

Serbia and Montenegro

Status Index (Democracy: 7.40 / Market economy: 6.50)		6.95	Management Index		5.33
HDI	N/A		Population		10.5 mn
GDP per capita (\$, PPP)	N/A		Population growth¹		0.5 %
Unemployment rate	N/A		Women in Parliament		7.9%
UN Education Index	N/A		Poverty		N/A
			Gini Index		N/A
Source: UNDP: Human Development Report 2005. Figures for 2003 unless otherwise indicated. ¹ Annual growth between 1975 and 2003.					

A. Executive summary

This analysis and its assessments focus largely on Serbia; Kosovo and Montenegro are discussed only where necessary. Serbia and Montenegro's statehood remains uncertain because key political actors and large parts of the population in Kosovo and Montenegro refuse to be part of the State Union and seek instead to establish independent states. Free and fair elections were organized for the parliament, presidency and sub-national governments. The army, police and state security services have been reformed since the assassination of Serbia's Prime Minister Zoran Djindjic in March 2003, but the police and security services still lack a new legal basis and effective control mechanisms. The independence of the judiciary continues to be restricted by politically motivated interventions, weak professional standards, carelessness and corruption. Serbia's party system is characterized by organizational instability and volatility, functional interest representation is dominated by a few strong business groups and civil society self-organization is limited.

Per capita income has risen to \$1,910 in 2003; it is associated with relatively positive macroeconomic parameters (except for the huge foreign trade and current account deficit). Market competition remained embedded in a weak institutional framework through 2004, although several new laws suggest improvements in the near future. Prices and trade were largely liberalized, small and medium-sized enterprises have been largely privatized by public auctions, the banking system has been partially restructured, taxation and fiscal systems have been reformed, and laws regulating the operations of electricity and telecommunication companies have been adopted.

The governments of Djindjic, Zoran Zivkovic and Vojislav Kostunica sought to build a market-based democracy, but occasionally postponed their strategic aims in favor of short-term political benefits. Policy learning has generally been limited. The change of government between November 2003 and March 2004 delayed the implementation of reforms. While demonstrating strong legislative activity, the government of Vojislav Kostunica has failed to ensure the adoption of a new Constitution as well as important public administration reform legislation. Structural inefficiencies and corruption remained significant in public administration, although the overall framework of budgeting has improved.

There is a basic consensus on democracy and market economy among Serbia's current political leadership, but it appears susceptible to populist political actors such as the Serbian Radical Party (SRS). Governments did not undertake much to overcome existing divisions over Kosovo, Montenegro and the conflict between the leading democratic parties. Serbia's political leaders have not yet fully addressed Serbia's responsibility in the wars of the nineties, despite some apologies expressed for war crimes. International assistance has been used effectively in many areas and Serbia's economic policy is perceived as reliable.

The Serbian Radical Party can be seen as an extremist political actor that relies on substantial popular support, but is likely to have less power if it remains a hard-line extremist party.

B. History and characteristics of transformation

Serbia and Montenegro's transition to democracy and market economy has been fraught with statehood conflicts that led to the disintegration of the former Yugoslavia and caused a series of wars in the Balkans. Conflicts about the nature and territoriality of the State Union continue to burden the consolidation of a market-based democracy and the path toward membership in the European Union. The toleration and emergence of political pluralism in the Socialist Federative Republic of Yugoslavia and its six constituent republics brought political elites into power that instrumentalized nationalist ideologies and stereotypes to advance their nation-state projects. Led by Slobodan Milosevic, Serbia's state socialist party won the first democratic elections in 1990 and sought to retain its political power by re-establishing a centralized federation and blocking economic reform. The political leaders of the republics of Slovenia and Croatia wanted to advance the decentralization and the confederal reorganization of the federation, partly in the interest of facilitating market transition and liberalization, partly to exit the federation. Irreconcilable aims and nationalist mobilization led to the collapse of the federation and the emergence of Bosnia and Herzegovina, Croatia, Macedonia and Slovenia as independent states. In Bosnia and Herzegovina, Croatia and Slovenia, wars of different duration and intensity began when the Yugoslav National Army attacked the republics, assisting the rebellions of ethnic Serb communities in Bosnia and Croatia against the secessions

Facilitated by the wars and nationalist mobilization, Serbia's President Milosevic was able to establish a semi-authoritarian system in the remaining parts of Yugoslavia that kept him in power until 2000. His regime was based on clientelist networks in the state administration, police, military and the state-dominated economy, which allowed him control over the electronic media, the skilful forging of elections and the effective fragmentation and isolation of the political opposition. Responding to its deepening integration and legitimation crisis, the regime increased political repression and started a war against the ethnic Albanian community in Kosovo. NATO air strikes forced the regime to abandon its control over Kosovo and contributed to the demise of Milosevic. However, the democratic breakthrough in October 2000 was driven primarily by the united opposition and student protest movement and the electorate's growing discontent with the worsening economic and social situation.

The Democratic Opposition of Serbia (DOS), a coalition of 18 liberal, social democrat and moderate nationalist parties, won the federal parliamentary and presidential elections as well as the Serbian local and parliamentary elections in 2000. The opposition leaders Vojislav Kostunica and Zoran Djindjic became federal president and Serbian prime minister. Once the governing coalition had achieved its main aim, the overthrow of the Milosevic regime, internal tensions grew over fundamental policy choices and the heterogeneity of the coalition increasingly limited the government's capacity to sustain its initially dynamic policy of economic and political reform.

The state framework of Serbia and Montenegro has changed several times since the dissolution of communist Yugoslavia. Between 1992 and 2003, Serbia and Montenegro, the two remaining republics of the former Yugoslavia, constituted republics of the Federal Republic of Yugoslavia. To prevent Montenegro from declaring its independence, the European Union mediated an agreement between Montenegrin and Serb governments establishing a loosely integrated State Union. The main aims of this new Union are the accession to the EU and the creation of an internal market in accordance with EU principles and standards. The State Union is based on a Constitutional Charter that came into force on February 4, 2003. Its powers are essentially limited to the enforcement of international law and cooperation with international courts, military issues and defense, and standardization, intellectual property rights, statistics, borders, asylum, immigration and visa issues. Montenegro's government, led by President Milo Djukanovic, is committed to holding a referendum on the republic's independence and has shown little willingness to establish and sustain the institutions of the State Union.

Following its military defeat, Serbia had to accept a U.N.-led interim administration in Kosovo. While this administration has exercised political authority over Kosovo since 1999, based upon Resolution No. 1244/1999 of the

U.N. Security Council, Kosovo de jure continues to belong to Serbia and Montenegro as the successor state of the Federal Republic of Yugoslavia. Most Kosovo Albanians refuse to be citizens of Serbia and Montenegro due to their experience of violent repression and expulsion under the Milosevic regime.

C. Assessment

1. Democracy

1.1. Stateness

While the present and future coherence of Serbia and Montenegro as a state is uncertain, the state's monopoly on the use of force is virtually uncontested in those parts of the country's territory over which the State Union (united Serbian and Montenegrin national governments) and its republics have full, internationally recognized sovereignty. The monopoly on the use of force is exercised by the State Union, which controls its administration and armed forces, and the republics, which control the republican administration, judiciary and police. In Serbia's formerly autonomous province of Kosovo and Metohija, the monopoly on the use of force is exercised by an interim administration headed by the United Nations and backed by a multinational military force – the NATO Kosovo Force (KFOR). While the ethnic Albanian revolt in the Presevo valley of southern Serbia was settled peacefully in 2001, occasional shootings occurred and local Albanian parties advocate the demilitarization of the region.

Serbia's autonomous province of Vojvodina and the ethnic Albanian settlement areas in southern Serbia have seen incidents of interethnic violence. The number of ethnically motivated attacks on minorities in Vojvodina increased in 2004, and the police and courts have failed to effectively protect the citizenship rights of those belonging to ethnic minorities. As this indicates, the enforcement of minority and civic rights remains problematic, although the necessary legal framework is already in place. Due to the wars, 278,000 ethnic Serbian refugees and 207,000 internally displaced persons live in Serbia and Montenegro. These refugees are granted citizenship rights.

Serbia and Montenegro is defined as a secular order. Religious dogmas have no noteworthy influence on politics or law. The two republics (Serbian and Montenegrin) constituting the State Union have differentiated administrative structures that operate throughout the country, albeit with limited efficiency.

1.2. Political participation

In 2003 and 2004, free and fair elections were organized for the parliament, presidency, local self-governments and assembly of Vojvodina. International and domestic non-partisan observers were generally satisfied with the polling procedures. Among other things, the OSCE remarked on the lack of a central voter register and recommended that election legislation should no longer allow parties to strip elected representatives of their mandates and to choose arbitrarily which candidates from their lists become members of parliament. The control of mandates by parties had been disputed between the DSS and DOS. In the parliamentary elections of December 2003, three party lists were led by indicted war criminals. After three failed attempts where turnout was insufficient to validate election results, a president was successfully elected in June 2004.

The government has the power to govern in principle, but units of the special police forces and state security services have challenged this power, most notably by assassinating Serbia's then-Prime Minister, Zoran Djindjic, in March 2003. Djindjic had tried to disband the informal power structures of state security services and organized crime left over from the Milosevic regime. Even though these organizations have been reformed since then, the framework of democratic control remains incomplete.

The Constitutional Charter of the State Union of Serbia and Montenegro, which came into force on February 4, 2003, explicitly subjected the army to civilian and democratic control for the first time. The general staff was incorporated into the Ministry of Defense, rendering it directly accountable to the defense minister. Several generals with close links to the Milosevic regime were forced to retire. Civilian institutions now have full financial control over the army. In early 2003, the army was downsized to approximately 78,000 soldiers and there are plans for further reductions. Responsibilities of military courts were transferred to civilian authorities in December 2004. The parliament of the State Union adopted a new defense strategy in November 2004, reorienting Serbia and Montenegro's military doctrine toward joining NATO.

The special police forces ("Red Berets") involved in the murder of Djindjic were dissolved in March 2003. Military intelligence and counter-intelligence security services have been transferred from the general staff to the Ministry of Defense, and have been reorganized. Leading officials of these services and of the internal security and intelligence agency were dismissed in 2004. However, the parliament did not adopt the envisaged new laws on the police and the newly established security agency until January 2005.

While freedom of association and assembly are constitutionally guaranteed and unrestricted, a Council of Europe monitoring report noted an increase of attacks on NGOs in 2004. While Serbia has no law to regulate non-governmental organizations, the old federal law on citizens' associations is still enforced. Unfavorable tax provisions hamper the work and independence of NGOs.

The freedoms of opinion and press are not restricted. Broadcast and print media provided largely balanced coverage of the election campaigns, and politicians refrained from interfering with the freedom of media during the campaigns. However, the state radio and television company is still controlled by the government and has not yet been transformed into a genuine public service. After protracted conflicts between independent media associations and the government the parliament established the Broadcasting Council, which is responsible for licensing and supervising TV stations. Media associations have criticized the government's growing influence on the Council and refused to participate in the body. Initiated by the government, the amendments to broadcasting law made in July 2004 removed the requirement of a parliamentary majority to elect or dismiss broadcasting council members and entrusted parliamentary committees rather than the assembly with the nomination of members.

In addition, NGOs and the OSCE criticized the fact that the draft criminal code continues to impose prison sentences for severe forms of libel, posing high risks to journalists. Oligarchs like Bogoljub Karic and Zeljko Mitrovic, who own their television stations because of their collaboration with the Milosevic regime, control a substantial part of the electronic media market.

1.3. Rule of law

The separation of powers is restricted partially and temporarily mainly because powers are not clearly distributed between the State Union and the republics. Political actors in the two republics continue to disagree on the interpretation of the constitutional charter. The Kostunica government has sought to improve the rule of law in Serbia by proposing a new constitution that strengthens the parliamentary accountability of governments, reduces the independence of ministries and restricts the appointment powers of the president.

New laws on litigation and judicial enforcement procedures were adopted on November 15, 2004. The parliament also adopted a law on the government, and a law on state administration has been submitted to parliament. However, the parliament ignored a ruling of the Constitutional Court from May 2003, which declared provisions allowing party/coalition control of seats unconstitutional, as they violate the independent mandate of individual MPs. The election of the central bank governor in July 2003 was marred by irregular voting practices.

The judiciary is established as a distinct profession and operates relatively independently, but its functions are restricted by politically motivated interventions, weak professional standards, financial restrictions, carelessness and corruption. The selection of judges and prosecutors by the parliament has been susceptible to political influences. The Kostunica government in April 2004

changed the composition of the High Judicial Council, the body responsible for nominating judges and prosecutors, and the parliament did not appoint the prosecutors and deputy prosecutors proposed by the council until December 2004. According to a survey conducted by the Center for Liberal-Democratic Studies, a Serbian think tank, in April 2004, among members of the judicial profession, 16% of the respondents considered a substantial number or the majority of officials corrupt.

Corrupt officeholders are prosecuted under established laws, but many slip through political, legal or procedural loopholes. In April 2004, the Serbian Parliament adopted a law to prevent conflict of interest for public officeholders and employees. The implementation agency was not established until December 2004.

Civil rights are violated and are not implemented in some parts of the country. The state of emergency in March and April 2003 introduced significant restrictions to civil rights (such as prolonged police detention, up to 60 days of pre-trial detention and suspension of judicial review) some of which were declared unconstitutional by the Serbian Constitutional Court in June 2003. The restrictions were then repealed in July 2003. International organizations and NGOs reported cases of ill treatment and even serious allegations of torture, which were not fully investigated. According to an assessment by the EU Commission, the issue of police brutality remains a cause of concern.

1.4. Stability of democratic institutions

Democratic institutions perform their fundamental functions, but there are severe frictions between institutions, in particular between the republics and the State Union. Lengthy disputes about the financing of the State Union institutions occurred among the republics. Montenegro's Parliament refused to adopt the law regulating the popular election of the State Union Parliament. The presidency of Serbia remained vacant between October 2002 and June 2004 because the electoral turnout did not reach 50 % of the registered voters and the parliament failed to change the electoral legislation until 2004.

Kosovo Albanians and their relevant political representatives refuse to accept any institution embodying the state of Serbia and Montenegro. Serbia's democratic institutions are not fully accepted by all relevant political actors in Serbia. The Serbian Radical Party openly rejects the provincial self-government of Vojvodina and does not appear to fully support democratic pluralism.

1.5. Political and social integration

Serbia's party system is fundamentally established but still characterized by organizational instability and significant electoral volatility. Shifting voter alignments indicate the ongoing socioeconomic transition and the social changes associated with war-induced migration. Since the parliamentary elections of December 2003, the effective number of parties has been 4.8, marking a decrease of party fragmentation compared with the heterogeneous DOS coalition of 2000. The main cleavages structuring the party system are socio-cultural in nature and concern issues of state and national identity. As such, parties reflect the disparity between a small educated urban middle class, larger traditional rural groups and the industrial workforce. Attitudes toward the old regime or socioeconomic divisions are less important in this respect. Parties are moderately polarized, weakly rooted in society and mostly dominated by individual personalities.

The network of interest groups is relatively closely knit. Business interests are still dominated by few oligarchs with dubiously generated assets, old-style managers of loss-making publicly owned companies and their problematic or illegal lobbying practices. Trade unions are best organized in the still-unreformed state sector.

Consent to democracy is high, and political protests do not question the constitutional framework. A representative opinion survey from July 2003 found that 35 % of Serbia and Montenegro's citizens consider the parliament and government as most representative of the interest of the citizens, in contrast to political parties, NGOs, professional societies, courts, media and other institutions.

Self-organization in civil society encounters political, cultural, socioeconomic and other barriers, is unevenly distributed, spontaneous and impermanent; there is relatively low trust among the population. There are approximately 20,000 NGOs in Serbia and Montenegro. The above-mentioned survey from July 2003 showed that 11 % of citizens were members of non-profit or civic organizations, while 6 % articulated interest in becoming active in an NGO.

2. Market economy

2.1. Level of socioeconomic development

With a per capita GDP of \$1,910 in 2003 (this data excludes Kosovo), Serbia and Montenegro belongs to the lower-middle income countries of the world and is the second poorest successor state of Yugoslavia, trailed only by Bosnia and Herzegovina. Social exclusion is quantitatively and qualitatively limited.

According to a World Bank survey from 2002, approximately 10.6 % of the population lived below the national poverty levels of €2.40 per day in Serbia and €3.50 in Montenegro. According to World Bank estimates, the informal sector accounts for approximately 30% of employment.

2.2. Organization of the market and competition

In 2004, market competition was still embedded in a weak institutional framework and scope of the informal and state sectors remained substantial. However, numerous new laws improving the institutional framework were adopted or submitted to parliament, including a new company law (adopted on November 15, 2004), a new bankruptcy law (adopted on July 23, 2004), laws on business registration and on the agency for business registers (adopted on May 21, 2004). Though telecommunication and energy laws were adopted in April 2003 and July 2004, the regulatory agencies were not yet operational as of January 2005, and a substantial part of the sub-statutory legislation needed to enforce the laws was still missing. A value added tax was introduced on January 1, 2005. Prices for most goods have been liberalized since 2000.

The formation of monopolies and cartels is not regulated. Since a Serbian law and agency have not yet replaced the former federal anti-monopoly commission, there is no competition policy. A draft competition law is under preparation.

Foreign trade is liberalized in principle, although tariffs are still applied to agricultural imports. Some steel products are subject to a specific system of import permits. In 2004, Serbia and Montenegro failed to start negotiations on a Stabilization and Association Agreement with the EU. Free trade agreements with the neighboring countries, which were concluded under the Stability Pact, have entered into force.

Serbia's capital market is still poorly differentiated, but the banking system was restructured in 2002, and three publicly-owned banks (Jubanka, Novosadska and Continental Banka) were sold to private investors in 2004 and 2005. The state still holds significant or majority shares in 13 banks. In 2003, the National Bank of Serbia replaced the abolished National Bank of Yugoslavia. The law was adopted together with amendments to the legal framework governing banking. In 2003, responsibility for the payment system was transferred from the state Payments Office to commercial banks.

2.3. Currency and price stability

Inflation was successfully reduced from triple-digit levels in 2000 to 8% in 2003. However, fueled by domestic demand, inflation increased to more than 9% in 2004. Since mid-2004, the national bank and the Ministry of Finance have been tightening fiscal and monetary policy to achieve further disinflation and reduce Serbia and Montenegro's large foreign trade and current account deficits. The exchange rate has been relatively stable since 2001, supported by a growth of the country's foreign currency reserves. Inflation and exchange rate policy are coordinated with other goals of economic policy, and are institutionalized in a largely independent central bank.

There is a consistent policy for stability, supported by Serbia and Montenegro's IMF commitments. The Serbian budget deficit was reduced to 1.7 % of GDP in 2004, down from 3.9 % in 2003. In July 2004, Serbia and Montenegro agreed with the London Club of commercial banks to restructure and write off 63% of the country's London Club debt (\$2.8 billion). The agreement followed a comparable 2001 agreement with the Paris Club of public creditors and reduced the external debt to GDP ratio to below 60%.

2.4. Private property

In principle, property rights and the regulation of the acquisition of property are well-defined: indeed, their enforcement is likely to be strengthened by the improved legal framework adopted in 2004. As of early 2005, however, a law on the restitution of private property and a new law on mortgages had not yet been adopted. By July 2004, the Kostunica government had only dissolved one privatization contract although it had promised to reverse many allegedly dubious privatizations. According to the European Bank for Reconstruction and Development (EBRD), the private sector's share of Serbia and Montenegro's GDP (excluding Kosovo) increased to 50%. Nevertheless, major companies in the automobile, oil and electricity industries (respectively, Zastava, NIS and EPS) are still owned by the state.

While private companies can act freely in principle, in reality they often encounter economic barriers to development. State companies or monopolies dominate the strategic business sectors. By the end of 2004, over 1,350 enterprises had been privatized through public auctions and tenders. In 2003, two large tobacco companies and a retail oil company were privatized. In 2004 however, the pace of privatization slowed down, persuading the new government to dismiss the head of the privatization agency in July 2004.

2.5. Welfare regime

Although social safety nets do not cover all risks for all strata of the population, poverty is confined to households affected by unemployment, lack of education and forced migration during the Yugoslav wars. Roma are particularly disadvantaged.

Social assistance, pension, unemployment and health insurance schemes compensate for gross social differences, but these schemes are limited in scope and quality. In April 2003, a new law on pension and disability insurance tightened the eligibility requirements by extending the pension calculation base period to the entire period of service, introducing stricter criteria for invalids' pensions and subsequently increasing the minimum retirement age by five years. Private pension funds have not yet been established. The government discussed a draft law on the health system in December 2004. In January 2005, the parliament discussed a new labor code that institutionalized, among other things, collective wage agreements, protection against discrimination and workers' rights in case of mass dismissals. Women are underrepresented in the public sphere.

2.6. Economic performance

The real GDP of Serbia and Montenegro (excluding Kosovo) has grown by approximately 5 % per year since the end of the Kosovo war. Serbia's real GDP grew by approximately 7 % in 2004, while industrial production increased by 7.1 % after a decline in 2003. The inflation rate was approximately 10 % in 2004. Official unemployment is approximately 30 % of the labor force, but surveys indicate that the real unemployment rate is lower due to the informal sector, between 18 and 19 %. Serbia and Montenegro's current account deficit amounted to 12.3 % of GDP in 2003 and approximately 10 % of GDP in 2004, caused by an even higher deficit in the balance of trade. These deficits were caused by rapid growth in domestic demand that was fuelled by large wage awards, a rapid credit expansion, and a strong import demand linked with a weak export performance due to the lack of competitive domestic production. Foreign direct investments and privatization revenues amounted to approximately €90 in 2004, significantly less than the record level of (€)1.4 billion Euros in 2003.

2.7. Sustainability

Ecologically compatible growth receives only sporadic consideration, although the parliament adopted laws on environmental protection and environmental impact assessment in December 2004. Additionally, the government approved a national environmental action plan and a national waste management strategy in 2004.

There are numerous institutions for education, training, research and development, but these institutions have suffered from decades of under-funding, isolation during wartime and corresponding brain drain. Investment in education, training, research and development is rather low: according to the Ministry of Finance, Serbia's public expenditures on education amounted to only 3.7 % of GDP in 2004. A new education law was adopted in 2003, decentralizing the provision of education services.

3. Management

The following assessments are largely focused on Serbia and its acting political leadership between January 2003 and January 2005. In general, they do not take into account the performance of the political leadership in Kosovo and Montenegro.

3.1. Level of difficulty

The structural constraints on governance are moderate. On the one hand, Serbia and Montenegro's path to democracy and market economy is burdened with unresolved statehood problems and the economic, social and political legacies of the Yugoslav wars. On the other hand, Serbia's population is relatively well-educated and the country's level of economic development has traditionally been relatively high. Ethnic diversity in Serbia proper and negative effects of the semi-authoritarian Milosevic period such as a distorted, uncompetitive economic structure and a politicized, corrupt state administration pose additional difficulties for the political leadership.

Traditions of civil society can be considered moderately strong, because Yugoslavia's socialist system conceded niches for a small segment of urban intellectuals and because the protest movement against the Milosevic regime mobilized many citizens, nurturing civic practices.

Society and the political elite are polarized over ethnic and national issues such as Kosovo, Montenegro, Vojvodina, ethnic Serbs in Bosnia and Croatia. Ethnic minorities in Vojvodina have recently been targets of harassment and attacks.

Profile of the Political System

Regime type:	<i>Democracy</i>
System of government:	<i>Semi-presidential</i>
1. Head of State:	<i>vacant</i>
Head of Government:	<i>Zoran Djindjic</i>
Type of government:	<i>oversized coalition</i>
2. Head of State:	<i>Boris Tadic</i>
Head of Government:	<i>Zoran Zivkovic</i>
Type of government:	<i>oversized coalition</i>
3. Head of Government:	<i>Vojislav Kostunica</i>
Type of government:	<i>coalition minority</i>
<p>Source: BTI team, based upon information by country analysts, situation in July 2005. Constraints to executive authority (1-6 max.) measures the institutional votes gained by party i; p_i is the share of parliamentary mandates controlled by party i. For presidential/ semi-presidential systems, the geometric mean of pres</p>	

3.2. Steering capability

In the period under consideration, Serbia had three different governments. Between January and November 2003, a majority government formed by the parties of the DOS coalition was in office, led by the late Prime Minister Djindjic and, after his assassination in March 2003, by Zoran Zivkovic. Following parliamentary elections on December 28, 2003, a new government headed by Prime Minister Vojislav Kostunica has been in office since March 2, 2004. This government is led by Kostunica's conservative/center-right Democratic Party of Serbia (DSS). Three additional parties participate in the government: the G17 Plus party of economic reformers, led by Miroljub Labus, and the conservative/populist Serbian Renewal Movement (SPO), led by Vuk Draskovic, which entered into an electoral coalition and forms a joint parliamentary group with Velimir Ilic's New Serbia party (NS). Controlling only a minority of the seats in parliament (109 of 250), the governing the government accepts support from Slobodan Milosevic's Socialist Party of Serbia (SPS).

All three of these governments sought to build a constitutional democracy and a socially responsible market economy, but occasionally postponed their strategic aims in favor of short-term political benefits. All three governments also proved unable to overcome the rivalry between the two major political forces committed to a market-based democracy, the Democratic Party (DS) and the DSS. This contributed to the collapse of the Zivkovic government in November 2003, necessitated compromises with political forces representing Milosevic's regime and slowed down the reform process.

None of these governments managed to solve the problems associated with the harmonization of customs tariffs between Serbia and Montenegro. The action plan to harmonize the economic systems of Serbia and Montenegro, agreed between the State Union and the EU to prepare the former for integration into EU structures, was not fully implemented. To protect the economic interests of Serbia's agricultural sector and other powerful economic interest groups, the government delayed the country's path toward an association with the EU. Closer relations with the EU and the membership expected to follow is not only an important strategic aim of Serbia's political leadership, but also an important step to improving the stability of market-based democracy in Serbia.

All three governments also failed to cooperate fully with the International Criminal Tribunal for the Former Yugoslavia (ICTY). Indicted war criminals were not arrested and transferred to the ICTY, although the ICTY and other organizations provided evidence that Serbia's authorities knew where some of the indicted persons resided. The Kostunica government called for the voluntary surrender of those indicted, but did not actively seize them. It argued that war crime trials should be held domestically, and that arresting them would create political instability. Aimed at sustaining the support of the party's conservative constituencies, in effect this policy impeded the country's EU and NATO integration.

All three governments were committed to democracy and a market economy, but the implementation of reforms was delayed by the lack of a government in office between November 2003 and March 2004 as well as by the parliament's legislative inactivity between August 2003 and January 2004. After the assassination of Djindjic, the Zivkovic government successfully acted against the criminal clans and dissolved the special police forces linked to them.

Despite its uncertain parliamentary majority, the Kostunica government managed to achieve the adoption of 79 laws in 2004, and submitted 24 further bills to parliament. While this high number (compared to 46 laws adopted in 2003 and 45 laws in 2002) indicates intense legislative activity, the implementation of these laws still poses a challenge.

Irrespective of some improvements in the country's legal framework, the judicial and public administration continues to be inefficient, corrupt, unprofessional and susceptible to political influences. The legal frameworks for the security services and the police were not renewed, perpetuating the lack of effective supervision over their activities. It should also be noted that, in the period under consideration, Kostunica's government was unable to ensure the adoption of a new constitution as well as important public administration reform legislation - although it had declared both reforms as high priorities.

All three governments initiated numerous reforms in order to establish a socially responsible market economy. Large state-owned companies, however, have not been restructured and the Kostunica government did not confront the mass dismissals associated with their restructuring. Major pension and health system reforms have not yet been implemented.

The government's policy against the groups involved in the murder of Djindjic can be interpreted as an example of political learning, insofar as the political leadership recognized that its previous strategy of addressing the informal power structures of army, police, security services and organized crime inherited from the Milosevic regime had been inadequate.

Another positive example of Serbia's (gradual) process of political learning was that the parliament managed to amend the election law in February 2004, removing the electoral turnout requirement of more than 50 % of the electorate in the second round of the presidential election. The fact that far-reaching structural reforms of the judicial, policy and security sectors did not advance well underscores the limited nature of such learning.

3.3. Resource efficiency

All three governments tried to use most available resources efficiently, but structural inefficiencies remained significant due to the delays in public administration reform. Serbia's budget deficit decreased from 4.0 % of GDP in 2002, to 3.5 % in 2003 to approximately 1.7 % in 2004, indicating that the government was able to strengthen fiscal discipline. In October 2004, parliament approved a revised budget for 2004 with substantial spending cuts. Amounting to approximately 10-11 % of GDP in 2004, wages paid to public servants were, according to the World Bank, comparable to other countries at similar income levels.

The number of civil servants in Serbia increased from 6,000 in 2002 to 27,000 in March 2004, mainly because tasks from the dissolved federation were transferred to the republics. Personnel planning procedures apparently did not function as an effective instrument to tailor the staff size of public administration units; the planned staff size was substantially higher than the number of officials actually employed. The government failed to establish procedures to evaluate civil servants, as well as to set up education and training facilities, modern personnel management units or an adequate personnel database.

Serbia does not yet have audit institutions. Since 2002, a single treasury account has been introduced to achieve better control of government spending. Taxes,

taxation procedures and the tax offices were reorganized and modernized in 2003 and 2004.

The Djindjic and Zivkovic governments had to coordinate the interests of 17 different parties and one trade union that were primarily united by the aim of ousting Milosevic. The leaders of the major parties constituting the DOS coalition took positions of deputy prime ministers in order to ensure a minimum of coordination, but the rifts inside the governing coalition widened successively, particularly after the loss of Djindjic. The Zivkovic government managed to act jointly against informal structures of organized crime and security services. However, it proved unable to resolve the intra-coalition conflict about the Ministry of Interior's supply contract with a firm allegedly owned by the minister himself. Referring to this conflict of interest, the Social Democratic Party withdrew its parliamentary support of the government, which subsequently lost its majority and initiated the dissolution of parliament.

In the Kostunica government, coordination was easier insofar as only four parties had to agree on a common policy and tasks were more clearly divided among the ministers. Nevertheless, coordination has been difficult among ministers dealing with economic policy issues. Whereas reformers from G17 Plus control the Ministry of Finance, the Ministry of Agriculture, the central bank and the post of deputy Prime Minister, DSS, SPO and NS politicians with statist-interventionist orientations hold the portfolios for economy, capital investment, energy and mining, trade, tourism and services; and international economic relations.

The Kostunica government and its two predecessors sought to create all necessary integrity mechanisms to effectively combat corruption. In November 2004, parliament adopted new legislation on access to public information. The Ministry of Justice prepared a draft national strategy for combating corruption in December 2004. In April 2004, the Serbian Parliament adopted a law to prevent conflicts of interest for public officeholders and employees. All members of the Committee to Address Conflicts of Interests envisaged by this law were appointed in December 2004. A law on the financing of political parties entered into force in January 2004.

These activities notwithstanding, several important integrity mechanisms do not exist or do not function properly. Auditing institutions and a modern civil service law are missing. Existing procurement rules are not sufficiently transparent. The prosecution of corruption is largely ineffective, given the state of the country's judiciary and police. Enduring state monopolies and state-dominated sectors provide opportunities for abuse of economic and political power.

3.4. Consensus-building

There is a basic consensus about democracy and market economy among Serbia's current political leadership, but it appears susceptible to populist political actors and their policies. The extent of consensus has been illustrated by the debate on constitutional reform. Here, debates have focused on whether Serbia should be defined more in terms of civic or ethnic state, how much autonomy should be granted to Serbia's autonomous provinces (Vojvodina, and Kosovo and Metohija) and whether the president should be elected by citizens or parliament. While these are key questions for the nature of the political system and the nation state, they are unlikely to affect the substance of democracy in Serbia.

The parliamentary elections in December 2003 and the presidential elections in June 2004 showed that this consensus might be eroded by the increasing political weight of populist parties. The Serbian Radical Party (SRS) emerged as the largest political party from the elections and controls 33 % of the mandates in parliament. Its leader, Tomislav Nikolic, attracted even more voters in the presidential election, where he received 45 % of the vote in the second round. Among other things, the SRS advocates the uniting of all ethnic Serbs in one state by annexing Serb-populated territories of Bosnia and Herzegovina and Croatia. The party has successfully mobilized the support of ethnic Serbian refugees, Serbs who feel their national pride being hurt and, increasingly, people who perceive themselves as losers of the economic transition. Although the party has recently moderated its political rhetoric, it has the potential to pave the way toward an authoritarian and nationalistic political system.

Other populist political actors include Vuk Draskovic's SPO and Velimir Ilic's NS which re-entered parliament as an electoral coalition, collecting 7.7 % of the votes in the December 2003 elections. These parties, along with the Socialist Party of Serbia (SPS), which received 7.6 % of the votes in the parliamentary elections, constitute potential veto players for the Kostunica government, as their support is needed hold up the government's parliamentary coalition.

Up to the end of the period under consideration, reform-oriented political forces in the Kostunica government – G17 Plus and parts of DSS – successfully neutralized the obstructive potential of these veto players. The government seems to have satisfied SPS expectations by its reluctant policy of cooperation with ICTY. It made a major concession to the SPS when the DSS, the Radicals and the SPS voted together to adopt a law on the rights of those indicted by the ICTY and their families in March 2004, guaranteeing financial support to the families of those indicted by the ICTY. The constitutional court later suspended the law. While Kostunica's government limited the veto power of the military, it failed to establish a new legal framework to control the security services and the police.

Serbia's political leadership did not undertake much in the way of reducing

existing divisions or preventing the escalation of conflicts based ethnic and national cleavages. This can be illustrated by the policies carried out in Kosovo and Montenegro.

In March 2004, Kosovo Albanians attacked ethnic Serb communities in Kosovo. The ensuing interethnic clashes left 31 dead and several hundred injured. While the Kostunica government did not use this interethnic violence as a pretext for radicalizing its Kosovo policy, it retained its territorial claim on Kosovo and demonstrated an exclusive concern for ethnic Serb interests. Serbia's Parliament responded by adopting a plan to decentralize Kosovo, grant territorial autonomy to ethnic Serbian enclaves and link the Serbian-populated enclaves with each other. Kostunica called upon Kosovo Serbs to boycott the Kosovo parliamentary elections of October 2004 if the decentralization plan were not supported by the international community.

The Zivkovic and Kostunica governments participated in talks with the Kosovo Albanian leadership that commenced in October 2003 under U.N. mediation and aimed at solving technical problems in Serb – Kosovo Albanian relations. The government withdrew from these talks in December 2004 after its failure to persuade the U.N. civilian authority in Kosovo to block the election of Ramush Haradinaj as Kosovo's prime minister. Kostunica's government refused to accept Haradinaj, suspecting him of war crimes during the Kosovo war.

Serbia's governments were also unable to bridge the differences with Montenegro's government over the common State Union. They failed to establish the common market envisaged by the constitutional charter and became caught up in disputes over the creation of the State Union institutions. This delayed the establishment of the Supreme Court until after 2004.

The political leadership tried to promote social capital, but largely failed to strengthen inter-personal solidarity and civic engagement. Supported by a broad social movement and representing a much wider spectrum of Serbian society than the Milosevic regime, the DOS coalition facilitated political participation and civil society. However, civic engagement quickly declined after 2000 and seems to have given way to renewed frustration, indifference and mistrust, as indicated by the low electoral turnout in the elections of 2003 and 2004. Inter-personal solidarity is largely limited to kinship networks and has been eroded by

authoritarianism and civil war. The Kostunica government has done little to accumulate social capital, as it has been reluctant to support citizens' associations or decentralization.

The political leadership accommodated the interests of civil society by

establishing a socioeconomic council composed of government representatives, trade union and business associations. The council was envisaged as a consultative body, discussing economic policy and negotiating agreements in the sphere of industrial relations. The parliament also abolished the threshold for parliamentary representation in the case of parties representing ethnic minorities, seeking to involve these parties in political deliberation. The parliamentary election in December 2003 had excluded ethnic minority parties from parliament since none of them succeeded in overcoming the 5% threshold. The Kostunica government established a council for national minorities in October 2004. However, it did not show a strong commitment to involving civil society actors in the preparation of major reform projects such as media or judicial reform.

Serbia's political leadership has not yet fully addressed the republic's responsibility in the wars of the nineties. Self-critical accounts of Serbia's role in these wars remain confined to a narrow segment of urban intellectuals. Cooperation with the ICTY is largely driven by the conditionality of external aid and EU accession, not by a broad-based domestic recognition of the necessity of coming to terms with the past. During his visit to Bosnia and Herzegovina in December 2004, President Tadic undertook a first step toward reconciliation. He apologized to all against whom a crime was committed in the name of the Serbian people. Serbia and Montenegro also exchanged apologies with Croatia for crimes committed in the recent past.

3.5. International cooperation

Serbia's governments have worked with international donors and effectively used international assistance for most items of their domestic reform agenda. The World Bank reported that Serbia and Montenegro had received by far the highest proportion of official development assistance in the world, amounting to \$237 per capita in 2002. This support contributed to the impressive progress in economic reform made in a very short period. However, only parts of this aid have been used to develop local capacity across the country and to support the acquisition of knowledge by local actors. The Kostunica government has not used the available assistance effectively to step up its judicial and police reform.

The Kostunica government tried to act as a credible and reliable partner, in particular through its stability-oriented economic policy. The London Club agreement from July 2004 reflected the trust expressed by foreign commercial banks in the country's economic reformers. On the prosecution of war crimes however, the Kostunica government did not meet international expectations when it showed reluctance to arrest and extradite indicted war criminals despite its general commitment to cooperate with the ICTY. After the Kostunica government failed to transfer the indicted persons by March 2004, the United States

government stopped all direct economic assistance to Serbia, and NATO refused to grant Serbia and Montenegro access to its Partnership for Peace program.

Apart from cooperation with the ICTY, Serbia and Montenegro's political leadership actively and successfully developed cooperative regional and international cooperation and integration. Free trade agreements were concluded with all neighboring states, though some of them are not effective. In November 2004, Serbia and Montenegro and Croatia signed an agreement on the protection of their respective kin minorities in the neighboring state. Serbia and Montenegro joined various regional cooperation initiatives and acceded the Council of Europe in April 2003. The delimitation of borders with Croatia and Bosnia and Herzegovina has not yet been settled and these two countries have submitted lawsuits to the International Court of Justice, charging Serbia and Montenegro of having committed genocide. In 2003, Serbia and Montenegro refused to accept the authority of the U.N. civilian administration in Kosovo to conclude free trade agreements on behalf of Kosovo.

4. Trend of development

4.1. Democratic development

Stateness, political participation and the rule of law have improved since January 2001. The Federal Republic of Yugoslavia was replaced by the State Union of Serbia and Montenegro. While this state framework has not become consolidated, it is accepted by substantial parts of the population and political elite in both Serbia and Montenegro. Interethnic relations in Kosovo have worsened again, and the final status of Kosovo remains unsettled. Parliamentary, presidential and sub-national elections were held without major violations of democratic principles. The former state president and major instigator of the wars in the former Yugoslavia, Slobodan Milosevic, was made accountable and sent to the ICTY. Reforms of the army, judiciary, police and security services have advanced to some extent.

The level of consolidation of democracy has not changed substantially since 2001. Frictions between the republics and the State Union have persisted, and state institutions are not accepted by Kosovo Albanians. While the party backing the Milosevic regime, the Socialist Party of Serbia, has lost much of its former popular support, the Serbian Radical Party has regained political weight. Serbia's party system has continually been characterized by organizational instability and volatility. Intermediary organizations are weakly differentiated and not broadly embedded in a strong civil society.

4.2. Market economy development

The country's level of development has improved slightly in the past five years. While the per capita GDP has more than doubled since 2001, social inequality has not increased dramatically. Social safety nets and health care have not become significantly better equipped to prevent social exclusion.

The institutional framework of a market economy has improved sharply in numerous areas. Prices and trade were largely liberalized, small and medium-sized enterprises have been largely privatized by public auctions, the banking system has undergone some restructuring, taxation and fiscal systems have been reformed, utility tariffs have been brought closer to costs, the legal framework for private sector development has been strengthened and the taxation system has been adjusted to a market economy.

Table: Development of macroeconomic fundamentals (2000-2004)

	2000	2001	2002	2003	2004
Growth of GDP in %	5.0	5.5	4.0	3.0	7.2
Export growth in %	14.7	4.2	20.4	25.0	33.7
Import growth in %	12.6	30.3	30.7	25.9	32.2
Inflation in % (CPI)	60.4	91.3	21.4	11.3	8.5
Foreign Direct Investment in m US-\$	25	165	562	1405	966
Unemployment in %	25.6	26.8	28.9	na	na
General government balance in % of GDP	-0.9	-1.3	-4.5	-4.2	-3.4
Current account balance in million \$	-327	-528	-1384	-2121	-2577

Source: EBRD transition report update; 2004: estimate. Inflation (annual average);

Overall, economic development has improved both quantitatively and qualitatively. This improvement was reflected in strong GDP growth, a sharp and substantial decline of inflation, increasing inflows of foreign direct investment and a significant reduction of the country's foreign debt.

D. Strategic perspective

Serbia and Montenegro is faced with crucial statehood choices in the near future. The final status negotiations on Kosovo, envisaged to begin in mid-2005, are likely to lead to an independent state of Kosovo, either with international

protection of the Kosovo Serb community or with the partition and integration of Kosovo Serb settlement areas into Serbia proper. Depending on the outcome of a referendum on Montenegro's independence, envisaged for 2006, the State Union would either survive or cease to exist. Both choices will in effect remove significant obstacles to Serbia and Montenegro's path toward EU membership. However, these choices are associated with domestic political costs for reform-oriented governments, since the opponents of both options will remain strong minorities. Populist political actors who seek to mobilize nationalist resentments and socioeconomic protest may attack the government for abandoning Serbian interests and ethnic Serbian communities in Kosovo and Montenegro.

Whether a reform-oriented and pro-Western government will assert itself against such critiques depends vitally on its ability to deliver material benefits of economic reforms and EU integration. In the short-term however, economic transition will entail more costs since most large state-owned companies in Serbia have yet to undergo restructuring or liquidation. To increase these companies' competitiveness, the government will have to either close them down and sell their assets or attract strategic investors who will modernize their capital stock and dismiss large numbers of workers. The employment losses can be absorbed only if the private sector is developing dynamically enough to generate a sufficient number of new jobs. The growth of the private sector should be driven both by foreign direct investment and by the spread and maturing of domestic business. This will require macroeconomic and regulatory stability as well as a reliable and professional public administration.

External supporters should recognize the dual risk of Serbia's transition: the accumulation of socioeconomic costs incurred by restructuring and statehood conflict settlements conceived of as lacking respect for Serbian national interests. The international community should address this risk with determined action in Kosovo and Montenegro. Such action would communicate to Serbia and Montenegro's political elite that violating international settlements and attempts to unilaterally change the territorial status quo will be associated with unacceptable costs. International organizations and agencies should simultaneously ensure that cooperative behavior and economic reforms yield tangible benefits for large parts of the population.

The European Union should upgrade its relations with Serbia and Montenegro by concluding a Stabilization and Association Agreement and by concretizing its prospects of membership as soon as possible. Removing the visa restriction imposed by EU member states on Serbia and Montenegro's citizens would be very important and have broad impact.

The European Union and other Western states and organizations should continue to provide financial assistance at the current levels. Visible, large investments in

transport, communication and environmental infrastructure would display the benefits of reforms and cooperation to Serbia and Montenegro's citizens. Western assistance should also focus on improving the quality of Serbia and Montenegro's judiciary, police and public administration. The country needs a civil service that is protected against corruption and politicization and committed to the highest standards of professionalism. The country also needs a public ethos; only civil service can provide the necessary framework for private sector development and the capacity to prepare for EU membership.