The Serbian Experience in Transition

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Article at a glance

• Important lessons have emerged from Serbia’s experience transitioning to democracy, including the need to capitalize on the window of opportunity and concentrate political energy to maintain momentum.

• Steps in the economic transition include macroeconomic stabilization, price liberalization, foreign trade liberalization, and privatization.

• Because the transition was only semi-successful, lessons can also be learned from Serbia’s failures in transition.
Dr. Begović was a chief economic adviser to the federal government of the Federal Republic of Yugoslavia for 15 months during 2000-2002. He shares lessons in political economy from Serbia’s experience that are relevant to democratic transitions and economic reform occurring today. This article is based on remarks by Dr. Begović delivered at a CIPE Middle East and North Africa workshop in March 2012.

**Introduction**

From 2000 onward, political transition moved Serbia decisively toward genuine democracy, simultaneously creating the opportunity to pursue pressing economic reforms and develop a market economy. Looking back, the greatest challenge in the economic reform process has been institutional reform, especially the continuing struggle to achieve rule of law as a foundation for free exchange. Important lessons have emerged from Serbia’s experience, including the need to capitalize on the window of opportunity and then concentrate political energy to maintain the momentum of transition.

1. **History and the Starting Point**

The starting point of Serbia’s transition, in October 2000, was heavily influenced by Serbia’s recent past. The political system of the 1990s could have been labeled as a competitive authoritarian regime or an illiberal democracy, not a fully fledged democracy, and not a totalitarian autocracy. It comprised three elements of democracy: (1) free elections (though not necessarily fair); (2) somewhat free media (with a firm grip on electronic media); and (3) basic civil rights for the majority of the people.

Serbia’s economic system in 2000 was a type of hybrid regime combining the socialism that had collapsed in the early 1990s with elements of a market economy. Private property and private entrepreneurship were legal, but the protection of private property rights was feeble. The market mechanism now operated in capital and labor markets, while product markets had already existed in the soft version of socialism in Yugoslavia. Nonetheless, arbitrary government intervention spoiled the market mechanism. Transparency and predictability were absent from market regulation. The only constants were the protection of incumbent domestic firms and the obstacles to free trade (tariff and non-tariff barriers, subsidies, and soft-budgetary constraints). A new class of tycoons, closely connected with the government, received special protection for their firms, which generated substantial monopoly rents.

By 2000, President Slobodan Milošević’s rule had decreased GDP to 60 percent of its 1990 level, when he took office. Inflation was about 100 percent per year, the fiscal deficit was huge (including losses of state-owned enterprises), and the public debt was about 170 percent of GDP. The unemployment rate exceeded 20 percent, with a widespread informal sector and with formal employment mostly limited to the public sector. Multiple foreign exchange rates prevailed, along with widespread price controls and huge barriers to foreign trade. The scope of urgent and long term problems was so wide that the crucial question was how to prioritize and sequence moves toward economic transition.

Despite economic collapse at the end of 1990s, the described political economy constellation was, due to the vested interest of the elite, very stable. Thus, political change (in particular the removal of Milošević from office) was a prerequisite for Serbia’s transition.

2. **First Steps**

Political change in October 2000 opened the doors for Serbia’s economic transition. The first step was macroeconomic stabilization. Without stabilization there could be no clear assessment of the economy nor could decision makers observe the results of reforms. Macroeconomic stabilization was achieved through a stringent monetary policy (printing of money was suspended) and consolidation of the quasi-fiscal deficit (losses, i.e.
deficits of the state-owned enterprises) into the budget. Inflation dropped instantly even though most price controls were removed. The lesson here was that price controls could not curb inflation; they had been introduced for political reasons, namely to create rents for favored constituencies.

The second step was full price liberalization, including abolition of multiple exchange rates. A single, market-based foreign exchange rate was established. The Central Bank of Serbia implemented virtually a fixed foreign exchange rate policy a policy, however, to ensure macroeconomic stability while foreign aid was flowing into the country. In the domestic market, price liberalization that happened during this step of transition was essential for product markets to function.

Taking into account the small Serbian domestic market, the third step in transition – foreign trade liberalization – was perhaps the most important. All non-tariff barriers were abolished and tariffs were substantially reduced and simplified. Prior to liberalization there had been 37 tariff rates, which ranged between 1 percent and 40 percent. After liberalization there were only five tariff rates, ranging between 5 percent and 20 percent. Interest group politics stopped a plan for more aggressive liberalization through a flat tariff rate of 5 percent. Domestic car producers were the liveliest interest group, demanding strong protection for their obsolete, low-quality cars.

### 3. Economic Restructuring

The next steps in transition focused on restructuring Serbia’s economy. The most important structural step was privatization, introduced in June 2001, roughly nine months into the transition. Being a latecomer to transition was an advantage for Serbia. Because Serbia’s privatization started about 10 years after the first wave of privatization in Central and Eastern Europe, lessons could be learned from the mistakes made in those countries. Accordingly, Serbia started with a rather robust privatization model based on selling firms to the highest bidder. This model provided for efficient corporate governance (no dispersed ownership) and favored selection of the most efficient owner. The problem associated with this model lay in political economy: it takes time to prepare firms for sale and eventually produce results. Not taking this into account, the government failed to manage public expectations. On the contrary, the government advertised privatization as a panacea for the country’s economic ailments, creating expectations that could not be met in the short-term or in one election cycle.

Consequently, public support for privatization diminished over the first years of the lengthy process. The government responded by accelerating privatization and ended up violating the integrity of the process and diminishing the returns. For instance, the government loosened controls on funds used for privatization (anti-money laundering controls), and this allowed criminal organizations to capture privatization in some cases. As a result, the privatization process is still not complete 10 years later and public support is at a historic minimum.

The restructuring of the state-owned enterprises in the real sector stalled. Initially, restructuring was considered as a step toward privatizing firms that could not be sold as they were, due to their indebtedness and negative expected future cash flow. If restructuring were not possible, the plan was to declare bankruptcy and sell off the firms’ assets. However, restructuring and especially bankruptcy would eliminate jobs and raise unemployment in the short term. The government reckoned that restructuring would decrease its popularity in regions where state-owned firms provided a substantial number of jobs. Accordingly, 10 years later most of the real-sector firms earmarked for restructuring have not been touched. They have been kept alive by state subsidies and soft budget constraints, including not having to pay tax liabilities or invoices from state-owned utilities.

The restructuring of the financial sector (i.e. banks in Serbia) went completely differently. All four large state-owned banks with negative
equity and huge ongoing deficits were liquidated and obstacles to new entry of foreign banks were eliminated. Even today in the aftermath of the global financial crises, the banking sector in Serbia (70 percent foreign-owned) is relatively healthy and has fulfilled high capital requirements. The main reason for this success was the decision to scrap old banks and open the door to new banks. The lower employment in the scrapped banks (only 10,000 employees in total) made them less politically important in the political economic considerations and allowed for radical reform in spite of their private interest in keeping jobs.

The liberalization of the labor market was one of the most important steps in economic reform. It happened rather early while local trade unions were still politically weak. The new labor legislation provided for flexible, mostly contract-based relations between employers and employees, with the minimum wage set relatively low. Collective bargaining had limited scope to impose its results on parties that did not take part in the bargaining process. All these changes provided for substantially higher flexibility in the labor market and decreasing unemployment. Nonetheless, the results were not sustainable. As trade unions have regained strength, they are fighting back and have managed to reverse a substantial part of the labor market liberalization.

4. Ten Years Later: Is the Glass Half Empty or Half Full?

About 10 years after the beginning of economic reform, Serbia is still far from a fully fledged market economy. The main reason is that deficiencies in institutional reform have negatively impacted the business environment.

The most significant reform deficit is in the rule of law. The judiciary is still far from efficient and in many cases not impartial. Further, judicial officials are not competent in specialized issues relevant to a market economy, such as bankruptcy procedures or enforcement of competition law. Litigation to protect private property rights and enforce contracts is lengthy and uncertain even for those whose rights were blatantly violated. The poor legal protection inhibits the free and safe exchange between economic agents who do not know each other. Such impersonal exchange is the basis for competition and a prerequisite for economic efficiency. Serbia's low economic efficiency and low competitiveness are a direct consequence of missing institutional reform in rule of law.

The other disappointment in Serbia’s institutional development concerns huge barriers to the entry of new competitors. Most barriers from the previous period remained, and new barriers have been created. The main reason behind the barriers can be found in the political influence of the domestic business elite, those tycoons who obtained their wealth in the shadowy period of Milošević’s reign. The tycoons have organized business empires along barriers to entry, enjoying rents due to limited competition. Their political strength and influence are a testament to the predictions of public choice theory that a strong, well-organized interest group can easily articulate private interests as public ones. Thus, public policies in Serbia have been biased toward tycoons’ incumbent firms by restricting competition. Taking all this into account, it is not surprising that economic freedom in Serbia is very low, and that, in this respect, Serbia is one of the least free countries in Central and Eastern Europe.

In the absence of substantial privatization, most employment remains in the public sector, including state-owned enterprises, utilities, education, and health. These sectors had no wage control and due to the ample proceeds from privatization of the
profit making firms that were first to be privatized wages have been increasing at a much higher rate than productivity. Pensions have also risen constantly. The increased income created domestic demand and investments focused on meeting that demand. This proved unsustainable: when privatization proceeds shrank, domestic demand also shrank. Private sector wages, by contrast, were controlled by the market mechanism and did not contribute substantially to the increase in domestic demand.

The wage increase in the public sector was again based on factors of political economy, as the government considered public sector employees and pensioners to be “its constituency”. By currying favor with this constituency, it expected to win support in the next elections. The same reasoning lay behind widespread subsidies for public sector firms as well as farmers. Subsidies (“state aid”) in Serbia are twice as high as a share of GDP as in European Union countries, including new member countries that joined following EU enlargement in 2004 and 2007. The problem is that such huge subsidies do not provide a level playing field and they constrain competition as the main driver of economic efficiency.

5. Lessons for Transition

Evaluated as only semi-successful, the Serbian transition experience should be carefully examined, with particular interest in the reasons for its partial failure. Lessons should be learned from this experience, as there is a pipeline of transition projects around the world.

First, there is a rather short window of opportunity at the beginning of a transition. That window of opportunity opened in Serbia with the defeat of the political and economic elite that had a vested interest in not changing the country. The window of opportunity was brief because the political and particularly the business elites were fast to regroup and reorganize. Some of the elite did not survive and some lost clout, but many reemerged as crucial players aiming to protect their interests in the new political economy. The Serbian transition vividly demonstrated how fast and efficiently the business elite can reorganize – almost all tycoons from the pre-transition period survived and some became even more powerful and influential. The crucial thing is to use the window of opportunity to push transition and implement irreversible reforms. The more that transition leaders can accomplish in the first few months of the transition, the more successful the transition will be in the end.

Second, it is crucial for any transitional country to find a mechanism that will enable transition leaders to focus political energy on the transition process and avoid its dissipation. Serbia's political energy in the first part of transition was focused on the hot constitutional issues such as relations between Serbia and Montenegro. The final separation of Serbia and Montenegro paved the way for another constitutional issue – the secession of Serbia’s province of Kosovo, which proclaimed independence in February 2008. This remains a central political issue, particularly as it became part of conditionality imposed on the path to EU accession. Both constitutional issues have drained substantial political energy from the transition and difficult political decisions that should have been made in the process.

The other diversion of political energy has been due to demands by the international community for facing the past, such as dealing with the difficult legacy of Yugoslav wars in the 1990s and the war crimes committed. This was especially embodied in the request for collaboration with the Hague-based International Criminal Tribunal for the former Yugoslavia, and the extradition of fugitive indicted war criminals. The wide-ranging debate about facing the past, in this and other areas, drained much political energy from the transition process.

Finally, political energy was diverted in the debate over what should happen to the business elite who profited under the Milošević regime. The government decided to take the middle path, which turned out to be the worst possible
path. Instead of either prosecuting or absolving violations committed in the 1990s, the government introduced a special one-off taxation of the “extra profit” earned through close connection with Milošević’s regime. In this way, business empires were legitimized and their positions as relevant players solidified. Instead of preventing the incumbent business elite from influencing the public policy process, the government actually introduced them into the process.

The role of the international donor community in the transition process must also be considered, including international financial institutions whose financial support is often conditioned. Conditionality is not necessarily bad in the short run, but it can adversely affect transition. The donor community has its own priorities distinct from those of transition countries, and donors’ priorities may change over time. For example, donor organizations frequently undergo a change of paradigm (“fashion”); for example, projects funded by the World Bank today are quite different from projects funded 10 or 20 years ago. Moreover, transitions based on externally imposed conditionalities tend not to be sustainable as people give their full effort only if they believe in something, not if they are intimidated by some conditionality.

The final lesson learned in the case of Serbia is the curse of easy money. With substantial foreign aid channeled directly or indirectly to the budget and with huge privatization proceeds, there was no fiscal deficit even with an increase in expenditures on public-sector wages, pensions, and subsidies to loss-making firms. In such a situation, the government had no incentive for radical, sustained economic transition that would achieve economic growth, increase the tax base, and enhance sustainable revenues. Good times are always bad times for the transition process.

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