They are generally unsafe, they suffer the lack of right to move freely (especially in small Serbian enclaves) and there has been no return of Serbian refugees. Regarding that, UNMIK estimates are that only 10000 refugees have returned, 50% of them Serbs. That means that the rate of return in the past six years has been 2.5% of all Kosovo refugees or around 2% of Serbian refugees only.

Apart from this, Kosovo is facing a catastrophic economic situation, criminalized society and massive unemployment (UNMIK estimates are between 50% and 70%). Since the government of Serbia (as well as that of the state union) have no jurisdiction whatsoever over the province, such a situation is undoubtedly the result of UNMIK's and local (Albanian) mixed administration. As the relative order in the province is owed to the presence of international troops, it would be very difficult to believe that possible

independence, which means total takeover of administration by local Albanians, would leave to an improvement. On the contrary, odds are that such a solution would irreparably take Kosovo and Metohija further down the road of economic, social and political chaos.

In spite of the total failure on the part of international administration to implement the essential provisions of the Resolution 1244, the international participants in the affair still keep open the possibilities for solving the problem of the future status of Kosovo and Metohija. The end of 2003 saw the shaping of the so-called 'standards before status' policy. According to this policy, Kosovo and Metohija should manifest progress in eight domains, with political talks on the future status to follow. The eight domains are: 1) democratic institutions functioning, 2) rule of law; 3) right to move freely; 4) return and rights of ethnic communities; 5) economic recovery; 6) property rights; 7) renovation and repair of cultural heritage; 8) the Kosovo protective corps. To general detriment, the greatest massive violence in the province happened a few months after this strategy had been promoted and overtly put it under the question mark. Despite that, the international participants did not abandon the strategy, although the time that has passed speaks of its practical impossibility.

If we were to describe the three main players on the Kosovo political scene, it would be as follows:

- the Albanians: for them, independence as soon as possible seems to be an only solution. The role of international community, according to their political representatives, is to finish the international mission mandate until mid 2006 at latest. Not only that any other political solution is openly threatened by violence, but several months back there have been announcements of unilateral moves by the temporary institutions and their expectations that unilaterally proclaimed independence would gain factual recognition by the international community.
- The international community: they are trying to lead their policy, which has not rendered results, to the next stage, and that is talks about the future status of Kosovo and Metohija. No one is making any statements concerning the solution content ; procedural side is still being given priority, and it counts on participation of the temporary institutions representatives, Belgrade and the international community representatives as mediators. General orientation reveals intentions to reduce the presence of international mission and strengthen the role of the EU.

- Serbia: insists on keeping and more energetic implementation of the Resolution 1244, particularly the fulfillment of obligations on the part of international community. The solution of the greatest problem in the province, namely survival, safety and return of the Serbian community, Serbia sees in providing higher standards of decentralization and achievement of self-government for the Kosovo Serbs. It sees the future status of Kosovo as atypically wide autonomy, following some European examples (South Tyrol, the Oland Islands, the Bask Country and Catalonia).

### **The prospects of Kosovo and Metohija : (re)integrations and reforms**

In its instable region, Kosovo and Metohija is the greatest problem. What makes it even worse, it is not a problem that can be localized and solved in the given territory, but it is a problem that spills over into the region. In principle, that is the main reason that any kind of independence of this territory does not offer the key to a peaceful, lasting and irrevocable peace. In an economic sense, such a solution would not be sustainable, since Kosovo does not have institutional, financial and human resources to back up its economic independence. Politically, today's Kosovo is not capable of preserving its chief historic characteristic – multiethnic and multicultural structure – as the new reality of Kosovo is heavily marked by practices of both spontaneous and planned ethnic cleansing of the smallest ethnic community by the largest one. In a regional sense, the independent Kosovo and Metohija would set a seriously bad precedent of creating an ethnically homogenous state in a historically multiethnic region, proving it is possible, internationally acceptable, even sanctioned by the normatively exemplary European and world *milieus*. Besides, it is hard to believe that the independence of Kosovo and Metohija would not lead towards the creation of Great Albania, in spite of all the international guarantees that it would not.

In short, an independent Kosovo of any form at any foreseeable time, would inevitably result in lasting hampering of modernization, economic integration and general political liberalization not only of Kosovo and Metohija itself, but of the West Balkan countries as well (Croatia excluded, probably). If, in principle, the solution to this problem is seen in the European integrations, then independence does not offer a good model. Quite contrary, it would lead towards a new vicious circle of border disputes, mutual accusations, potential

and overt hostilities, new ethnic migrations and dormant revengefulness. If such tendencies are present in the region for a longer period of time, and that is quite likely if such unilateral model be applied, it would essentially jeopardize European integrations of the whole region.

In such a present and likely future of the 'Kosovo and Metohija' problem, determined by the Albania constant of 'independence', a decisive role to alter the situation could be played by the remaining two players: Serbia (Serbia and Montenegro in the international sense) and the international community. Their *strategy to change the existing tendency* must be comprehensive, synchronized and at least minimally persuasive for all the local population of Kosovo and Metohija. The elements of the strategy are as follows:

- The international community should preserve but also structurally differentiate its preventive- security plan from the developmental - peace one of its presence in Kosovo and Metohija. The former plan should remain within the frame of UN, whereas the latter should be given over entirely to the EU. In that way, Kosovo and Metohija would remain under the protectorate of UN, but would be in economic and social custody of the EU. The status of the territory in terms of international law would not be changed against the fundamental provisions of the UN Resolution 1244.
- The Serbian community position in Kosovo and Metohija would have to be changed in principle and for a lasting period of time. That could be done by institutional establishing of Serbian community self-government within Kosovo and Metohija, with guarantees that it retains some functional and financial ties with Serbia. In a certain legal and functional sense, the Serbian self-government would be linked, and to a certain degree even subordinated to the reformed legal and institutional system of Kosovo and Metohija. That system, on the other hand would not have any legally binding institutional ties with Serbia and the state union apart from the institutions of Serbian self-government.
- In time, functional integration between Serbia and Kosovo and Metohija (free flow of people, goods, capital, traffic, energy, telecommunications etc.) would be established, aided and controlled by the European Union. Such policy of functional integration could be incorporated into the Agreement on Stabilization and Accession in a later stage of implementation.
- A strategic arrangement of this kind would create realistic chances for the inner reforms and modernization of Kosovo and Metohija, and would

leave open the possibility to reassess that special status when Serbia and Montenegro enter negotiations to join the EU. That leaves about 5 to 7 years that should be used fully for economic, legal and political reforms in Kosovo and Metohija and its reintegration into the wider space of free market.

The essence and meaning of such proposed strategy to resolve the problem of Kosovo and Metohija are in creating basic prerogatives for the economic recovery and legal and institutional rebuilding of this area independently of difficult, belligerent, therefore politically unfit questions of ruling the territory. From a methodological angle, the issues over which the opposing sides cannot reach a compromise should be put aside for a while, until conditions are created for compromising. Instead of unilateral forcing of the so-called ultimate solution, where the international community conveniently intervenes in favor of one side only, it is necessary to follow the method of *gradual minimalism*. It means that the limited period of time should be used to achieve results that would undoubtedly be valuable for both sides.

For the time being, Serbia seems the only player in this uncertain and ominous game that is ready to take this approach. A minimal condition to apply the approach would be the attitude of international community, the destined mediator in this deep and troublesome argument. After six years of rather unsuccessful mediation and participation, the international community should finally accept the approach that is rational in a general strategic and developmental sense and not only in its particular-political sense. In other words, not one of the local players in this game should feel privileged because of the international community mediation.

Boris Begović

## Four Years of Transition in Serbia: The Resume and a Look Ahead

### THE CONTEXT OF THE TRANSITION IN SERBIA

In order to understand the process of transition in Serbia one must identify the initial advantages that the country had in that process as well as the most significant difficulties which place limits upon it.

The most important advantage Serbia has is probably the very fact that it embarked on transition late, due to political constellation and international situation in the 1990s. Transition in Serbia began in 2000 together with the political change that occurred in October that year. In other words, transition in Serbia was ten years late. During those ten years the transition states, excluding Serbia, had gained experience on various aspects of transition – for example, experience relating to macroeconomic policies, price liberalization policies and foreign trade, privatization and restructuring of the real sector, reform of social services etc. Thus a body of knowledge was generated concerning the outcomes of particular transitional policies and models. Much experience has been gained on the mechanisms leading to certain out-comes as well as those leading to the formulation and implementation of transitional policies – much has been learned about the conditions which have to be fulfilled in order for certain policies to be carried out successfully. In that respect the fact that Serbia was lagging behind presented an opportunity to learn lessons from other states' mistakes and to avoid certain pitfalls. Among Central and East European states only Slovakia has also had such an advantage.

Then, some consider it an advantage for Serbia that, during those ten years without transition and due to factors that have nothing to do with it (wars, sanctions, loss of former markets) there had been a recession – a considerable reduction in the amount of production of the real sector. As opposed to other states which endured a transitional recession, producing a number of transitional losers for which voters held their governments accountable (leading to the fall of many a transitional government), Serbia

suffered a recession mostly caused by factors which were not directly under the control of the government of the time (leaving aside to what extent the then government indirectly brought this about) and thus there have not been the political consequences of such a recession. In Serbia transitional governments already inherited low levels of production which simplified their task in comparison with other countries enduring transitional recession regardless of whether such recession still lies ahead of them. However, this did not prove to be much of an advantage since considerable political pressure was generated aimed towards the “revival” of the production of the inherited real sector and the resurrection of the economic system which had existed before.

Some considered it an advantage that socialism in our country, after the conflict between domestic communists and the Soviet Union and the Soviet Communist Party, took the form of self-management, that is, of something that was mistakenly called market socialism. Naturally, market socialism is a *contraditio in adjecto* and in such a system the only form of market that operated was the product market, also controlled by the Party. However, on such a market there were certain institutions which did not exist in other East European states, that is, in the states of the so-called real socialism. In addition, the country was quite open in that period and the general public freely traveled (without visas) to almost all countries of the world; in that respect a market economy was not unfamiliar to them. Those who hold this view maintain that such experience should ease the acceptance of the institutions of a full market economy. However, this did not prove to be of much benefit, especially since the openness of the country and the freedom of travel has long been lost. The most important legacy of self management is the mind-set of workers who are also the owners of the means of production (as often as not financed through loans at negative real interest rates whose principal was never paid back) – self managers who had the authority to take decisions concerning pay increases while the losses suffered by their companies ate away the capital (“workers’ ownership – state’s responsibility”, Lajos Bokros). Such a mentality always focuses on real or alleged rights failing to link them with responsibilities, that is, without any wish to understand and accept causal relationship between certain actions and their results. Moreover, socialistic self management was not imposed on Serbia from the outside as in most other East European states – it was a warmly and widely accepted domestic product. Thus it is obvious that the self-managing tradition is far more to the disadvantage than to the benefit of Serbia in relation to transition.

The self management mind set is still alive and well in Serbia. It is in part the result of the wide-spread and tenacious left-wing ideology which results in a tendency towards economics populism. Since most political parties in Serbia have not taken solid ideological form as yet, that is, they still have not developed a consistent ideology of their own, many of them have taken over leftist rhetoric and other elements of left-wing programs especially in respect to economic transition and institutional reform. Therefore it is not surprising that there is no consensus of relevant political actors on basic issues such as the desirability of the transition which should lead us to the market economy, economic freedoms, restrained or curbed state intervention and the rule of law. The lack of such a consensus is the main stumbling block to transition in Serbia.

Another major obstacle to transition in Serbia is the fact that basic matters of state remain unresolved (chapter fourteen). We do not know where our borders are (still less where they will be in 10 or 20 years), what the territory of the state is and what is its population. It is still not certain what the constitutional system of the country will be and what structure of the state administration, especially in respect to the relationship between central and the other authorities will take. All this has powerful negative effects on transition in several ways. Firstly, a tremendous amount of political energy is wasted on the debating of these issues – energy which could be put to better use in actually solving key problems of economic and social transition. Political energy, being a limited resource, incurs its own opportunity costs – the energy burned in one place cannot be used in another. Secondly, unsolved fundamental matters of state increase business risks, that is, investment risks, thereby increasing the price of capital and reducing its placement – as investment. Without new investments there cannot be economic growth and well-being – without success in this area there cannot be very many of those who will benefit from the transition. In this manner transition itself is compromised in terms of the expectations of the voters.

Another major impediment to transition in Serbia is the historical legacy of the wars waged in the 1990s and the pressure generated by the need to face up to the past. The pressure is exerted by certain political parties and NGOs. However, there has been no general agreement on what this would actually mean; however, it is usually taken to mean facing up to war crimes. Why is this impediment to transition in Serbia? First, because the mechanisms already discussed in connection with unresolved matters of state are at work here as well – the opportunity costs of political energy wasted. Second, in this case,

the political agenda is even more drastically altered – political debate veers far away from economic transition and institutional reform. Moreover, those who have much to say about the wars and the past gain political weight (they are usually divided into “patriots” and “mondialists”) – while they are usually very loud in such debates they seldom offer much in terms of transition to a market economy and the rule of law. In contrast, those who advocate facing the past often maintain that it is a necessary precondition for successful transition. However, the problem is that such a claim is usually not supported with an appropriate argument showing the causal relationship between facing the past (supposedly successfully completed) and the necessary conditions for successful transition. In addition, the critical point at which facing up to the past can be considered to have been successful and at which we are free to start dealing with the present has not been defined. Moreover, dealing with the past does not seem to include issues concerning the performance of domestic institutions at home, that is, issues such as the abuse of the justice system for political purposes – a legacy which truly holds relevance for the reform of the administration of justice in Serbia.

Facing up to the past also has significant international relevance – far greater than that at home – the Hague Tribunal. Powerful pressures mounted by the international community (chapter 13) have had a considerable impact on domestic political life. These effects are, most obviously the destabilization of the political scene (such as the conflict between the DOS and DSS which broke out only six months after the crucial victory at the parliamentary elections in December 2000) and the strengthening of domestic “patriotic” forces, that is, they simply fostered xenophobia. Certainly, it should not be claimed that all this was done intentionally; however, the road to Hell is said to be paved with good intentions.

#### THE EFFECTS OF THE CIRCUMSTANCES: THE POLITICAL FRAMEWORK OF TRANSITION IN SERBIA

The above advantages and especially the disadvantages led to several effects in terms of the political framework of transition in Serbia.

After more than four years of transition in Serbia there is still no strong political commitment to reform – a commitment which would persistently formulate and carry out economic transition and institutional reform in the

state. It is obvious that there is no political consensus of relevant stakeholders concerning a single key aspect of transition. There is no unambiguous political answer to the question of what our goal is, or what our goal should be, still less the answer to the question of how we are to get there – to the point that we are not even sure if we need to reach it at all. The inevitable consequence is that the mainspring of transition in Serbia is not within the country but outside it. There is no original, internal driving force for transition since there is no consensus among political forces on whether transition is necessary, that is a desirable outcome. Therefore transition in Serbia is mostly unfolding under the influence of international factors, that is, the international community. The main driving force of transition is the European Union followed by (and closing in lately) international financial institutions, especially the IMF.

It should be noted that for a moment, at the very beginning of the transition, it seemed that the consensus had been reached while the enthusiasm for reform was high. However, it turned out that “transition fatigue” appeared in Serbia far sooner than expected. The fatigue, together with other factors, led to the resurgence of those political parties, political orientations and forces which were thought to have been marginalized by the end of the year 2000.

The European Union, or rather desired membership of the European Union is the mainspring of transition in Serbia. This is due to the fact that a large majority of the electorate fully supports accession to the European Union, specifically, Serbia’s membership in this organization. The EU and especially its original member states (EU 15) still symbolize high living standards and wealth in Serbia. Opinion polls regularly show that the Serbian population is mostly preoccupied by their living standards. Most people seem to have found a direct link between EU membership and a dramatic increase in living standards.

Domestic politicians discovered this linkage quite early on and the accession process has regularly been used as a trump card in public broadcasts aimed at increasing popularity. There have been too many populist appearances and public bidding on which year we will “certainly join” the EU. Rarely is public mention made of the serious and as often as not painful economic and institutional reforms necessary even to approach membership status, even to begin negotiations concerning accession, let alone membership itself. Still less mention is made of the extent to which we will have to change our lives if Serbia is actually to become a market economy under the rule of law. These truths are skillfully concealed since they are unpleasant; both to domestic

voters strongly influenced by self-management and leftist ideology, and to that part of the political elite which still holds similar views.

On the part of the EU, the accession process has been taken quite seriously and the demands concerning it have encouraged many economic and institutional reforms which have been successfully completed, in a large part as the result of the demands made by the consultative working group, as a part of the process for attaining a positive result for the feasibility study. Now we can expect negotiations on the stabilization and accession process, the implementation of which will generate new incentives for transition in Serbia.

Recently, in terms of economic policies and economic reforms, stronger incentives than those provided by the EU have been generated by international financial institutions, namely, by the IMF. It is obvious that the domestic authorities deem it necessary to maintain good relations with the IMF, that is, to honor arrangements with this institution since to break them would entail severe consequences for Serbia (a small state with a large deficit in the balance of payments, a low international credit rating, a considerable foreign debt and a substantial repayment due to foreign creditors in the years ahead).

However, this raises the question of what the essential difference is between the internal and the external motivation for transition. What is wrong with the mainspring of transition being outside the country?

Actually, there are several things. The main problem is whether such a driving mechanism is sustainable. Namely, Serbia is only one of the points of activity of the international community and international institutions. Their policies and priorities are subject to change in line with changes in the world which have no connection to Serbia. However, it is Serbia that will bear the consequences of such changes. Second, it is questionable whether such external mechanisms can be effective since their effectiveness is achieved through the laying down of conditions. Specifically, the Government implements certain policies, not due to a sincere belief in their value but through coercion. The whole thing becomes a cat and a mouse game. It is true that the Serbian mouse is at times quite creative, but in the end the cat always wins. However, the crux of the matter is that you will implement a policy much better if you believe in it, which holds true for transition as a whole.

Finally, such a situation eliminates or severely reduces the room for “influencing” foreign influence. If the government itself (consulting international institutions) does not formulate relevant reform policies, then international institutions will intervene by imposing the so called ‘universal

recipes' which are not necessarily optimal. Moreover, since there is no clear commitment to reform, and we do not know what we want, less than optimal solutions can be imposed through the more or less erroneous judgment of those who cannot be held accountable by domestic voters. At the same time those who are held accountable view their relationship with the external driving mechanism as a part of their political struggle; a new division appears into "patriots and mondialists", that is, into "tough guys and wimps" according to the manner in which pressure is handled – to what extent the side in question is willing to give in to the international community.

The additional consequence of this is the lack of a broad, serious and well balanced public debate on important issues of transition, that is, on key reform projects. Without doubt, when you do not know what you are striving for, there is not much point in discussing how to reach that goal. In many cases there has been no public debate, even on the adoption of new and essential reform laws – they were passed summarily and the debate in Parliament was reduced to party squabbles and taunts aimed at winning cheap popularity. Occasionally the adoption of core legislation was subject to political trading, leading to a compromise, not on the content of the law in question but rather about the trade off: I will vote for yours if you vote for mine.

Such is the political framework which has influenced the results of transition in Serbia.

## THE RESULTS OF TRANSITION IN SERBIA

As has already been said (Chapter one) assessments of the results of transition range from, on the one hand those who believe it to be a complete failure, that it remains essentially at the very beginning and those, on the other, who claim that we are the champions of transition and leaders in the Balkans (and wider) although this standpoint has had to be abandoned under the pressure of reality.

However, the question remains how to assess the results of the transition in Serbia. Should we seek to reach an overall estimate or focus on particular sectors of the transition? It seems that focusing on separate sectors can yield better, more accurate results, especially since there are considerable differences in the outcomes across sectors.

Still, as for the overall assessment, it is certain that transition in Serbia started off at a fast pace and that by the end of its first year considerable results had been achieved. However, it turned out that such a pace simply could not be maintained. Transitional fatigue overcame Serbia as soon as unpleasant and painful elements of the process were embarked upon. It became clear then that there was no consensus between the relevant political actors concerning basic issues of transition; political energy began to be diverted to other burning topics – at that time to the problem of relations between Serbia and Montenegro. In short, transition slowed down dramatically and occasionally even came to a complete standstill. This and the ten-year delay at the start pushed Serbia to the bottom of the list of European transitional states – still far away from a market economy, the rule of law and stable democracy.

In respect of **macroeconomic policy** (Chapter two) four cycles have been identified: 1) the reform cycle, at the very beginning of transition, 2) the abandonment of the reform macroeconomic policy around the middle of 2003, 3) the arrival of the new government in power in early 2004 accompanied by strong economic populism and 5) the return to the reform macroeconomic policy in 2005 under pressure from international financial institutions as well as the announcement of the beginning of the negotiations concerning the stabilization and accession process.

Thus, less than half the time in the first four years has been spent on serious transitional issues while the rest was characterized by typical macroeconomic populism accompanied by announcements of the revision of the liberalization already accomplished (the final part of prime minister Zivkovic's time in government), of the change of privatization methods and the revision of all privatizations affected, the abandonment of the steps towards liberalization already made, and similar (Kostunica's government). Such "on-off" policies are in stark contrast to the two key principles for successful management of an economy: a) that all change should be implemented gradually so as to reduce disruption to a minimum and b) that each subsequent measure must be recognizable as a logical sequel to the previous one.

The current policy mix with a restrictive monetary and the predominantly expansive fiscal policy has become untenable since the economic environment is permanently 'overheated' and the populist system of benefits and unearned pay-outs threaten to put at risk the only unquestionable achievement of the economic policy – price stability. This is why it is necessary to abandon the policy in which the rate of exchange of the dinar is used as a nominal anchor – which causes the most harm to exporters. Easing the restrictiveness will

cause interest rates to drop; it is necessary to cut fiscal expenditures sharply, primarily in the area of subventions and unearned pay – the remuneration policy should be in line with the ‘golden rule’ that the increase in productivity should at least be equal to the amount of real appreciation and real increase in earnings, while the foreign trade policy in the process of joining the WTO and the process, already underway, of the accession to the EU will have to be liberalized at least to the same extent as in other EU states. All these measures can yield results if strict budgetary limitation is imposed first and if the state gives up the management of the property of public companies and allows them to be brought under the rules of contemporary economics. Part of the credit for the obvious success of the macroeconomic policy (price stability) goes to the very active international financial institutions, especially the IMF and its insistence on the control, reduction and finally elimination of the deficit and the maintenance of monetary stability.

Occasionally strong attacks by both the professional and the general public have been launched against the macroeconomic policy implemented in the four years of transition. Such attacks were also in part based on the belief that all the economic problems of the state can be solved through macroeconomic policy and that Serbia can be transported painlessly and overnight from an undeveloped, poor and backward country into an EU state – developed, rich and progressive. However, once again, it has been proved that the effects of macroeconomic policy in transition are relatively limited. Adequate and consistent macroeconomic policy is just one lever for transition. The other one is structural macroeconomic reform, that is, a comprehensive restructuring of the economy.

In terms of the **dynamics of economic activity** (Chapter two), the key fact is that the starting position of the state in the year 2000 was extremely low and that, after the beginning of transition, economic growth rates were not spectacularly high. Cold facts confuted the propaganda about a swift recovery. In addition, the economic structure remained largely unchanged. Finally demand rose sharply resulting in a negative balance of trade. This was accompanied by a swift rise in real income (over 20% a year) which has not been reported in any other transitional economy. Unemployment is widespread and unemployment rates are high, regardless of the method used to calculate them and the source of research. Some of the officially unemployed have been absorbed by the informal sector (the grey economy) which also provides jobs for those who still formally work for socially owned companies.

As regards the **reform of public finances** (Chapter three) and the overall reform in this area, the results are unquestionable. However, the problem is that there has been much more activity and success in terms of public revenue policies than public expenditure. Especially successful was the initial simplification of the turnover tax, primarily the introduction of the unified rate, considerable increase in its collection (legalization of transactions) and later the introduction and fairly successful implementation of value added tax (VAT). New forms of consumption taxes resulted in a significant increase in public revenues and in the last year some budgetary surplus has even been reported. Besides the achievements, however, there have also been some ill-advised moves such as the extra-profit tax, an unclear tax based on inconsistent political ideas and the philosophy of some sort of legal Robin Hood – we shall take from the rich (some of them) and give to the poor, that is, to the users of budgetary funds, who certainly are not one and the same. If we cannot or are not capable of taking revenge on those who supported the previous regime, let us at least punish them in this way, and this will enhance our popularity with the voters as well. Both the political and the economic damage caused by this tax far exceed the benefits, if any.

The greatest success relating to public expenditure reform is the adoption and implementation of new solutions regulating the budgetary system and the new transparency introduced into its operation, especially the introduction of the Treasury which phases in complete centralization of all payments from the Budgetary account rendering the transactions open to public scrutiny and ultimately contributing to effective control over budgetary spending. However, the real reform of public expenditure in Serbia still lies ahead. Such reform would mean the cessation of subventions to (unsuccessful) companies, the restructuring and privatization of state owned companies and the extensive reform of social services, that is, matters concerning the financing of healthcare, social protection and the pension system. Indeed, public spending is too high (in 2004 it amounted to 42.3% GNP) constituting the gravest problem in the public finances policy in Serbia and one of the main obstacles to transition in general. The problem amounts to the relationship which exists between excessive public spending and the restructuring of the real sector (Chapter six) and social services (Chapters eleven and twelve), that is with the non-market, re-distributive character of the economy in which subventions and social benefits amount to as much as 49% of total public expenditure. It is obvious that state intervention is still strong - the state pays out too much of its

revenues. This fact is the best illustration of how far away from a real market economy Serbia actually is.

In addition, the budgetary balance cannot be maintained without cuts in public spending. Budgetary revenues cannot practically be increased any further – the introduction of VAT was about the last trump card to be played to that effect. In addition, the repayments of the principal of the state debts will soon be due, which will inevitably lead to an increase in overall public expenditure unless spending is drastically reduced, excluding additional dues to foreign creditors.

It is exactly such restructuring of public expenditure, that is, public spending reform, which has been persistently avoided over the last four years, since such measures are necessarily painful and cannot win political popularity in the short term. Most political actors in Serbia hold only short term views; the crux of the matter for them is to stay in power now, not to come into power again.

In addition to the extensive restructuring of public spending, Serbia must also launch a reform of local public finances; intervention in this area still lies ahead – the first steps have just been taken in this direction. Finally, further simplification of the tax system is required as is a reduction in the number of fiscal instruments.

Transition in the area of public finances can be deemed a partial success. Results have mostly been achieved in the area of public revenues while much remains to be done in respect of public expenditure. The reduction in public spending is of essential importance for the future success of transition, since it requires deep reforms in various domains (primarily the restructuring and the privatization of the real sector as well as the reform of social services and their system of finance).

The success of the public finances reform can in part be explained by strong incentives provided by the IMF. This institution seems to have been the main driving force of reform in this area, which is quite understandable since deficits here pose grave risks to macroeconomic stability. The results concerning public revenues testify to this; in the last year analyzed, the IMF requirements focus far more on the amount of public spending; as a condition for further support the IMF demands its further reduction and specifically, the structural and institutional reform which will lead to this, such as restructuring and privatization of public enterprises and the reform of pension funds. It remains to be seen whether the incentives, or rather demands, laid down by the IMF

will be effective, since considerable political risk is involved – such reforms can incur high political costs, primarily those relating to the loss of popularity.

As for the **privatization of the real sector** (Chapter four) Serbia has gained from being late in the reform and from the opportunity to learn by other states' mistakes. Indeed, privatization in early transitional states was riddled with errors. The privatization model selected in 2001 is basically sound, which is not to say that all details of its implementation are faultless, for instance the one stipulating several criteria for awarding tenders which, among other things, inevitably results in a lack of transparency in decision-making.

The basic (inherent) problem of the model selected is slowness of implementation, especially in the first phase when capacities for its implementation need to be built. Just when the privatization began to gather pace, a political change occurred and the new Government led by the PM Kostunica sent a clear message through its initial nomination of personnel that it was not striving for faster privatization; it even raised the question of its possible revision. In a political environment used to political flak where each (real or constructed) spin story whets the appetite of the public for another, privatization could not be continued and all was back to the 'old way'. Only precious time was lost – and we in Serbia are certainly skillful at that.

Many are disappointed with the results of the transition so far. However, facts (Chapter four) as such do not justify such disappointment; rather, it seems that grandiose, utterly unrealistic expectations led to the sense of disillusionment. Many in Serbia believe in magical medicines (especially in those which do not taste bitter) and privatization (in part deliberately and in part unintentionally) was portrayed as such a medicine often enough. However, this is far from true since it soon became obvious that in Serbia there were only a few solid enterprises which were capable of becoming a driving force of economic development through privatization. Those which have gone through privatization mostly stand well and become centers of productive employment. Experience has proved that it is new private companies, that is, new actors, that can tug the economic growth along – and this is exactly what Serbia lacks. Barriers of entry are still high and connected to numerous state policies (often at the local government level); sometimes the barriers are built up or at least supported in cooperation with the authorities by major actors who have already taken strategic positions and do not want effective competition.

In public debate the proceeds from privatization are often portrayed as the main criterion of the success of privatization – the allegedly low amount of the proceeds is then taken to stand for the 'clearance sale' of public wealth. Two

things should be noted here. First, the capital of a company is privatized which means that the new owner in addition to assets also 'buys' the liabilities of the company. Privatization does not follow the rule: 'what you see is what you get'. Second, the overriding question to be posed is that concerning opportunity costs incurred through avoiding privatization, i.e. what is lost by not going through with the privatization of socially and state owned enterprises.

What lies ahead of Serbia is the continuation and the completion of the transition. This should be done according to the current model although there are still unsolved issues concerning the privatization of public (state owned) companies. Their privatization is somewhat more complex since they need to be restructured first and in some cases, because institutions of economic regulation need to be set up first. There is not a single economic reason why the existing public state companies or company parts which will stem from them through restructuring should not be privatized. State-owned railways are probably the exception primarily in terms of the possible demand for them, which does not mean that this should be a priori ruled out. In addition, it is necessary to begin the privatization of public utility companies and municipal land. While it is quite probable that some public utility companies, especially those in smaller communities, will remain public property, there is no reason for the delay of the privatization of municipal land which is not in public use (providing public good). The problem of restitution should also be resolved.

The restructuring of the real sector is one of the most painful questions in every transition. To face up to the legacies of socialism as an ineffective economic system actually means having to decide the destiny of the real sector and what further actions need to be taken in that area. Restructuring aims to improve the economic performance of such enterprises, that is, their economic effectiveness; from loss-making firms they become profitable businesses, from those with low margins of profit they become those with high profits. Politically the most painful question is the fate of the workforce which also needs to be restructured: some will have to work more and better, some will have to go through additional training, some will lose their jobs and yet others will be pensioned off. The working classes, especially those who still hold socialistic self-management views, do not like restructuring. Since it is painful it is only to be expected that those who carry out restructuring will not win much popularity.

At the very beginning of transition a principle was adopted in Serbia that all restructuring of all companies except public enterprises is to be left to the private owner. It is certainly a wise decision since the state is a very poor

manager and cannot achieve desirable results in this line of work. Initially, the problem arose from the fact that many enterprises which at least formally could have been privatized were not put out to tender since it was justifiably believed that no one would buy them at any price in the condition that they were in at the time – long-term loss makers with enormous liabilities, often with negative capital – conglomerates without specialization with huge numbers of surplus employees. Until transition these enterprises had mostly lived off ‘soft budgetary limitation’, that is, implicit and explicit subventions by the state in addition to the gradual loss of their own capital. Therefore it was decided that such companies needed to be restructured before privatization. This created problems.

The working class, that is, the voters will be aware who is responsible for restructuring regardless of whether it is affected directly by the state or by the new owners. The political costs of restructuring will be borne by the administration in power, the popularity enjoyed by the government will fall. At the same time the opposition will spin heavily demagogic stories about deliberate destruction of the Serbian economy and those who “padlock factories”. The Serbian economy in question was practically destroyed by the decisions by which it functioned. Investment decisions taken at Central Committee Party meetings by people who were not held accountable for them is not the best way to achieve economic effectiveness. Even before the onset of the 1990s with wars, bombardment, sanctions and the loss of markets, the Serbian real sector was not economically viable. It placed its products on the markets of the former Yugoslavia and the Soviet Union which were well protected from competition; even under such circumstances it could not cover its costs and suffered losses. It lingered on like a hangover after a drunken party called self management socialism and the still unnamed ten year period in the nineties.

Little has been done in respect of the restructuring of the real sector – almost nothing has been agreed on in the four years of transition. The political risks turned out to be to severe, although it must be said that the task itself was daunting in the technical sense.

The account of the following steps is of key importance. First success was recorded in 2005: several restructured enterprises were sold. However, the key element concerning the real sector is the establishment of strict budgetary limitation for all enterprises. This means the withdrawal of direct and indirect subventions as well as the consistent execution of the liquidation procedure to settle debts with the creditors of insolvent, bankrupt debtors as well as the procedures for settling accounts with solvent debtors.

However, it is reasonable to ask whether there are political incentives for the implementation of the measures discussed; can the activities of the government in that direction be realistically expected? The answer lies in the following facts.

There is strong pressure from the IMF for the restructuring of the real sector to tackle the problems of excessive public spending and the balance of payment deficit. Excessive public spending is primarily connected with public enterprises while the trade balance deficit results from the fact that socially and state owned enterprises which have not undergone restructuring and privatization are not able to export. The pressure from the IMF cannot be expected to ease up, it can only increase.

Changes in political circumstances can be expected (they may already have occurred) where most of those who work in companies which have not undergone restructuring see themselves as the losers of the transition. So, in the large majority, they vote for the political parties which are against transition and against the establishment of a market economy. In other words under such political conditions, restructuring of the real sector will not create any more political opponents and so there is nothing to be lost in restructuring. This could also lead to stabilization of the government which begins the work on the restructuring of the real sector. Indeed, without restructuring there will be no progress in transition.

All the failings of the real sector of the Serbian economy, its inefficiency and insolvency, spill over into the domestic **banking system**, multiplying in the process. In practice banking in Serbia before the beginning of transition was a mechanism of redistribution, since the deficits of the real and the public sector were 'covered' by so-called 'soft' loans, that is, non-returnable loans. In other words, the deficits of the real and the public sector spilled over into the banking sector multiplying along the way due to its own inefficiency. In addition, the low level of public trust in this sector led to the withdrawal of practically all personal deposits.

There are several key steps to banking reform. The first is the entry of the new banks whose capital is owned abroad, by reputable foreign banks (banking 'brands'). In the first years this entry mostly involved the opening of new banks while somewhat later, partly owing to restrictive licensing, it included the take-over of existing domestic banks. The second step was the closure (liquidation) of the four major socially/state owned banks where most 'contaminated' assets were deposited as the consequence of the spillover of the

deficit into the banking sector. Although this move was expected to result in extensive protest by former employees and subsequent political (mis)use of the situation, nothing much actually happened. The third step was the partial and temporary nationalization of the banking system carried out through the conversion of the debt of commercial banks to the Paris and the London Club (the debt with sovereign guarantees) into the state capital in banks with such liabilities.

These three steps were the basis of the radical reform of the domestic banking system that has been affected in the last four years. This led to the fast renewal of lending activity and high annual growth rates in the value of loans made have been recorded. The level of lending activity rose by so much that at one time it was regarded as a hazard in terms of macroeconomic stability, that is, of the excessive aggregate demand. The banking system also began to win back public trust which resulted in a considerable rise in deposits (both absolutely and relative to money supply). However, the banking system in Serbia is still quite shallow, measured by, for example, the proportion of loans approved to the economy as a share of gross domestic product – almost all our neighbors have overtaken us in this respect. Loans are still a minor source of finance for the economy.

Probably one of the reasons for this lies in interest rates – they are still rather high. On the one hand, this is the consequence of the still highly risky placement which, in turn, is the result of doubt concerning the collection of debt from the debtors which, in the final analysis is, among other things, caused by the ineffectiveness of the justice system and inadequate lien regulations. On the other hand, however, high active interest rates are also the result of high interest margins, produced by the high costs of financial brokerage i.e. high banking costs incurred by their ineffectiveness in the area of financial brokerage.

In that respect two of the main strategic objectives for further transition in the banking sector are to build up the capacities of the banking sector and the improvement in its efficiency and the effectiveness of financial brokerage as a whole. Both objectives gain importance when we take into account the undeveloped capital market as an alternative source of supply for this resource. New entry into banking and the increased pressure from competition within the sector will promote the achievement of these goals.

As for **economic legislation**, much has been done, especially in the area of new regulation. Many laws have been adopted, regardless of the government

under which they were prepared and before which Parliament they were placed. However, legislative activities have rarely been accompanied by serious and comprehensive public debate. A large number of laws were often needlessly passed summarily, according to emergency procedure; their adoption was the object of political horse trading aimed at securing the majority in Parliament rather than the result of a serious political consensus. Furthermore, certain laws were delayed for political reasons. The gravest problem here lies in the relations between Serbia and Montenegro which have been problematic for some time. Under the legislation of the former Yugoslavia, part of economic legislation was dealt with at the federal level, and part at the level of the republic. Certain important laws (for example, the Law on Enterprises, the Law on Enforced Settlement, Bankruptcy and Liquidation) were passed at the federal level while the other federal unit, already on the path towards independence, had created its own economic legislation. It had long been thought that, for political reasons, Serbia should not take the same course. However, in waiting for a final constitutional solution to the federal puzzle the change of course from federal to republic legislation began relatively late (in most cases after the adoption of the Constitutional Charter) which caused considerable delay.

As for the content of new legislation, problems of conception occasionally arose there as well. Since there was no clear and consistent idea for the direction transition should take, there was also no unified concept of legislative activity and often the laws were in essence mutually inconsistent (the inconsistency stemmed from variations in the pace of the changes), and certain laws called for inappropriate solutions. The lack of a clear vision and a plan for transition occasionally allowed foreign donors to practically impose solutions which, for one reason or another were familiar to them. In addition, the preparation for the beginning of the process of stabilization and accession to the EU led to the request for partial harmonization of domestic laws with those of the EU, regardless of whether they are optimal for this state.

However, problems with the implementation of the new laws are far more serious. In part they result from the lack of specialized institutions (the Agency for the Registration of Economic Agents, the Telecommunications Council, and the Broadcasting Council) necessary for their implementation. Such completely new institutions in line with modern legislation require special resources, primarily human capital with specific knowledge who have largely proved impossible to find in Serbia so far. It takes time and hard work to establish such institutions and for them to become effective and they cannot be instantly produced even with strong political will. However,

along with this objective difficulty, in many cases (the Law on Broadcasting and the Law on Telecommunications for example) there was no political will to even embark on the establishment of these institutions. The task was (in part) the responsibility of the parliament which selected the members of the bodies; however, even though the law set a time frame for the establishment of the institutions the majority in parliament never even tried to meet it. This proved that the legislative body holds no respect for the laws it passed which is a poor message for all who are expected to abide by the law. Moreover, the administration of justice holds much responsibility for the implementation of these laws and the situation in this sector (Chapter eight) makes it too optimistic to expect that judges and public prosecutors will soon be ready for change and the implementation of new regulations, especially in terms of the new philosophy by which the state partly delegates both the regulatory and the supervisory function to independent bodies. Finally, certain legal solutions were inappropriate, over complex and even mutually contradictory, putting their unified implementation out of the question, notwithstanding the above problems.

**The reform of the justice system** has certainly been the greatest failure of transition in Serbia so far. Unquestionably, the legacy was extremely unfavorable: in the 1990s the system was constantly misused for political purposes while simultaneously pushed to the margins economically speaking. It is not strange that about one third of judges resigned their positions. Because there was no doubt concerning the gravity of the existing situation, it is odd how carelessly the authorities in Serbia have tackled the reform of the justice system in the last four years. This is especially true considering that the main principles of the reform ('cleaning out' the personnel, strengthening independence, changing the procedures for appointment and dismissal, more effective organization of courts) had been formulated before the political change in October 2000 as part of the preparation of the then opposition for coming into power.

The legislative reform of the administration of justice from 2001 shows the depth of the problem. The laws in this area were not proposed by the Government of the time nor by the relevant ministry but by a Parliamentary Group (DSS). The Ministry of Justice, which had itself set up the working group for the preparation of a set of laws concerning the administration of justice, opposed the proposals, but they were adopted nevertheless. It was claimed at the time (and has never been convincingly rebutted) that this manner of legislative operation was the result of a political trade: we will vote for your law on labor if you support our laws concerning the system of justice. So the

laws were passed without any properly thought out, even less publicly debated concept for the reform of the administration of justice. The two propositions discussed differed considerably in relation to the key aspect – continuity. The laws adopted, which aim to reform the justice system, retain full continuity of institutions and the inherited personnel. However, even laws adopted in this manner have brought about some improvement, at least formally (a cynic would say that it was not very difficult in the light of the inherited situation), especially in terms of the nomination and dismissal of judges and public prosecutors, the material status of the sector, reorganization of courts and institutional guarantees of objectivity and efficiency.

Unfortunately, however, even these regulations have not been enforced consistently. As for the nomination and dismissal of judges and prosecutors a conflict of interest was soon revealed, escalating into open conflict between the judicial authority on one side and executive and legislative authority on the other. There has certainly been some improvement concerning the material status of the judiciary, although many consider it to be far from ideal. As for the reorganization of courts, the stipulations of the new laws have still not been implemented and the legal deadlines for their execution have been exceeded (for example in the case of appellate and administrative courts). As for objectivity and the effectiveness of justice, it is obvious that the institutional guarantees provided by the current laws on the judiciary are ineffective. Both domestic and foreign empiric research has revealed the existence of widespread corruption (direct as well as institutionalized through pressure exerted by executive powers) as well as poor effectiveness (on average the enforced execution of a contract takes 1, 030 days). The concept which has endured the most flexible interpretation in the last four years is the independence of the judiciary. On the one hand there are some in executive power who interpret independence to mean the full freedom of the justice system to carry out their directives, while in the judiciary there are those who read it to mean that they are not accountable to anyone regardless of how poorly, incompetently and ineffectively they work.

Things are somewhat better as regards the reform of procedural law including the new criminal and civil executive procedure. Although it is still too early to assess the effects of the reform of the law on procedure (which, in part, provides for improvement in the effectiveness of the administration of justice), in practice certain procedures stipulated by the new criminal law have proved questionable.

After four years of transition the reform of justice is still at the very beginning – apparently these have been lost years. The main reason for this is the lack of any consistent and purposeful strategy for reform, comprising measures adopted and resources earmarked for their implementation. Moreover, if not all relevant actors, then at least the majority need to agree on this strategy. It was only in the fifth year of transition that work on it has begun. Indeed, without such a strategy, based on the will to face the past and the present reality of Serbian justice, with a consistent plan for overcoming such a present and by drawing together all relevant agents of the reform, there is little hope for sustainable improvement in this area.

For the assessment of **the reform of the financial market** in Serbia of the utmost importance is the fact that, practically until early 2002, there was no activity on the capital market – it only began to operate during 2002. The main instrument of such activity are shares issued in privatization according to the regulations in force before the new privatization model from 2001. However, in the next few years the amount of activity was drastically reduced – the market was depleted. To be precise, the capital market in Serbia served for purposes completely opposite to those in market economies. Instead of establishing companies on the stock market, that is, for their financing, it serves either to close them down or take them over. This phenomenon directly relates to the failure to protect small, or minority shareholders, those who do not have the ambition to run a company but only to receive dividends on the basis of the placement of their capital. Then, trading in the best quality securities was largely transferred into out of stock exchange methods of trading. The phenomenon of trading out of the stock exchange is connected with regulations which were effectively introduced in the autumn of 2003.

For the consideration of the linkage between the capital market and the corporate control market the main parameters are the poor protection of minority shareholders and regulations which are discriminatory to the advantage of the individual taking over the company. It has been noticed that a certain exchange of functions has occurred on the corporate control market as well. While in developed market economies such a market primarily leads to takeovers which eliminate ineffective companies and managers, in Serbia the function of rent formation predominates (due to the establishment of uncompetitive market structures), and therefore, also to high capital returns. Then, it turned out that when joint stock companies are taken over in Serbia there is a massive breach of the ownership rights of the current owners. Immediately

after taking control, the new owner often executes the expropriation of the rest of shareholders through (abuse of) recapitalization.

In terms of the strategy for the development of the capital market the overriding question is its survival, taking into account the dramatic fall in market activity. The survival can only be secured through a change in its character. Instead of its current function as a mechanism for the re-allocation of ownership rights, the market should become a mechanism for financing the real sector, that is, the enterprise sector. This is why the existing regulations need to be radically changed, primarily the Law on Securities which is not in keeping with the basic standards regulating financial markets. It is also necessary to adopt new regulations concerning the take over process, although the new Law on Economic Associations offers some solutions to this problem. In addition to the introduction of new legislation it is also necessary to secure its implementation which can be achieved either through strengthening of the existing specialized institution (the Commission for Securities) or through the establishment of a new institution for monitoring all financial activities (banking, insurance, financial markets etc). Regardless of the solution selected – whether it is a specialized or an universal institution – it is of the utmost importance that its independence is protected both from the influence of the executive powers and from participants in the market.

**The reform of labor relations** and the labor market is one of the areas where the most important changes concerning the introduction of a market economy are expected. Change is of utmost importance for a state where a type of product market existed in the era of socialist self-management but where the labor market has never existed in recent history and where unemployment is rampant. The more flexible the labor market, the more freedom employers (entrepreneurs) have to dismiss employees and the more freely they will also employ them and in larger numbers. The improved flexibility of the labor market, primarily through the reduction of the protection of employees and the responsibilities of employers allows an increase in employment and therefore causes a fall in unemployment. At the present level of economic activity a high level of protection for employees and a high level of employment are mutually exclusive. In other words, a high level of protection for employees incurs opportunity costs – high unemployment. The self-management mind set refuses to accept this basic relation. Such disregard for reality gives rise to much misunderstanding as well as to demagogic spin by political parties and trade unions.

From 2001 to 2003 some far reaching changes were effected in the labor relation and employment laws. New provisions of the Law on Labor provided a fairly strong basis for the transition of the Serbian economy and effective operation of private enterprises by introducing a considerable amount of flexibility into the labor market. The provisions of the labor laws from 2003 provided for the modernization of the state employment policy. In 2005, after much dispute and strong pressures applied by trade unions and leftist circles, the Law on Labor was amended so that the flexibility of the labor market was reduced. The interventions and the demands of international financial institutions, especially by the World Bank seem to have prevented a higher level of workers' protection being incorporated into that Law, which otherwise would have further reduced the flexibility of the labor market. Nevertheless, this modification of the law did, to a large extent, annul the progress made in relation to the deregulation of the labor market from 2001.

As for movement on the labor market, the level of employment is in mild decline while unemployment is on the rise. Such dynamics should be considered in the light of the fact that the restructuring of the real sector has, in fact, hardly begun and that this process, together with the coming into force of the bankruptcy regulations, will further increase unemployment. In addition, the investment climate in Serbia is such that no new large investment which would open up new productive jobs can be expected.

The main direction of further reform of labor relations should be the deregulation of the labor market and its improved flexibility which would provide help a relatively modest level of economic activity to generate higher employment and better use of human capital.

**The reform of the pension-disability system** began against a background in which the number of pensioners is disproportionately high in relation to the number of the employed. Difficulties relating to the system which is based on the current financing of pensions stemmed from the fall in the number of those in employment, the evasion of payment of contributions and the spread of the grey economy on the one hand and from the effects of an aging population and very liberal entitlement to pensions (pensioners as an electoral body gravitated towards the former regime) on the other. This is why the system was in considerable debt at the beginning of transition.

First steps in the reform, immediately after October 2000 were aimed at the stabilization of the system and the regular payment of pensions. The payment of pensions has remained one of the priorities of the Government in all four years of transition. As for the reform of the system itself, steps were

soon taken to establish short-term sustainability of financing. For long term reform, the idea of the so-called second pillar (obligatory additional insurance of the younger population) was discarded relatively early; instead the option was considered that a third pillar be introduced (voluntary additional pension-disability security).

As for the existing system (the first pillar), by the end of 2001 the pension age limit was raised by three years, from 55 to 58 years for women and from 60 to 63 years for men. Simultaneously the minimum age was raised from 50 to 53 years of age. In this manner Serbia caught up with other transition states which had began the changes earlier, but decided to phase in the raising of the limits. The other significant change concerned transition from keeping pensions in line with pay to indexing based on the rise in salaries and the costs of living. In this way pensions were prevented from rising too fast, which would be untenable due to the deficits in the pension fund.

One of the most important changes introduced by the new Law on Pension-Disability Security from April 2003 concerns the introduction of a new formula for the calculation of pensions, based on the point system and extending the accounting period to the whole working life. The accounting system provides for closer connection between the amount of pension and the contributions paid in, since it takes into account all the years in which they were paid, doing away with the spill over to those who achieved a rapid rise in career or pay in only one part of their working history. The new law also extends the coverage of pension security – for example, it introduces obligatory payment of contributions for engagement through authorship fees and temporary service contracts.

From an optimistic perspective, in the short term, the problem of financing pensions will be alleviated through the rise in employment and the reduction of the grey economy. However, in the long term, problems stemming from the aging of the population will remain. This is why we can expect further increases in the pension eligibility age limit, especially for women, and changes in the indexation of pensions and further revision of entitlements. In the long term, the pressure can be alleviated through the introduction of additional insurance pillars, primarily of the third pillar. The reassessment of the possibility for the introduction of the second pillar should rest on careful consideration of the experiences of other transitional states, but only after Serbia becomes ready to bear the transitional costs of its introduction.

Poverty in Serbia exhibited dramatic growth in the 1990s; the middle class disappeared and the number of the poor doubled while the number of those who are immediately above the poverty line is on the rise. According to national criteria, measured by income per consumer unit, in the year 2000 over a third of the population, that is, nearly 2.8 million, were below the poverty line. Before transition such a situation was dealt with through social policy which mainly consisted of extending direct subventions to loss-making companies on the one hand and through imposing low prices of staple products and services (bread, milk, oil, sugar, electric power, rents) on the other. Simultaneously, in the 1990s the minimal social security net was practically destroyed.

Immediately after the beginning of the transition of social security, the first activities were of an interventionist nature, in essence aimed at the stabilization of the system. Among other things the repayment of long accrued debt began, regularity of payment of benefits was established and the situation in hostels was improved. The other part of activities was to initiate reforms in the system. The guiding principle was the rationalization of resources and the sustainability of social protection, which means that entitlements need to be in line with the financial status of society and that assistance should be accessible to all, under equitable conditions, especially to vulnerable groups.

In accordance with these basic postulates changes in the benefits system took the direction of establishing the absolute line of poverty the same for the whole territory of Serbia, the real value of which will be retained through indexing to the cost of living, with stable access to entitlements and better targeting of users. The changes in the area of services in social protection were directed towards decentralization, deinstitutionalization and the development of alternative forms of social protection, the inclusion of the nongovernmental sector into service provision and gathering together all actors which can provide active and passive protective measures, both at the central and at the local level. In this way the foundations for social security and social protection were laid down.

In the 1990s in Serbia a policy was at work which aimed at retaining all capacities and all employees in **the healthcare system**, as well as all legal entitlements concerning healthcare in the hope that the economy would recover and that it would be possible to keep all resources and avoid any serious perturbation. Meanwhile the socio-economic situation in the country worsened dramatically and the healthcare system had to adapt haphazardly to the changes, with constant diminishing of basic capital (facilities and equipment), the lack of medical supplies, a drastic fall in the quality of medical

services and their reduced use, informal modes of payment and corruption, the transfer of patients and part of the equipment from the state into the private medical sector and the subsequent deterioration of the health status of the population.

The reform of the healthcare system came rather late only really getting under way in 2002. Since then some things have been accomplished: The healthcare system operates in decent surroundings with sufficient essential equipment and supplies. However, the medical staff themselves, their professional commitment and satisfaction at work have not changed much.

Medical institutions have been furnished with modern equipment and the provision of medicines and other supplies is better. All this is accompanied with measures for rational consumption, especially that of medicines through the establishment of the “positive medicines list” and the introduction of an information system to monitor their consumption.

However, hardly anything has been done concerning the in-depth reform of the healthcare financing system, that is, the reform of the health protection system. This key task still lies ahead.

The status of the private medical care system has also not been adequately regulated; it has developed in a random manner lacking appropriate legislation and inspection; today it is a powerful interest group demanding equal status in the medical protection system which is at this moment impossible due to the limited financial resources of the Insurance Fund, surplus capacities and staff in the public sector, the unchanged form of financing and inadequate state inspection.

Important aspects of the medical care reform such as the reform of financing (insurance), continuous improvement of the quality of services provided, accreditation of medical institutions and programs, issuing of licenses for healthcare providers and the assessment of medical technologies depend on the adoption of new systemic laws on which consensus as yet had not been reached. The work on the solution of this problem still lies ahead.

The consideration given to **international relations** which Serbia (independently and as a part of the FRY and of the State Community of Serbia and Montenegro) has kept up and promoted in four years of transition should be seen in the light of the already discussed conclusion that the main driving force of transition in Serbia lies outside the state. Moreover, since there is no national consensus on the need to integrate into the world as there are political forces which are against it out of interest or because of ideology, it is of the

utmost importance that it be clearly demonstrated that Serbia should gain benefit from it. In this manner the strong driving mechanism of the transition through international relations could be preserved while the laborious process of the creation of a similar internal mechanism can be initiated.

In terms of the directions for the future of the integration of Serbia into the international community and its impact on the transition process underway, we should start with the fact that at the moment (and in the foreseeable future) the accession to the EU is the mainspring of our reform. The harmonization of legislation and the appropriate rearrangement of the institutional framework are the main elements of the reform. This concept leads to the solution to several problems since the reform can then be established both as a political necessity and as a value in itself if only in the instrumental sense for the achievement of the main objective called European integration. Certainly, it is not that the institutional framework of the EU is ideal and that the policies carried out are optimal. Unquestionably, in the EU there is too much state interventionism, too much regulation and discretionary decision-making by supranational authorities which are practically accountable to no one. The separation of power from accountability never bodes well. The room for a free market, unbound individuals and enterprising initiative shrinks. However, the approach to and the final integration with the EU provides for the establishment of a clear and consistent legislative framework on the basis of (in many cases) several decades of practical experience, eliminating the need to invent the wheel. Moreover, where there is still a powerful majority in favor of European integration, many changes can be smuggled in under the cover of the slogan: "This is something we must do if we want to get into Europe". However, there is still room for domestic creativity, primarily in the execution of the reform, its dynamics and priorities.

On the home scene the priority is certainly the creation of a competent state administration - the core of which will be able to communicate on a more or less equal footing with the representatives of international political, financial and economic institutions and with the representatives of the leading partner states. Without such administration Serbia simply will not be able to impose its own interests in the area of international relations.

Three main **state issues** which in the last four years have used up considerable political energy, although their relative importance and the intensity of the energy expended vary all the time, are: the constitutional system of Serbia, relations between Serbia and Montenegro and the problem of

Kosovo. Almost five years after the political change which made the beginning of the transition possible, Serbia still does not have a new Constitution nor has it amended a single provision of the one passed by the former regime which was identified with this piece of legislation and which was voted out of office in October 2000.

One of the central dilemmas confronted in relation to the constitutional change concerns the procedure. Namely, the current Constitution calls for a complex procedure for changes. According to it, the adoption of the new Constitution would practically demand the consensus of all parliamentary political actors in the state. The alternative lies in discontinuity in order to circumvent the current exacting procedure. After four years of transition two politically relevant drafts, that is, two constitutional projects have appeared: one offered by the Government, the other by the President of the Republic. The essential difference between them does not lie in the contents of the document in terms of basic constitutional solutions but actually in the procedure for their adoption. As in many other transitional issues Serbia is still far away from agreement in this respect. Meanwhile the existing Constitution is still in force providing opportunities for the creative misuse (more or less successful) of its provisions for the introduction of the market economy such as private ownership over city land.

Relations between Serbia and Montenegro have become a veritable soap opera after October 2000 (before they were at the risk of becoming a vaudeville with singing and shooting). Four years after the beginning of transition there is still no functional common state. The present solution was practically imposed through mediation by the EU representatives. It sought to prevent worse from happening, especially in terms of security. In other words, the incentive for mediation was the maintenance of at least the same security status in the Region. As for the future of the state community, it should be viewed through the disproportion between its international-legal capability (communication address for example for the process of association with the EU) and the internal-legal failings, for example the inability to implement the terms of the future contract on stabilization and accession which is to be signed with the EU. The announcements concerning a referendum in Montenegro and the manner of political communication in this republic about this and other issues reveal such a deep rift the basic question (independence or not) that, in comparison, conceptually divided Serbia begins to look like a state with an insane level of political consensus.

Finally, solving the problem posed by Kosovo is a state predicament which is increasingly gaining in importance and more and more domestic and international activities are taken in that direction. Irreconcilable interests seem to be at the core of the problem. One side demands that Kosovo should remain in Serbia with some internal-legal arrangement which can be discussed. The other says that it should be granted independence, as soon as possible. The international community increasingly calls for the so-called final solution. International priorities have changed and it can be felt that resources are being withdrawn from the region to be applied where needed more, primarily in the 'war against terrorism'. It remains to be seen whether any final solution which is sustainable, that is, which is at least in part acceptable to both parties can be reached in the foreseeable future.

#### INSTEAD OF A CONCLUSION

After a vigorous beginning transition in Serbia has slowed down and in places come to a halt. In some of its segments much has been accomplished while in others hardly anything has been done. Rather a dismal picture. The reasons for this were discussed above and can be found in the circumstances creating the political framework of the transition, the framework which gave rise to such results. The circumstances produced the framework and the framework produced lackluster results. These results have disappointed many supporters of transition.

Sadly, Serbia is still far away from a real market economy and the rule of law. Today only a small number of new companies enter Serbia; there is a modest rise in new, productive employment, large budgetary transfers, considerable subventions, all encompassing state intervention and high business risk. Serbia is still a society where seeking rent is a very profitable activity.

Accordingly, the overriding question concerns the continuation of transition: what are the conditions for its successful continuance, what will make it gather pace and in the end establish a market economy and the rule of law?

First of all, the driving mechanism of transition needs to be returned into the country itself. This can be achieved through the consensus of all relevant political agencies in the state. The consensus need not concern the details

of the process; rather there should be agreement on basic issues: where are we heading and when do we want to get there? This can also be defined in a negative manner: what is it that we want to avoid at any cost? Until such a consensus has been reached, Serbia will need an outside driving mechanism.

The obvious question is whether such consensus can be reached in Serbia at this moment, a little over four years after the beginning of transition. Many will say that, on the Serbian political stage, there are powerful political forces which are simply against transition, whose belief system does not value a free market economy, the rule of law and stable democracy. This is certainly true, but the question is how to break the vicious circle. The only tenable possibility for this is to weaken anti-transitional forces. This can occur either through their internal reform (which can be triggered by division inside their organizations) or through the weakening of their political influence as the result of insufficient political support.

For both success in transition is needed, the kind of success which creates transitional winners. In the short term, transitional measures do have their costs; they create losers, diminish political popularity and can lead to the loss of office. In the long term, if consistently carried out such measures create winners and considerable political support for transition within the electoral body. If the horizon of the people in power in Serbia, the horizon of those who firmly believe in reforms broadens, that is, if they begin to think how to get back into office before they are voted out of it, Serbia will have the chance to continue and in the foreseeable future to complete the transition to a market economy and the rule of law. Otherwise...



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