

Priorities of economic reforms in Serbia

For the first time in this decade Serbia has chance to start radical economic reforms and catching up other countries in the region. However, the political window opportunity will not be long lasting and must be used in the most effective way. This brings the issue of priorities in economic reform program and its proper sequencing. The brief list of priorities presented below reflects my personal understanding of the economic and political situation in Serbia and logic of economic transition (basing on experience of other countries in the region). My key recommendations would be:

1. Forget about Yugoslav federation. In fact, in economic sphere this federation already does not exist. Montenegro has a separate currency, separate tariffs system and custom administration, different tax system, does not pay anything to federal budget. In spite of a high political sensitivity of this issue fast recognition of the real status quo will be extremely helpful for at least three reasons. First, country must have clearly defined economic borders even if they differ temporarily from the formal political ones (this remarks relates to Kosovo). Otherwise, tax and custom systems will have serious loopholes threatening fiscal stability. Second, Serbia cannot have two parallel governments (federal and republican) controlling exactly the same territory because it will unavoidably lead to serious political and personal tensions (even if they will be formed by the same political parties) and will slow down the entire reform process. Additionally, the current division of responsibilities between federal and republican authorities is not fully clear. Third, without solving the problem of federation any serious reform of government structure and public administration will be practically impossible. Serbia may try to return to monetary and custom union with Montenegro, if introduce Euro (see p. 2) and liberalize its foreign trade following Montenegro's example (see p. 3).
2. Replace dinar with Euro. Level of monetization in domestic currency is extremely low and it will be very uneasy to rebuild it to at least two-digit level (which still is low, comparing to other Central European countries). In such the circumstances the independent monetary policy trying to bring inflation down to one digit level will be extremely costly (high nominal and real interest rates). The potential benefits of retaining an exchange rate shock absorber will be very doubtful. Additionally, almost all neighbors and major trade partners either already use Euro (the EU countries, Montenegro, and Kosovo), or have Euro-denominated currency boards (Bulgaria, and Bosnia and Hercegovina) or currency pegs to Euro (Croatia, Macedonia). In the coming years the next countries in the region (EU candidate countries) will peg their currency to Euro and eventually introduce this currency. People in Serbia, in fact, use already Euro (D-Mark) as mean of saving and major transactions, and they assess level of prices and their income in D-Mark terms. Thus, such a decision will be politically attractive. Additionally, it will help to rebuild monetary union with Montenegro and Kosovo.
3. Liberalize foreign trade. Serbia is a small economy and must be very open, if wants to start any serious restructuring and build its international competitiveness. The best thing would be: (i) abolish all the non-tariffs import restrictions and all the export restrictions; (ii) introduce unified and rather low level of import tariffs and try to agree them with the

Republic of Montenegro in order to rebuild the custom union; (iii) allow all the economic agents to conduct import and export operations; (iv) start negotiations on joining the WTO.

4. Adopt the European criterion in the process of screening all the institutional and legal reforms. Country will have to undertake in the coming months and years several legislation changes related to economic system, public administration, justice administration, NGO sector, etc. In order to avoid the “second generation” legal transition when country starts its EU accession negotiation in the future it is very important to look for legal compliance with the EU *acquis communautaire* already now. This also will help in early starting the negotiations of Stabilization and Association Agreement with the EU.
5. Liberalize the domestic entrepreneurship environment. The most successful transition economies (Central Europe and Baltic countries) managed to return to economic growth and make it sustainable due to early price, trade and entry (PTE) liberalization and imposing the hard budget constraints in relation to state owned enterprises (what forced them to relieve redundant assets and labor, which could be employed by the new private firms). This was also the most pro-social policy as hundreds thousands on new private enterprises absorbed a significant part of the unemployed labor. I do not have sufficient knowledge about all existing legal and informal impediments to private business initiative in Serbia but I guess that registration procedure should be radically simplified, licensing requirements reduced to these activities where are really needed (such as banking, insurance, weapon production and trade, etc.), and tax system should be adjusted to the needs of small enterprises. There is also necessity to complete the process of price liberalization.
6. Adopt the national treatment principle in relation to foreign investment. This is extremely important in relation to foreign banks and non-banking financial institutions, which should be brought to Yugoslavia as quickly as possible.
7. Start the privatization process, with participation of foreign investors, adopting the maximally transparent procedures. Proceeds from privatization should be used for repaying part of a public debt and clearing other (domestic) government liabilities (such as, for example, households foreign currency deposits seized by the government in the beginning of 1990s). However, strategy of privatization needs a separate discussion, going beyond the limited agenda of this memo.
8. Prepare the balanced budget for year 2001 (both federal and republican). There is obvious for me that expenditure side of both budgets needs in serious adjustment. The revenue-to-GDP ratio is already high enough and unlikely can be sustained for longer period of time (deep structural reforms of the state and “socially owned” enterprises will probably bring decline in budget revenues from this sector). At first look, the expenditures for military purposes, police special forces, state security agency, various subsidies, and ineffective social and pension expenditures (particularly for early retiring and disability pensioners) are the first candidates for cuts but both sides of federal and republican budgets need a deeper analysis. On the revenue side most of tax exemptions should be eliminated.
9. In the course of year 2001, the complex tax reform should be discussed. All the tax system needs in serious simplification, removing numerous distortions, and exemptions, reducing the number of taxes, etc. The complicated, and, in fact, cascade-type sale tax should be replaced by the VAT. Various personal taxes should be consolidated into general personal

income tax. Simplified tax system for small business should be established. However, before starting general tax reform (particularly reform of indirect taxes) the status of federation and issue of custom (fiscal) borders should be clarified (see above).

10. In the course of year 2001, the complex social policy and labor market reform must also be initiated. The excessive level of pension and other social expenditures has been already signaled above. Similarly to other transition countries, you need probably an increase in retirement age, reduction of privileges for early retirement, review of the pension benefit formula, verification of eligibility criteria for disability pensions, and other social benefits (for example, for refugees and war “veterans”). Serbia has also probably the most rigid labor market institutions and highest rate of unemployment in the region. The expected structural reforms, privatization of big enterprises and demilitarization will additionally increase the level of unemployment. Hence, labor market needs in substantial liberalization in order to absorb the unemployed labor force, increase overall productivity, and alleviate at least part of the social tensions.

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