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## THE TRANSITION PROCESS: STIMULATING FREE ENTREPRENEURSHIP<sup>1</sup>



APSTRAKT: Tekst se sastoji iz dva dela. U prvom obrazla`emo tezu da je tranzicija zapravo proces stvaranja institucionalnih preduslova za razvoj privatnog preduzetni{tva u datom trenutku i zate-enim okolnostima. Potrebno je mnogo znanja, kreativnosti i pragmatizma (op{teg modela nema) da bi se stvorio ambijent koji podsti-e slobodno preduzetni{tvo i omogu}uje uspe{nu tranziciju. Ostalo je posao preduzetnika. U drugom delu analiziramo iskustvo SRJ pre i posle promene vlasti. SRJ u vreme biv{eg re`ima predstavlja primer degenerativne veze politike i privrede usmerene na zaustavljanje reforme. Zadatak novih vlasti je radikalna raskid sa dosada{njom praksom. Ukoliko reforma ne bude radikalna i usmerena ka stvaranju institucionalnog ambijenta koji punom snagom podsti-e konkurenciju i privatno preduzetni{tvo (to do sada nije bio slu-aj) ona nema velike {anse za uspeh.

KLJU^NE RE^I: tranzicija, privatizacija, preduzetni{tvo, pravila, podsticaji

ABSTRACT: The text consists of two parts. In the first we expound the thesis that transition is actually a process of creation of institutional preconditions for development of private entrepreneurship at a given moment and under the inherited circumstances. To create an environment that stimulates free entrepreneurship and enables a successful transition requires a lot of knowledge, creativity and pragmatism (there is no general model). The rest remains on the entrepreneurs. In the second part we analyse the experience of FRY before and after the change of regime. During the former regime FRY was an example of degenerative connection between politics and economy geared to prevent reforms. The task of the new government is to make a radical break with the earlier practice. If the reform is not radical and not aiming to create an institutional environment that fully stimulates competition and private entrepreneurship (which has not been the case so far), it has no good prospects to succeed.

KEY WORDS: transition, privatization, entrepreneurship, rules, and incentives

### I INTRODUCTION

The process of transformation of former socialist societies has been going on for a decade. It is a sufficiently long period of time allowing to identify basic characteristics of the transformation process – both the positive aspects and the

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negative results. The objective of "transformation" was to create the assumptions for establishment and successful functioning of market economy and institutions of a democratic society. It involved the need for a simultaneous change of economic and political system. The problem was particularly made more complex and aggravated by the fact that these reforms are interdependent. Although the starting positions of the countries in transition differed, several standard reform measures have been applied: macroeconomic stabilization – control of the quantity of money in circulation and removal of budget deficit; liberalization of economy – release of prices and opening to the world market; as well as privatization – sale of state companies to individuals and institutions.<sup>2</sup> What has differed from one country to another was the timetable of measures and the intensity with which they were applied. In spite of the positive effects achieved so far in a significant number of countries, one must not neglect the fact that their future status and the perspectives within the world economy are still open.

Economic science was not prepared for this process. At the very beginning unrealistic optimism, simplification of the problem and failure to understand its true gravity prevailed. International financial institutions behaved as if it was an almost routine job. Before long it became obvious that the problem of transition was oversimplified. The ambitious economic engineering proved both counterproductive and powerless. Due to the nature of economic problems and type of knowledge they possess, economists were unable to provide precise recommendations for efficient management of the transition processes. It is clear now that there is no theoretic model of transition that could be globally applied.<sup>3</sup>

The central thesis of this text is that the success of transition is fundamentally dependent on how much private entrepreneurship is stimulated. The article is divided into two units. The first expounds the thesis that the crucial factor for transition to succeed is to provide entrepreneurship environment that is creation of such institutional framework that stimulates private initiative. First we shall talk about the initial problems arising as a consequence of establishment of market principles – about "transformational crisis", about the causes that have led to such a condition, as well as about how to overcome it. Then, the article will deal with basic institutional assumptions for entrepreneurial environment. In the second part of the text we will talk about the experience of transition in the Federal Republic of Yugoslavia (FRY), that is whether entrepreneurship has been stimulated. We shall first present the

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2 See, for example, Balcerowicz (1995, p. 105).

3 See Mencinger (2000, p. 145)

transition process during Milošević's regime (the time of "suspended transition"), and then will point out also the basic problems of reforms under the new government.

## II TRANSITION DILEMMAS AND SOLUTIONS

### 1. THE COURSE OF TRANSITION

At the beginning of the transformation process similar problems appeared in all economies. The initial results were almost identical – high degree of macroeconomic instability manifesting through a drop in production, decrease of GDP and increase of unemployment. Monetary stability in the first years of transition was not achieved either. A "transformation crisis" occurred.<sup>4</sup> After some time economic situation in some countries in transition has stabilized. New market institutions are created and economic infrastructure is changed, so that there is a growth in economic activity. With time it accelerates and transcends the level that existed at the beginning of the reform process. One can ask whether such course of transition is applicable to all economies, that is whether it is a "regularity"? It is not hard to notice that the "J" shape of the transformation curve does not present a regularity. Its concrete appearance differs for individual economies. The reasons for this are numerous. Before all, their initial conditions differed. The countries spent different periods under the regime of central planning, there were differently burdened with macroeconomic imbalances (inflation, foreign debt, inadequate economic structure).<sup>5</sup> They also differed according to available material and non-material potentials (cultural level, different tradition and heritage, etc.), as well as in the selection of reform measures, timetables and consistency in their implementation. Thus, it is no wonder that in some countries the level of economic activity after a mild growth suffers a relapse to the zone of instability and stagnation, or after dropping to a certain level "stabilizes" there ("L"-shape). The fundamental question is: how to shorten the period of the initial decline of production that is how to reverse the trend and step up economic activity. To answer this question, it is necessary first to explain why the transformation recession came about.

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4 Janos Kornai (Kornai, 1994) wrote about "transformation recession". For details see Blanchard & Kremer (1997).

5 In statistical analyses one encounters "distortion index" as summary value of the elements marking the "starting position" of economies in transition. See Transition Report 1999, p. 28. For a clear analysis of the key problems of socialist economies, see Naishul (1991), also Balcerowicz (1995), Prokopijevic (1996).

## 2. CAUSES OF THE TRANSFORMATION RECESSION

The reasons that have brought about such transformation crisis are not hard to understand. The introduction of economic criteria for economic activities ("hard budget constraint") into the inherited socialist infrastructure necessitated primarily structural changes. When referring to this condition, economists usually use the well-known Schumpeter's expression – "creative destruction". The problem was in the discord between the dynamics of destruction and the dynamics of creation. Actually, one kind of macroeconomic disequilibrium was replaced by another.<sup>6</sup> What was the cause of the drop in production and of inflation (stagflation)? The explanation often uses the argument of structural adjustment. Increased demand for "new" goods could be met only by investments and additional production. As a result of inefficient functioning of the capital market and along with short-term inflexible offer of new goods, their prices shot up.<sup>7</sup> On the other hand, diminished demand for "obsolete" goods, bearing in mind high elasticity of their supply, led to a drop in the level of production. Empirical research has shown that this explanation cannot be accepted as the whole answer. There was also the question as to who was the „main culprit“ for the negative macroeconomic effects: whether the shock by supply or the shock by demand. Empirical research indicates the prevalence of shock caused by supply, while the effect of demand was less significant, although it cannot be said that it was negligible.<sup>8</sup> Acceleration of inflation in this initial phase of transition to a large extent was also influenced by devaluation.

The key question is why did "supply" (companies) react in this way? To answer this, it is necessary to bear in mind the behavior of state companies in the initial period of the transition. There are two different approaches with corresponding two different recommendations for overcoming the problem: the neoinstitutional advocating the "strategy of rapid privatization" and the evolutionary proposing "strategy of organic development".<sup>9</sup> The former has undoubtedly dominated among academic economists. Institutions, that is formal and informal "rules of the game" are the patterns affecting behavior of market participants, determining and limiting the scope of choice of each individual. They reduce uncertainty, since they make it possible to observe and

6 For a comparative analysis of the initial transition results, see Richet (1993), Bruno (1993).

7 For a detailed analysis, see Cassel & Apolte (1994).

8 See Borensztein (1993).

9 For an overview of these approaches, as well as intellectual influences behind them, see Kornai (2000).

accept certain regularities in behavior.<sup>10</sup> Analysts of this orientation have been claiming that actually it involved postponement by companies to adapt to the "new circumstances" caused by historically rooted routines in behavior and still insufficiently precise ownership relations. Thus the emphasis was laid on the connection between property rights and behavior of management.<sup>11</sup> Without precisely defined property rights there is no efficient entrepreneurial behavior. It is observed that as long as a state company has not been threatened to the level of survival, it uses its market position and power to prevent any restructurings - even those not causing internal conflicts. As long as property rights are not clearly defined, the process of decision-making is strongly influenced by various interest groups. Such condition has resulted in the maintenance of transition crisis. Consequently, the solution can only be in the opening of the market and exposing enterprises to additional pressures by the competition. Specific recommendation would consist of the following: speeding up institutional changes (especially rapid privatization and „hard budget constraint“) along with a high degree of liberalization of economy. In other words, implementing a new institutional framework, which will force companies to look for new „equilibrium solutions“ and change their present behavior strategy.

Evolutional explanation of the illness would be somewhat different, as well as the therapy proposed. Inadequate adjustment of companies is accepted also in this approach as the main cause of transformation crisis, but the interpretation is different. Evolutionists reject analyses based on full rationality of the decision-maker. They think that it is rather a case of "bounded rationality", that is rationality that is the result of a long process of repetition of the same behavior and acquisition of a routine. Consequently, the existing routine can be transcended only in a long-term process of adjustment and "learning by trial and error". The informal system of the rules of the game developed and established over many years cannot be abrogated by a single move. It takes time for new patterns to become part of everyday behavior. That means that only with passage of time it is possible to expect attainment of a higher level of efficiency. Exposing companies abruptly to competition pressures would sooner lead to their disintegration than to a change in their present mode of behavior.<sup>12</sup> Companies endeavor to adjust to new conditions

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10 See North (1988, 1998), also Pejovich (1998).

11 See Carlin & Aghion (1996). On the lack of quality managers even in German economy, see Mueller & Dyck (1994).

12 See for example Weitzman (1993). For a good overview of literature about this subject see Grabher & Stark (1998), Roland (1994), Dewantripont & Roland (1992, 1996). For a critical approach, see Mlcoch (1998).

trying to survive as long as possible through gradual changes in their routine behavior. That practically means reducing production and trying to establish monopoly prices. The evolutionists have suggested "step-by-step" liberalization in order to allow functioning and positive effects of the process of adjustment and learning through "trial and error". They have also considered that it is unnecessary and unreasonable to invest too much energy into transformation of existing enterprises. In their opinion, it is much more useful to direct their resources, which are scant anyway, towards the creation of a genuine entrepreneurial environment, that is to establishment of new (primarily small and medium size) companies.<sup>13</sup> What both approaches have in common is the position that the basic problem was in the lack of entrepreneurship.

### 3. INSTITUTIONAL ASSUMPTIONS FOR ENTREPRENEURIAL ENVIRONMENT

On the basis of statistical data it has been established that in the economies in transition the newly formed private companies are more efficient than both state companies and privatized ones. An exception is the companies privatized by foreign investors.<sup>14</sup> The key issue in all cases is stimulation of entrepreneurship. Economies in which an environment for development of entrepreneurship has been created have performed better. What is it that has induced massive appearance of new entrepreneurs in some countries, while in others it has not? The establishment and maintenance of a high degree of economic competitiveness is related to the existence of institutional environment conducive to free market economy and stimulating entrepreneurship and not rent-seeking.<sup>15</sup> In other words, it is related to privatization and protection of ownership rights, adequate macroeconomic policy, removal of the entry barriers, simplification of the procedure for registration of new companies, systematic stimulation of small and medium size companies, opening of markets to international competition. The crux of the matter is the need to create an environment stimulating to businesses.

The socio-economic environment characteristic of any market economy is based on several elements: on individual decisions and activities, on institutions in the widest sense (markets, laws, rules) within which these activities take place; on signals manifesting through relative prices and revenues on the basis of which the individual makes decisions, as well as on political activities tending

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13 See Murrell & Wang (1993).

14 See Transition - The First Ten Years (2002, p. 24)

15 For a detailed analysis of the problem of overcoming rent seeking in the economies in transition by means of public choice methodology, see Colombatto & Macey (1997).

to affect all of the factors mentioned. Only these situations, when all of these elements have been so harmonized as to create a climate in which it “pays off” to individuals to engage in economic activities, result in investments and economic growth. Further on, we shall direct attention to a few basic elements of the transition strategy, which give boost to free entrepreneurship: stable environment and stable expectations, deregulation and decentralization, radical change of the rules, consistency of reform measures. In brief, private entrepreneurship is inseparable from the creation of room for economic freedom. Actually, the point is to create institutional assumptions for the system of prices to perform its function. In order for an appropriate institutional framework to exist, it is not enough for political subjects to declare their commitment to competition. It must be stimulated and maintained.

### 3.1. STABLE EXPECTATIONS

The creation of a macroeconomic environment that stimulates investments is the fundamental question for the success of transition. First of all, it is necessary to create a predictable economic environment. That, of course, doesn't mean to eliminate standard market uncertainties, which are not only a basic characteristic of market economy, but also an assumption of entrepreneurship. If the environment is unstable, entrepreneurs are not able to make business plans. In other words, if there is no stable and predictable environment, then criminals enter the scene and not entrepreneurs, and economic activity shifts to the zone of “grey” market.<sup>16</sup> The basis of functioning of efficient economy is primarily stable money that is stable expectations based on it. Incidentally, Walter Eucken claimed that in the establishment of a competitive order, stable money has the primacy.<sup>17</sup> Therefore one of the central problems facing monetary authorities in the economies in transition involved the necessity of gaining credibility. In economic literature declared economic policy is considered reliable to the extent that it coincides with expectations formed by the public.<sup>18</sup> Actually, the point is in the consistency of economic policy. This holds true also for monetary policy. Reputation of the central bank is reflected through the height of inflationary expectations. This problem had a particular gravity in the economies in transition, since they were faced with the pressure of unemployment and all kinds of deficits. Thus, there was a steady and strong pressure towards a more “flexible” monetary policy. The first move that the economies in transition had

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16 Under such circumstances entrepreneurial capital leaves the country. See Sheets (1996).

17 See Eucken (1990, Ch. XVI, p. 254-291.).

18 See Lenzner (1998, p. 41). For a more complex insight into the issue of central bank's autonomy, see Weinert (1999).

to make was to establish the central bank as an institution, which will make monetary policy responsibly and independently. The mechanisms by means of which this was achieved differed (in gravest cases they resorted to the creation of a currency board). Formally speaking, almost all transition economies have established key instruments that allow autonomous monetary policy; however, their successfulness varied from one country to another.<sup>19</sup>

### 3.2. DEREGULATION AND DECENTRALIZATION

Improvement of the inherited efficiency cannot be achieved without market economy that is without private ownership being its basic element. Therefore, privatization and stimulation of private initiative are necessary steps. Privatization is a necessary, but not sufficient condition for a stable and efficient economic system. What are lacking are institutions that allow economic and political stability. Especially institutions protecting economic freedom (freedom to conclude contracts) and competition. Without control provided by free competition, private ownership alone does not guarantee attainment of best results. Additional measures completing the entrepreneurial environment are deregulation, particularly liberalization of prices and opening of market, as well as decentralization. Why is price liberalization important? The socialist economic system left in its wake a system of relative prices, which was not based on the availability of resources but was the result of a strict control of prices. To activate the process of structural changes it is necessary to liberalize prices and create a new system of relative prices thus sending "new signals" to entrepreneurs. It is worth noting a statistically identified fact, which is in our opinion crucial. A high degree of direct correlation has been established between the speed of liberalization and the growth rate of real GDP.<sup>20</sup> Those countries that had decided earlier to carry out radical reforms and liberalization of the market achieved more steady economic growth. Without liberalization of economy it is not possible to stimulate the necessary increase in the degree of competitiveness of economy. Efficiency of investments depends on numerous factors, but essentially it depends on the competitive environment.<sup>21</sup> It turned

19 For a good overview see Bishev (2000), as well as Rosati (2000).

20 See Transition Report (1999, p. 62); also Transition - The First Ten Years (2002, p. 16)

21 It is interesting to note the results of empiric research on the relation between the rate of investment and the growth rate of the national product. Namely, it was shown that a high rate of investment does not necessarily mean a high rate of economic growth. This points to the efficiency of investments. One wants to emphasize the fact that efficiency of investments is more important for economic growth than the total mass of investments. The research covered countries in transition. Of these 27 countries were observed in the interval 1989-1996, while data for China were available for the interval 1979-1986. See Popov (1999). This problem is well known in socialist economies. On the experience of ex-Yugoslavia see Bajt (1988).



out that the countries where the degree of liberalization of economy is higher (where reforms were more radical) have a higher productivity of capital (efficiency of investments) than those that delayed with reforms. On the other hand, it happened that those countries that had started liberalization earlier had a much less average increase of the Gini coefficient than the countries that opted for liberalization later. This is important for the fact that it is necessary to maintain a stable political support to reforms. With major social turmoil's it is much more difficult.

Decentralization is necessary because it allows available information (Hayek would say „knowledge“) to be used at the right time and in the best possible way. If individuals (or organizations) are allowed freedom of action, then they will, guided by their goals and interests, look for and find the information they need. Nobody can perform that task better on their behalf than they themselves. These activities simply cannot be delegated. The essence of free entrepreneurship is actually reflected in the activation of personal initiative in the broadest sense. Hayek argumentatively proved (these pages have been for decades a classical point of economic science), that the system which provides maximal freedom to economic participants to use available information and resources, has a better overall performance than the systems that limit such behavior in any way. The point is that decision-making should be delegated to the level where the effects of decisions are felt most. Any other principle of activity leads to loss in the degree of efficiency.

### 3.3. RADICAL CHANGE OF THE RULES

Efficient market institutions, so we have learned from the experience of developed economies, cannot be made by decrees. They are developed and formed through a combination of spontaneous and long-term interactions between the actors and constructivist enterprises. It is also essential to bear in mind the fact that institutions cannot be „transferred“ from one country to another. Some institutions that successfully protect economic freedoms and stimulate economic efficiency in one country show bad results when applied in some other countries. Successful change of inherited institutions and establishment of new ones is one of the most difficult and complex problems for reformists. It involves, as Hayek would say, „complex phenomena“ with specific manner of functioning. Since it involves an array of intertwined activities and effects of various factors, it is illusory to try to perform this task from one center and in one moment. It is a dynamic process that is going to take several decades. What is possible to do within a short period is to establish the basic principles of market economy and the relevant institutional

framework, while economic life itself (a network of activities of free participants pursuing their interests) according to its internal dynamics, demands and needs, will impose the direction and modalities of changes. On the basis of spontaneous interactions of market participants the initial market framework will in time be upgraded and create adequate market environment with institutions in conformity with local system of values, internal rules, customs and preferences.

It is essential that the initial change be radical. The problem is how to harmonize formal and informal rules. It is a complex problem area, which implies amending some existing rules, establishing completely new ones, as well as the time necessary for adjustment (process of learning). The process of learning is shorter and more efficient if the rules are more coherent. On the other hand, the process of learning depends on the manner and pace of implementation of new rules. If one insists on gradual reforms, this creates a mixed institutional framework that increases uncertainty. This also affects transition costs and the final outcome of the reform. A radical change of the rules makes market participants face the necessity of changing behavior, which in the case of gradualist adjustment is less emphasized.<sup>22</sup> The way in which one approaches the reform is a kind of "signaling-game", where political decision-makers with their activities send signals to the citizens about their intentions. Likewise, the rules defining the market game in the interim period are incoherent. Incoherent rules imply the same such expectations of the actors and actions corresponding to them. What is important for us is the fact that any gradualist insistence on halfway solutions destimulates private entrepreneurship, since the entrepreneurs haven't got a clear-cut environment in which they are able to plan and make business decisions. Of particular importance is to establish "hard budget constraint", forcing the companies to either restructure or go bankrupt. On the other hand, it is conducive to the creation of room for opening of new companies. Halfway solutions have a destimulating effect even on the workers, because they have no motive then to increase productivity and improve their working skills. That of course has negative effects on the efficiency. It has been noticed that faster recovery and higher economic growth are achieved through a combination of more radical economic reforms and perseverance on the strategy so chosen. The countries, which opted for more radical reforms, have managed within a shorter period to achieve price stability and boost economic growth, to initiate necessary structural adjustment, as well as to overcome the pressure of unemployment faster.

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22 See Winiecki (2000).

## 3.4. CONSISTENCY OF REFORM

In what way are the new rules to be established? Should these rules be imposed by force or is it necessary to achieve appropriate social agreement? Analysts have identified a complex transition problem known under the name "new theorem of impossibility".<sup>23</sup> Namely, they claim that it is impossible to establish a radical reform and at the same time preserve democracy. Even the authors thinking that this formulation is "too strong", emphasize that the problem exists and that it is complex. Can it be overcome? As a matter of fact, it concerns the height of transition costs and their distribution. What is to be solved is in what way can one make it possible for a reform program to have a lasting voters' support. This problem does not exist only in a special case. If the post-reform condition is superior in Pareto's sense with regard to the pre-reform condition, then it is to be expected that reform (assuming that voters are rational) will get a sure support from the voters. However, in real economic life there are a small number of conditions comparable to Pareto's optimum conditions, because the point is that some win and others lose.

It is necessary to arrive at an appropriate social consensus in order to reduce the obstructions to the reform to the least possible measure. If one bears in mind that the transformation process the basis of which is a democratic procedure, it should be open to different views and programs, to various mutually competing interests and needs. Only in this way it is possible to come to a program that will get necessary support of the voters. An acceptable strategy of change should come about as a result of a negotiating procedure between the parties having different interests. A final negotiating solution ("Nash equilibrium") would be achieved as a result of decentralized strategies of all relevant negotiating powers functioning in a society.<sup>24</sup> The problem is that it includes also those whose interest is to prolong the reform or to prevent it completely. Individual expectations play a key role in this "negotiating process". The factors on the basis of which individuals create their expectations are their subjective perceptions. In this, they are not prepared to postpone the expected improvements to a distant future. Transparency of the reform is also essential that is it is necessary to present clearly its course and its timetable, so that each participant could identify both his present and his future position. These measures are intended to minimize the danger of aborting the reform in some of its phases. Some analysts think that institutional elements of a reformed economic system should be elevated almost to a constitutional rank, in other

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23 See Voigt (1994).

24 See Przeworski (1991).

words that from the launching of the transformation process they should be protected as much as possible.<sup>25</sup> Practically, to be made “untouchable”.

### III TRANSITION FAILED – THE CASE OF FRY

If stimulation of private entrepreneurship is the basis of transition, then the process unfolding in FRY in the past decade can be viewed as an example of unsuccessful transition. Basically, these were the processes going to a completely different direction from the one implied by an efficient transition. The text below will deal with how the economy functioned in the period until the removal of the former regime in 2000, as well as with reform moves of the new government.

#### 1. “TRANSITION” IN THE TIMES OF MILOSEVIC

##### 1.1. A BRIEF OVERVIEW

The early Nineties saw the culmination of the political and economic crisis, civil war, and disintegration of the country. At the same time, it meant that a new economic-system infrastructure was needed. Until that time academic disputes among Yugoslavia’s economists had taken place solely within the socialist paradigm. Socialist economic system had not been questioned until then: the economists had been looking for an „error within the system“. The pressure of economic problems, as well as of the events in the socialist environment, forced the need for a reform. The transition to new mechanisms of economic coordination required creation of different institutions. First of all, it became clear that it was necessary to change the existing ownership relations. To that end already in 1989 the Law on Social Capital was passed (innovated in 1990), which institutionalized the assumptions for opening of the privatization process. After 1994 the process of privatization was practically suspended and thus a considerable part of economy was retained in the state and social ownership.<sup>26</sup> Besides, in that period a number of so-called economic-system acts were passed. Despite formal existence of some market rules, they were not complied with in real life. Legal insecurity, non-compliance with contracts,

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25 In this context one can speak about the role of social policy. Primarily, it concerns social policy which is to be development-oriented. It means that it is necessary to invest in social infrastructure, primarily in health and education. See Tomann & Scholz (1996). It also implies the standard activities of social policy designed to provide protection of the socially neediest. Klaus has defined the principles on which this policy should be based. See Klaus (1997).

26 Currently, less than 10 % of the social capital has been privatized. See Begovic, ivkovic & Mijatovic (2000).

inability to collect debts was prevalent in everyday practice. Even the state failed to comply with the rules prescribed by itself.<sup>27</sup> In this way mistrust of the institutions was created and maintained.

In 1992 United Nations subjected FRY to political and economic sanctions. The war environment and sanctions with all of their economic consequences (increase in budget expenditures, decline in production output and employment, increase of production costs, loss of portions of the market) along with irresponsible monetary policy and weak institutions of the system, led to a powerful inflator impulse culminating in hyperinflation in 1993. Hyperinflation resulted in numerous negative economic and social consequences. Among other things, it brought about worthlessness (and even complete annihilation) of financial stocks nominated in domestic currency, while foreign currency was introduced into domestic monetary flows to be used in parallel with the domestic one. At the end of 1993 and at the beginning of 1994 the so-called „Avramovi} Program“ was stopped.<sup>28</sup> The key goal of the program was achieved – inflation was curbed by drastic monetary restrictions; however, the problems of growth stimulation were opened up. Several months later there was a follow-up of the program aiming to stimulate economic growth. Before long, there were strong disagreements between the governor and the government resulting in his being sacked from the position. The economic situation kept getting worse and worse year in and year out. Conflict with the NATO followed (1999), bringing new devastations and ever-graver economic problems. This dramatic situation culminated in 2000 with early elections and change of government.

#### 1.2. CAUSES OF ECONOMIC COLLAPSE

The government behaved absolutely opposite to the principles of a successful transition. The state of “suspended transition”<sup>29</sup> brought about also grave economic problems. Immediately before the change of government the economic situation was disastrous: drastic drop in production and in GDP (to about 40% of its 1989 level), high share of “grey” economy, high unemployment, devastated banking system, technological backwardness, economic isolation.<sup>30</sup> The question arises as to what were the basic causes of such condition. Usually among the public, and even among professional economists there prevailed opinion that economic sanctions were the basic

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27 See Mad ar (2000b).

28 After its creator, Dragoslav Avramovic. See Avramovic (1998).

29 See Crab Movement - Serbia in Transformational Processes (Racji hod - Srbija u transformacijskim procesima) (2000).

30 For more detailed information on the state of economy as a consequence of Milošević' s rule see “Bela knjiga Milo(evi)jeve vladavine”, Grupa 17 (2000).

cause of all economic problems. Politicians were artfully using the sanctions as a firm alibi. The sanctions did create additional problems, but Yugoslav economy was inefficient for two fundamental reasons: lack of a market environment and state-controlled economy, and bad economic policy as well. Both these causes acted simultaneously.

Economic system in this period was state-controlled. Since there was no market environment and market verification of results, (on average 40% of prices were under direct state control)<sup>31</sup> the ever-present political interference with economic processes created a privileged position to certain groups. Politically influential individuals (or groups) imposed their own interests as “strategic goals” of the state. In FRY majority of political nomenclature occupied the positions of general managers of large industrial and trade companies (often monopolies) or large banks. A firm network of intertwined interests was created, articulated through various lobbies that had the same stance: they opposed privatization endeavoring to maintain the status quo. There was interdependence between the economy and the state (holders of power), the state and a part of workers and workers unions, as well as between the banks and the economy. Economy functioned as a process of permanent administrative coordination of interests of the conflicting groups. Besides, the chosen ones were allowed to evade tax, to extort racket, to deal in smuggling, and use funds under special facilities. Getting rich by means of criminal activities and mass corruption became the norm and created special „rules“.<sup>32</sup>

Economic sanctions isolated Yugoslav economy to a large extent (although not completely). They could have had a sobering effect on all economic participants signaling the necessity to change the inherited patterns of behavior. The closure of economy caused shortages of many goods and opened room for informal economy and criminal activities. Under such circumstances it was rational to abolish internal barriers to business and provide room for stimulation and expansion of individual initiative. The government chose to freeze the existing inefficient and inflexible economic system. Certain room was opened to private initiative, but only to the measure and in those economic segments suitable to the regime. Everything outside that was directly or indirectly disabled. Thus a paradoxical situation was created whereby the entrepreneurs found themselves in a double blockade – the outer represented by the sanctions and the inner, imposed by the regime.<sup>33</sup>

31 With high degree of price control, and later on during the drastic hyperinflation, it was not possible to stimulate structural changes.

32 See Lazic & Sekelj (1997), Corruption in Serbia (2001), also Stojanovic (2001a, 2001b).

33 For more information, see Mad`ar (2000a, poglavlje XII).

Degenerative economic processes were additionally aggravated and partially caused by the economic policy. Basic characteristic of economic policy was short-term measures. The regime insisted on short-term positive economic effects, which could be politically capitalized. For example, credit policy was discriminatory. Allocation of credits was under direct state influence and only those socially owned companies were subsidized which maintained the existing level of employment. This brought about short-term political gains (social tensions were reduced), but in the long run the level of economic efficiency was reduced because of the pressures exerted by surplus labor. Thus, meagre financial means of the economy were not used rationally.

Economic strategy and policy were designed to consolidate political power without taking into account the price to be paid, and without any considerations about the economic future of the country. Economic policy was directed at redistribution of scant social product, and not at stimulation of entrepreneurship. An essential problem of the economic policy (primarily of fiscal and monetary one) consisted in the fact that it was not based on firm rules, but was implemented discretionarily and selectively. On account of that, the measures were chaotic and often mutually in conflict. The end result was three big and lasting deficits: losses in economy, in the sector of public spending and in foreign trade.

The basic problem, which occurred as a consequence of the said processes, was the loss of entrepreneurship, because under the prevailing circumstances it would be meaningless. Material assumptions for a higher standard and social reputation were not attained by private entrepreneurship, but by political lobbying. Those economic actors who complied with the rules were not able to survive in the competition with those who did not pay taxes, who broke the laws, and availed themselves of primary emission. The regime gave unjustified privileges to some economic subjects at the expense of others ("selective paternalism") thus disrupting the nature and stimulatingness of the "market game". At the same time, majority of society was rapidly getting pauperized.

## 2. NEW GOVERNMENT AND THE CHALLENGE OF TRANSITION

The new government found a dramatic situation - politically and economically isolated country with almost devastated economy. Fast action was indispensable.<sup>34</sup> The country was reinstated within a short period into most of important international institutions. This was primarily the result of

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34 As early as in 1997 Group 17 addressed the public with its Program radikalnih ekonomskih reformi u SR Jugoslaviji (Program of Radical Economic Reforms in FR Yugoslavia), with the remark that it was the program that would be implemented when the opposition wins the elections.

benevolence of the international community. There is not enough room for a more systematic and detailed review of reform measures carried out so far, so that attention will be paid only on the question whether the present activities and measures have created (and whether they do create?) conditions for stimulation of domestic and foreign entrepreneurship. Actually, we shall speak about the problems that, in our opinion, aggravate the process of an efficient transition in Serbia. These are: overemphasized interference of the state in economy, unstable and "mixed" environment due to slow and half-way institutional changes, as well as the fear of radical reforms.

#### 2.1. OVEREMPHASIZED ROLE OF THE STATE

The first remark concerns the behavior of the state in reform processes. What is easily perceived is the exaggerated presence of the state in the economy. The government often places itself in the position of an arbiter who is in possession of the knowledge as to what are the best possible economic solutions, that is it thinks that it can control the market processes at will. The overemphasized activity of the government in economic processes is justified with the non-existence of relevant institutions and with the need to protect the empty room that would be taken by mafia.<sup>35</sup> Such behavior from the viewpoint of stimulation of private entrepreneurship and economic efficiency is not a good strategy. Powerful and active presence of the state in the economy additionally incites the already established process of lobbying and "rent seeking". There is still no radical breakthrough with regard to the behavior, which has been present here for many decades.

The logic of government behavior can be well observed on the example of privatization. The government and its institutions have great jurisdiction (almost a monopoly role) in the total process of privatization. The Privatization Agency has particularly large authorizations (it initiates, mediates, coordinates and controls the whole process of privatization). The government's discretionary role is also overemphasized in "determining priorities" concerning distribution of money obtained through privatization of enterprises. Besides other purposes, there is also "stimulation of economic development". If by stimulation of development it is meant that the government estimates where (somebody else's) money should be invested – that practically means that it is planning, in addition to its other functions and activities, to perform the job of an entrepreneur.

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35 See Djindji} (2001).



On the other hand, there are no activities directed to the establishment of firm and clear rules, which would stabilize economic environment and stimulate entrepreneurship. What does it specifically imply? First of all, providing a stable legal order that will protect private property and contracts and will not discriminate. The state influence should be reduced to those activities that are necessary to protect economic freedom, ownership and contracts. The rest is not in its competence but is the job of the entrepreneurs. In other words, the state should participate in the establishment of rules and make sure that they are enforced, and should not, as it is now doing, get directly involved in the game itself changing the rules as the game goes. The enforcement of firm tax discipline and legal security would entice the process of restoring major part of „grey“ economy back to official economic flows, which would lead to a growth of revenues raised by taxes and to removal of the burden weighing down on legal economy. Should the government be able in this moment to ensure impartial enforcement of the established rules (compliance with the law), i.e. to abolish the sign of equality between crime and entrepreneurship that would be its greatest contribution to economic stability and development. The problem is lobbies to whom the regular market game is not to their advantage and who are trying to oppose it.<sup>36</sup> The only way to grapple with them successfully is to insist on deregulation of economy and opening of room to domestic and foreign competition, and not in additional normativism and regulation. Opening of economy to international competition would have positive effects on the break-up of monopoly market structure and power.

## 2.2. NON-STIMULATING ENVIRONMENT

FRY is in a state of devastated institutional system. That's why a quick establishment of new institutions and new rules is of utmost importance. One should bear in mind that a serious problem of Yugoslav economy is lack of capital. For a long time to come capital will be the main limiting factor of economic development. Therefore, it is necessary to create such an institutional framework so as to ensure activation of available domestic capital, as well as enticement of foreign capital, particularly of direct investments. It is not our intention to summarize the changes in present legislation; we are only going to draw attention to some problematic issues involving the matters on which it depends whether private entrepreneurship is stimulated or discouraged.

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36 These are the individuals who amassed enormous riches during Milošević' s regime, who are now trying to save their positions through their influence on the new government. As a global transition problem, this was also identified by World Bank analysts.

As of this writing the law on foreign investments still has not been adopted. Bankruptcy law is not even in the adoption procedure. The process of privatization, despite the fact that the Law on Privatization has been adopted, has not gone too far. So far, just a few large companies have been privatized. Some measures are directly aimed against private entrepreneurship. A good illustration is the Law on one-time tax on extra revenues and extra property acquired through the use of special facilities. The law was designed to raise extra revenues for the budget that is basically it had a fiscal goal.<sup>37</sup> In this way, intentionally or unintentionally, two messages are being sent to the public. One is populist by its nature trying to meet the demand for "justice to be done". Thus it is quite certain that some short-term positive political points will be gained with the voters' body, socially endangered to a large extent. On the other hand, a much more lasting message is being sent to investors that investments in this country are not safe. This move will in no way contribute to the enticement of free entrepreneurship and allurements of lacking capital.

Regarding the reform of the labor market, the matters are still at the beginning. In other countries transition led to necessary structural adjustments, resulting among other things in "transitional unemployment". In FRY, after the imposition of economic and political sanctions in 1992, the government established the principle – as long as there are sanctions there are no dismissals. Thus the necessary adjustment to changes in the level of production (which was declining drastically) was taken over by the level of wages – they were paid with delay of several months and in ever-smaller amounts. To be more exact, the wages had no longer anything to do with work and performance at work. They became a political and social category, and not an economic one. Thus the problem of necessary adjustment has remained untouched to date. It is absolutely necessary to make a break with the present practice whereby the surplus workers are taken as fictively employed. To continue such practice is economic nonsense, since it has a disastrous effect on company efficiency. Low wages and wages leveling (which is very hard to get rid of from the minds of people in this country) are not a good impetus to work and creativity. All workers that are surplus at a given moment in Serbia should be struck off from company's employee records and sent to labor market.

The issue of labor market reform is at the same time one of crucial issues for the reform in general. It is necessary to make decisive changes in labor legislation that would eliminate the relics of self-management.<sup>38</sup> Without adjustments in this area it is not realistic to expect domestic private

37 A modest sum was raised, far below the one predicted.

38 For basic elements of the labour market reform in Serbia, see Krstic & Stojanovic (2001).

entrepreneurs to leave the zone of “grey market” in which they mostly do business, and it is especially unrealistic to expect a mass inflow of private capital. So far, the Labor Act has been adopted with great problems and strong resistance put up by trade unions, but it is a step in the right direction<sup>39</sup>. However, it is only a first step in the reform of relations in the labor market. Once there are large-scale lay-offs there will be additional pressures on the government to make compromises. It is precisely this problem, in our opinion, that is going to be a turning point in the reform process in Serbia. Because of this, stimulating entrepreneurship and opening new companies to absorb an enormous number of unemployed is the central issue of the reform.

### 2.3. LACK OF READINESS FOR RADICAL CHANGES

One gets the impression that the intention of the government is not a radical reform. The term radical is used to denote simultaneous and decisive changes in key segments of economic life making a radical break with the past. It seems that the government is still not ready for such a step. After takeover of power, the new government publicly declared that they are against radical reforms, claiming that it is a wrong way.<sup>40</sup> They usually elaborated on this by explaining further that they are trying to prevent massive lay-offs and thereby social and political costs that are inevitable as a consequence of radical measures. Such behavior is without any doubt motivated by political calculations, since implementation of painful reform operations cannot ensure long-term political popularity. It was shown that reformists usually lose the next elections. The unstable political situation and conflicts within the ruling coalition itself, manifesting also the deep conceptual differences particularly aggravate the problem.<sup>41</sup> The reformists are again and again facing the same dilemma: whether to be consistent insisting on radical changes or to let up under social and political pressures postponing the changes until some future

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39 The process of entering an employment according to the Labor Act is considerably simplified with regard to the earlier highly bureaucratized practice. There is no legal obligation for recruiting new employees through the complex procedure of a public advertisement as has been the case. Only the general terms of employment are defined by the law (minimum age and overall health ability), while all other terms of employment in connection with a given workplace are to be defined by the employer. The employer is left full freedom to determine commencement and arrangement of working hours. Flexible forms of employment are also possible (work for a definite period, part time, temporary and intermittent work...) all of which in all variants guarantee the employees basic rights arising from employment.

40 There are also opinions that the government is too radical in the implementation of reforms. See Du{ani} (2001).

41 See Djindji} (2001), Ko{tunica (2001).

time. Choosing the latter strategy would bring short-term political gains, but from the medium and long-term standpoint such behavior can only be counterproductive. Viewed from the angle of economic efficiency it would be a suicidal behavior. On the other hand, to postpone the changes would be a message to citizens to carry on with unrealistic expectations that it is possible to live better without paying appropriate price for that. The government is nurturing the illusion that it is possible, thanks to its skill, to avoid the transitional recession. What is now happening is recession but without transition.

#### IV CONCLUSION

Transitional process has opened up theoretically and practically a complex questions: how to achieve a successful transition from planned to market economy and from an undemocratic to a democratic society. The present experience has made it possible to separate successful and unsuccessful strategies, as well as to overcome illusions. One of these illusions was that it is possible to carry out the reform within a short period. Now its is quite clear that it involves a long-term process that is going to take decades. The success of transition depends above all on a rapid creation of conditions – institutional, legal, microeconomic and macroeconomic, that are conducive to the development and growth of the new private sector.

To be successful, reform programs should be based on the “initial conditions” that are naturally different for each country. That means that there is no optimal strategy identical for all countries. It is necessary to search for best possible solutions on the basis of theoretically grounded and practically tested principles with the objective to establish a free competitive economy under the inherited circumstances (according to concrete internal balances and forces in politics and economy). In this way one avoids “falling into theoretical dogmatism, as well as into disoriented punctualism” (Eucken). It takes a lot knowledge, creativity, and pragmatism to create an environment that stimulates entrepreneurship and consequently a successful transition. Economist can help only in creating institutional preconditions for liberation of entrepreneurship at a given moment and in concrete circumstances. The rest is up to the entrepreneurs.

FRY is an example of disastrous consequences of the degenerative connection between politics and economy aiming to stop the reform. In the early Nineties the post-Communist government (the old party monopoly) estimated that launching a reform would lead to profiling different interests and

to changing the balance of power among the voters' body. The goal of the "suspended transformation" was that the existing political elite should keep its privileged position. Economic policy was also pursued with the aim to preserve political domination and economic interests of a limited group of participants close to power. Political competition and development of a free market were also prevented. Enormous price has been paid for all that – destruction of social institutions and preconditions for future economic development. The new government must make a radical break with the present practice. If the reform fails to be radical and if it is not directed to creating an institutional environment that stimulates at full blast free competition and private entrepreneurship (which has not been the case so far), it has no good chances for success. The insistence on "cautious" halfway solutions and on the conspicuous role of the state in the economy (redistributing only, that which already exists) is going to aggravate the existing problems.

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