

Political Economy of Enterprise Restructuring in Serbia

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Abstract

The aim of this paper is to explore, from the political economy perspective, public policy towards enterprise restructuring in Serbia in the post-Milosevic period, including incentives to the decision-makers for such a policy, its achievements, and dynamics. Also, it empirically tests the conventional wisdom in Serbia that economic issues, such as employment and real wages, are dominant factors for the constituency in deciding whether to vote for pro-reform or anti-reform political parties.

This model of voting behavior is also strongly supported by both theoretical and empirical literature in this field. However, the evidences from 2003 and 2007 elections show that, in spite of improved macroeconomic environment and dramatically improved living standards, anti-reform SRS is now by far the strongest party.

By regressing election results in 150 municipalities on various economic, social and demographic variables, we distinguish whether and to what extent economic transition influences the voting behavior in Serbia. We find that economic variables are mostly statistically insignificant, but that employment in failed companies did influence the voting behavior in 2000 and 2007. However, increased support for antireform parties over the same period can not be explained by enterprise restructuring. We offer potential explanations for these observations.

Part one provides introduction and literature review. Part two consists of the brief political overview of the situation in Serbia. Part three provides details on the enterprise restructuring in post 2000 period. Parts four and five summarize the main hypotheses that we want to test and we present the data that is going to be used. Part six is econometric analysis of the voting behavior in 2000 – 2007 period. The final part provides discussion and conclusions.

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1. Introduction

Since the democratic changes in October 2000, starting with ousting of Slobodan Milosevic from the office and with the election of the new, democratic and reform-oriented government, which took the office in January 2001, the economic issues started to dominate the political agenda and debates in Serbia. Phrases such as restructuring, investment climate, privatization and liberalization entered the political arena. Although the politicians soon realized that some of these words are popular and some are not, it was and still is widely believed that increased living standards, inflow of foreign investments, low inflation and higher real salaries would strengthen the democratic political forces and help them in dealing with the remains of the Milosevic regime and breaking with his political legacy. However, it is also widely perceived that for closing the loss-making socially owned companies (SEOs) and associated job losses the government will be punished by the electorate, so all democratic governments since 2000 have been dealing with the issue of enterprise restructuring very carefully, since only several of these companies were privatized or liquidated. The others are still in indeterminate state.

This thinking has been strongly supported by the public opinion polls, where most of the people stressed that economic issues, such as unemployment and living standards are the issues that they mostly care about. However, at the December 2003 and January 2007 parliamentary elections, the huge and sustained increase in support for the non-reform political parties like Serbian Radical Party (SRS) and Socialist Party of Serbia (SPS) demonstrated that what people say the important things are, and how they vote are two very different things. Also, recent public opinion polls show that, in spite of improved macroeconomic environment and dramatically improved living standards since 2000, SRS is by far the most popular political party in Serbia with ratings of about 35-40% in mid 2006. It is worth mentioning that SRS is basically the only political party that has not adjusted their rhetoric from 1990s and the only party which still promotes and insists on purely political issues, with only limited elements of social issues based on leftist/egalitarian populism. Also, public opinion polls show that SRS is perceived as lacking the capacity to reform the economy even by their voters/supporters.

The described public policy that preserves and subsidizes inefficient SOEs is strongly supported by the both theoretical and empirical literature in the field of political economy of transition. One approach, brought forward by Shleifer and Vishny (1994), argues that self interested politicians intervene in the conduct of SOEs in order to pursue goals that are not aligned with enterprise efficiency. In particular, politicians are interested in maintaining excess levels of employment to please their constituency. Privatization depoliticizes enterprises: when managers receive cash-flow and control rights over assets, it becomes more costly for politicians to influence the conduct of firms, their leverage to intervene decrease and the management of firms can make more efficient decisions.

Although the models of Shleifer and Vishny (1994) and Bennesen (2000) provide some predictions about the process of privatization, they do not uncover the motives of a government to privatize. Given that the government loses its ability to influence firms' conduct as a consequence of privatization, why should privatizations ever happen—except for exogenous reasons? Debande and Friebel (2004) develop a model in which they give a positive theory of privatization in a framework similar to the one of Shleifer and Vishny (2004). They argue that the government may be interested in making firms more efficient because of the following mechanism: privatization provides managers with stronger incentives to exert effort; more managerial effort may help to create or to maintain jobs that otherwise would be destroyed, without requiring the inefficient kind of government intervention. Put differently, privatization, via increased managerial efficiency, may be a cheaper way to maintain or to create employment than the subsidization of loss-making SOEs.

This is similar thinking to another type of approaches, whose goal is to find the optimal rates of job creation and job destruction (Aghion and Blanchard 1994, Fidrmuc 1999, Roland 2002). The basic thinking is that job creation and job destruction are normal consequences of transition from planned to market economy. If the job destruction in large-scale SOEs is not compensated by the job creation in emerging, privately-owned sector of the economy, it may lead to excessive unemployment, resulting in strong opposition to future reforms and obstructing it. Sometimes, politicians are aware of this sequencing, and then the incumbent governments tend to slow down

the job destruction in order to stay in the office, i.e. prevent opposition (anti-reform) parties who will benefit from increasing number of losers from winning the next elections.

On the other hand, nonetheless, too little enterprise restructuring, i.e. too little job destruction, because of continued extension of subsidies and/or application of soft budget constraints to the SEOs undermines the growth of private sector and job creation in that sector due to high tax burden or high wages on the labor market induced by the SEOs. Lack of job creation will decrease the number of winners and number of losers on the margin will decrease popularity of the incumbent government. Accordingly, there are at least in theory some political incentives that will drive the reform both ways.

However, all of these approaches are based on one implicit assumption: constituency votes only or predominantly based on the economic situation and on their self-interest as they perceive it. We will test whether it is justified to use this assumption in Serbia, whose transition, due to the 1990s wars, has been rather specific.

The reason for doubting the importance of economic variables is mostly linked to the rational ignorance and/or bounded rationality. Rather uneducated population, low circulation of newspapers and rather short democratic tradition/practice could explain why constituency in Serbia is not very well informed and that are not aware of all the costs and benefits of voting for one political party or another. That way they can over or under estimate the effects of their voting. We will be able to control for these effects by controlling the education level on voting patterns. However, this (rational ignorance and/or bounded rationality) hypothesis only predicts that uninformed voters will occasionally vote wrongly, not that they are systematically biased in one direction – toward SRS, for example, or any other anti-reform political party. But, rational ignorance could still influence the outcome of elections. Pro-reform political parties usually have more sophisticated programs – the ones that include difficult and not so clear-cut issues such as EU integration, trade liberalization or restructuring of the economy. Then, rational ignorance and/or bounded rationality assumption could be very relevant, since it would lead to bias, as voting for pro-reform parties requires more information and understanding of more sophisticated political and economic concepts.

Another explanation could be a wider one – economy is not really the key issue. Of course, professional politicians might try to make economy the issue of the day, but they don't always succeed. Glaeser and Ward (2006) argue that cultural politics in USA is not unusual: "The true aberration was the mid-twentieth century era of economic politics."

For the time being, apart from Milanovic (2004), empirical studies such as this one were not done in Serbia in econometrically rigorous manner. The conclusions could provide insight into what really matters/doesn't matter for voters in a specific transition country – Serbia. Furthermore, these results can be compared to the results of empirical research from other transition countries (Symposium on Job destruction, job creation and voting in post-communist societies, *European Journal of Political Economy*, 2006) and the factors of that difference could be explored. The belief of the researchers is that economic variables have only marginal influence on voter behavior in Serbia. Milanovic (2004) demonstrated that 2003 parliamentary election results (voting in favor of non-reform political parties, predominantly SRS) are determined by the share of refugees and internally displaced persons, the share of ethnic minorities and the education level of the constituency. Nonetheless, this research deals only with the 2003 election results, not the change in the election results 2000/2007 and the change in the both economic and non-economic explanatory variables.

If this hypothesis is empirically verified – that the economy doesn't really matter - the pessimistic view of its policy relevance is that growing economy, higher living standards and inflow of FDI's will not help the pro-reform (democratic) political forces in Serbia. On the optimistic view of policy relevance, it also means that faster pace of enterprise restructuring, privatization and liberalization will not hurt popularity/ratings of the democratic parties and endanger their pro-reform policies. The empirical investigation outcome will be relevant for the policy implementation, as government, although taking care of its political rating (popularity), will have a signal that it can be involved in more radical, swifter and fast-implemented enterprise restructuring and that it can be directly communicated to the constituency. The result is not policy relevant in terms of the policy content, but it is relevant in terms of the policy implementation and communication.

2. Economic and Political Situation in Serbia

Serbia is widely perceived as a latecomer to the transition process. On the eve of October 2000 changes, Serbia nominally had many institutions of standard market economy: there were laws on companies, property protection, privatization, bankruptcy, stock exchanges, securities, foreign investment, taxes, antimonopoly legislation, accounting, etc. The only significant exceptions were the non-existence of the formal foreign exchange and labor market. There were also institutions that were formally equal to those in market economies - independent companies, central bank and other banks, stock exchanges, courts, arbitration, chambers, trade unions, etc. Entry into business was to a great extent free, although there were certain barriers; there was a freedom of possession and sale of property; competition of economic subjects was recognized. Despite all that, the Serbian economic system was certainly not a market system in the standard meaning of the term. The laws were usually bad and were often not enforced, while the state and policy informally and illegally took over the role of all-powerful arbitrator with decisive influence on all economic flows.

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

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

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

On the political front, in Serbia it was not possible to garner political support by simply abolishing central planning, state monopoly on foreign trade, etc. (since these institutions did not exist at first place), which assisted authorities in other transition economies to create a powerful transition momentum. Secondly, the Serbian reformers were still facing three very controversial political tasks – issues related to the collaboration with the Hague based ICTY (International Criminal Tribunal for the Former Yugoslavia), the relations with Montenegro regarding the Union and the resolution of the final status of Kosovo, which were often (both explicitly and implicitly) included in the conditionality set for both financial assistance and support to economic reform. Prime Minister Đinđić's assassination in early 2003 and the election of the second reform government of Prime Minister Koštunica practically postponed reform by a whole year. Prime Minister Koštunica's government itself has then traveled the road from a feverish advocate of macroeconomic populism, "development budget", a high budget deficit and subsidies to public and socially owned enterprises, to the adoption of a revised budget with a fiscal surplus, announcing phasing out of subsidies and privatization of public and socially owned enterprises. A change in policy came after the IMF made the approval of a 15 percent

write-off of the debt to the Paris Club of creditors (amounting to some 750 million dollars) to Serbia conditional upon accepting more radical reform. To a great extent, such policy of setting conditionality has compelled the (basically populist) ruling parliamentary majority to pass this quite restrictive package of economic policy measures.

3. Restructuring of the Real Sector

3.1. Differences among firms in the real Sector

At the beginning of transition in Serbia, in late 2000 and in early 2001, the real sector in the Serbian economy comprised of, for all practical purposes, five groups of enterprises:

1. Completely new private companies, established through private investment after 1989, when private business was legally allowed.
2. Companies which were partially privatized under the privatization model in application as of early 1997, until end-2000.
3. Socially and state owned companies which do not need pre-privatization restructuring.
4. Socially and state owned companies which need pre-privatization restructuring, i.e. which cannot be privatized without such restructuring.
5. State owned public enterprises.

With the exception of the companies in group 1, all other companies in the domestic real sector constitute the legacy of socialism in the Serbian economy, with all their minor or major weaknesses displayed long before a political crisis that broke out in 1991. All weaknesses of these companies were just intensified in the course of the 1990s, with changes in the region, i.e. the new catalysts which came from the break-up of the country, international sanctions and isolation of the Serbian economy, extraordinary political circumstances and an institutional vacuum of its own kind that was caused by the implosion of institutions of communism, which was not followed by the building of the institutions of market economy. Consequences of these developments for many companies in the real sector were numerous: inferior and outdated

technology, poor production programs, uncompetitive products, a lack of good incentives for employees, low economic efficiency. In line with the above, the situation of the Serbian real sector in early 2001, at the beginning of transition, was such that its large share was not competitive at the international level.

For this reason, a vast majority of companies in the real sector (including some companies from group 1) should undergo restructuring to a smaller or larger extent, i.e. make adjustments to new market and institutional circumstances. Consequently, there was a need for restructuring of practically the entire real sector of the Serbian economy. Of course, the scope, the degree and character of restructuring differ from case to case, principally at the level of individual companies, but also at the level of industries.

A key strategic decision related to this issue was adopted in early 2001: in all the mentioned cases, except for the specific case of public enterprises, restructuring should be carried out by a private owner of those companies. That decision was based on the assessment that the private owner can do the job of restructuring far better than the state, hence a conclusion was drawn that post-privatization restructuring would be economically more efficient than pre-privatization one. In that sense, a precondition for efficient restructuring of the real sector is its privatization, i.e. the sale of companies in that sector.

Namely, at that time such model of privatization was chosen which was based on the sale of the majority socially or state owned equity stake (at least 70 percent of shares) in the real sector companies. One of the main motives for the application of such a privatization model was to establish concentrated ownership, i.e. to create a private owner of the company's capital, who has efficient incentives and mechanisms to carry out its restructuring, embodied first and foremost in his indisputable majority stake in ownership.

The strategic decision to leave the restructuring of the real sector to private owners for the most part can be assessed as justified, bearing in mind that there are unarguable theoretical and empirical findings which indicate that a private owner is much more efficient at this job and that better results of restructuring can be expected by opting for such approach in comparison with

the alternatives. However, it is much more interesting to consider political circumstances in which such a decision was taken. Namely, against this decision, that is, the restructuring strategy, were those who cannot benefit from restructuring as such, primarily those who will be left jobless. In early 2001 those interest groups were not well defined and did not have mechanisms for projecting their interest into the decision-making process. That was the time of a firm reformist coalition and great political energy focused on reform. Simply, the political opposition of that time was non-existent. In addition, financial and political support of the international community was very strong then, so an image (an illusion) was created that the said support will be enough to resolve by itself the problem of redundant labor in the real sector, i.e. of unemployment which was to be generated. Finally, the policy of the World Bank, that is, consultancy provided by that international financial institution in this field, significantly influenced the adoption of that strategy.

3.2. Pre-privatization Company Restructuring

One of the major problems in post 2000 period was and still is related to large socially and state owned companies which could not be privatized through sale, bearing in mind that nobody was interested in buying them on sight. The reasons for this lack of interest could be broadly found on two sides. Firstly, an absence of any business prospects of such companies, which are in a large number of cases conglomerates, i.e. engaged in many different activities, without being specialized in an area where they would have the competitive edge. Furthermore, these companies very often were wrong (“failed”) investments from the very start – they were constructed on the basis of investment decisions taken by those who did not have to bear the consequences of these decisions. In some cases of such conglomerates, there are certain plants, i.e. parts of the enterprise, which have some kind of business prospects. Consequently, fragmentation of such companies should be carried out and those units which have some business prospects should be established as separate companies. Other units without any future in business are candidates for bankruptcy and liquidation, in order to privatize their assets, primarily fixed assets, instead of their equity. Of course, in such a division it is necessary, in collaboration with creditors, to allocate liabilities of the company to the units which are formed by its partition.

The second problem was accumulated debts of companies, i.e. their obligations which in many cases were higher than assets – such companies had negative capital. Consequently, it was necessary to resolve the issue of their debts before launching privatization. It turned out that the largest part of liabilities of these companies (in some cases more than 80 percent) was debt to the state - direct debt, such as tax and contribution arrears, or indirect, such as unpaid utility bills to the public enterprises (power, gas, water, etc.). Still, the bulk of the liabilities of these companies to the government is a consequence of foreign loans for which creditors were issued sovereign (government) guarantees, which have not been repaid.

Namely foreign (sovereign) loans were taken by domestic real sector companies, domestic banks acted as financial mediators, namely in most of the cases four large banks liquidated in early 2002, and the state issued sovereign guarantees to foreign creditors. Consequently, the state took over all the claims of these banks arising from extension of foreign loans with sovereign guarantees and allocated these claims to the Bank Rehabilitation Agency (BRA). Although the liabilities of the state to foreign creditors arising from these loans (in arrears) were considerably reduced on the basis of agreements with the Paris Club creditors (51 percent of government debt was written off in November 2001, while the remaining 15 percent was written off after successful completion of the Extended Arrangement with the IMF in 2005) and the London Club creditors (a write off amounting to 62 percent in total), the state did not write off its claims on its debtors respectively, i.e. the companies which used these loans. In other words, a reduction in the state's liabilities to foreign creditors did not result in a reduction of government's claims on debtors in the real sector.

Two mentioned problems created a need for pre-privatization restructuring of these companies, in order to make their privatization possible at all, that is their sale at any selling price. The envisaged restructuring implies organizational changes (mostly fragmentation) and resolution of company liabilities. In addition, restructuring can also imply bankruptcy/liquidation of parts of these companies (followed by the sale of assets) and cutting employment. Such pre-privatization restructuring (in the unofficial World Bank jargon called "dressing-up the pig") explicitly bans any investment, be it in fixed assets or working capital. It is just light pre-privatization

restructuring which is followed by privatization through tender or auction, i.e. by the sale of equity of that company, or its parts, to a new private owner. Therefore, as early as 2001 a group was formed of 69 companies with around 155,000 employees (those who formally have a work place).³

The above described restructuring, provided that a solution is found for the liabilities of the company, may be also called a substitute for bankruptcy, i.e. liquidation of a company through bankruptcy. One should not completely disregard the possibility that one of the motives for introducing such restructuring lies in the awareness of the shortcomings of the then legal arrangements related to bankruptcy at that time, in particular extremely long duration of bankruptcy proceedings, weaknesses in its implementation and uncertainty with respect to the adoption and implementation of new bankruptcy legislation (which proved to be reasonable, considering that the new bankruptcy legislation, although passed by the Parliament, has not been implemented until 2006).

However, in the first four years of transition nothing came out of the said restructuring and subsequent privatization of these companies. The question may be asked why there are such delays in the restructuring and privatization of this group of companies.

It is obvious that two main technical problems have arisen in relation to the implementation of thus designed restructuring. The first one is the problem of identification, separation and verification of claims by different creditors on these companies, taking into account that their arrears are years and even decades old. That problem is aggravated by the already mentioned problem of debts to the state, for the write-off of which, conditional or unconditional, irrespective of government policy, in some situations there were no legal grounds. The second problem is a relatively complex and pretty absurd organizational structure of these companies,

³ The number of such companies varies. So far, since 2001 only several such companies have been privatized, which decreased the initial number of companies under restructuring. Contrary to that, companies which were not initially slated for restructuring, and whose privatization failed after two attempts (nobody offered the initial price), are included into the group for restructuring, as it has been assessed that further attempts at their privatization will not be successful. Hence, the total number of companies slated for restructuring was around 80 at the beginning of 2006. Moreover, this number of companies should be increased by more than 200 smaller subsidiaries. These companies are in a way hostages of large companies, bearing in mind that the future of subsidiaries, whatever it may be, is linked to the fate of large companies which need to be restructured.

primarily the cases of socially owned holdings created through the transformation of the so-called complex organizations of associated labor. This second problem is augmented by the engagement of foreign advisors, which in certain cases was mandatory, where big multilateral donors provided grants. Foreign consultants, unused to such organizational arrangements, were wasting time searching for the sense where there is no sense, nor has ever been.

However, the key reason for the absence of activity in the field of restructuring of this group of companies lies in the lack of political will to do that. Overstaffing in those companies is the main reason behind the lack of that will. Namely, the restructuring of these companies would inevitably lead to lay-offs of a sizeable number of those presently employed - whether directly, in the course of pre-privatization restructuring, or indirectly, after privatization, as part of efforts by a new owner to restructure his own company and enhance its economic efficiency. The total number of future retrenchments in restructured companies will vary from company to company, but in general terms, it could be said that these will be older employees, with lower levels of qualifications and relatively limited capacity to acquire new skills and change their work habits. Furthermore, one should bear in mind that a number of such companies in the cities, i.e. regions, where they are located, generates sometimes significant portion of total employment, which is relevant in light of proverbially low labor mobility in Serbia.

In that respect, the restructuring of these companies, i.e. lay-offs of redundant workers, can have negative political consequences – significant falls in political popularity of those taking these decisions and those implementing such restructuring. Therefore, there is a direct incentive to politicians to maintain the inherited redundancies, namely in the case under consideration here, not to carry out pre-privatization restructuring. General managers, i.e. employees' representatives in those companies, being aware of the mentioned incentives related to political popularity, are in a position to blackmail politicians, mostly by demanding a constant flow of, and an increase in, subsidies to such companies, i.e. suspension of any restructuring of such companies.

In this manner political equilibrium has been established in the form of balanced subsidies to non-restructured and non-privatized companies, maintenance of redundancies in them and political support which those employees and their families lend to the politicians who are not

carrying out restructuring. This finding is in full compliance with the findings of the model of relations between politicians and firms (Shleifer and Vishny, 1994). In the equilibrium, explicit subsidies are paid to loss-makers (budget item subsidies to non-financial organizations) and soft budget constraints are made possible. Namely, in addition to direct subsidies, non-payment of utility bills to public enterprises is tolerated, and as for other creditors, the efficiency of collecting claims from socially and state owned companies in Serbia is proverbially low.

An indirect confirmation of the thesis that political equilibrium was established relatively early on, which was not conducive to the real sector restructuring, is a relatively low level of efforts invested in institution building, i.e. in creating institutions and building administrative capacities necessary to carry out pre-privatization restructuring. Namely, in setting up the Privatization Agency, which is, among other things, in charge of the real sector restructuring, far more attention was paid to the building of the Tender and Auction Centers than of the Restructuring Center.

In this manner, a connection empirically verified also in other countries (Djankov and Murrell, 2002), was confirmed in Serbia as well, and that is the connection which exists between soft budget constraints and absence of enterprise restructuring. Moreover, on the basis of domestic experience, there is room for an even firmer conclusion, which reads that without the imposition of hard budget constraints, there are no incentives for the real sector restructuring. In other words, with soft budget constraints in place, the real sector cannot be expected to restructure.

On the example of these companies another empirical finding could be tested (Djankov and Murrell, 2002), which is that foreign trade liberalization and tougher international competition spurs the restructuring of such companies. Namely, it could be said that in Serbia the first year of transition saw liberalization of foreign trade flows, largely due to the elimination of quantitative import restrictions, and to a lesser extent owing to the reduction in customs protection. Nevertheless, such changes did not bring about the restructuring of this group of companies. On that basis, it can be concluded that the imposition of hard budget constraints is a necessary

condition for restructuring. Without this condition in place, foreign trade liberalization can not by itself create incentives for restructuring.⁴

It is obvious that, in principle, political equilibrium was established in Serbia, namely a vicious circle in which there are no incentives to any of the parties to begin the restructuring of the real sector, i.e. of this group of enterprises. However, a question is raised as to the extent to which some of the perceptions underlying the decision-making process are based on reality. On the one hand, the first transition government lasted almost three years, longer than in nearly any East European transition country. Still, it is questionable how justified it would be to link this political result primarily to the non-implementation of the real sector restructuring. Furthermore, the fall of the first Serbian reformist government in 2003 certainly was not a consequence of the restructuring of the real sector, since no such restructuring ever happened. Finally, a question may be asked to which degree the real sector restructuring influences the popularity rating of the government, that is, of the ruling parties, today. Namely, employees in these companies indubitably belong to the losers in transition, so it can be assumed that this part of the electorate turned against the government, that is, against reform policies, a long time ago and that they have long been voting for opposition political parties, in particular those which for sure are not reform-oriented, i.e. whose political programs do not envisage orientation to market economy.

In the long run, political equilibrium is established based on the political popularity (voters' support) which is a result of increased subsidies, versus the political support which is a result of cuts in taxes collected for financing these subsidies.

⁴ The relation between foreign trade liberalization and hard budget constraints is more complex than it might seem at first sight. Namely, protectionism increases equilibrium prices on the domestic market, which can enable such companies (if they still produce something) to operate without losses by selling their goods on the domestic market, thus also making the component of soft budget constraints lose its relevance. Foreign trade liberalization is cutting prices on the domestic market and forcing the state to (unless it wants them closed down) subsidize such companies. In that respect, foreign trade liberalization produces higher transparency, bearing in mind that explicit subsidies have to be introduced. Clearly foreign trade liberalization is not a sufficient condition for restructuring, but in the case of Serbia it is not clear whether it is even a necessary condition. Namely, even in the conditions of protectionism many of the companies in this group were not able to cover expenses out of their own revenue, which means that the imposition of hard budget constraints would bring about restructuring, or bankruptcy, even in the absence of foreign trade liberalization.

In Serbia, seven years after the beginning of transition, political popularity as a result of increases in subsidies is still far greater than political popularity won on the basis of cuts in the tax burden on the taxpayers. Namely, in present-day Serbia, the number of those who are mindful of their own tax burden is still relatively small. The number of those who live on subsidies, that is, on transfers, is considerably larger. With a rise in wealth, i.e. at an increased level of steady income, the number will also increase of those who define their preferences in politics on the basis of tax burdens, among other things, which political competitors are offering to them. Such a change will bring about the establishment of a new political equilibrium in which there will be no incentives for keeping the redundancies in the real sector. Support to such change can come from a tax reform which would increase the share of direct taxes in total tax revenue at the expense of indirect taxes. Namely, a tax burden based on direct taxes is much easier to notice and a larger number of people will see the connection between increased subsidies and their own increased tax burden.

Greenfield private investments generate economic growth and increase the number of voters to whom their own tax burdens matter much more than the subsidies the state is providing and this will inevitably result in the shifting of political equilibrium toward a reduction in subsidies. The problem is, however, in the fact that such a solution takes time and may be jeopardized if interest groups which demand subsidies get well organized.

In the short run, however, help in terms of incentives to scale back subsidies and carry out restructuring of the real sector may come from those who represent the interests of budget balance, and in Serbia that is only the IMF for the time being. When the Serbian parliament adopted the 2004 annual budget providing for a deficit in the amount of around EUR 625 million or around 5 percent of GDP, only the pressure from the IMF managed to force the Government to submit to the Parliament a rebalanced budget with a dramatically decreased budget deficit. Likewise, it is only thanks to the IMF's pressure that the projected deficit in the 2005 annual budget amounted to "a mere" EUR 250 million and allocations for subsidies to non-financial organizations, that is, subsidies to the real sector, are declining. Obviously, against the backdrop of prevailing economic populism and relatively instable ruling coalitions, the IMF was the only

relevant and credible political force which prevents uncontrolled growth in the budget deficit, i.e. which reduces it to a more or less acceptable level.

4. Hypotheses

There are several hypotheses that will be tested.

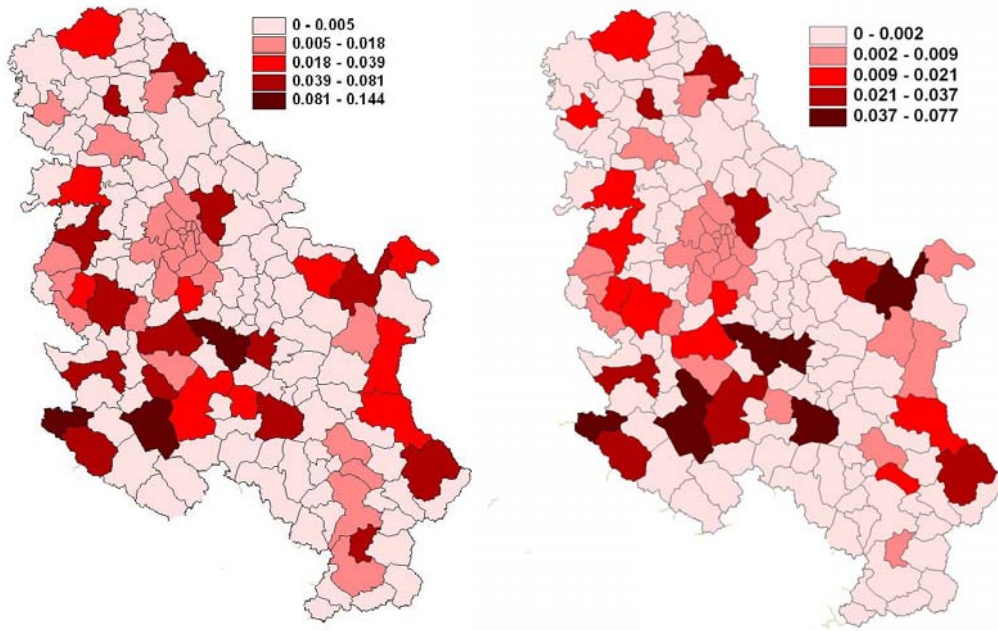
The first one is that 2000 election results were affected by the people working in the socially owned companies, namely that they tended to vote for Radicals or Socialists. We believe that this group of people is very risk averse, and that they perceived regime change as potentially disastrous for their employment and living standard.

The second hypothesis is linked to the importance of other economic variables. Conventional wisdom is that growth in living standard, average salary and employment shall decrease the support for the antireform parties.

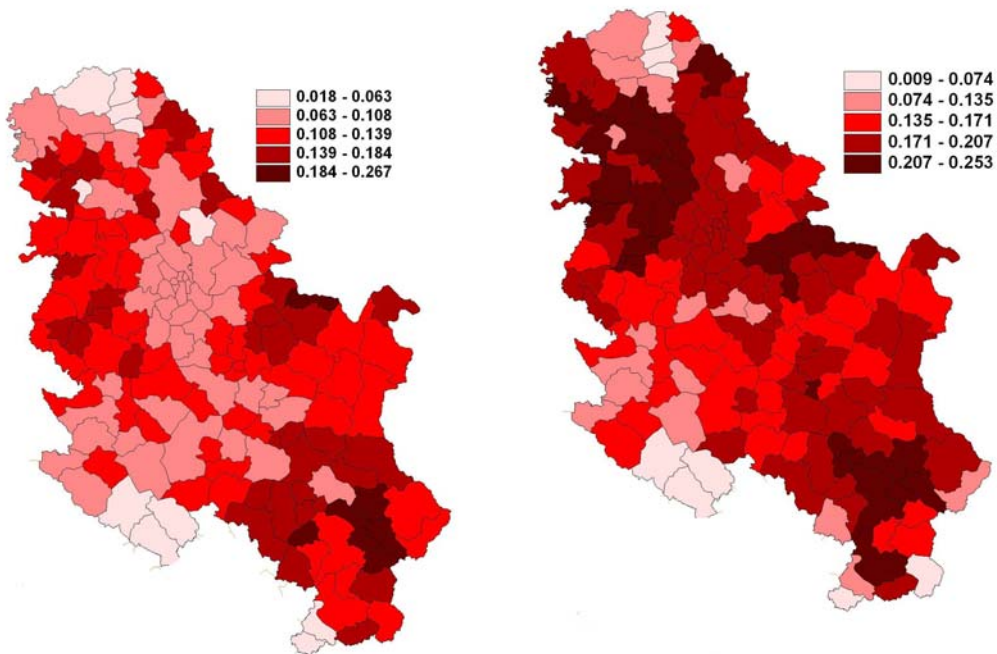
The third group of hypothesis is linked to the importance of mainly demographic variables, such as share of Serbian population, share of old people and share of refugees, since some previous research indicated that these variables are instrumental in explaining the voting patterns in Serbia.

The fourth hypothesis to be tested is whether the restructuring process has actually decreased the support for antireform parties. The explanation would be that people who were working in these companies and lost their jobs, have switched their voting from reform to antireform parties. It seems that most politicians in Serbia are afraid to push for the faster restructuring as they believe that that would undermine their support. This does not necessarily contradict the first hypothesis, as it is focused to these employees who initially voted for the reform political parties.

Picture 1 – share of employment in companies undergoing restructuring, by municipality in 2001 and 2006



Picture 2 – share of votes for antireform parties (SRS and SPS), by municipality in 2000 and 2007



5. Data

The data set consists of the following data at the level of municipality (150 municipalities in Serbia, cities of Belgrade, Novi Sad, Niš and Kragujevac are each considered to be a single municipality): share of people working in the socially-owned companies undergoing restructuring process in 2001 and 2006 in total municipality population; relative change in share of people working in these companies; average nominal wage in December 2000 and December 2006; relative change of salary in 2000-2006 period; share of employed people in total municipality population in 2000 and 2006; relative change in employment in 2000-2006 period; percentage of refugees and internally displaced persons in total municipality population; share of people receiving social assistance in total municipality population (as a proxy for poverty rate for which data do not exist at the municipal level); illiteracy rate, measured on a 1-5 scale (a proxy for education level); share of residents of Serbian ethnicity in total municipal population; share of population older than 65 years; GDP per capita in 2004. In addition, we have collected the data on municipality votes for Radical and Socialist parties at 2000 and 2007 elections.

The main link that we are seeking to test is the link between share of employees of restructuring companies and voting results. All of the other variables can therefore be treated as control variables. However, more broadly, we want to test the prediction strength of other economic variables, to see whether they influence election results at all.

Most of the data are official statistical data. However, the data on the employment in companies undergoing restructuring is collected from the financial statements submitted by the companies to the National Bank of Serbia. We have identified more than 200 companies in this group and collected employment data for the 2001-2006 period. The employment data has then been summed by municipalities. The registry of all of these companies does not exist. Namely, there is a list of around 70 major companies, but all of their subsidiaries had to be identified manually. We believe that we have identified more than 80% of these companies.

6. Econometric analysis

We start by looking at the 2000 December election. It is widely perceived that these elections were somewhat specific since they were held 3 months after the ousting of Milosevic from power. However, it seems that a very high percentage of variation can still be explained with a relatively small number of variables.

The initial specification included all the variables that could theoretically influence the voting behavior: share of people working in restructuring companies in 2001, share of refugees, share of people receiving social assistance, GDP per capita, average salary, percentage of Serbs. It turns out that neither percentage of Serbs, nor average salary and GDP per capita are statistically significant, hence there were excluded from the model.

The final specification is the following, with R squared of 0.95:

model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	-0.202	0.026		-7.874	0.000
65+	0.866	0.144	0.129	6.028	0.000
Refugee%	1.234	0.075	0.698	16.44	0.000
MOP%	2.523	0.356	0.301	7.095	0.000
EDU	0.02	0.006	0.072	3.351	0.001
Rest%01	0.006	0.002	0.049	2.516	0.013

All of these variables are statistically significant and with the expected sign – following factors lead to more votes for antireform parties – older population, higher share of refugees, higher share of people receiving social assistance, higher illiteracy rate. Maybe the most interesting finding is that people who were at that time working in the companies that are going to be selected for restructuring have also voted for antireform parties. It seems that this can be explained by their high risk aversion. Namely, they probably understood that their companies are not viable and that the victory of reform-oriented government would mean loss of job, through restructuring of the company or its liquidation through bankruptcy.

The second regression involved 2007 January election results. The initial specification included nominal salary, relative change in salaries in 2000-2007 period, share of refugees, share of people receiving social assistance, share of Serbs, change in employment, illiteracy rate, share of old people, GDP per capita, employment in companies undergoing restructuring and relative change in employment in these companies in 2000-2007 period.

The final specification is following, with R squared of 0.96:

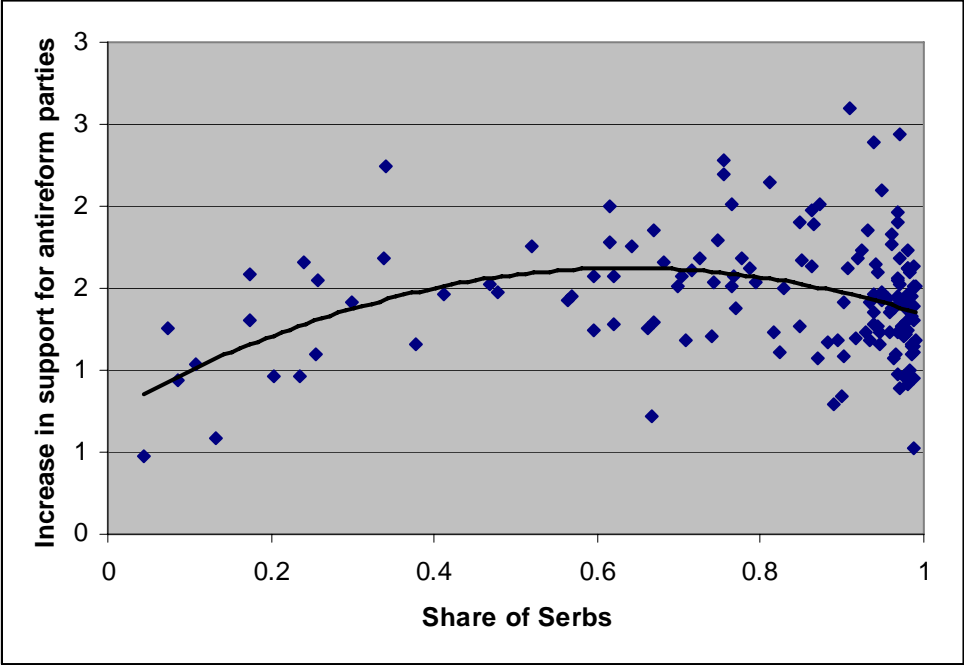
model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	-0.18	0.037		-4.837	0.000
65+	0.745	0.208	0.074	3.586	0.000
Refugee%	1.967	0.109	0.744	18.018	0.000
MOP%	3.215	0.516	0.256	6.229	0.000
EDU	0.018	0.009	0.043	2.082	0.039
Rest07-00	0.065	0.23	0.038	2.013	0.046

All of coefficients are statistically significant and signs are expected. However, the variable share of employment in companies in restructuring is not statistically important, but the change in the employment is significant. Therefore, the municipalities where restructuring process was proceeding at a faster pace tended to vote less for antireform parties, which is expected, taking into account the 2000 econometric result. It is the size of the workforce in these firms that is a crucial factor of voting for non.-reform political parties, precisely due to the mechanism already explained in 2000 model. Furthermore, it is important to notice that none of the other economic variables is statistically significant, i.e. they are not the factors of voting behavior of Serbian constituency.

The third regression was looking at the relative changes in votes for antireform parties in 2000-2007 period.

The initial specification included relative changes in salary, change in restructuring employment, illiteracy rate, share of people receiving social assistance, nominal salary in 2007, change in employment, share of Serbs, GDP per capita, share of refugees and share of Serbs squared, as we

had reasons to believe that the link between share of Serbs and votes for antireform parties was not linear.



The final specification was as follows, with R squared of 0.51:

Coefficients					
model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	1.057	0.182		5.805	0.000
Srbs%2	-1.558	0.374	-1.303	-4.17	0.000
Srbs%2	2.361	0.457	1.597	5.163	0.000
65+	-3.287	0.554	-0.415	-5.936	0.000
EDU	-0.74	0.025	-0.223	-2.935	0.004
GDPpc04	1.34E-03	0.000	0.168	2.409	0.17
DEmp07-00	0.272	0.095	0.175	2.874	0.005

Restructuring (either level or change) is statistically insignificant. Some of the other variables are significant, but some of the signs are completely unexpected.

7. Discussion and conclusions

Analyses of both 2000 and 2007 elections results demonstrate that economic variables (GDP, salaries, and employment) are still not important when citizens of Serbia decide who to vote for.

However, the analysis of 2000 elections shows that people who were employed in the companies that were going to be companies in restructuring were even then fully aware that their companies are not viable and that any reform oriented government will tend to reduce employment in those companies by their restructuring or liquidation. Therefore, they responded by voting for anti-reform political parties in 2000. The explanation probably lies in the extreme risk aversion among this part of constituency. Although the reforms could in the long run prove to be useful even to this part of the constituency, it seems that they favored the situation in which they have a job, no matter how poorly paid and insecure, i.e. unsustainable it was.

Analysis of 2007 election results shows the similar results. Other economic variables, besides the pace of restructuring are statistically insignificant, including the level of employment in restructuring companies. However, the pace of restructuring (measured by the change employment in these companies) is statistically significant and of the expected sign. Strong positive correlation (0.723) between the level of employment in these companies and the change of employment (slower change and higher level of employment) could be an indicator that politicians tended to restructure more quickly the companies in the municipalities where the share of that employment was relatively low. Obviously, such operation has been considered less politically risky than operations in municipalities with substantial share of total employment in firms under restructuring.

The most interesting and probably the most difficult to interpret is the third regression model, the one aimed to explain the relative differences in votes for anti-reform parties in 2000 and 2007 elections. As already mentioned, employment in companies in the restructuring process is statistically insignificant, meaning that the evident increase in support for antireform parties from 2000 to 2007 had nothing to do with enterprise restructuring.

In addition, the constant is highly statistically significant. Taking into account that we are trying to explain the relative change, the presence of the statistically significant constant means that some other unidentified factors are at work in all of the municipalities, namely that some national issue is probably the cause, since the strongest non-reform political party (SRS) has an image of party protecting “national interest”. The crucial factor that could be omitted from the regression is the change in the process of finding final status of Kosovo, as the issue was not important (not on the agenda at all) in 2000 and highly important in 2007. There is no reason to assume that this factor will have stronger effects in some municipalities and weaker in the others, i.e. there should be no significant variability of the effects of this very factor other than random.

Also, the quadratic relation between share of Serbs and votes for antireform (basically nationalistic) parties means that there is some local maximum of antireform voters (at about 65-70% share of Serbs in the total population). The relative reduction in the votes that antireform parties get at the higher levels of Serbian share of population might mean that in those municipalities Serbs tend to feel safe and nationalistic issues are not on the top on the agenda, hence they are not very interested in the nationalistic ideas. Small share of Serbs means that the majority of constituency is national minorities who are not voting Serbian nationalist political parties anyway. In short the least of the increase of the votes going to the non-reform political parties is in the municipalities which are not ethnically mixed.

Secondly, signs of the parameters of the “demographic” variables are mostly unexpected (negative), which means that older population and less educated electorate tended to switch from antireform to pro-reform parties. Taking into account that average pensions have increased in real terms as well as the arrears have been cleared, this result could still make sense. Also, since most of the old people tended to vote for antireform parties in 2000 (regression 1), a cynical view would be that their support could only go down. The other negative sign of the parameter, linked to the education level is more difficult to explain, as it means that the municipalities with lower average education level also tended to switch from anti-reform to pro-reform parties. Potential explanation could be that people in these municipalities have strong feelings towards the government and authority and therefore tend to vote for whoever is in power.

The impact of the last two variables is challenging to explain, since both GDP *per capita* and change in employment are positively correlated to votes for anti-reform parties, and these two are the only economic variables whose estimated parameters are significant. One potential explanation could be that Serbian constituency does not have sufficient reform stamina, i.e. that reform fatigue has already surfaced in Serbia. Hence, seven years into the transition, as the living standards (purchasing power) have increased, the constituency had enough, and it is moving towards non-reform political parties that will stop or at least decelerate the reform.

The main finding is that conventional wisdom regarding enterprise restructuring in Serbia proved to be wrong: enterprise restructuring does not decrease political rating of reform oriented incumbent government. On the contrary, lack of restructuring and keeping employment in these firms provided to be the ground for political support of non-reform political parties. The main reason for that is labor employed in these firms have no illusion about sustainability of these firms and their jobs in these firms and their rational expectation is that reform political parties will make them unemployed. Taking into account high level of risk aversion of that segment of constituency, their obviously choice is to vote for non-reform political parties.

As the consequence, incumbent political parties can push forward enterprise restructuring without a significant political risk. Their employees already vote for non-reform political parties.

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