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## Post-Conflict Reconstruction in Serbia: A Political Economy View

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The 1990s in Serbia were marked by war, uncertainty, and illegal rent-seeking. Those who took advantage of the system profited, and thus supported the status quo of Slobodan Milošević's regime. However, once Milošević was removed from office, the outward veneer of stability in Serbia crumbled and citizens were forced to face the legacy that Milošević had left behind. Initially, the influence of Milošević's allies was stymied and reform proceeded at a rapid pace, with positive results. Serbia was able to engage in substantial economic reforms while avoiding the transition-economy policy mistakes that befell Eastern Europe and the former Soviet Union in the early 1990s.

However, success did not last long. The rise of interest group politics halted economic reform as successful members of the business community supported policies that would safeguard their empires. The involvement of international organizations exacerbated internal Serbian politics at times, to the detriment of political coalition unity and effective economic reforms. Currently, Serbian post-conflict resolution and reform is at a crossroads. Although institutions are weak and economic policy is guided by interest group politics, the expansion of small businesses governed by rule of law could facilitate the development of a capitalist economy in Serbia. However, without proper support for legal entrepreneurship, stagnation is the most likely outcome.



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*Entrepreneurs are not suddenly created in profusion by spontaneous generation and their ranks are not suddenly decimated by some undescribed plague... Baldly put, the activities that promise the greatest monetary (or other) returns lead to a reallocation of entrepreneurs from one sector of the economy to the another, and this reallocation can take forms that give the appearance of the vanishing or emergence of entrepreneurs as a group.*

William J. Baumol

## Introduction

During the 1990s, Serbia endured a prolonged conflict that started as a quarrel between neighbors and ended up as a regional war with extensive international involvement. As a result of the war, the country shrank substantially and was turned upside down. The international community imposed a trade ban and other sanctions, creating shortages on the domestic market and a huge potential for rent seeking in the political environment. As communism collapsed in the early 1990s, no other coherent structure of institutions, rules, and regulations emerged.

War activities became a very profitable business in Serbia in the 1990s. This meant engaging in various war crimes, looting, sanction-breaking importation, racketeering, drug dealing, blackmailing, extortion, and similar activities from the industry of crime and rent redistribution. To participate in these activities, entrepreneurs of “distribution and destruction” had to have strong personal contacts with the government, its secret police, the military, and other various paramilitary units. Notorious criminals became national heroes and were considered to be patriots fighting for the protection of Serbian national interests, as well as successful “business” people – through their involvement in the aforementioned activities. Successful non-criminal business people, although not involved in criminal operations, earned huge rents by obtaining legal monopolies for importing the most profitable goods in times of shortages. Entrepreneurs involved in productive, value-added activities were mocked (“only fools and horses work”), and their private property rights were not protected. One can assume that such is the heritage of conflicts in all parts of the world, as the incentives entrepreneurs face in times of conflicts are the same regardless of region, location, or culture.

During the decline of the Serbian state in the 1990s, entrepreneurs of “distribution and destruction” became a social elite and a role model for younger generations. They acquired huge political influence and were in a position to shape public policy – in essence, they “captured” the state. The crucial problem with such a state of affairs was that they had no incentives to introduce and enforce the rule of law,

particularly the protection of property rights. They had their own way of protecting property rights, whether through a corrupt judiciary, by violence, or by a credible threat of applying it. On the other hand, they did not want effective protection of others’ private property because such protection would be a barrier to the redistribution of wealth. Finally, they had no incentive for any political change – “Milošević forever!” was their slogan.

Other Milošević allies were people with strong risk aversion. Their attitude was dominated by nostalgia for the times of fully-fledged communism, with all decisions made for them by senior party officials at no risk to themselves. In the old times, being efficient was unimportant – although the salary you would get was low, at least you were getting it. During the first multi-party elections, the official Milošević slogan was: “There is no uncertainty with us!” He won a comfortable 2/3 majority in the parliament with that slogan, proving that people did not want change. Ten years later, the bulk of the people who had voted for Milošević had changed their minds. They thought that having him in the office was the risk second to none. They made up their minds that the devil they know is worse than the devil they still do not know. To make such a change in the attitude of Milošević’s constituency was a great accomplishment of the Serbian opposition.

## Post-Conflict Conditions: First Steps to Reform

Election results and hundreds of thousands of angry people kicked Milošević out of office in October 2000. And then the Milošević legacy surfaced, for everyone who wanted to face it. That legacy was a criminalized society, institutionalized corruption, an impoverished population, and a devastated social security network. From the economic perspective, the legacy of the old regime was a GDP per capita 40% less than that of the pre-conflict period, a very small and undeveloped private sector contributing only 35% to the GDP, big state-owned enterprises producing nothing but losses, an uncompetitive economy, and average wages of about \$100 per month. Furthermore, the country also had a large, incompetent, and non-competitive labor force that held the general attitude that something should be done for them, not that they should ask what they can do for themselves. Finally, the most important legacy of the Milošević regime was a ruined institutional framework, and, as a consequence of that, most entrepreneurs were involved in the distributional and/or illegal (criminal) activities, with only a very limited number of entrepreneurs engaged in legitimate, productive activities.

For all who directly or indirectly profited from the conflict and collaboration with Milošević, particularly those who built business empires during his reign, that was a

critical time. They knew that the good times were over, they knew that they were facing serious threats, and they knew that they would have to restructure and find new patrons. Some of them would have to move to legitimate business and to launder the money they earned. But all of them knew very well that they would have to be very quiet about their vested interests and keep their heads down to buy some time.

Accordingly, many of the entrepreneurs who successfully specialized in rent seeking or blatant criminal activities in the 1990s started to praise the reform and the reformers' moves, and virtually none provided any resistance to the reform efforts. They did not organize interest pressure groups and did not influence public policy. The same goes for the inherited state administration (civil servants), i.e. people who served Milošević and his circle, with some of them even loyal to the communist system of the 1970s and 1980s. All of them were afraid of their past activities and possible consequences.

Without a doubt, October 2000 was a revolution, and one can go back in time to the French Revolution to understand the mechanism of the post-revolution time. That can be done by using Robespierre's speech from Georg Büchner's play "Danton's Death": "The weapon of the Revolution is terror — without terror, virtue is impotent!" The original meaning of the word "terror" is fear, although contemporary meaning inclines more toward violence. Hence, the October 2000 revolution in Serbia created fear for many, mainly Milošević's allies. However, this threat was not manifested through any type of violence. Using the more modern language of public policy, the revolution, through fear, created a window of opportunity, and that fear was the leverage for enforcing public policy reforms.

Although the revolutionary fear was not institutionalized, it was based on the wide range of options for action available under the new rule of Serbia. That fear was so substantial that ordinary (non-organized) convicted criminals, during the rebellion in one of the Serbian prisons, hung the banner stating "We support DOS (acronym for Democratic Opposition of Serbia)," knowing very well that the prison warden, obviously a vehement supporter of Milošević, would be too scared to do anything about it, let alone to punish them. His fear was paralyzing, so the rebellion was successful.

Hence, the paralyzing fear of Milošević's powerful allies virtually removed opposition to reform in the early stage. That created a window of opportunity in October 2000, and it was used for the first generation of transition reforms. These included price liberalization, foreign trade liberalization and deregulation, macroeconomic stabilization (including national currency convertibility and market-based exchange rate policy), taxation reform and consolidation of the budget deficit, introduction and enforcement of the new

and economically sound privatization model, beginning of the restructuring of the domestic real and financial economic sectors (including liquidation of the biggest domestic insolvent banks and introduction of foreign banks), adjustment of public utilities prices, and reform of the social security system. Membership and outstanding issues (mainly arrears) in relations with the international financial institutions were sorted out, and agreement with the public creditors of Serbian sovereign debt (Paris Club) was reached (including writing off 66% of the total debt and rescheduling the rest with a generous grace period). International support via grants and loans enabled rehabilitation of the infrastructure (particularly the power industry and transportation sector), substantial budgetary support, reform of financial support to pensioners, and payment of vast segments of the government's arrears to the population.

This first stage of reform (until the end of 2001) was very successful. In addition to the lack of reform opposition due to fear, the advantage for Serbia was the fact that the country had been a latecomer to the transition, hence there was no reason to repeat the transition policy mistakes already made by the pioneers of transition in Central and Eastern Europe.

### **The Rise of Interest Group Politics and the Stagnation of the Economy**

The problem with fear as a mechanism of enforcement was that it was not institutionalized and, therefore, it was not sustainable. As time passed, the fear and the related credible threat diminished. Longtime Milošević allies and opponents to the market reforms managed to regroup and to organize themselves to influence the policymaking process. They were actually helped by the attitude of the late Prime Minister Zoran Đjindjić, who had a business-like mentality ("Scratch my back, and I'll scratch yours") and was open to various business deals in politics. A new equilibrium, though not necessarily a stable one, emerged for many of the conflict-era entrepreneurs and put them in a better position to protect their interests. After the period of fear, Serbia entered a period of interest group politics that influenced public policy. The interest groups' aim was to protect and enhance their business empires. They were against economic freedoms and the rule of law because these developments could disable their attempts to seek new rent opportunities. The situation in Serbia resembled classic economic arguments that the bigger the barriers to entry into the market and the weaker the institutions, the better for the old style business people who gathered vast resources during the 1990s.

The rise of interest group politics enabled business people and former Milošević allies to exercise substantial and effective political pressure against reform and against the creation of

a free-market institutional framework. This change of the political landscape took place as the second stage of the transition came about, in which comprehensive deregulation, institutional reform, and substantial judiciary reform had to be introduced. These second-generation reforms stalled due to a lack of political will for their implementation, partly because of strong interest group pressure.

In effect, the government began to micromanage the Serbian economy as it was running a big company. Such an approach coupled with a huge regulatory burden on the private sector created significant barriers to doing business. Some big multinational foreign direct investors could deal directly with the government and found the way, not always the most transparent, to circumvent these barriers. Moreover, the majority of entrepreneurs never began productive activities, because the expected profitability of these activities was not substantial – both barriers to business and lack of deregulation being the primary reason. In some cases, the new legislation designed to reduce barriers to business had been passed through the Parliament, but not enforced at all due to interest group pressure and weak institutions.

The direct consequence of regulatory burdens and substantial barriers to business was the negligible number of new entries in business. This was particularly evident in the area of small and medium enterprises (SMEs), which were expected to generate most of the new jobs. Meanwhile, due to a lack of reform to the state administration and regulatory policies, there was still much room for rent seeking. However, the number of illegal activities by businesses diminished for several reasons: the end of the conflict, normalization of foreign economic relations, and the overall decriminalization of the state. These changes created a flow of entrepreneurs from illegal to legitimate redistributive activities. Although the amount of criminal activities has decreased, a very limited number of entrepreneurs moved from the old redistributive activities (both legitimate and criminal) to the productive ones.

## **The International Community and the New Political Landscape**

The role of the international community in the first stage of the reform produced mixed results. On the one hand, the international financial institutions positively contributed to the reconstruction process. Serbia obtained membership in the International Monetary Fund (IMF) rather swiftly, and the IMF provided crucial support for the country's macroeconomic stability and negotiations with major creditors. The World Bank also moved in quickly, resolving huge arrears problems, and the country reached favorable status with the International Development Association (IDA).

The European Bank for Reconstruction and Development (EBRD) stepped in to provide funds for SME development and infrastructure rehabilitation.

On the other hand, the role of other international institutions was not so beneficial. The policy of the International Criminal Tribunal for ex-Yugoslavia (ICTY) and its principals has been rather controversial. Since the end of Milošević's rule, the ICTY insisted on arresting and deporting all its indictees from Serbia, including Milošević himself and other senior government and military officials. The extradition of Milošević to Hague in June 2001 created a political crisis that brought an end to a strong reform-oriented coalition in the Serbian parliament. Not since has such a coalition been formed. Obviously, the agenda of the ICTY and its principals was quite different from the agenda of the Serbian reformists. On the impact-analysis level, the ICTY activities amplified, if not created, political instability, fragmented the reform coalition, and drained political energy away from reform. Ultimately, some link the assassination of late Prime Minister Đjindjić to the activities of the ICTY and their potential clients.

The European Union (EU) played a significant role in the reconstruction process. On the one hand, the European Commission (EC) provided a great deal of funding for various projects, some of which, however, have been rather ineffective. But the most important political input provided by the EU was the resolution of relations between Serbia and Montenegro within the dying Federal Republic of Yugoslavia. The EU stepped forward and offered a plan that neither side could refuse, but the substance of the plan was highly problematic. Eventually the creation of the State Union of Serbia & Montenegro as a loose confederation of the two states created more political problems that it solved. Again, these political problems drained valuable political energy from reform issues (making more space for influence by interest groups) and in some cases directly interfered with the reform process. Coupled with the Kosovo issue, such conditions constantly raised questions about state borders and constitutional design, draining political effort away from the economic reconstruction.

Criminal entrepreneurs fought the changing political environment with the assassination of Đjindjić in March 2003. Ironically, that only increased the drive to fight organized crime and pushed entrepreneurs away from criminal activities. A state of emergency was introduced and thousands of suspects were arrested, as the time became ripe for institutional reform, particularly for reform of the judiciary. Nonetheless, the government took the opportunity to exercise political pressure on opponents rather than to initiate economic reforms. These actions led to a political

crisis and the resulting premature elections, not to an improved economic environment.

### Lack of True Economic Reforms

The new election campaign that followed the assassination of Đjindjić was well founded in cheap economic populism, promising new jobs and subsidies from the budget to various interest groups. These elections and their results created a vast area for interest group politics, because the new government was built on a weak coalition of many political parties that did not trust each other. As a consequence of the populist approach embraced by the new government, a huge budgetary deficit appeared, with large subsidies going to inefficient state-owned enterprises. This sent a strong message that the new government was not oriented toward the reform, and that the business community should not expect any radical reform moves in the near future.

Such a political landscape emerged exactly when the need for the rule of law, deregulation, and the elimination of huge state-owned enterprises running at a loss became ever pressing. For such reforms to be implemented, the country faced the need for a strong political commitment to reforms, because given the incumbent political leadership and the very short time horizon of Serbian public decision-makers, there were still few incentives to change. Yet such a commitment to reforms was nowhere to be found.

Furthermore, weak rule of law further suppressed the desire to implement real economic reforms. Weak rule of law relinquishes politicians from decision-making responsibilities and allows them to use public office for personal gain. Given the fact that few policymakers expected to stay in the government for a long period of time (expected short terms in office were due to political instability and high probability of premature elections), there were few incentives for them to commit to sound economic reform. In such an unstable environment, political returns of economic changes are too far away and not likely to come before the next election campaign.

### Conclusion

Taking all these issues into account, it is easy to understand the stymied state of post-conflict reform and reconstruction of Serbia. The country is far from achieving rule of law, the judiciary is inefficient and corrupt, contract enforcement is very weak, huge barriers to entry and general barriers to business persist as no substantial deregulation occurred, and the regulatory risk remains sizeable. Such an institutional framework was decisive for the character of private sector involvement in Serbia's post-conflict reconstruction. It is not surprising that the majority of entrepreneurs continued to produce innovations in rent-extraction activities, rather than in productive activities.

Meanwhile, partisan political struggle, ongoing political scandals, and a lack of foreseeable political/social consensus on the main strategic direction and vision for the country continue to plague public morale. Some time ago, it seemed that accession to the EU could provide the grounding for such a consensus, but these days it is obvious that many have second thoughts.

Almost five years after the end of the conflict, post-conflict reconstruction and reform in Serbia is at a crossroads. The path to be taken from here will be decisive for the future role of the private sector and the allocation of entrepreneurship between productive and unproductive (distributional) activities. And this division is crucial – if entrepreneurship is channeled via rule of law toward productive activities, Serbia can expect what Baumol refers to as a “free-market innovation machine or the growth miracle of capitalism” – substantial economic growth that will improve social welfare and eliminate poverty. Otherwise...

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