
Property Rights, Liberty, and Corruption in Serbia

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The privatization process in Serbia, which began in the early 1990s, may be characterized as a dismal failure so far. It was originally expected to be completed by the end of 2005; however, at the end of that year an amendment to the privatization law made the process open ended. The amendment reflected the reality that less than half of state assets had been privatized. In fact, only small-scale industrial plants and a few big firms had acquired new private owners. Almost all the leading plants, facilities that once were the pride of the Communist regime and now only generate losses, have remained in government hands. Moreover, all state enterprises that had been formed by special laws (natural monopolies and local utilities), which were also slated for privatization according to the original privatization law, have remained in the government's portfolio. In addition, the government has changed the Share Fund law in accordance with its declared interest in influencing the decisions of all companies that have minority state ownership (almost all privatized companies). This action indicates clearly that the government does not intend to loosen its grip on the economy.

Various surveys rank Serbia among the most corrupt states in Europe. According to the 2006 Transparency International Corruption Perception Index (CPI), Serbia shares ninetieth position worldwide, with only five European countries ranked as more corrupt—Albania, Belarus, Macedonia, Russia, and Ukraine.¹ The Heritage Foundation (2006) has not ranked Serbia in its latest survey of economic freedom

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1. See rankings at http://www.transparency.org/policy_research/surveys_indices/cpi/2006.

around the world, although it paints the situation in colors as dark as those used at Transparency International: “Belgrade’s underground power structure remains in the grip of war criminals, corrupt security chiefs, and ultranationalist politicians.”² The Freedom House country report repeats almost the same wording, stating that “corruption remains deeply entrenched [in Serbia] at all levels” (2006, 16). The latest World Bank survey found corruption in Serbia to be on the rise between 2002 and 2005 (Anderson and Gray 2006, 54–58), especially in the government’s procurement and among the judiciary (the second-highest increase among transition countries, exceeded only by Albania).

The link between the two important features of postcommunism—privatization and corruption—is by no means accidental. Several studies have explored the likely connection between the privatization scheme and the extent of corruption. Kaufmann and Siegelbaum found that spontaneous privatization and management-worker buy-outs are the methods with the greatest potential for corruption, whereas privatizations by vouchers or by sale fare better (1997, 434). Under forceful World Bank pressure, Serbia accepted the sale privatization model in 2001, yet corruption there is greater than in countries that adopted some of the supposedly more corruption-boosting strategies. For example, Slovenia, another spin-off from Yugoslavia, relied on a worker-buyout scheme, but by all accounts it is the least corrupt country in the region.³

In this article, I argue that government-induced definition of ownership rights must lead to inefficiency, waste, and insecure property rights, which is a recipe for high overall corruption and the erosion of efforts to liberalize society. First, I deal with the mainstream (neoclassical) approach to transition efforts in central and eastern Europe (CEE), which fosters the governmental role in shaping the economic system; second, I briefly explain the privatization process and recent institutional changes in Serbia; third, I explore the causes of the current extensive corruption in Serbia; fourth, I try to establish common features of government assignment of property rights in two dissimilar political, economic, and cultural environments; and finally, I present some tentative conclusions.

The Two-Tier Neoclassical Consensus and the Role of Culture

At the beginning of the transition process in CEE, economists affiliated with international financial organizations in Washington reached a consensus on the reform agenda for the region. The so-called Washington consensus was achieved along neoclassical lines, with only a few dissenting voices being heard, and emphasized the

2. Available at <http://www.heritage.org/research/features/index/country.cfm?id=SerbiaandMontenegro>.

3. Slovenia ranks twenty-eighth in the Transparency International CPI, ahead of Hungary (forty-first), Italy (forty-fifth), and Croatia (sixty-ninth).

following commandments: fiscal discipline; reorientation of government expenditures; tax reform; interest-rate liberalization; unified and competitive exchange rates; trade liberalization; openness to foreign direct investment (FDI); and, most of all, policies of privatization, deregulation, and securing private-property rights (Rodrik 2004). The CEE countries were expected to implement these policies simultaneously and thoroughly by means of decisive top-down actions.

Because the policies did not work in many cases, a second generation of reform suggestions emerged, and the augmented Washington consensus was reached. In addition to the meeting the objectives of the first consensus, the governments in transition countries were also to effect improvements in ten more areas: corporate governance, anticorruption, flexible labor markets, adherence to the World Trade Organization principles, adherence to international financial codes and standards, capital-account opening, exchange-rate regimes, independent central banks, social safety nets, and targeted poverty reduction. A combination of sticks and carrots served as incentive for the achievement of these goals (Rodrik 2004).

When one examines these objectives, which had to be implemented indiscriminately although they were in effect a bundle of institutions that had emerged under the common-law tradition and welfare-state policies, one's first impression is that creators of the list approached the problem in a technical manner. It was an expression of neoclassical economists' belief in the mechanical nature of an economic system. If something goes wrong with it, simply replace the malfunctioning part, and everything will then run smoothly. Such an approach not only is naive, but also can be damaging if implemented zealously, disregarding local conditions.

In devising reform policies, the neoclassical economists and the international organizations that accepted their analysis overlooked at least two substantial objections: the rich countries were not always the same as they are now, and all attempts to transfer institutions without country-specific tailoring with reference to informal constraints have failed historically (North [1990] 1993, 36–45). For example, Iraq once had a constitution modeled on Belgium's, and several Latin American countries modeled their constitutions closely on the U.S. Constitution, but with radically different political and economic consequences (North 1988, 7).

Moreover, the rich countries cannot be treated as a single entity. Some are more successful in curbing one form of corruption, but less successful in curbing other forms, and some countries lag behind in curing all forms of the disease. According to certain evaluations, the United States, the chief advocate of clean business relations worldwide, successfully controls only petty (bureaucratic) corruption, but allows substantial grand (political) corruption (Bardhan 2005, 342). Sometimes a single nation has different degrees of corruption in different regions, as present-day Italy does (Del Monte and Papagni 2001, 8). Therefore, if the rich Western countries were unbundled, many differences would become visible, concerning not only the effectiveness of anticorruption policies, but also the form, position, and scope of different institutions in their economic systems.

By treating the economic system as simply a black box that needs certain inputs in order to achieve particular outcomes, the neoclassical economists involved in formulating the consensus were plainly mistaken, and therefore their policy recommendations could not prove successful. Several CEE countries encountered serious obstacles in trying to implement the proffered advice: the Russian debt crisis in 1998; corporate-governance problems in the Czech Republic; the stop-and-go of Polish privatization; and current-account deficits in Romania and Hungary.

At the same time, off-mainstream economists were arguing that history and culture matter. Formal institutions are created and enforced by political means, and politics is strongly affected by cultural values. An application of this approach to CEE countries is straightforward: one is tempted to state that by going east and southeast in CEE, one finds a diminishingly favorable attitude toward capitalist values, along with a rising degree of corruption, owing to differing political attitudes based on culture and essentially on religious affiliations, regardless of these countries' closely related or even common historical background (Pejovich 2006, 239).

Accepting such an explanation, one must become pessimistic about a short-run improvement in CEE countries. Historically embedded traits are tenacious; cultural norms and values change slowly. Nevertheless, substantial evidence shows that policy changes can exert a strong influence on the structure of incentives and thereby bring about dramatic changes in the economic system. For example, if endemic corruption in China is a product of history and cultural values, we might expect it to have remained pervasive among the Chinese living in Hong Kong and Singapore. However, in these two places, corruption was practically eradicated in a decade or so, with a clear policy design in which changes in public servants' salaries played an important role (Wei 2001, 109).

Relying exclusively on the Transparency International CPI, one will certainly be inclined to accept the thesis that the proclivity toward corruption becomes higher the farther to the east one goes in CEE. However, countries that share history, religion, and cultural values sometimes differ in their attitudes toward corruption.

A striking example of such a distinction is the differing corruptibility of people living in the Czech Republic and Slovakia. These two countries were separated only in the last decade of the twentieth century, and they previously shared both history and values. They were in succession parts of the Holy Roman Empire, Austria, the Austro-Hungarian Empire, and finally Czechoslovakia, and both have had dominantly Roman Catholic populations. Yet a survey investigating corruptibility in selected former Communist countries found striking differences in the proclivity toward corruption in the Czech Republic and Slovakia. When respondents were asked whether they would pay bribes if asked, 41 percent of Slovaks and 30 percent of Czechs responded affirmatively. The majority of the Czechs (52 percent), but only 31 percent of the Slovaks, would refuse to pay, which implies a "pay minus don't pay" score of -22 for the Czechs and +10 for the Slovaks (Miller 2005).

According to the survey's author, internal values and external pressures interact.

People generally condemn corruption (90 percent overall in both countries), but not all are in a position to resist temptations. Therefore, striking differences emerge in a single country among different occupations and even within a single occupation:

[T]he correlation and regression analysis is corroborated by the very detailed occupational patterns of bribe taking that emerged: high rates of accepting large gifts among hospital doctors (but not among nurses), among traffic police (but not among other police), and among customs officials (but not among passport officials). That survey reflects the bargaining power and opportunities of certain specific occupations rather than the “psychological” or moral culture within the health service or the police. Indeed it links traffic police who work within an institutional culture which is exceptionally antagonistic toward bribery to doctors who work within an institutional culture which is exceptionally indulgent toward bribery. (Miller 2005, 378–79)

Of course, any empirical finding may be challenged, but this research cannot be dismissed simply because it conflicts strongly with cultural and historical determinism. Just as we cannot say that only dishonest people become hospital doctors (or traffic police), whereas more responsible people become nurses (or other police), so we cannot label some nations as morally corrupt. If we find that year after year a nation or a group of countries constantly ranks high on an international scale of corruption, we may easily jump to the conclusion that something inherent in that nation or group makes it corrupt. Likewise, we may be tempted to identify a certain religion, for example, as a fertile ground for corruption.

If we exclude the neoclassical approach as too narrow, but recognize that by focusing on cultural differences, we enter an uncharted territory full of dead ends and side roads that lead to plainly wrong conclusions, with what explanation are we left? If each case is specific to its particular historic, economic, and political background, does this specificity necessarily suggest that no general conclusions can be drawn from different experiences? I return to this question after a short examination of Serbian privatization efforts and the characteristics of its prominent corruption.

Twists and Turns of Privatization

Old Yugoslavia was one of the first Communist countries to introduce elements of market socialism. Beginning in the 1950s, the Communist regime supposedly relinquished its control over productive assets by establishing a system of worker management. In this hybrid system, employees were theoretically the decision makers, although in reality the government exerted its command through the Communist Party and the secret-police chain. The official owner of capital was the state, or the

“whole society,” in tune with the labor theory value—all members of society contributed to the creation of wealth and consequently were the rightful owners.

These developments clashed with the principles of economic theory. As early as in the 1930s, F. A. Hayek, following the trail blazed by his mentor Ludwig von Mises in the 1920s, emphasized that there could be no rational third way between central planning and market economy ([1935] 1950, 237–41). He argued that so-called market socialism was bound to be inefficient and wasteful because decision makers did not own the resources they commanded, and therefore, even in principle, they could not act as rationally as private owners could. In 1944, Hayek developed these ideas more fully in *The Road to Serfdom* and concluded that market socialism would combine the worst characteristics of central planning and a market economy ([1944] 1979, 31). Unfortunately, at that time hardly anyone accepted his conclusions.

Yugoslav socialism was a strange combination of market elements and worker management. Owing to the second feature, maximization of the employees’ income substituted for profit maximization as firms’ objective, and the system had an ingrained tendency to react adversely to market signals (Ward 1958, 584). Of course, the Communist rulers had no intention of giving up their hold on the economic reins, and the system never worked on its own, which helped to conceal its inherent instability.

During the Cold War, the West supplied ample resources to Yugoslav Communists, who channeled them into private consumption, creating a false impression that the system was viable. In addition, Yugoslavs were free to travel abroad, which created a force of more than a million migrant workers by the late 1960s. The emigrants sent remittances and thus substantially raised living standards at home. These facts created a common impression (unfortunately shared by some respected Western economists) that self-management, though perhaps not a perfect system, was satisfying to a certain degree. The system supposedly supplied the best possible solution to the imagined trade-off between economic efficiency and social justice.

The First Privatization

When foreign aid and cheap foreign credits dwindled, the Yugoslav economy started a prolonged stumble. The Communist rulers eventually realized that something had gone wrong with their sacrosanct system, so they chose a reform-minded federal prime minister, Ante Marković, at the end of the 1980s. He initiated the first privatization program in 1990. In part out of Communist prejudices, in part out of constitutional constraints, he proposed an employee buyout scheme of privatization.

After Yugoslavia’s breakup in 1991, Serbia passed its own privatization law along the same lines, but its version also imposed revaluation of existing capital, which made it in effect the *first revision* of previous privatizations (Privatization Agency 2005). Despite this revision, however, employees soon found buyout to be profitable again because they could pay for their shares in installments not indexed to the accelerating

inflation. In 1994, after taming the hyperinflation, the state decided for the second time that privatization had not been “fair” and ordered the *second revision* by adopting the revaluation law. It renationalized 436 already-privatized companies and restored their socially owned status (Privatization Agency 2005).

In the same period, the United Nations (UN) started to implement more strictly the economic sanctions imposed on Serbia in 1992. The country had to pay in cash for basic imports, so the government illegally transferred foreign-currency reserves to Serbian companies’ affiliates in Cyprus and the Middle East. The affiliates were managed by trustworthy persons, usually from the *nomenklatura*, but closely controlled by the secret police. As the sanctions’ grip tightened, this select group started their own phony companies by using the same money with which they were entrusted (Dinkić 2000).

The Second Privatization

As the experiment with fake companies paid off in the mid-1990s and Russian privatization proved that managers could control their firms even with a single-digit percentage of its shares, Serbian Communists devised their own privatization scheme. This time, the law introduced a free distribution of shares to employees, in the nominal value of DM 400 for each year of work performed with the company (Privatization Agency 2005). The government sought to keep its grip on the economy through trusted managers, while stifling potential unrest. In the best self-management tradition, it declared that “members of the collective” would keep company fortunes in their hands.

The managers agreed to play the game because they knew that their position was virtually unchallenged—there was neither a developed market for shares nor a group of external investors hoping to oust unsuccessful management. Internal “investors” were fundamentally interested in keeping their jobs; earning the negligible dividends had for them, at most, only secondary importance. In such an incentive structure, a threat of job cuts could prove effective against any potentially hostile coalition of employees-cum-shareholders. In addition, managers were convinced that by manipulating financial statements and paying out no dividends, they would force small shareholders to sell their shares cheaply, thereby concentrating ownership in management’s hands.

Employees also accepted the arrangement because getting something for nothing is always profitable. Almost all companies had surplus labor, so the workers calculated that having a share would be helpful in keeping the job (“nonowners will be first fired”). Therefore, both workers and managers supported the proposed privatization, although for different reasons. Consequently, the ownership transformation law was passed in 1997 with little opposition, and in the ensuing three years many profit-making companies were “privatized” according to the model.

In reality, companies with a high capital-labor ratio had a problem of low insider

shareholding, which in practice kept a substantial part of capital in the limbo called “social ownership.” In the spirit of self-management ideology, the employees were granted “social capital” to take care of it. In theory, the employees’ remuneration had three parts: wages and salaries for performing work with the company; dividends for their share in the company’s capital; and surplus wages as good custodians of social interest in the company. In practice, managers manipulated financial statements and misinformed shareholders and employees in order to channel resources to their private firms or foreign bank accounts or to force employees to sell their shares at a large discount. One way or another, the socialist managers secured their dominant position in the economy. The outcome of privatization, at this stage, had basically the same features as contemporary Russian privatization (Black, Kraakman, and Tarassova 2000).

The Third Privatization

The third phase of privatization started with the democratic changes at the end of 2000. A new privatization law was passed in the following year under the World Bank’s scrutiny. The give-away type of privatization was abandoned in favor of the sale of assets. Tender procedures were devised for big and strategic firms, and auction procedures were developed for small and medium firms. The law did not distinguish “social” from state ownership or “public” from “ordinary” enterprises: all capital was eligible for privatization. Fifteen percent of the tender-sale proceeds were to be allocated to the Restitution Fund and an equal percentage given to employees free of charge (to secure their approval of the reforms). The privatization was to be completed by the end of 2005.⁴

An “independent” body, the Privatization Agency, was formed in accordance with the World Bank’s belief that the best way to stifle corruption potential is to disconnect privatization from ministries that have established close relations with firms’ management. Seventy-five big loss-making firms were put under this agency’s control, with the cloudy objective of restructuring and selling them “under competitive conditions.” For that purpose, the agency employed foreign experts and Serbian nationals with Western university degrees, and its budget was separated from the state budget (Privatization Agency 2006).

After six years of the privatization law’s implementation, the results are modest: about one-quarter of the total number of socially owned firms has been privatized through tender and auction procedures, and only a few of the restructuring or public (state) firms have been. The Restitution Fund has accrued approximately 100 million euros, which is far short of the amount needed;⁵ and no restitution claim has been

4. The Law on Privatization, *Official Gazette of the Republic of Serbia*, no. 38/01.

5. For example, back-of-the-envelope calculation gives at least 4.5 billion euros for restitution claims in real estate.

settled so far (Đelić 2006, 77). The agency's own proceeds and budget subsidies have not been revealed, and no annual financial statement has ever been published.

Only small- and medium-size firms capable of earning a profit were privatized. Big firms could not find investors owing to (among other things) their huge accumulated debts. Some of these firms had entered bankruptcy procedures that were extremely inefficient, in some cases lasting more than ten years, with constant asset stripping. Therefore, the government decided to change the bankruptcy law's procedures, giving an upper hand to creditors instead of debtors.⁶ Although the law cut the proceedings short, it kept in place some highly inefficient provisions. For example, state revenues and employee remunerations (wage and salary arrears) secured priority in distribution of liquidation proceeds. Only after those demands were satisfied was the residual committed to the creditors who initiated the bankruptcy.⁷

Before the new bankruptcy law came into effect, the government amended the privatization law by exempting firms slated for privatization from bankruptcy proceedings! The minister in charge of privatization can arbitrarily write off or set aside the firm's debt to the state budget, and all state firms must likewise set aside the privatizing firm's accumulated debt. Those debts are to be covered from the privatization proceeds only after covering the Privatization Agency's selling costs and other costs related to privatization. In practice, all nonprivatized firms that were generating losses have been put under the agency's fiduciary control.⁸

In addition, the government extended its role in all companies in which it held part ownership, however small, thereby gaining a "golden share" in privatized companies in that most firms had at least 2 or 3 percent state ownership. According to the new legislation, the government may block proposed recapitalization whenever it presumes that its share will be diluted (which is inevitable). In addition, it may block the sale of equipment, merger with another firm, or acquisition of a new plant. All these legislative changes were introduced under the rationale of protecting the minority rights and curtailing self-dealing.⁹

Corruption as Usual

Bearing in mind all these twists and turns of privatization, one can hardly be surprised to learn that Serbia ranks among the most corrupt nations in Europe. It appears, however, that other factors also contribute to its dismal record.

6. Contrary to the European creditor-oriented tradition, U.S. bankruptcy law is debtor oriented in an effort to facilitate business rescue (Franken 2004). However, the U.S. business environment is not comparable to the Serbian because U.S. firms have clearly defined property rights, and ultimately their debt must be settled.

7. The Law on Bankruptcy Proceedings, *Official Gazette of RS*, no. 84/04.

8. Amendments to the Privatization Law and the Share Fund Law, *Official Gazette of the Republic of Serbia*, no. 45/05.

9. At the same time, some other anticorruption laws were changed. For example, the altered Law on Public Procurement gave greater discretionary powers to ministers in charge, which increased the general insecurity of business relations.

A Culture of Corruption

As a part of former Yugoslavia, Serbia had a good background for developing endemic corruption. It is no mere coincidence that all countries emanating from the former Yugoslavia have more corruption than their neighboring states. According to the Transparency International CPI, Slovenia is more corrupt than Austria; Croatia is more corrupt than Hungary, Italy, and Slovenia; Serbia is more corrupt than Hungary, Romania, and Bulgaria; and Macedonia's corruption is exceeded only by Albania's. There must be a logical explanation for this common proclivity among the diverse successors of the former Yugoslavia. In contrast to the people of Czechoslovakia, the people of Yugoslavia had dissimilar historical experiences, religious affiliations, and degrees of economic development. Apart from the short inter-world war period, they shared only the forty-five-year experience of common statehood under the Communist dictatorship.

It seems that the Communist regime tried to obtain popular acceptance by imposing a culture of corruption. Easy access to foreign grants and credits allowed the regime to bribe a wide spectrum of subjects by subsidizing their consumption. In the 1970s, for example, the World Bank supplied ample resources for financing private agriculture through the so-called green plan. Government-controlled banks administered the loan and disbursed highly subsidized credits (denominated in the Yugoslav dinar, without indexation, despite the high inflation rate) to all individuals who could prove countryside residence. In practice, one had only to have a relative in the countryside in order to raise credit to buy a house or a car or simply to travel abroad. Credit repayment was in installments that after a few years equaled the value of a pack of cigarettes.

Of course, this credit was not the only credit accessible under favorable terms, and the regime boasted its economic system's superiority to the systems of both the East and the West. A popular saying was, "They can't pay me as little as what [work] I do." The government constantly supported the notion that in achieving a good living standard, milking the state is more important than hard work or entrepreneurship. The leading economists in the country advised that the politicians collect as much as possible in foreign grants and credits because the West would write off all debts for political reasons. It was a period of consumption rush, and to participate one had only to be well positioned relative to the public purse.

The UN Sanctions

In addition to the common "experience with market forces," the former Yugoslav republics shared the experience of military conflict in the 1990s. War not only brings destruction and shortages of staples, but also increases both the supply and the demand of corruption. Even more than the wars, however, the UN sanctions imposed on Serbia in 1992 gave a lasting impetus to corruption in the region.

To import basic staples, Serbia had to evade the sanctions on a grand scale. Most frequently, huge bribes were offered to neighboring countries' high-up customs officials. However, because 10 million people could not satisfy their basic needs with just a few illegal border crossings and industry could not function with a few Western spare parts, illegal trade had to be organized on a large scale, which presupposed coordination at the highest level. Government officials of neighboring states were willing to cooperate and simply turned a blind eye to the sanctions-breaking trade. They sometimes undertook illegal activities out of political or ethnic sympathies, but more often they simply sought to make lucrative deals. The system of UN sanctions soon became a gold mine for government officials in the region.¹⁰ High-ranking politicians always serve as examples—either good or bad—for the common people, so corruption in the region had similar aspects, which provides a sound reason for grouping these countries in a corruption cluster (Anderson and Gray 2006, 54–58).

Hot Money

The Serbian government stimulated officially employed but practically jobless workers to enter the black market in order to defuse the pressure on the state budget, which supported the wages and salaries of companies with losses. Instead of waiting for subsidized salaries and wages that were months in arrears, employees were to earn their living through illegal trades. Official propaganda created an impression that illegal activities such as smuggling, bribing foreign officials, tax evasion, and even outright theft of foreign resources were not only helpful, but also justified because they loosened the international community's grip.¹¹

The government illegally transferred abroad a greater part of foreign-currency household reserves, collected through the pyramid schemes organized by the government-controlled private banks. Because transferring 60 million German marks in plastic garbage bags was no easy task, customs officials in different countries had to be bribed. After crossing the border, the money had to be put into legal channels. Because Hungary, Bulgaria, and Greece all take measures to prevent money laundering, the next step consisted in bribing acting officials. The money was eventually invested in fake companies located mainly in Cyprus and Moscow.¹² Only part of it was used to finance oil and arms imports; the greater part was saved for a rainy day.

10. The Serbian government paid bribes not only to politicians in adjacent countries, but to officials elsewhere, too. The best-documented grand corruption related to the sale of Serbian Telecom implicated the Italian and British foreign ministers, Lamberto Dini and Lord Hurd, among others. For details, see "Political Scandal Erupts" 2001 and "City Bankers" 2001.

11. The notorious secret-police assassin Željko Ražnatović Arkan (indicted for war crimes by the Hague International Criminal Tribunal for the former Yugoslavia [ICTY]) was hailed as a national hero in the government-controlled press.

12. These investments usually included hefty bribes for local high-ranking politicians. The Hague ICTY found in trials regarding the former Yugoslavia that at least \$800 million invested in Cyprus was used to finance illegal Serbian import of arms. Most of the money was under trusteeship of the current Cyprus president Tassos Papadopoulos's law firm. See "Fantasy Island" 2006.

When the rainy day eventually came in the autumn of 2000, the government could not use the money because the trustees had changed their allegiances in the meantime. The government was soon overthrown, and its leading figures were transferred to the Hague International Criminal Tribunal for the former Yugoslavia (ICTY) penitentiary. Consequently, the illegal-money trustees felt free to invest wherever they wished, and they chose to invest in Serbian privatization. The money started to flow back into Serbia, this time labeled as foreign private investment.

Serbia devised several institutions, some called “independent,” to detect money laundering, but none of them has ever identified a privatization deal that includes millions of euros invested by never-heard-of companies registered in some exotic islands. After a few initial small-scale privatizations, the illegal-money trustees felt encouraged to enter high-profile privatizations. Even some high-ranking officials of the previous regime, whose whereabouts were unknown for a long time, now openly bid for big firms in food production and processing industries or acquired real estate; the most prominent among them is Milan Beko, a former minister of the Milošević government. These extensively publicized facts suggest that high-ranking politicians and bureaucrats have turned a blind eye toward the previous regime’s irregularities. Their inaction has fostered a peaceful reunion of two parts of the socialist *nomenklatura* into a new class.

The New Class

A deliberate plan to create a new ruling class by giving controlling rights to trusted managers significantly influenced the socialist government in the late 1990s. In that plan, the central position was occupied by the ownership transformation law passed in 1997, which supplied managers with powerful leverage either to collect shares from employees or to strip the firms’ assets by combining the law with substantive legal loopholes. Because the privatization scheme was based on free distribution of shares to employees, no additional or foreign investment was needed, and the money transferred abroad could remain intact.

Managers in big firms hastened the process by giving hefty kickbacks to judges in commercial courts and to members of regulatory bodies. The two sets of institutions served to legalize gains obtained by extortion and fraud. In addition, many managers farsightedly financed not only the ruling party, but also the opposition parties. Overall corruption increased substantially in the final years of the socialist regime. By the end of 1990s, Transparency International ranked Yugoslavia (which then comprised only Serbia and Montenegro) as the most corrupt country in Europe and among the most corrupt in the world (along with Kenya and Paraguay).¹³

After the democratic change and the lifting of the UN sanctions, the illegally

13. See rankings at <http://www.transparency.org/cpi1999/cpi1999.html>. See also Anderson and Gray 2006.

transferred money started to pour back, and socialist managers bolstered their position by recapitalization (share dilution) or by buying in. Despite widespread mismanagement and meager financial results, “foreign” investors rarely replaced incumbent management (Privatization Agency 2006), which testifies to the special ties between the members of the *nomenklatura* temporarily assigned abroad as custodians of appropriated hard currency and those in charge of domestic companies.

Instability of Property Rights

Serbian democratic politicians added their own impact to the already unfortunate legacy. They produced constant instability in property rights by several privatization reversals. In the aftermath of the hyperinflation, the Democratic Party, although in opposition, proposed almost total reversal of privatization. The ruling socialists (former Communists) readily accepted the motion (Begović et al. 2005, 188). In March 2004, the coalition government led by constitutional lawyer Vojislav Koštunica took power with a slogan of reversing all “corrupt” privatizations. In addition, he promised to return all property taken through several nationalizations and other takings by the Communist regime. Since gaining power, however, the coalition partners have shown no interest in restitution claims, and no privatization has ever been found to be “corrupt.” In other words, the coalition parties became aware of the importance of stable property rights, but they failed to understand that without solving restitution claims, many privatization deals become questionable, and therefore instability of property rights has only been postponed, not eliminated.

In almost sixteen years of privatization startups and recalls, no process has ever commenced on a clear, level field. In a long series of successive left and right governments, no politician has sent a clear message about the importance of stable property rights for developing a liberal-democratic society. Even the Koštunica government collected requests only for the property taken during the Communist dictatorship and with only a vague promise to return it to legal claimants at an unspecified future time. The goods slated for restitution, however, already have title holders who (at least in some cases) paid full price for their ownership. In other words, the property-rights mishmash has not yet been resolved, and unstable property rights only foster greater corruption.

Inconsistent implementation and successive changes of the bankruptcy law have also contributed to the instability of property rights. When creditors initiate bankruptcy proceedings, they can never be sure when and whether their claims will be satisfied. There is also a tendency to prolong the process and make it more uncertain for debtors with a high value of assets because bankruptcy trustees have both incentives and privileges to milk the company. Many trustees have proved to be unqualified for their job—a normal consequence of assigning them according to party affiliation. Some prolific persons have had more than one hundred firms in their portfolio of trusteeship. Bankruptcy proceedings soon became one of the most inviting means of

personal enrichment, and consequently the commercial courts have been swamped with corruption. Several empirical studies have confirmed that the commercial courts are the most corrupt institutions in the judicial system (Begović et al. 2004, 92). Media attention recently focused on the Belgrade district commercial court president Goran Kljajević, who was imprisoned and indicted as a ringleader and charged with corruption, criminal conspiracy, abuse of power, and rigging of bankruptcy procedures.¹⁴

Grand Corruption

Several high-profile cases bear witness to the great corruption in commercial courts and to politicians' influence and pressures on judges even after the democratic change. Perhaps the most illustrative case is the bankruptcy proceeding for the steel maker SARTID (Smederevo). The company accumulated huge losses of U.S.\$1.8 billion. An independent valuation found that it could be sold for more than U.S.\$400 million if rid of debts. Several leading companies were interested in purchasing it, including the world leader Mittal Steel Company, which also considered assuming at least part of its debt. However, the government arranged a noncompetitive sellout to U.S. Steel for a negligible U.S.\$21.3 million, free of any debt obligations. Because SARTID was in bankruptcy, the government moved the process from one court to another, pressured judges, and committed several other breaches of legal procedures.¹⁵ To cap the abuses, the selling contract was signed even before the creditors were able to report the pending debts. No one has determined whether the deal was sweetened by kickbacks or by trade in political influence, both of which are of minor importance compared to the politicians' demonstrated determination to influence the judicial system.

The executive branch has demonstrated not only its upper hand in dealing with other branches of government, but also its unaccountability. High-ranking politicians and tycoons who finance the block of democratic parties were implicated in yet another large corruption scandal that remained unacknowledged by the judiciary. The saga of the privatization of the National Savings Bank cannot be told completely at this time. It has already been well documented, however, that the central-bank governor secured a privileged position for the National Savings Bank by pouring millions of euros of taxpayers' money, interest free, into the bank. In addition, the bank secured the 4 billion euro business of servicing the so-called foreign-currency old saving deposits under an uncompetitive bid. The best office space in Belgrade and several other towns was "rented" to the bank free of charge and later sold under privileged conditions. Starting with virtually no capital, the bank climbed to the top of the industry in just a few years. The controlling stake changed hands from different

14. See "Serbia Ex-court Chief on Trial" 2007.

15. More details can be found in the Anti-Corruption Council report on the SARTID bankruptcy, at <http://www.antikorupcija-savet.sr.gov.yu/eng/view.jsp?articleId=60>.

state companies to private investors in just one day by a financial fraud.¹⁶ Not surprisingly, it appeared that the implicated tycoons were close friends of the Serbian former central-bank governor Mlađan Dinkić.

Grand corruption cases have a substantial lasting impact on the overall level of corruption. Medium- and lower-level officials feel free to practice extortion or to enter into corrupt deals after realizing that high-ranking officials do not suffer for their misdeeds. At the same time, citizens, experiencing economic hardships and great job insecurity and stimulated by bad examples of corruption in the higher ranks, do not want to miss the opportunity to seize a slice of the pie, however small it may look to an outsider. Grand corruption that went unopposed by law-enforcement institutions supplied an initial trigger for a rising spiral of corruption in the overall society.

It Couldn't Do Better

Shortly before privatization efforts started in CEE, Fred McChesney cautioned in an essay on the privatization of Indian lands that two risks arise whenever government defines property rights: first, officials will not create an efficient system of property rights, but rather one beneficial only to them; and second, privatization will not be carried out at all (1990, 298). These warnings were often neglected. After all, in the post-Communist countries, neoclassical economic analysis supplied a “scientific” blueprint for an efficient system of property rights, and the prevailing political will made privatization appear unstoppable. Compliance with the Washington consensus seemed to guarantee success. Now, however, after sixteen years, several CEE countries painfully realize that McChesney was right: the road to privatization has proven to be extremely bumpy, to say the least. In some states, the bureaucracy has “stolen” the privatization, and in other states the process remains far from complete. Unfortunately, Serbian privatization is a case in point.

Stop-and-go policies, with several trips back to square one, have characterized the sixteen years of Serbian privatization. These policies created tremendous instability in property rights, which resulted in very small FDI per capita. By the end of 2004, cumulative FDI per capita in Serbia was U.S.\$526, in Romania U.S.\$807, in Bulgaria U.S.\$958, in Croatia U.S.\$2,952, in Slovakia U.S.\$3,222, and in Estonia U.S.\$7,330.¹⁷ Consequently, the unemployment rate is high, the restructuring of the economy is slow, Serbian products are uncompetitive in the world market despite hefty subsidies, the trade deficit is yawning, and economic growth is lagging.

The process of privatization has been slow and painful, and nobody can tell if and when it will be completed. Approximately two thousand “socially owned” firms remain to be privatized. Adding the capital employed in public and other enterprises

16. Explained in detail in the Anti-Corruption Council report on the National Savings Bank, at <http://www.antikorupcija-savet.sr.gov.yu/eng/view.jsp?articleId=57>.

17. *Official Gazette of the Republic of Serbia*, no. 22/06, 59.

under government control, we find that more than half of total capital still awaits privatization.

McChesney suggested that if the bureaucracy is left alone, it will choose a property-rights system that suites it instead of a system that best promotes the creation of wealth. Events in Serbia conform to this model. As we have seen, the first Serbian privatization relied exclusively on buyouts—the most suitable scheme for the bureaucracy itself in the circumstances of the moment. Employees' disposable income was small in comparison to the value of capital slated for privatization, owing both to the economic stumble in the 1980s, which produced stagnant income and savings, and to frozen foreign-currency savings. The only liquid resources were the remittances from the workers employed abroad, but only a few individuals who received the money were foolish enough to invest in socialist firms. It seemed to the bureaucracy and therefore to the politicians that the privatization would take several decades, permitting constant meddling by the privatization administration.

This system might have worked indefinitely except for the hyperinflation. The bureaucracy was not prepared for such an environment, and firms' capital was not adequately indexed. Consequently, employees started to obtain a growing share and in some companies even a majority of shares, which proved that the bureaucrats' calculations were wrong. The bureaucracy and the politicians suddenly realized that such a trend would eventually bring their central role to an end. Therefore, the political cry was raised for eradication of "injustices" in privatization—that is, for the renationalization that soon followed.

As the UN sanctions against Serbia tightened, the economic decline was inevitable, and related social unrest was likely. In addition, the privatization efforts in CEE countries started to pay off, and Serbs could not overlook the rising living standards in the countries that had previously lagged behind. The government was consequently forced to change the privatization system. It started the second privatization process with at least two objectives: to stifle potential unrest and to secure the dominant position of trusted socialist managers (the new class).

In choosing the privatization scheme, the politicians and bureaucrats were not concerned with economic efficiency; otherwise, they would not have chosen the employee-ownership model, the most inefficient ownership arrangement by far, with the greatest potential for corruption. They simply examined the Russian privatization and realized that the old comrades were still in charge, so they accepted the Russian model and even simplified it by stripping employees of the right to invest their vouchers in another firm. The modified model abandoned vouchers and simply distributed shares. From the politicians' and bureaucrats' perspective, this was a better model because the employees' only options were to keep worthless shares or to sell them to management at a discount. The objective of concentrating ownership in the hands of management was achieved in a less roundabout way than in Russia.

The regime change in 2000 produced a political discontinuity and terminated the second privatization. As the new rulers assumed power, the bureaucracy's position

was undermined. Economic efficiency arguments gained force, and the bureaucracy tried to show its usefulness. Now, in view of the altered power structure, it was ready to accept any privatization system in order to save its position.

At this point, the World Bank experts stepped in and persuaded the leading politicians to accept several propositions (supposedly confirmed in the extensive World Bank experience throughout the transition world). First, free distribution of shares must be abandoned. Second, the new privatization system has to be “sale,” in order to solve the principal-agent problem and to obtain a transparent corporate-governance structure. Third, privatization reversals are unproductive, so they should let bygones be bygones. Fourth, restitution is inefficient and slows economic growth. Nobody dared to challenge any of these propositions or even to question the usefulness of the sale system of privatization in a country with virtually no savings.

With the new privatization law in 2001, the third privatization scheme was devised in accordance with the World Bank experts’ recommendations. A powerful new bureaucracy was created, the Privatization Agency. The rationale was to restructure the loss-making firms and prepare them for privatization. The agency obtained a portfolio of more than seventy big firms, but after six years only few of them have been privatized. In addition, the agency received the special privilege of selling state minority shares in successful companies by issuing a call to employees-cum-owners to join and form attractive stake for sale. In practice, the agency used its privileged position to favor individual buyers, which resulted in high-profile scandals, including those connected with privatization of the mineral-water company Knjaz Milos¹⁸ and the retail-store chain C-market.¹⁹ Both cases raised concerns over grand corruption among the top-ranking politicians in charge of overseeing the agency’s performance.

The ever-expanding Privatization Agency pressed for changes in the privatization law in order to legalize a broader range of activities. It soon obtained a right to control all insolvent firms and to prepare their restructuring. It increased its discretionary powers and practically positioned itself above the bankruptcy law. It became the exclusive bankruptcy trustee for companies with state ownership. In addition, the Share Fund, an agency subsidiary, obtained new authority in selling minority shares and controlling companies with minority state shares (golden share regardless of the government’s stake in the company). In short, all legislative changes actually broadened the bureaucracy’s grip on the economy and increased the number of its arbitrary decisions. We may confidently expect such changes to enhance corruption and to cripple privatization.

McChesney (1990) found that privatization of Indian lands was constantly postponed in the interest of the bureaucracy and the politicians. The privatization process evolved with substantial waste, an ever-rising budget, neglect of economic efficiency,

18. See “Knjaz Milos Auction Descends into Chaos” 2004.

19. See “Nine Arrested” 2006.

and disregard for Indians' rights. The striking similarity to Serbian privatization is evident. Perhaps the similarity reflects the fact that in both cases the state's bureaucracy undertook to define property rights, and such state engagement must lead to growing waste and corruption.

Conclusion

It is now almost universally accepted that private-property rights and freedom of contract are absolutely essential guarantors of individual liberty. Less than half a century ago, these simple truths were not so obvious, and many people simply dismissed Hayek's words: "The recognition of private or several property is thus an essential condition for the prevention of coercion, though by no means the only one. . . . The recognition of property is clearly the first step in the delimitation of the private sphere which protects us from coercion. . . . The whole network of rights created by contracts is as important a part of our own protected sphere, as much the basis of our plans, as any property of our own" ([1960] 1993, 140–41). Hayek entrusted the state with the central role in protecting private-property rights and freedom of contract. So far, so good. Even the neoclassical economists who produced the Washington consensus were willing to support this view. However, in advocating the state's central role in defining property rights in CEE, they overlooked Hayek's warning about the government's encroachment on individual rights: "The protection of private property as a safeguard against coercion, for instance, may require special provisions that do not individually serve to reduce coercion but serve merely to insure [*sic*] that private property does not unnecessarily impede action that does not harm the owner. But the whole conception of interference or non-interference by the state rests on the assumption of a private sphere delimited by general rules enforced by the state; and the real issue is whether the state ought to confine its coercive action to enforcing these rules or go beyond this" ([1960] 1993, 144–45). In light of twentieth-century experience, we see that the state is bound to go beyond these general rules and in a great number of cases to impose particular interests on the population at large. Even in a society where property rights evolved in a spontaneous and natural order, the government's action is not guided by principles of just conduct (in Hayek's sense of the term), but by particular group interests, as McChesney suggested. The government's action in defining private-property rights on Indian lands was rationalized by general principles, to be sure, but implementation of those principles served the interests of the bureaucracy, the politicians, and whites.

McChesney's interpretation is scarcely idiosyncratic, nor does the perverted privatization of Indian land reflect an odd deviation from normally good government behavior. According to Mancur Olson (1982), even a government in a democratic society usually falls prey to group interests. As a rule, small groups that seek redistribution of income or wealth are more influential because they have "disproportionate organizational power for collective action" (41) and therefore enjoy greater success

in imposing their particular interests on the state. They have a large stake and can gain a great deal by lobbying, whereas the losses caused by their action are usually dispersed among the whole society, adding only a small burden to each individual. Particular groups' endeavors thus go more or less unopposed in practice.

Because such state capture is a characteristic of democratic societies, it seems strange that it was simply ignored in the neoclassical analysis of post-Communist society and in the recommendations made to CEE countries. Some countries were lucky or smart enough to pay only lip service to the World Bank agenda, instead going forward with their own economic reforms. Serbia, however, was among the less-fortunate countries that could not resist the World Bank's aims and recommendations. The democratic opposition needed the cooperation of certain members of the ruling class in order to overthrow the socialist government. Therefore, the political and economic life in the country remains dominated by the elite created during the prolonged Communist (socialist) rule. They secured their dominant position during the Milošević government's last decade, and their position seems unopposed for the time being. Their ascension to power was rife with corruption, extortion, fraud, and pressure on legal institutions, and the present pervasiveness of corruption simply reflects those facts. Because more decisive, radical reforms are lacking, the result has been prolonged corruption and slow economic growth, which are characteristic of all countries that skipped the so-called process of *lustration*—the purging of former Communists from positions of political power (Arias-King 2003).

We may easily detect that privatization and corruption go hand in hand in many countries in addition to Serbia, but we can say neither that corruption is a consequence of privatization nor that a particular attitude toward corruption resulted in corrupt privatization. Rather, Serbia's particular economic and political conditions produced endemic corruption, which tends to spill over into neighboring states.

The good news, however, is that this bad situation may be only temporary. Many relatively rich groups have historically gained de facto political power and made a decisive push for political and economic institutions in their own interest (Acemoglu, Johnson, and Robinson 2005). Serbian tycoons have already accumulated substantial wealth, not only compared to the rest of the generally impoverished nation, but even from the international point of view: the wealthiest person, Miroslav Mišković, has assets valued at U.S.\$1.5 billion, according to the Polish weekly *Wprost*.²⁰ These rich people are currently interested in solidifying and exploiting their monopoly position, in making procurement deals on special terms with the Serbian government and other governments in the region, and in buying real estate cheaply to resell it dearly (to foreigners). However, once the privatization process has been completed, they will be interested in stable private-property rights. Having a substantial influence over the leading politicians, their interests will likely prevail in rivalry with the bureaucracy or with any other influential pressure group.

20. See information at <http://najbogatsieuropejczycy.wprost.pl/>.

The crucial push for each of the three Serbian privatization schemes came from abroad. The first privatization began after the Berlin Wall fell in 1989; the second received a critical impetus from the Russian privatization; and the third was designed to conform to the Washington consensus. Therefore, in addition to the interacting internal forces, foreign influences will likely prove to be decisive in shaping the economic system again. Despite bumps in the road, Serbia's inclusion in the European Union appears to be inevitable. To complete the process, Serbia will have to show a substantial progress in curbing corruption, strengthening the judiciary, adopting antimonopoly practices, opening its borders to European Union goods and services, and upgrading the transparency of policy decisions. All of these measures will effectively lower rents and erode currently unassailable power. By and large, we may expect Serbia to embrace more liberal values, at least to the level characteristic of the present-day European Union.

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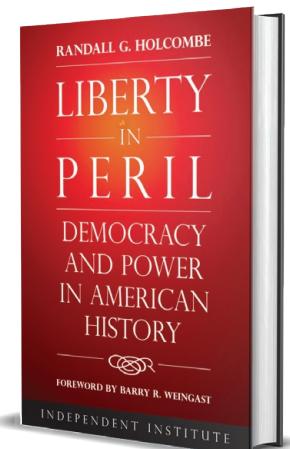
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