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Serbia: equity and efficiency – hand-in-hand

Abstract

This article is not an attempt to provide a comprehensive analysis of all the major aspects of the efficiency-equity nexus in Serbia in economic and social policy. Rather, it presents our main thesis that, at least in the present Serbian context, the equity-efficiency trade-off is not really relevant. We argue that, explicitly or implicitly, applying policies tailored in favour of the worse-off in labour, welfare and education would simultaneously improve both the efficiency and the equity of the Serbian economy. Our main contribution is progressive income taxation, which favours not only the equity factor but also the competitiveness of the economy. In addition, we argue that spending more on social assistance and less on public sector salaries would reduce poverty but also reduce the queues of members of the labour force attracted by the winner-takes-all allure. Restructuring spending on education so that teachers get relatively less and students relatively more would, again, be a socially-desirable outcome, simultaneously enhancing the efficiency of the education system.

Keywords: *transition, resource allocation, redistribution, market failure, state failure, employment restructuring, privatisation, fiscal reform, labour taxation, social assistance, poverty alleviation, education reform*

Introduction

In the 2001-2008 period, the Serbian economy grew at an average rate of almost 6 %.[1] Real growth was boosted by a privatisation programme (which brought in a steady inflow of foreign investment), massive foreign borrowings, expansive fiscal policy and a strong inflow of remittances. All of this enabled strong private consumption but also resulted in low savings and investment rates. This caused severe imbalances, the most dangerous of which have been high fiscal and trade deficits.

Private consumption in 2001-2008 was strong, but it did not lead to more job creation. In fact, since 2001, Serbia has been experiencing jobless growth: the economy has been growing but, employment has, for the most part, been steadily declining. Eventually, in 2009, the growth rate also slumped and became negative (a drop of 3 %). Following the start of the crisis, jobless growth has turned into a dramatic loss of jobs, unseen in comparative perspective – the cumulative drop in GDP from October 2008 to April 2010 was 4.7 %, whereas the cumulative drop in employment during the same period was as great as 12.5 %, with a negative elasticity of employment with regard to growth of only 2.6 % while normal values (observed in other European coun-

1 The data in this paper, unless otherwise indicated, are from the Economist Intelligence Unit database for Serbia.

tries) are in the range of 0.1-0.9 %. The slump was largely a consequence of the global financial crisis, but recent forecasts suggest that, in 2011-2013, Serbia cannot expect to get back to pre-crisis growth rates anytime soon.[2]

The reasons for the huge drop in the employment rate and the overall poor performance of the Serbian economy are numerous. In this article, we look into how the misallocation of resources, stemming from a disregard for equity considerations, and a very simplistic idea of efficiency contributed to the failure of the Serbian transition to create more jobs and a sustainable economy. We claim that the 2001 privatisation programme that mandated the sale of old, loss-making and (usually) inefficient socially-owned enterprises enabled the redistribution of resources and the redeployment of those assets in trade and services. The attractiveness of the trade and service sectors was additionally shored up by an economic policy designed by the new political, economic and technocratic elite who wanted to reverse the economic policy of the 1990s that, in relative terms, benefited the lower classes, largely at the expense of the middle class (Arandarenko, 2010). The creation of a large service sector after 2000 came at a price: it was paid for by the gradual devastation of manufacturing and agriculture. In addition, the boom of the service sector – most prominent in financial services, but also in predominantly public services, such as education and health – and its alluring reward structure attracted too many entrants. At the same time, the so-called real sector, especially labour-intensive sectors, was made much less attractive via a combination of fiscal rules and barriers to doing business which, in turn, reduced the labour force that could have been deployed in industry.

Such kinds of disproportionality have created serious problems because growth in an economy that mainly provides services and produces very little of actual substance is not sustainable in the long run. In this article we explain the market and state failures that created the misallocation of resources and put forward some general ideas in the areas of labour taxation, social and welfare, and education policies that would correct the imbalances and improve the overall efficiency of the Serbian economy.

The winner-take-all metaphor

An economy can always be more efficient and more equitable. The aim of this article is to explore if, in the Serbian context, higher efficiency can be achieved without the usual trade-off between equity and efficiency. In general, efficiency can be improved if it is shown that there are some market and state failures. Removing such failures would lead to less waste and a more efficient allocation of resources. A more efficient economy would enlarge the economic pie, which would enable economic policies (notably, fiscal policy) to distribute resources without reducing efficiency. Thus, we begin with market and state failures. In this section, we lay out a concept[3] for

2 The recent forecast by the Economist Intelligence Unit for Serbia predicts 1.5 % growth in 2010 and 3.5 % in 2011.

3 We adopt the major outline of the model from Robert H. Frank's and Phillip J. Cook's *The Winner-Take-All Society* (New York: Free Press, 1995). The metaphor was also used in some of Frank's later works (Frank, 1999, 2007). We put forward this metaphor in some more detail because it is largely unfamiliar to our academic public.

a competitive market, called a winner-take-all economy, that we see as a suitable metaphor for the current state of the Serbian economy. In the following section, we point to some state (policy-making) failures that have brought about large market inefficiencies in terms of a misallocation of the factors of production.

The winner-take-all metaphor may be contrasted with Adam Smith's invisible hand. Smith claimed that, provided individuals are rational and there is no external interference, the free market will, most of the time, lead to efficient outcomes. In other words, the market is efficient in that it directs human and physical capital to where they are most needed. It is also self-correcting: if there is an abundance of goods, prices fall and production slows; if there is a shortage, prices go up and supply expands (Smith, 1976: 48ff). Thus, we only have to leave economic agents alone (by setting no legal constraints on trading and exchange; no price controls; etc.), and the interaction of people's self-interest, as if guided by the invisible hand, will stimulate technological innovation, satisfy human wants and minimise wasteful activity (*ibid*: 456).

Smith's popular phrase that social value is created out of individuals' self-love rather than their benevolence (*ibid*: 27) became a building block for contemporary economics (Friedman and Friedman, 1980: 5). Yet, this is exactly what we want to challenge with the winner-take-all metaphor. When the reward structure depends on absolute performance – which is a standard presumption in mainstream economics – the invisible hand metaphor works fine and the interaction of individual choices usually results in efficient outcomes. However, when reward depends on relative performance, the invisible hand stops functioning and unrestrained choice by economic actors leads to inefficient outcomes (Frank, 2009: 74). In such cases, physical and human capital is not directed to where it is most needed. In what follows, we show that, even if we presuppose that economic agents are fully rational, their interaction can lead to a division of labour whose outcome is not efficient. Serbia after 2000 can be seen as an example of such an economy.

Imagine a hypothetical economy with only a dozen participants who are self-employed, i.e. they are, at the same time, both employers (firms) and employees. They can grow blueberries or, alternatively, sing, act, play tennis, engage in investment banking, etc. The blueberry growers earn a fixed amount of money for each kilo of blueberries. Their salary depends on their productivity: if this year they grow twice as many blueberries as last year, they will earn twice as much. In contrast, the market for, say, tennis players is based on the relative performance of economic actors. This is the essence of the winner-take-all metaphor. For instance, if you had won the 2009 Roland Garros tournament, you would have received €1m. If you had lost in the final, you would have received half that much. However, it does not necessarily mean that the champion is twice as good as the one who finished second. Actually, the second placed player is usually a lesser player by only a fraction or, sometimes, may even be better but could have lost due to bad luck. The player who came in third received one-quarter of what the winner received, although that player is surely not a lesser player than the winner by three-quarters.

This is the logic of the winner-take-all economy: it is driven by a few agents who can make the difference, for which they receive fat rewards; the majority are paid several times less (Frank and Cook, 1995: 1-22).

Such a kind of a market, as a rule, suffers from overcrowding: it attracts too many competitors and produces social waste. The phenomenon is similar to what Garrett Hardin described as the tragedy of the commons:

> If everyone sends their steer to no-one's land to graze, the land will soon be used up and no-one will be able to use it in the future. (Hardin, 1968)

This is so because such farmers ignore the cost they create for others: each time a farmer sends steers to the commons (thus satisfying a private utility), no attention is paid to the whole, thus diminishing social utility. Similarly, when another young CEO, market expert, trade or firm manager, organiser, TV hostess, folk singer, fashion model, tennis player, lawyer, or public administrator enters an already-crowded market, he/she reduces the chances of winning of the other existing contestants on these markets.

The theory of an efficient market would claim that, provided individuals are rational and external intervention is absent, the market for any profession is generally efficient: the invisible hand efficiently allocates the resources, deciding who will grow blueberries and who will be a tennis player. However, even when the two conditions (rational individuals, no external intervention) are met, the market might not efficiently allocate resources. In other words, it is quite likely that the whole dozen people in our example will go after the top prizes in tennis, thus abandoning blueberry growing.

If this happens (and we argue that this is what is happening in Serbia today, and far beyond simply the labour market), it cannot be said that it has happened because the economic actors were either irrational or fools. Quite the contrary: imagine you are at a cocktail party where everyone talks loudly in order to hear each other. It is in your (rational) interest to talk louder so that your interlocutor can hear you. But this behaviour only makes things worse because this is what everyone else is also thinking. Eventually, everyone is shouting and no-one hears any better than before. Similarly, participants in the market typically do not assess their participation according to social utility but according to their own personal utility. However, this is precisely the problem, because sometimes the individual rationality of many individuals, when combined, produces socially irrational outcomes. If the tennis competition offers only one prize, it turns out that entry into the tennis market is misleadingly attractive for participants because those who end up losing have abandoned productive alternatives elsewhere. This is clearly inefficient, for it creates waste; something Smith said would not happen if markets were left alone.

Waste-creation can also be explained by Martin Shubik's dollar auction game, sometimes also called the entrapment game (Shubik, 1971; Frank and Cook, 1995: 128). If you auction a $20 bill but specify that, after the auction is over, you will collect the first and the second bid, you will usually end up with more than you had offered in the auction unless there is co-ordinated activity on the part of the bidders (which means also that the bidders have to overcome the collective action problem). For instance, if the highest bid is $15 and the second-highest is $14, the auctioneer collects $29 but has had to give up $20. Note that the 'social' loss here is much higher: the winner gains $5, but the second-highest bidder loses $14.

This expressively exemplifies the central problem of today's Serbian economy: there is too much investment in activities in which there can be only one, or few, winners, meaning that others who pursue the top prize waste their investment in terms of time and money. This is a crucial theoretical finding, for an economy that produces such kinds of waste is inefficient. It would have been more efficient if such people had taken up these jobs immediately after high school or had chosen other occupations (e.g. blueberry grower) from the very beginning.

Occupations based on relative performance can mainly be found in services (entertainment, sports, management, business, banking and finance, insurance, law, health, etc). These are the sectors in which advertisements frequently pick one or several people to represent the whole sector. These individuals – such as top financial and business managers, business leaders, top models and designers, doctors, publishers, novelists, tennis players or singers[4] – are usually extremely well-paid, but their appearance in public sends a misleading message to the rest of the workforce: that they can be as successful as the top performers. In such top-reward occupations, there are already too many competitors, which reduces the chances that each one will get the top prizes, but research into psychological and behavioural economics (Gilovich, 1991: 75-87) has demonstrated that the trend of over-estimating one's chances can easily lead individuals to believe that it is just them who will be the winners in this kind of competition.

Society's total income would be higher if fewer people and firms competed in markets characterised by relative performance (i.e. on whether others may lose). Instead, economic actors should be nudged to choose sectors and occupations in which what one can win primarily depends on one's absolute performance. We argue that the Serbian economy after 2001 has developed into the kind of economy in which winner-take-all activities have attracted too many competitors to fight for fewer prizes, thus making them abandon the pursuit of productive alternatives which, from a social point of view, would create higher total utility (i.e. a larger social pie).

The essence of our proposal is to put forward some measures that would help create an economy that would attract more economic actors into activities which depend on absolute, rather than relative, advantage. We believe that increasing investment and employment in those economic sectors whose growth is driven by productivity, rather than the pursuit of 'winner-take-all' extra profits and monopolistic and speculative gain, is the best policy from which everyone stands to gain. We want, however, to shy away from suggesting measures that would weaken trade and services in favour of industry, manufacturing and agriculture. What the Serbian economy needs is an optimal mix of investment decisions and career choices that maximise the combined value of services and industry. In the realm of distribution, it also needs a system of incentives and penalties – basically, reward structures and a tax system – which would replace the winner-take-all economy with a healthier, more efficient and more equitable economic system.

It may be seen that our proposal resists the claim – exemplified by Arthur Okun's 1975 book *Equity and Efficiency – The Big-Trade-off* – that more efficiency can be

4 Some of these professions are, of course, not that successful in a Serbian context but are so in the US and in western European economies.

achieved only at the cost of less equity. We do not want to enlarge the pie for some by reducing it for others. Thus, when we say that the winner-take-all market attracts too many contestants, we mean that society's total income would be higher if fewer people competed in these markets and chose alternative sectors and occupations instead. We maintain that no trade-off between efficiency and equity is needed but, rather, that the whole economy is inefficient (i.e. it lies below its full production potential) and that Pareto improvement is possible by improving both the efficiency and the equity of the system.

State failures

Our main criticism of economic and social policy developments, and of the emerging socio-economic system in Serbia during the last decade, is that they have intentionally supported the spread of a 'winner-take-all economy' instead of – as other governments usually do – taking measures to subdue and correct for the imbalances, inequities and waste which are inherent in winner-take-all activities.

We have mentioned already that the inefficiency which we find in the Serbian market is a product of two kinds of imperfections – market and state failures – and have just looked at market failures. We claimed that, even when the market is free, the allocation of labour and capital may not always be the most efficient. Here, we put forward a complementary claim: the ineffective allocation of resources in Serbia is also brought about by the actions of the state. Therefore, in this section we look at how the Serbian government's economic policy since 2001 has created inefficiencies.

The Serbian government's economic policy after 2001 has created fiscal and trade imbalances and a misallocation of capital and labour. Ten years after the regime change, the employment rate in Serbia hit its historical minimum, reaching 47.2 % of the total population (the current employment rate in the EU is about 65 %), while the unemployment rate in April 2010, reaching 20.1 %, appeared to be going back to 2005/06 levels. The structure and quality of jobs in Serbia is even more worrying. The primary labour market is reduced to state administration, modern services (banking, finance, IT, marketing), and a small number of privatised companies which have been bought up by foreign firms. The secondary labour market is reserved for most workers in private firms, as well as the self-employed. The former is characterised by higher job security and higher salaries; the latter by higher job insecurity and lower salaries (Arandarenko, 2010: 71).

The entire private corporate sector, which was supposed to become the backbone of the Serbian economy when the privatisation programme had been completed, accounted in 2010 for some 900 000 people of a total workforce of 2 278 504. Potential employees have steadily been losing interest in looking for jobs in the private corporate sector, but have shown increasing interest in working in the public sector, state administration and various kinds of services. However, the capacity of these sectors is limited, and so the workforce is overcrowding the service sector. A part of the workforce could be redirected towards industry and manufacturing, but these sectors appear to be underdeveloped and, therefore, unappealing to the workforce.

We maintain that the ten years of economic reforms in Serbia have failed to create an economy that would provide for productive employment and an increase in welfare

for the majority of the population. Policy analysis reveals that the post-Milošević political elite has never had an interest in creating an efficient economy that would provide 'the greatest happiness for the greatest number', but was rather engaged in redistributing wealth by means of economic policy and privatisation. The economic history of Serbia after 2000 can be understood as the struggle of distributive coalitions for the control of resources which, in the long-run, has had an adverse impact on the creation of a viable economy (Olson, 1982).

We have already mentioned that the current model of growth in Serbia between 2001 and 2008 was based on massive foreign inflows into banking, insurance, property, the trade sector and various other types of services. Shored up by an expansionary fiscal policy and a strong local currency, such an economic policy enabled significant private consumer spending which fuelled economic growth. Private consumption also encouraged the import of various kinds of consumables, which created a large trade sector. The result was that the trade and banking sectors (which financed imports) thrived after 2001, while industry, manufacturing and agriculture suffered from under-investment and a production slump during the same period.[5] The labour force was attracted to services, turning away from traditional sectors of the economy.

The growth of the service sector was facilitated by the 2001 model of privatisation that was based on tenders and sales by auction. The aim of the model (previously implemented with some success in countries like Hungary and Estonia, and suggested to Serbia by the World Bank) was to do away with unprofitable socially-owned enterprises, thereby making room for new private corporate property. However, the real effect of the programme, in the way it was embedded in Serbian circumstances, was to relocate resources from industry and agriculture to services, as well as to relocate wealth from an abstract 'society' to a privileged minority.

In addition, the model was lax in its implementation in that it mandated different criteria for different cases. There were three weighting factors – price, investment level and social programme – that determined who would buy a company, but the weight attached to each of them differed from case to case. This created a huge leeway for the political, economic and technocratic elite, and even the mafia, to manipulate the sale procedures and to take advantage in relocating resources for various purposes. The political elite manipulated the privatisation process before each electoral phase; the economic elite and the mafia had a chance to buy some resources on the cheap; and the technocratic elite received fat fees for its consultative services. These were the winners. The losers became the workers and former owners (Arandarenko, 2010: 79).[6]

The structure of the government encouraged this inefficient relocation of resources. The Privatisation Agency, the government's body tasked with the implementation of

5 Interestingly enough, a production slump took place even in those sectors that received the most subventions from the government since 2001. This is the case with the Serbian agriculture sector. In sectoral terms, the largest programme of subsidies in 2008 consisted of subventions to agriculture (around 40 %) (World Bank, 2009: 53), but some sectors, such as dairy production, suffered a harsh destruction in terms of the reduction of livestock.

6 Speaking of old owners and the relocation of resources, it is surely worth noting that Serbia is among the few remaining post-communist societies that, twenty years after the breakdown of communism in central and eastern Europe, not to have passed a law on restitution.

the privatisation policy, did not always require from the new owner the continuation of the original activity of the firm which was up for sale (except in cases in which the socially-owned firm was already successful). When the new owner transformed the activity of the company (for example, from producing wool to engaging in mobile phone services), used the land for a different purpose (to build real estate and offices), or simply bought the whole of a company on the cheap, broke it up and sold it in pieces for ten times more, the Agency simply failed to act. In many cases, the government bodies did not even bother to check the origin of the money used for the purchase, which explains why many socially-owned firms were bought up by the mafia.

Monetary and exchange rate policy also played a role. The dinar was allowed to appreciate in real terms by some 100 % against the basket of currencies between 2000 and 2008. This favoured imports, trade and the consumption of foreign tradable goods, and affected exports and the consumption of local products. The dinar started to depreciate only in 2009, when the effects of the global financial crisis reached Serbia.

The growth of the Serbian economy after 2001 was, in a way, a consequence of a bubble. The trade and service sector that swelled after 2001 did not reflect growth in the fundamentals; instead, it grew rather as a consequence of strong imports after 2001. For example, in the 2002-2008 period, the current account deficit swelled from -4.0 % of GDP to 17.7 %. It halved in 2009, but as a consequence of the global fiscal crisis and not as a consequence of changes in the fundamentals.[7]

Fiscal policy after 2000 was also a function of the redistribution of resources from lower to middle and upper strata. Serbia's public spending exceeds 45 % of GDP (which is close to the European standard), but it has not been directed towards the reduction of existing inequalities. Around 78 % of the consolidated expenditure of the Serbian budget in 2008 was accounted for by pensions, health, education, security, transport infrastructure and social assistance (which itself accounts for around 5 % of the budget) (World Bank, 2009: 7-8). However, the structure of public spending in these areas is directed toward final consumption rather than toward capital investment: almost everything is used to finance pensions and salaries in the public sector. In welfare economies, high fiscal spending enables redistribution from the well-off to the badly-off, but the massive amount of public spending in Serbia is directed to maintaining a huge public sector that employs a significant proportion of the electorate[8] and to pensioners, an ever-more significant electoral group in an ageing society.

Tax policy has been among the most important instruments of the new political elites regarding redistribution after 2000. Progressive income tax rates was already a standard across the EU, but the 2001 tax reform in Serbia introduced a flat-rate of income tax, without even a basic personal allowance. Flat-rate income tax was coupled with high and intrinsically regressive social security contribution rates. Such an income

7 Although Serbia's current account deficit has come down sharply from 17.7 % of GDP in 2008 to 5.4 % in 2009, the trade deficit is still high, and it was not a result of a change in trade policy: Serbia still has rather poor export that is not able to compete on the competitive European market (Serbia generates 55 % of its export revenue in the EU).

8 According to a labour force survey from March 2010, the public sector employed around 472,000 people.

tax system has been more harmful to the working poor while favourable to the well-off, because its relative burden is higher for those on lower incomes than for those on higher incomes. For instance, the tax wedge for a worker who received only one-third of the average wage up to 2006 was 47 %. In contrast, the tax wedge for a person making eight times the average gross wage was only 34 % (Arandarenko and Stanić, 2006; Arandarenko, 2010: 78).

On the other hand, much of the government's revenue has been collected from sales taxes and, later on, from the value-added tax that was introduced in 2005. In 2010, the Finance Ministry announced that it would implement yet another tax reform that would raise the rate of VAT from 18 % to 21 or even 22 %. This is again likely to deepen inequalities and increase poverty. The poorer usually have to spend their whole income, while the wealthier are inclined to save more of it. Where the propensity to save rises with income, a higher VAT rate will affect the poorer the most.

To sum up: the Serbian government's economic policy (notably, privatisation and its fiscal and exchange rate policies) has created incentives and directed resources in such a manner that traditional and export-oriented sectors of the economy (industry and agriculture) were weakened and became economically unappealing. In contrast, the labour force and investors rightly saw the service sector as more attractive. This has had two simultaneous negative effects – both on equity and on efficiency. First, due to such an economic policy, the middle and upper classes improved their relative positions whereas the lower strata were disadvantaged. Second, the structure of the economy became unbalanced, as it was oriented too strongly towards services. This had a negative bearing on development, growth and employment since Serbian service sector firms, while strong in local markets, are only weakly competitive on international markets – and, often, their products are not at all tradable. Serbia cannot excel in the export of services such as mobile phones, finance, trade, entertainment and public administration. Yet, these are the companies that have made the largest profits over the past five years.[9]

At the end of the previous section, we claimed that those occupations that are mostly based on relative performance and the winner-take-all metaphor are usually related to reward structures in finance, law, business, entertainment, sports, etc. Overcrowding in these sectors is a natural outcome of the competitive market's failure. The major reason for this is that such occupations are based on relative, rather than on absolute, performance. This section, however, showed that there are a number of occupations which, while based on absolute rather than on relative performance, have been made attractive as a result of the policy of the government. This refers to occupations in the public sector and in services. The relocation of resources undertaken by the government's privatisation policy, the unequal tax burden brought about by its fiscal policy and its direct influence on wages in the public sector, public administration and education made these occupations more appealing than occupations in traditional sectors of the economy.

9 See the *300 most successful* and the *300 most profitable* companies, published annually by the ekonom: east group.)

Labour taxation policy

In the last part of this article we put forward our brief analyses of and proposals for labour taxation, social and welfare, and education policy. We begin with taxation policy which, to our minds, has the largest impact on labour and welfare policy.

We have mentioned already that Serbia introduced a flat-rate tax on wages in 2001, at a universal rate of 14 per cent. It was an extreme version of a flat-rate tax, since there was no personal allowance (i.e. a zero tax bracket). Coupled with very high social security rates, as well as a high minimum basic amount of social contributions, this regulation introduced regressivity in income taxation. A small personal allowance was introduced in 2007 but, from a comparative perspective, low-waged workers and the firms employing them (like those in the textile industry) are still heavily taxed while people with higher salaries and the firms employing them, such as banks, enjoy comparative advantage.

The sum of contribution rates in respect of the gross wage stands at 35.8 %, while the wage tax rate stands at merely 12 % with the small, tax-free threshold. Consequently, social insurance contribution revenues account for over three-quarters, and wage tax revenues for less than one-quarter, of overall labour tax revenues. The contribution rates are, by definition, strictly proportional to wages within the minimum and maximum base range – their redistributive effects on wages below and above that range are manifestly regressive.

A broader regional study (Arandarenko and Vukojević, 2008) has shown that the labour taxation system in Serbia has quite a few regressive features which, even if equity is disregarded, *inter alia* lowers the profitability of labour investment and increases the costs of the labour of low-skilled workers; discourages the formalisation of informal employment; has adverse effects on the competitiveness of labour-intensive branches and investment in them; and increases the inter-sectoral and inter-regional differences in wages, employment and development. This study also demonstrated that the share of collected wage taxes in the total of collected labour taxation is much smaller in Serbia and, consequently, that the share of social insurance contributions is considerably greater than in other European countries, especially in comparison with old EU member states.

Personal income tax reform ensuring greater equity is a necessary, but insufficient, prerequisite to eliminate or, at least, alleviate the multiple negative effects of the current labour taxation system. However, even an optimal reform of income taxation cannot lead either to significant cuts in labour costs, to a significant increase in overall labour demand, or in the demand for less-skilled labour, or to a significant improvement in Serbia's international competitiveness. Apart from reforming income taxation, the government must also slash the current level of the fiscal burden on labour if it wants to improve international competitiveness and boost aggregate labour demand – an obvious priority for a country with an economically active population of five million of which corporate private sector waged employment barely exceeds 900 000.

These first-rate economic goals will be achievable only once the parameters regarding social insurance contributions are changed in the context of labour tax reform.

These ideas have led us to formulate the following preliminary guidelines for the comprehensive reform of labour taxation in Serbia:

1. increase the relative share of wage tax revenues, and decrease the relative share of revenues from social insurance contributions, in overall labour tax revenue
2. reduce the tax burden on labour of low-waged workers by raising the tax-free threshold and lowering social insurance contribution rates. The target value of the tax wedge[10] at the level of the minimum wage, now standing at 37 %, ought to be slashed to between 25 and 28 per cent. Such a radical cut would increase the demand for less-skilled labour, encourage investment in labour-intensive low-waged sectors and cut the costs of formalising informal employment
3. ensure progressivity in labour taxes by introducing three progressive, non-zero tax rates on income from labour (i.e. wages). The three rates are needed not only to ensure vertical equity and to yield sufficient revenues; they would also serve as an instrument for conducting a tax-based incomes policy given the dual labour market and the monopoly sectors which are pushing wage inflation. The tax-free threshold (i.e. the zero income tax rate) needs to be set relatively high, at approximately up to the level of the minimum wage (around 40 % of the average wage). The first non-zero nominal rate (set at around 20 %) would also be the only rate levied on around two-thirds of workers earning below-average wages. The second nominal tax rate (set at around 25 %) would cover wages immediately above the average and would be the main tax instrument for controlling wage inflation. The third, highest nominal rate (set at around 35 %), applied to incomes exceeding five times the average wage not burdened by contributions, would only serve to ensure that top earners pay wage taxes which are not much lower than those levied on the middle class
4. cut the overall combined social insurance contributions rate from 35.8 % to a maximum of 30 % of the gross wage.

The above measures would reduce the tax wedge on labour to a level below the European average, which would significantly boost international competitiveness and aggregate labour demand, but this would *ceteris paribus* entail lower labour tax revenues and an increase in the fiscal deficit.

In a static context, there are two basic complementary ways to keep the proposed reform fiscally neutral: first, increase the revenues from capital income tax; and, second, increase the revenues from value-added tax. An increase in the capital income tax rate would automatically improve equity, since this tax is paid mostly by the well-off. However, the overall increase in VAT revenues, if indeed necessary, ought to be achieved without hurting the poor. This could be done by differentiating the VAT tax rates with particular classes of products and services. At present, there are only two VAT rates in Serbia, the basic rate of 18 % and the reduced rate of 8 %, limited to staples and a few other items. Any increase in the basic VAT rate, if indeed necessary at all, should be asymmetrical, keeping the reduced rate unchanged and possibly broad-

10 The tax wedge is the ratio of total labour taxes (i.e. income taxes and contributions paid partly by employers and partly by employees) to total labour costs, which comprise both the net wage and all labour taxes.

ening the range of products taxed at that rate where their share in the consumption of lower income groups is above average.

The simultaneous reconfiguration of income tax, contribution rates and the VAT rate would ensure that the overall macroeconomic and redistributive effects of comprehensive tax reform are positive. In a dynamic context, expanding the labour tax base by formalising informal employment, and the stepping up of growth in employment due to greater international competitiveness, ought to help preserve the previous level of tax revenues notwithstanding the cuts in the average and total burdens on labour.

The international competitiveness of the Serbian labour force is critical to our concept because it forms part of the overall competitiveness of the Serbian economy. A 'cheaper' labour force attracts more foreign investors. A foreign investor is more likely to become an exporter rather than to produce solely for local needs. (Take, as a good example, US Steel-Serbia, whose exports in 2006 accounted for 10 % of the total value of Serbian exports.) Therefore, tax reform would, in the end, have a positive impact on the whole economy. The economy would become more efficient, growth could return to pre-crisis levels, the structure of the economy would change and the social pie would become larger. When the pie is larger, it is easier to implement more redistributive policies without trading-off efficiency for equity.

Social and welfare policy

Serbia's reform of social assistance, initiated in 2001, was aimed at improving the level of targeting and reaching those who are most needy, while trying to cut general-type social programmes, such as universal child allowance. That goal was only partially achieved. Recent analyses show, however, that the main social assistance programme, so-called material support for the family, is very well-targeted, with the poor receiving over 90 % of the total funds from that programme, the rest representing so-called leakage, i.e. assistance given to the non-poor. This result is very good in a comparative perspective.

At the same time, another side of the coin is that such a result has been achieved at the expense of the poor themselves. The rules on eligibility for social assistance are so draconian that many people who are poor on any reasonable count are technically not eligible for assistance. After 2003, the maximum amount of social assistance has, legally, been exclusively bound to changes in the cost of living. In effect, within just five years the amount of the maximum available assistance for a family of five dropped from 32 % of the average wage to only 16 %. In addition, means tested child allowance was made available for a maximum of three children, meaning that families with more than three children receive less assistance per child. Child benefits are also adjusted only semi-annually to the cost of living, so they deteriorate even more sharply in relation to average wages. These reductions have meant that spending on programmes targeted at the poor and allocations for the MOP and income-tested monthly child allowances have declined, even though the Serbian public outlay on social assistance programmes as a whole has increased, from 1.3 per cent of GDP in 2006 to 1.8 per cent in 2008.

The share of public spending in GDP in Serbia was around 45 % during the last decade, which is above average compared even with developed countries. But, unlike developed countries, higher public spending in Serbia is not correlated with lower levels

of inequality. Looking at the structure of public spending, it becomes clear that it is very different from that found in welfare states. In welfare states, public spending ensures relatively large transfers from wealthier to poorer social strata, but its primary role in Serbia is to provide for an 'adequate' standard of living for public sector employees and pensioners, as representatives of powerful and numerically-strong interest groups. For example, total expenditure from public sources on education, health and pensions, expressed as a share of GDP, was around, or above, the average values for OECD or EU countries, whereas the share in GDP of social assistance expenditure and active and passive labour market programmes was less than half the average of OECD and EU countries (World Bank, 2009).

Education policy

Serbia's education system has also suffered from inefficiencies and inequities. In 2008, education accounted for about 5 % of GDP. Even so, a restructuring of spending within this overall share could improve public investment in education. Primary and secondary education suffers from having too many teachers. Tertiary (higher) education suffers from the opposite trend: Serbian universities have too few teachers and too little teaching space. This creates inefficiencies, such as waste and overcrowding.

The primary and secondary school system could be rationalised if the number of teaching staff was reduced. Primary school enrolment has been in decline over the last fifteen years, simply because school-age generational cohorts are smaller and smaller, and will continue to decline (World Bank, 2009: 36). The decline has created a continuing fall in the size of the average class. The number of classes, however, has continued to rise since 2000 (*ibid*: 37). The World Bank suggests reducing the number of teachers and increasing the number of pupils per class so that the optimal number of pupils per class is somewhere between 30 and 34:

> If a minimum class of 30 is accepted, the calculation shows that Serbia has 11 000 too many classes (37 %) in primary education. A calculation for secondary education show a surplus 1 300 classes (13 %). (*ibid*: 39)

The solution would be to cut the number of classes by one-third, which would free resources for improving the quality of teaching in those classes which remain.

In higher education, the trend is the opposite: we have too many students per member of teaching staff. Table 1 shows that both the number of applicants for higher education and the number of teachers have been on the rise since 2000 in approximately the same proportion.

Table 1 – Number of faculties and higher education schools, students and teachers, 2002-2007

	Faculties and higher education schools	Students	Teachers
2002/03	135	197 322	6 511
2003/04	201	203 909	6 992
2004/05	223	218 368	7 534
2005/06	243	229 355	7 737
2006/07	272	238 710	8 150
2007/08	194	237 958	7 459

Source: Statistical Office of the Republic of Serbia.

Yet, both trends do not seem to have made the higher education system more efficient. The existing system still appears to be in short supply compared to the increasing level of demand.

The question of efficiency is documented by two pieces of information provided recently by the Serbian Statistical Office: in 2009, the average number of years of study was 7.6,[11] whereas 40 % of enrolled students never graduate. Such a long period of study hinders teachers from dedicating more time to each student. When someone spends 7.6 years in a classroom by taking up the space and energy of the teacher that could have been used for other students, two kinds of inefficiencies are created. First, the time of the professor is taken up with the repeat of lectures and seminars and the retaking of exams.[12] For the time spent in engaging each student twice, a professor could educate another student. Secondly, as every university professor knows, it is one thing to have fifty students in a class and quite another to lecture in a theatre that packs in five hundred people twice a week. The overcrowding effect significantly reduces the quality of teaching at universities and adversely affects their 'production': the consequence of overcrowding is that fewer and fewer quality students complete their studies.

Higher demand for higher education is a product of increased levels of interest since 2000. However, demand has not been driven by any apparent rise in a knowledge-based economy; rather, it has been driven by the rise of the winner-take-all economy facilitated by the allocation of resources that took place in Serbia in the same period: the rise of services, the entertainment industry and the public sector have sent a message to the labour market that landing a job in these spheres pays off better than landing a job in, say, blueberry growing.

11 The average number of years per undergraduate programme at Serbian universities is four.

12 Under the 2005 university law, each student can retake each exam five times per year. Most exams at Serbian universities are verbal, which means that each student's examination rarely lasts more than ten minutes.

The number of private universities has grown since 2000, but the existing facilities there do seem to be sufficient to meet the existing demand for higher education. In the years after 2001, however, the Serbian government has invested very little in expanding the physical space for teaching and in increasing the numbers of teaching staff at state-funded universities. Instead, it has mandated that universities take in more and more students for each existing teaching space and member of teaching staff. What it has done with such a policy has been to replicate in education the tragedy of the commons phenomenon.

The solution is either to allow universities to limit the number of students that each faculty takes in or to allow university administrations to raise scholarships with which to finance the expansion of the teaching space and the number of members of teaching staff. In case a better level of scholarship is not possible, the government should undertake measures that would, in time, lead to the expansion both of the teaching space and the numbers of teaching staff.

We claimed earlier in this article that some professions have been made more attractive as a result of government policy. Education is one of them. The analysis of the World Bank has shown that the primary education sector has swollen in terms of the number of teachers and the number of classes, although the number of pupils has decreased. The reason for the overcrowding of teaching in education is largely political: the government has behaved economically irrationally, because this was one of the ways in which it could create a segment of the electorate that is dependent on government-controlled wages. Our proposal would even put an end to such a policy.

Conclusion

This article does not represent an attempt to provide a comprehensive analysis of all the major aspects of the efficiency-equity nexus in Serbia in the areas of economic and social policy. Rather, it uses metaphors, illustrative examples and some evidence to present our main thesis that, at least in the present Serbian context, the equity-efficiency trade off is not really a relevant consideration. The current socio-economic system and policies are far enough away from the optimal situation in which tension between the two concepts might arise.

We hope, in contrast, to have shown that applying explicit or implicit *pro* poor policies in Serbia would simultaneously improve efficiency and equity. Introducing progressive income taxation would be beneficial not only for equity but also for competitiveness. Spending more on social assistance and less on hefty public sector salaries would concurrently reduce poverty and the queues of people attracted by the public sector's winner-take-all allure. Restructuring spending on education so that teachers get relatively less, and students get relatively more, would again be a socially desirable outcome, simultaneously enhancing the efficiency of the education system.

Actually, we might even question whether the trade-off between efficiency and equity exists at all beyond the realm of abstract theoretical modelling. However, discussing this claim would entail an entirely different article.

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