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The New Model of Privatization in Serbia



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Summary

The latest political changes in Serbia place on the agenda the issue of transition, i.e., the establishment of a liberal democratic order, the basis of which is capitalism. Indeed, the time has come for Serbia to make up for lost time and join those luckier countries that have, in the past ten years, set foot on the path of economic progress. Privatization is one of the components of the transition process. The change in property relations, i.e., abandoning the domination of collective property on behalf of private property, is truly a basic issue. It is not possible to build either an efficient economy or a free society on the basis of social and state property.

The main goal of privatization is *to increase the efficiency* of enterprises, which arises from healthier business motivations and is achieved through the reduction of expenses, financial re-capitalization, better work discipline, better organization, new investments, etc. Another goal of the privatization process is *to improve the financial situation of the state*, which is to be done by means of the following three methods: based on the revenues gained from the process of privatization; based on the revocation of subsidies for state and social enterprises; and based on the increase in tax revenues from improved economic activities. For the cabinet, the *attempt to increase its own political rating* through the choice of a demagogically convincing privatization program may become an important goal of the privatization process, yet this goal is in contradiction with the first two goals.

The privatization model existing in Serbia is very bad. It does not guarantee that the privatization process will take place, the privatized enterprises do not increase their efficiency, and the model itself is not fair. Therefore, it should be rejected and replaced with a better one.

The privatization experience of countries in transition, Serbia included, has shown that the sale of public and state capital is a far better model of privatization than the voucher and employee stockholding models of privatization.

The basic elements of the new concept of privatization are the following:

- The basic model of privatization in Serbia should be the sale of public and state capital;
- The privatization model should be adjusted so as to provide for a dominant owner (strategic investor) who is to own the control stock in the property in order to be able to efficiently manage the enterprise;
- The prevalent method of sale should be the tender, i.e., the assembling of competitive bids following a public announcement;
- Price should be an important, but not the only, criterion in the selection of the bid; other elements, such as future investments, employment, etc., should be taken into consideration;
- Foreign investors should have the same right to participate as domestic investors;

- The government, management of enterprise and interested investors should have the right to propose a privatization program and thereby initiate the privatization of a given enterprise;
- In the event that, after the sale, any unsold public or state capital still remains in a given enterprise, the remaining capital shall be privatized by means of a initial public offering, where money, frozen foreign currency savings or vouchers can be used as means of payment;
- The state, which should be honest and enlightened, should fully participate and supervise the sale;
- In the case o the privatization of certain bad banks, the state should temporarily step into the role of an owner and sell them to interested investors, after a certain restructuring.

I INTRODUCTORY NOTES¹

Property and Efficiency

Enthusiasm for government enterprises has dwindled around the world over the last two decades, and more than 75,000 state (and public) companies have fallen “victim” to the process of privatization. Most of those companies are enterprises in countries in transition; however, there are a number of them in developed countries.

It is an undisputed fact that the form of ownership is important, and private property is the most important factor for the successful management of an enterprise. The economic history of various countries as well as empirical studies have shown that private companies are more efficient than state or public enterprises. Meggison and Netter reviewed the empirical studies related to the issue of privatization around the world, and their conclusion is that the privatized “companies almost always become more efficient and profitable, that they increase capital investment and become financially healthier,” and that “the empirical studies document a significant (frequently dramatic) performance improvement” after privatization². Havrylyshyn and McGettigan, who analyzed the empirical studies on the effects of privatization in countries in transition, have arrived at similar conclusions: “The empirical studies almost unanimously demonstrate that privatized enterprises surpass state enterprises with respect to performance.”³

Serbian economist Cedomilj Mijatovic wrote some 130 years ago: “There are sufficient reasons to believe that even the net profit from a plot of land worked by the state is, as a rule, worse than the profit gained by a private entrepreneur under the same circumstances. The state manages the agriculture through paid officials, whose private interests are to a very small extent or not at all related to the results of their work on it. As a result, the national economy still incurs a loss because a certain amount of capital brings it less than it would have been able to bring otherwise.”⁴

Of course, private property is not the only reason for a good result of a given enterprise; other necessary elements are smart economic policy and the quality of legal and administrative institutions, particularly of those that ensure property rights and their exchange (capital market) as well as the existence of competition on all markets. For the above reason, privatization is usually one of the elements of a broader program of structural adjustment, which also includes institutional reforms, liberalization of prices and foreign trade, a reform of the financial system and public revenues and spending, anti-monopolistic legislation, etc.

¹ The authors are grateful to Branko Milanovic for his useful comments and suggestions.

² W. L. Meggison and J. M. Netter – From State to Market: A Survey of Empirical Studies on Privatization, Conference *Global Equity Market*, December 10-11, 1998, Paris, p. 44.

³ O. Havrylyshyn and D. McGettigan – Privatization and Transition Countries: A Sampling of the Literature, IMF, WP/99/6, January 1999, p. 1.

⁴ C. Mijatovic – *Nauka o drzavnom gazdinstvu ili nauka o financiji* [The Study of State Economy or the Science of Public Finance], Drzavna stamparija, Belgrade, 1869

Goals of Privatization

The goals of the privatization process are numerous, and it is convenient to divide them into two groups: economic and political. In addition, it is necessary to keep in mind the fact that privatization is not a universal remedy; therefore, it should not be burdened with too many goals because, in that case, it would be impossible to avoid the conflicts between them.

The basic and most important goal of privatization is ***the establishment of an efficient economy*** based on the prevalence of private property instead of the current incongruous economy based on inefficient social and state property. The experience, a few decades long, of the former Socialist Federal Republic of Yugoslavia and its successor, the Federal Republic of Yugoslavia, clearly speaks to the fact that no economic progress can take place on the basis of social and state property, and their unhealthy incentives and that stagnation and crisis are their inevitable consequences. This goal is based on the expectation that private owners and the managers they appoint will bring about an improvement of performance and an increase in the chances of a given company to survive the competition through the introduction of new technologies and products, new financial sources, better organization and work discipline and, generally, through better management of the company.

The second goal of privatization is ***the improvement of the financial position of the state***. Through the sale of public and state capital, the government may obtain substantial funds with which it may fund activities that are commonly beneficial or service its debt. A poor country should not be making presents; it should sell. Two more factors have a positive effect on the financial position of the state. They are: the revocation of the subsidies that the state used to give to state and public enterprises prior to the privatization, and an increase in tax revenues resulting from greater and more efficient production.

The third goal of privatization is ***the revocation of the constant preference given to the social and state sectors*** at the expense of the indigenous private sector, which constitutes a great impediment for the latter and restricts its development. The state had been constantly, and almost inevitably, saving inefficient public and state enterprises by means of subsidies of various kinds (loans and foreign currency below their market price, import favoritism, debt remittance, tax breaks, etc.), which meant that limited resources are redirected from the productive to the less productive or unproductive enterprises.

The expansion of private property as the basis of a liberal democratic order, the strengthening of the middle class, de-politicization of the economy and society, etc., are among the political goals of privatization. The frequent use of privatization as a means by which a ruling party attempts to increase its political rating is bad because then the privatization decisions are not made on the basis of economic criteria but on the basis of media and marketing criteria.

Politics and Privatization

In addition to its economic aspect, privatization also has a social and political aspect. It changes the distribution of political power because it transfers it from the hands of one group of managers and political parties, usually appointed by the state, into the hands of another group, i.e., a group of new private owners. Workers are usually afraid of the

changes they see in privatization, although their financial situation frequently improves after privatization. Many others, for example, those who seek an opportunity to gain an easy and quick profit in troubled waters, find interest in the process of privatization. For this reason, for good or bad, pure politics has a share in the outline and implementation of the privatization process. In order to be successful, a privatization program should have sufficient political support, but the provision of this political support may introduce too many political elements, at the expense of economic rationality, into the formulation and implementation of the privatization program.

From a political point of view, the first, initial phase of the new democratic rule in Serbia is the most convenient moment for the outline and legalization of the new model of privatization (the speed of its implementation is yet another issue). In other words, the current political situation is most favorable for the establishment of a good model of privatization and this moment should not be missed. Firstly, the elections are over and there are no new elections on the horizon; therefore, the new cabinet of Serbia will not be under the pressure of an election campaign, the need to gain votes and other factors, and is able to approach this issue in a statesmanly fashion and try to find the best solution from the point of view of rationality. Secondly, as of this moment, interest groups do not represent a great problem because the old interest groups have been dispersed and are not able to consolidate, while the new interest groups have not become sufficiently strong. As our experience shows, interest groups may represent an exceptionally large obstacle for a worthy model of privatization and divert it into waters that meet their particular interests. Therefore, it is possible that the labor unions and the association of businessmen become so strong in mid-term, that they attempt to change the process of privatization in directions that suite them but are unjustified from the common point of view. For example, in Russia, under the pressure of various lobbies during the process of the legislative procedure, the privatization process initiated by the cabinet underwent such changes that the Russian privatization ended up as one of the worst and least successful in the countries in transition⁵.

In order for a privatization process to be successful, it should have strong political support so as to overcome the inertia of bureaucracy and any particular financial and political interests.

It is not necessary even to attempt to reach a consensus among the public (interest) groups. It is much more productive to create a consensus of the citizens, i.e., of all those who will benefit from the privatization.

Privatization in Serbia

The process of privatization in Serbia began 11 years ago and has not advanced much. As of today, significantly less than 10% of the public capital has been privatized. As of November 2000, the situation was as follows:

⁵ Certain authors, such as Jeffrey Sachs, even suggest that a portion of the Russian economy be renationalized.

Table 1.

	Number of Enterprises
Process of privatization has begun	428
Subscription in the first round has been completed	284
Subscription in the second round has been completed	246
Process of privatization has been completed	18

Source: Report of the Office for the Evaluation of Capital Values, Belgrade, November 10, 2000.

As we can see, the privatization of only 18 has been completed pursuant to the current law, which is quite low for the three-year period during which it has been in effect. In addition, with the exception of a few mid-sized enterprises, almost all of the enterprises that have begun a privatization procedure are small. The total value of shares issued during the first round (for free distribution) amounted to 11.9 billion dinars, 7.1 billion of which were distributed.

The laws had been changed, supposedly for the better, but no major offers were ever made. There was always a step missing for achievement of better privatization results and better laws, and the reason why it was missing was the lack of the political will to enter into a real process of privatization. The socialist government pretended to be inclined toward privatization while, in fact, tended toward and succeeded in the preservation of its own control over the economy. A true and complete privatization would have freed the economy of the control of politics, which was not to the taste of the former regime.

The existing privatization law is bad. It does not ensure that privatization will take place, a privatization process pursuant to this law would not bring about efficient enterprises and it is not fair.

The law currently in effect does not ensure that privatization will take place because it leaves the decision regarding an entry into the privatization procedure up to the free will of the enterprises, as if this were not a matter of public capital but a matter of group property of the employees. Such decentralized decision making without a given deadline for reaching a decision leaves the process of privatization at the mercy of the game of individual interests within the enterprise, or to the judgment of the management and the employees as to whether it is in their best interests to privatize the company or maintain the status quo. The law itself contains encouraging and discouraging solutions, with the discouraging solutions being predominant, which is also demonstrated by the experience of a relatively small number of mainly small enterprises that have begun the process of privatization.

Even if privatization were mandatory and even if it advanced quickly, the chosen type of shareholding of the employees is very ineffective from the standpoint of restructuring and further operation, as we will see in following sections. There is no doubt that this model generates insider privatization because many benefits are given to the employees of the given enterprise, and they personally have the interest and significant capabilities to keep control over the enterprise.

The model currently in effect is not fair, because only employees and retirees from the social and government sector have the right to receive shares as a gift, which may reach 60% of the company's capital, a right that is denied the rest of the citizens. Moreover, by various means, the employees prevent the participation of other citizens in the distribution of free shares, by which they are breaking the law. At the same time, the state is on their side because it does not promote privatization and the rights of citizens.

The distrust of citizens and employees of the stability of the institution of privatization is another problem because the so-called revalorization of 1994-1995 revoked the previous privatizations, which was justified from a moral point of view but set back the process of privatization and destroyed its credibility.

Serbia's experience during ten years of privatization attempts is exceptionally unsuccessful. Very little has been privatized, and what was privatized continued to carry on a miserable existence. The reason for this lies not only in unfavorable outer circumstances but also in the inherently unfortunate characteristics of the chosen model. The system of employee shareholding is just another, again unsuccessful version of the system of self-management.

The system of employee shareholding did not bring about, even in companies where the process of privatization was at an advanced stage or entirely completed, the replacement of failed managers. This confirms the fear that dispersed ownership within the enterprise (hundreds and thousands of shareholders) makes any changes difficult and enables unsuccessful managers to keep their positions.

Some are of the opinion that the removal of the restrictions on the trading of gift shares would put everything in order, i.e., that a quick secondary purchase and sale would lead to the concentration of shares within a few individuals, therefore to the occurrence of a predominant owner, ready and able to run the company successfully. However, Russia's experience demonstrates that the great majority of enterprises privatized by means of employee shareholding continue a poor existence even when ownership is concentrated into the hands of the management. It seems that there is no match for an outside owner.

In Serbia, discussions regarding the best model of privatization have been carried out for a whole decade and are not over yet. Putting details aside, it is fair to say that the main parties in the discussion were those of the proponents of the model of voucher privatization and the proponents of the system of employee shareholding. The former emphasized the speed of privatization and the lack of sufficient capital for the purchase of enterprises at a somewhat reasonable price, particularly due to the impossibility for a steady foreign capital inflow under the circumstances of wars and international sanctions. The latter, implicitly, had in mind mostly political motives, i.e. the reduction in the resistance of employees, to the process of privatization, i.e., a "socially acceptable" privatization as they called it. Both the proponents of voucher privatization and the proponents of insider privatization included in their models – although without much enthusiasm, which was based on the limited capabilities for domestic funding – the sale of enterprises, i.e., the sale of social and state capital.

It is easy to find the intellectual origin of these two models. The proposal of vouchers in our country is a part of the opinions, prevalent among academic economists in numerous countries in transition, from 1990 on, and particularly after the seeming success of the first

phase of the Czech privatization. The orientation towards employee shareholding has its origin in the old spirit of self-management, which has been declining very gradually during the 1990s.

II PRIVATIZATION OF THE ECONOMY

Privatization Models and the Experience of Other Countries

Models

There are numerous models of privatization that differ both with respect to their techniques of implementation and with respect to the post-privatization structure of ownership and the method of operation of the enterprise. Unfortunately, none of them is perfect, but each has its advantages and disadvantages.

There are four basic models of privatization: re-privatization (denationalization), sale, free distribution and employee shareholding.

Re-privatization is a form of privatization because it involves the return of ownership of state or social enterprises and other productive forms of property to their former owners or to the former owners' heirs. The return may be in the form of a natural restitution (restoration of the ownership of the property or enterprise) or co-ownership of the given enterprise or property, in the form of a compensation as co-ownership in another enterprise or property, or in the form of government bonds or money. Even though re-privatization in the countries of Eastern Europe is carried out for other reasons (for moral reasons or for the purpose of ensuring the credibility of the government), its side effect is the privatization of public or state capital.

Among the countries in transition, efforts to carry out re-privatization on a scale as broad as possible were made only in Estonia, while in the Czech Republic, Poland, Slovenia, Croatia, Macedonia, etc., it was done with little enthusiasm and produced limited results.

Since the process of re-privatization depends primarily on the political philosophy of the cabinet and since this is a method through which only a minor portion of the public and state capital can be privatized, we will ignore it in our further discussion⁶.

The oldest method of privatization is the **sale** of a state-owned enterprise to individuals. This technique has been and still is used both in the developed part of the world and in developing countries. The most famous example is the privatization carried out in Great Britain during the 1980s, which started a privatization wave around the world. There are two main methods of sale: first, a initial public offering; second, a direct sale to the highest bidder. In the first case, the state sets a fixed price of the shares and offers the shares for sale to interested parties, be they individuals, be they institutional investors. In the second case, the state organizes the collection of bids in a competitive manner (through tenders) or directly negotiates with interested investors. A combination of these two methods of sale is also possible.

The sale is practically the only method of privatization applied in developed countries and developing countries alike. Sometimes there are deviations from the method of sale at a full

⁶ See D. Hilber and B. Mijatovic – Zakoni o denacionalizaciji (nacrt zakona) [Laws on Denationalization (Draft of the Law)], League for the Defense of Private Property and Human Rights, Belgrade, 1997

price because cabinets, as the British government at the time, tend to promote the expansion of shareholding and the strengthening of the middle class and for this reasons organize a initial public offering of shares at prices lower than their market prices in order to enable private citizens to purchase them. The idea behind this is, by means of discounts, to ensure capital gains for the buyers-citizens and in this manner encourage them to apply.

Among countries in transition, privatization through sale was most systematically carried out in Germany (with respect to the economy of East Germany), Hungary and Estonia. While it is clear why the privatization in East Germany was exclusively based on the method of sale, it is interesting to look at the reasons of Hungary and Estonia: in both countries the prevalent opinion was that good governance of enterprises can be ensured only if they were sold and not if they were distributed among the citizens free of charge or among the enterprises' employees at a low price. The pro-reform Estonian cabinet even engaged experts from the German privatization agency, Treuhand, for the conceptual and logistical work, and to a large extent applied the experience of international tenders.

Around 1990, the necessity to privatize a great number of enterprises in the countries in transition launched the search for an innovative approach. This is how the model of **voucher privatization** was discovered. The idea is simple: special privatization money (vouchers) is distributed among the citizens, and then the citizens can purchase corporate shares with these vouchers. Vouchers may be distributed among the population either at an equal amount or at an unequal amount, based on age or work experience or any other criteria. The voucher model of privatization may be organized in a centralized manner, for a great number of enterprises at the same time (as in the Czech system) or in a decentralized manner, for each enterprise individually (as in the Russian system).

The best-known examples of voucher privatization are the Czech (and Slovak) and the Russian privatization. Voucher privatization was also partially used in Poland, Lithuania, Latvia, Slovenia and the republics of Central Asia (Armenia, Kazakhstan, and Kyrgyzia). The Czech privatization was centralized – the state simultaneously sold a great number of enterprises using the iterative technique of “price” changes. Since the vouchers were not transferable between citizens, a number of investment funds were established, and they were accumulating the vouchers of the citizens and “purchasing” shares of the enterprises. In Russia, the voucher privatization was decentralized, and the vouchers were transferable. However, the sale of vouchers was limited, and most were invested in enterprises where the voucher holders were employed.

The model of **employee shareholding** involves significant discounts for the price of shares (or their distribution partially free of charge) granted to managers and/or employees of the enterprises subject to privatization. In this manner, it constitutes a combination between a sale and a free distribution, while the benefits of free distribution are limited to the employees of the given enterprise. Deferred payment is common, and its purpose is to overcome the frequent problem of insufficient purchase power of the employees.

Employee shareholding is a model popular on the territory of the former Yugoslavia as the politically the least painful method of transition from an economy based on the principle of self-management to a private economy. It is the least painful model because the system of employee shareholding changes the type of control over the enterprise to the least extent – control over the enterprise still remains in the hands of its employees, at least in the short-

and mid-term, until a greater turnover and concentration of stock is achieved. For the above reason, this model was applied in Slovenia, Croatia, Serbia and Macedonia. Among other countries, Poland also partially applied the model of employee shareholding, using its socialist market economy as a starting point. As we have already seen, Russia started from an entirely different model of privatization but, due to decisions related to the logistics of the privatization process, ended up to a large extent with management/employee shareholding, where the managerial class succeeded in becoming the predominant owner in many enterprises. Romania and Slovakia also applied this model to a certain extent.

Advantages and Disadvantages of the Specific Models

Since the main goal of privatization is the **establishment of efficient enterprises**, i.e., a gain in efficiency, future good corporate governance should be of the highest importance in selection of a model of privatization. The different methods of privatization produce different structures of corporate ownership and, subsequently, a different degree of efficiency.

In essence, the structure of ownership depends on the following two pairs of possible solutions: the owners are either outside investors or employees of a given enterprise; the ownership is either concentrated in a smaller number of individuals or it is dispersed between a greater number of owners. Good corporate governance in the countries in transition depends on these four combinations.

Outside investors have a clear interest in the best possible operation of an enterprise because only then does the value of their property grow. If they succeed in controlling the managers and force them to work to the best interest of the enterprise, then the best result is most likely to be achieved. However, managers have their own interests, which do not coincide with the interests of the enterprise and the owners. In this case, the question is how to ensure that the managers work to the benefit of the enterprise and to the benefits of the owners (well known agency problem). The problem may occur in an aggravated form when the number of corporate owners is too high and when none of them has the power or the interest to supervise the management; then it is possible that the managers work poorly and/or to their own benefit but without facing the real risk of being replaced by the owners. Mature market economies have found an answer to this problem through the mechanisms of the managers market, capital market and corporate takeover, incentive compensation for managers, boards of directors, bank influence, etc. However, it is unlikely that, at any time soon, these indirect mechanisms can be used with a good result in countries in transition. It is necessary to find something stronger and this is the reduction of the agency problem to the least possible degree through the **existence of a predominant owner**, i.e., an owner with a sufficiently high share who will be able and have the will to successfully supervise the managers in his own interest.

A predominant owner is such an owner who owns either the entire enterprise or has a sufficiently large stake in the corporate ownership, i.e., holds a controlling block of shares. From this standpoint, a broad dispersion of ownership (a great number of small owners) is not good because it does not ensure nor does it enable good corporate governance; to the contrary, the passive behavior of all owners strongly resembles public property, where there is no one who controls and replaces the managers. It is far better to have one major owner who either owns the entire enterprise or has the predominant share in its ownership.

The easiest and fastest way to secure a predominant owner in a given enterprise is through the sale of that enterprise to the interested parties, provided that this is not done by means of initial public offering (which usually leads to dispersed ownership) but by means of a direct sale (for example, through tenders). This second type of privatization is based on the idea of the sale of the entire enterprise or a major part of it to a single buyer (or a single group).

Therefore, the **sale** of corporate capital to a predominant owner is superior from the standpoint of economic efficiency. It usually brings about good governance, which means a re-capitalization of the enterprise, expansion of its business, reorganization, improvement of the discipline, a greater degree of entrepreneurship. It is particularly beneficial when a serious foreign investor has become the predominant owner because of the reliability, the transfer of managerial skills, the greater financial capacities, the ability for orientation on the international market, etc., such an investor brings about. The model of sale also brings revenues to the state treasury, which is a benefit in itself.

The difficulties that the model of sale faces are mainly political and logistical. We can enumerate the following political difficulties: coming from an egalitarian system of values, a portion of the population may view the post-privatization distribution of property as unfair; the purchase of enterprises by foreign investors may seem as a sale of the national sovereignty; the employees and current managers may, in defense of their interest, oppose the sale and create political obstacles, etc. These arguments are not sufficiently valid, but the political situation may and should be taken into consideration when choosing a model of privatization, even though it should not be given more weight than the economic situation. At least there should be an awareness that the neglect of economic criteria has a high price, as the experience of the countries in transition clearly indicates.

The logistical problems are related to the complexity, duration and costs of the procedure related to the preparation of each individual enterprise for sale, whether in the form of initial public offering, whether in the form of a direct sale. This is so because the evaluation of the corporate value, as a basis for the method of sale, is a complicated and demanding procedure, especially when there is a significant degree of political and economic uncertainty (risks) and when the information and accounting data regarding the enterprise are not reliable. From this point of view, the direct sale (tender) is preferable to the initial public offering because as a technique, which is based on the collection of bids and on the competition between all interested parties, it can be organized more quickly and at a lower cost than the initial public offering, which requires detailed preparations in order to determine the price as precisely as possible.

The sale of a large number of enterprises cannot be carried out quickly, which is sometimes considered an important disadvantage of this model. However, the alternative models often do not bring quick results either. The model of voucher privatization, being the fastest in theory, has taken a great number of years to implement in the countries that have applied it. The Czech voucher privatization was the fastest – it was carried out in the period of 1991-1994; the Russian voucher privatization lasted just as long but covered only a portion of the government enterprises; Poland carried out preparations for the process of voucher privatization for five years, only to apply it later only to a small portion of the economy. The process of privatization through employee shareholding is not progressing any faster as evident from the experience of the former Yugoslav republics, even though, in theory, it

could have been implemented in a relatively short period of time. On the other hand, a sale may be accelerated if the whole procedure is not taken over by the state (with its always limited administrative capacities) but, instead, the enterprises themselves and interested investors get involved in the process.

The successful example of Hungary and Estonia demonstrate that the sale of state capital can be carried out to the best result if there is a sufficient political will and if the process of privatization is well organized.

Voucher privatization is an elegant and a relatively quick method of privatization, very favorable for the political rating of the cabinet that carries it out. Even though it does not bring about revenues to the state, it is believed that this loss is compensated by the method's speed and fairness. The model of voucher privatization is more transparent than the other models of privatization and allows for the avoidance of the assessment of value related to the other types of privatization.

One of the points in favor of the method of voucher privatization is in the claim that the population of a given country does not possess a sufficient amount of money to purchase the valuable production funds, therefore it is necessary to give state-owned enterprises away. This argument is valid only if the role of foreign investors in a privatization process is excluded, for example, because of the intention to keep the economy within domestic ownership. Of course, this argument is not valid from an economic point of view and the practice of countries that had used voucher privatization (the Czech Republic, Russia) shows that, later on, these countries were not even slightly disturbed by the influx of foreign capital. On the contrary.

A quickly implemented voucher privatization may have one advantage as compared to the model of sale: it prevents the formation of an anti-privatization coalition, which can be established over time and can block the process of privatization. This argument had a certain weight at the beginning of the 1990s but today, after the ten-year long experience of the countries in transition, it is no longer convincing because the resistance to privatization turned out to be less significant than expected.

The problem with voucher privatization lies in the fact that it does not ensure good corporate governance. In other words, the broadly dispersed ownership, resulting from the equal "purchasing power" of all citizens, inevitably leads to a situation where no one has control over a given enterprise and where the enterprise's actual results are automatically worse than its capabilities. A remedy can be sought in the formation of investment funds on whose behalf the citizens may give up their vouchers in exchange for shares of the investment funds (as in the Czech case). In this manner, the funds can accumulate vouchers and become substantial or predominant owners of particular enterprises. However, the solution of the problem of managing the enterprises has brought about a new problem – the problem of managing the funds. The ownership of the funds would be dispersed; therefore, the owners would not control the way in which the fund is managed, and this would result in the inefficiency both of the fund and of the enterprise in its portfolio⁷.

⁷ D. Ellerman – Lessons from East Europe's Voucher Privatization, Kent University, CGO, 2000.

The process of privatization through **employee shareholding** can be implemented relatively quickly by means of setting forth a deadline by which the privatization of a given enterprise must begin (as in the case of Croatia), by means of significant discounts of the price of shares and deferred payment. Or, as the experience of Serbia and Slovenia demonstrate, it can be a very slow method of privatization.

The main advantage of privatization by means of employee shareholding is political – it lies in the minimization of resistance on the part of workers and managers in the companies subject to privatization and particularly in enterprises that have been operated within the system of self-management (former SFRY, to a certain extent Poland) or where the managers have had strong positions (Russia). It is possible that their resistance may block the process of privatization, since this model of privatization attracts them to the cabinet that carries it out.

There are also opinions among the proponents of self-management and the school of “economics of participation” stating that employee shareholding brings about incentives for good governance because the employees, in their capacity as owners, have more reasons than before to work well and to exercise good control over the management.

On the other hand, this model has significant shortcomings. In order to maintain control over the enterprise, employees tend to obstruct the access of outside investors to it, which leads to insufficient investments. Moreover, outside investors are not interested in investing in an enterprise that is dominated by its employees. There is an incentive in such enterprises, as in enterprises operating within the system of self-management, to pay wages that are too high and to maintain an unwarranted level of employment. Managers, again, can hardly resist such pressure by the employees if the former have a small share in the corporate ownership. Such processes hinder or even make impossible the restructuring of the enterprise with all of the negative consequences that this entails.

The economic analysis indicates the advantages and disadvantages of the individual models of privatization; however, it is well to complement it with empirical analysis of the effects of the various models of privatization.

The general review of empirical literature on the effects of privatization in countries in transition prepared by Havrylyshyn and McGettigan indicates that new private companies have the best performance; they are followed by privatized companies with outside owners, and companies privatized by means of employee shareholding are at the end of the list⁸.

A study of the performance of more than 500 mid-sized enterprises in the Czech Republic, Poland and Hungary confirmed that privatized enterprises with outside owners are far more efficient than enterprises where the employees are shareholders. In the latter case, enterprises with a substantial ownership by the manager(s) show mixed results, while the performance of enterprises where the workers are the predominant shareholders is no better than the performance of state enterprises⁹.

⁸ O. Havrylyshyn and D. McGettigan – Privatization and Transition Countries: A Sampling of the Literature, IMF, WP/99/6, January 1999.

⁹ R. Fridman, C. Gray, M. Hessel and A. Rapaczynski – Private Ownership and Corporate Performance: Some Lessons from Transition Economies, World Bank, WP 1830, June 1997.

For Serbia, the study of the results of 1,900 Slovene enterprises is particularly interesting in light of identical legacy. Among the six categories classified based on the structure of ownership, companies with foreign ownership showed the best results, followed by indigenous private companies, then by companies with outside owners, then by companies owned by the employees, and finally by companies with the status of social or state enterprises¹⁰.

The previous reviews of the gain in efficiency as a result of the various models of privatization are summarized in the following table.

Table 2. Effect of Privatization on Efficiency

Degree of Concentration of Ownership Type of Owner	Concentrated	Dispersed
Outside Owners	**	*
Employees	*	—

- None or limited effects
- * Moderate effects
- ** Significant effects

At the beginning of the process of privatization ten years ago, it was believed that the particular method of privatization was not crucial for the end result of privatization because the capital market was going to quickly transfer resources from those less capable hands to those more capable, thus ensuring the most satisfactory structure of ownership and a good degree of corporate governance. Time showed that these expectations were not met and that the post-privatization, often unsatisfactory, configuration of ownership can be maintained over a long period of time thereby threatening the efficiency of the management and the restructuring of the enterprise. Evidently, the type of ownership is important. The old opinion of Janos Kornai, dating back in 1990, that the best model of privatization is sale, was confirmed.

Sale as the Primary Model of Privatization in Serbia

There is no perfect model of privatization. There is not even an excellent model whose advantages would gradually overcome its disadvantages as time goes by. Every model is accompanied by difficulties of one nature or another. Therefore, the choice among the various methods of privatization is difficult and ought to be based on the desired goals and on the knowledge of the relevant circumstances existing in the country. The discussion of the advantages and disadvantages of the individual types of privatization presented in the previous sections provides the basis for the proposal and selection of a new method of privatization in Serbia.

The choice of a method of privatization should depend on the following factors: (1) the principle advantages and disadvantages of the particular methods of privatization, (2) the

¹⁰ M. Simoneti, M. Rojec and M. Rems – Enterprise Sector Restructuring and EU Accession of Slovenia, mimeo, 1999.

condition of the enterprises subject to privatization, and (3) the economic and political environment in which the privatization process is to take place.

We have already discussed the models of privatization and their advantages and disadvantages.

The state of the economy of Serbia, or of enterprises with primarily public and government capital, is very bad. Such enterprises can be classified in three groups: the first groups is comprised of enterprises that operate well and can be privatized without any great difficulties; the second group includes enterprises that are experiencing great difficulties but would have business prospects after a significant restructuring; the third group is comprised of enterprises that have no business prospects.

Enterprises of the first groups can be privatized relatively easily based on any of the three models. However, the number of enterprises of the other two groups is too high in Serbia, which suggests that, in their case, voucher privatization and privatization by means of employee shareholding should be avoided because these methods do not bring about good corporate governance and subsequently prevent or significantly hinder the thorough restructuring of the enterprise.

The recent substantial political changes brought about a change in the environment in which privatization is to take place. Serbia is no longer a closed country without the possibility for an influx of foreign capital. The opening of the country to the world and the institutional changes in the country will significantly increase its attraction for direct foreign investments, which will enable, like in other countries of Eastern Europe, privatization by means of the sale of social and state capital. Therefore, the voucher model of privatization, the only realistic model until now, has presently lost its attractiveness. It is so, because this model is good for quick privatization at a time when there is no money that can buy the public and state capital.

The primary model of privatization in Serbia ought to be the sale of social and state capital. The advantages of the model of sale are substantial, and they meet the needs of Serbia.

First, the sale of enterprises ensures the best governance of privatized enterprises, which is, from the standpoint of economic efficiency, the most important issue of privatization. As long as the desired result is a healthy, efficient economy, capable of long-term economic progress, then good governance of the enterprises subject to privatization is the most important criterion for the choice of a particular model of privatization. The alternative models – voucher privatization and employee shareholding – do not provide for good corporate governance and for this reason should not be the basis of privatization in Serbia.

Second, the sale of public and state capital provides the state with much needed revenues, which can be used for servicing government debt, for coverage of fiscal deficits, for funding social protection and other commonly beneficial activities and/or for reducing taxes and fees.

As we know, from a political point of view, the model of sale is the least opportune model for a cabinet because it provides for the payment of a full price and does not allow that public

and state property be given away to citizens, as a result of which it does not “bribe” voters for the next election. However, the economic advantages of the model of sale are what is most important. Therefore, the government should not require from the process of privatization too much, more than can be implemented; instead, it should focus on a limited number of well-defined goals.

During the process of privatization, domestic investors, both legal entities and individuals, can also act as buyers. The only possible objection here is that this could enable the legalization of “dirty” money or money of questionable origin, i.e., it could enable the legalization of wealth acquired during the Milosevic’s era. The answer is that only the laws and the courts can decide what money has been earned honestly and that the process of privatization cannot be a method for the determination of the origin of certain property.

Who Starts the Privatization of an Enterprise?

All interested parties – the enterprise itself, potential investors, and the state – would have the right to start the privatization process. Any one of them would have to propose a privatization program containing all necessary elements (the value of the enterprise, the price of the shares, the method of payment, etc.) The decision to accept or to reject the proposed privatization program is to be made by a Privatization Ministry or Agency.

Such a system takes into consideration the limited administrative capacities of the central government, which is not able to master the job of selling a large number of enterprises in a short period of time; therefore, the system includes the rest of the interested parties as well. The employees of an enterprise do not have to wait for a government decision regarding privatization, but are able to initiate the procedure themselves in their own well understood interest. Also, any potential investor can initiate the procedure without waiting for a decision by the corporate board or by the government, which speeds up the process of privatization.

The revocation of the current practice of non-mandatory privatization and the exclusive right of employees to decide whether a privatization process is to begin, will have a positive effect on the performance of an enterprise even before its privatization. This is true, because the certainty that the privatization of the enterprise is to be initiated in the near future will stimulate both its management and its employees to make greater business and work efforts in order to meet the beginning of privatization as a company operating as well as possible (the Polish experience) because, otherwise, many employees and particularly managers would most certainly suffer personal consequences.

The Constitution is not an obstacle for the implementation of the proposed system for the initiation of a privatization procedure. The previous regime erroneously interpreted the provision of the Constitution of Serbia regarding the equal protection for all forms of ownership, while attempting to avoid the introduction of mandatory privatization through an interpretation stating the equality of all forms of ownership. On the other hand, such an interpretation did not prevent that regime from transforming enterprises with a social form of ownership into state enterprises, supposedly in the interest of all. Since privatization is undoubtedly in the interest of all, the participation of the state in the privatization of any given enterprise is not anti-constitutional either.

Various Techniques of Sale

The choice of the model of sale does not necessarily mean an identical method of privatization in all circumstances or in the case of all enterprises. In some instances, the privatization procedure will be initiated by the state, in other instances it will be initiated by the enterprise itself, while in third instances it will be initiated by an interested investor. In some instances, a tender will be used, in other instances an initial public offering will be more appropriate, in third cases an auction will be applied, in a fourth instance a bankruptcy proceeding may be a better option. In some instances the payment will be made in monies, in other instances it will be done through the debt-equity swap, in third cases payment will be made through frozen foreign currency savings. In some instances the monetary payment will be made at once, in others – in installments. The diversification of techniques, as long as they are applied consistently, can only help and accelerate the process of privatization.

The choice of a method of privatization depends on the size of the given enterprise. If the enterprise is large, the state interest in its privatization is significant, and a logistically sophisticated approach is necessary. If the enterprise is small, then a greater degree of flexibility is possible and even necessary.

All buyers would have equal rights and would have to pay the full price of shares. There would be no discounts granted to any particular types of investors (employees of the enterprise versus the outsiders, domestic individuals and entities versus foreign individuals and entities, etc.). The discounts granted to employees were neither fair nor did they bring about a sound structure of ownership. The concept of preferences for employees is based on the incorrect supposition that employees have had a decisive role in the creation and accumulation of the enterprise's capital. On the other hand, as we have seen, the concept of employee shareholding does not bring about efficient governance. Our proposition lies in the conviction that there is no such thing as free lunch and that everybody has to pay the full price for everything. There have been enough privileges for one category of citizens at the expense of other categories of citizens.

Any privatization procedures completed so far would be respected, as long as the effective rules and regulations have not been violated.

The Role of Foreign Investors

Foreign investors ought to be granted the same rights in the process of sale as domestic investors. There is not even a single good reason for their discrimination. The sale would be carried out at the real price, without any discounts, so foreign investors would have to pay in full for the enterprises or property that they would like to acquire. The national pride (or "sovereignty") will be preserved by means of the economic progress and the welfare of the citizens, as well as by means of greater tax revenues, rather than by national ownership of poorly run enterprises.

There are two main reasons why the involvement of quality foreign investors into the process of privatization is desirable. They are as follows:

- Foreign investors create greater demand for the stock of a certain enterprise, which leads to a higher price of the corporate shares during the process of privatization and, subsequently, to greater revenues for the state; more importantly, without foreign participation, privatization through sale would not be possible in Serbia due to the scarcity of domestic capital in relation to the value of the enterprises offered for sale;
- Foreign investors, when in the position of predominant owners (strategic investors), bring about management skills, organization, technology, capital, foreign markets, all of which enable the appropriate restructuring of presently inefficient domestic companies and their transformation into competitive manufacturers.

Foreign investors may find interest in making investments in Serbia for two reasons: the first reason is the business opportunities offered by the domestic market through the purchase of a respected domestic company that has a share on that market; the second reason is the cheap labor, in light of the orientation toward export transactions (the preferential arrangements between Serbia/Yugoslavia and the European Union and the general liberalization of world trade would contribute to this).

The failure of some countries to sell their enterprises (for example, Russia) is not the consequence of a weakness in the model itself, but a result of a weakness in the logistics of the privatization process and the general environment around it. In order to engage private capital – be it domestic or foreign – in the privatization process, it is necessary to meet a number of requirements: transparency of the procedure, accessibility of all substantial information regarding the enterprise, good legal protection of property, macroeconomic stability, lack of obstacles before the restructuring of the enterprise, etc. Otherwise, the sale may proceed only at very low prices of the enterprises, which would compensate for the risks involved and would attract speculative capital. The latter scenario is not acceptable both for economic and for political reasons.

Privatization of Large Enterprises

The main goal before the privatization of large enterprises with significant amounts of capital is to find a predominant owner (a strategic investor) capable of restructuring the enterprise and ensuring its successful operation. Due to the high value of such enterprises and the scarcity of capital in the country, the main orientation here would be a sale to foreign investors. In this manner, such enterprises would be privatized according to the strict international procedures of corporate sale, with the full participation of the state.

Within the model of sale, it is necessary to resolve a few more strategic dilemmas related to the choice of the method (initial public offering or direct sale), the technique of the direct sale and the role of bankruptcy.

The method of direct sale is superior to the method of initial public offering because it enables:

- The concentration of ownership, because the entire enterprise or a significant portion of it may be sold to a single buyer, while in the case of initial public offering there is usually a substantial number of owners; a small number of owners or a predominant owner ensure better operation of the enterprise;
- The sale of weaker enterprises, the number of which is presently quite high in Serbia, which is practically impossible in the case of an initial public offering (the latter means the sale of the stock of well-known, large and profitable enterprises); and
- Greater revenues from the sale because it is based on auction techniques.

The direct sale must be carried out in a competitive manner, whenever possible. This means that the sale of good enterprises should always be carried out through international tenders. Only in the case of weak enterprises, for which it is certain that there is no wider interest for investment, should a direct agreement between the state and the buyer be permitted.

The price of the enterprise should not be the only criterion during the sale. Price is an important and certainly the single most important criterion for deciding to whom is a given enterprise to be sold because it is best to sell the enterprise to that person or entity who value this enterprise most highly (in general, such a person or entity have the best business plan). However, other elements of the proposal, such as further investments, employment, etc., should also be given consideration.

The privatization program could also include the designation of individual auxiliary businesses within an enterprise that constitutes a conglomerate, as well as their separate sale.

As a rule, the payment ought to be made in a lump sum.

If and when there is a remaining portion of the public or state capital that has not been sold during the direct tender sale, it is possible to privatize that portion through a public registration of shares, where money, old foreign currency savings or vouchers may be used as means of payment.

There is a significant number of weak enterprises in Serbia, such that are not in operation at all or which operate with the minimum use of their capacities and which do not have any business prospects. They still exist only because they are not paying their liabilities and because the state is helping them out in various ways by transferring limited resources from the more productive sector of the economy. When hard budget constraint, i.e., payment of liabilities, is established, many of these enterprises will go bankrupt. One outcome of the bankruptcy procedure is the recovery of the enterprise by means of reprogramming its debts or their transformation into ownership shares and the continuation of the company's existence, while another outcome is the company's liquidation and the sale of its property. A bankruptcy procedure does not mean the loss of the property; it is only a change in the relations of ownership and a removal of a portion of the debt burden and bad governance from the enterprise and its property.

The transparency of the procedure is an important precondition for a successful privatization through sale. A neutral agency should carry out the estimation of the enterprise's value in order to make sure that the price is real and convincing. Over the past ten years, domestic consulting agencies have acquired substantial experience in the evaluation of the value and in the privatization of enterprises, but the support of foreign agencies would also be welcome. The cabinet ought to carry out a public media campaign in order to make potential investors aware of investment opportunities in Serbia.

Privatization of Smaller Enterprises

The role of the state in the privatization of smaller enterprises should be more limited, while the role of the enterprises themselves and that of investors should be greater. Because of the state's inability to organize a great number of privatization procedures within a limited period of time, a decentralized initiative would speed up the process of privatization.

Because of the smaller amount of necessary capital, it would be easier to find an investor who would be willing to become a predominant owner, regardless of whether this is an outside investor or a corporate manager.

The predominant technique here should be the tender; however, the initial public offering or – in the case of small enterprises – the auction would be more frequently employed in these instances than in the case of larger enterprises. Payment could be made with money, with liabilities and with frozen foreign currency savings.

This group also includes the sale of facilities such as stores, restaurants, etc., particularly from the fund of state enterprises for business premises. The sale would be carried out by means of an auction, and the payment would be in cash and in a lump sum.

III PRIVATIZATION OF THE INFRASTRUCTURE

The strategy and policy of privatization of the infrastructure industries should be specific due to the very pronounced specifics of the activities related to the infrastructure. Many of these activities have the characteristics of natural monopolies, with a very high barrier to entry into industry, while in certain cases we are dealing with public goods or with the production and consumption of services provided by the infrastructure, which generate significant external effects. Therefore, the new model of privatization in Serbia should contain a specific strategy and policy of privatization of the infrastructure. Hereinafter the term infrastructure will mean the following: telecommunications, power supply, gas transmission, water supply, railroads, roads and local public utilities (municipal infrastructure).

Goals of Privatization of the Infrastructure

The main goals of privatization of the infrastructure in Serbia are as follows:

- Increase the economic efficiency of infrastructure industries;
- Improve the state's financial position, which would ensure dynamic development of the infrastructure.

The preconditions for increasing efficiency of the infrastructure, i.e., the operative goals for its privatization, are as follows:

- Establishment of efficient business management (corporate governance);
- Transfer of the modern know-how;
- Restructuring of the enterprises of the infrastructure.

Dynamic development of the infrastructure means:

- Maximization of privatization revenues;
- Maximization of the inflow of fresh capital for funding of investments in development.

The choice of the models, methods and techniques of privatization must be the result of their evaluation based on the above goals or criteria.

The 1997 Privatization of TELECOM

The only privatization in the area of infrastructure that has been accomplished so far – the privatization of Telecom Serbia – brought about disappointing results. The number of telecommunication lines is in a state of stagnation; the quality of service is not improving; the supply of new services is negligible; prices are far above European prices; and customer relations of the national telecommunications provider are very bad. Although it may seem

paradoxical, the development of telecommunications in Serbia was far more dynamic during the period prior to its privatization.

The main reason for the above results is in the application of inappropriate techniques and the bad policy of privatization. The sale was conducted without a tender, through private negotiations (sale) agreement; the results expected from strategic investors were not specified; the privatized national telecommunications provider was awarded a legal monopoly (the exclusive right to carry out this type of activity) for no less than eight years (this period expires in June 2004) – competition was banned; the privatization also covered a license for mobile telephone services; the regulation of the prices of telecommunication services was not covered by the privatization agreement, nor was it defined in any other manner; the privatization revenues were not used for development in the area of telecommunications, but for covering the budget deficit. The provisions of the privatization agreement are so unfavorable for the country as a whole that they severely threatened the development of this area of the infrastructure.

Even though the former Government claimed the amount of the privatization proceeds (approximately DM 1.5 billion for 49% of the capital of the national telecommunications provider, or approximately 1 million subscribers) as their own great success, this amount is far below the revenues obtained from the privatization of telecommunications in other Eastern European countries.

The only goal of the privatization of telecommunications in Serbia was to cover the budget deficit and to fund budgetary spending, all for the purpose of gaining short-term political popularity. With a goal so defined and without any consistent Government (national) telecommunications policy, in addition to the use of consultants of dubious value, it was impossible to achieve good results. The privatization of Telecom is an example of what should not be done.

Models of Privatization of the Infrastructure

There are five main models for privatization of the infrastructure:

- Management contract;
- Contracting-out the services;
- Lease;
- Concession;
- Privatization of the equity capital.

Management contract

The mildest model for privatization of the infrastructure is based on assignment of the management of public enterprises to private individuals or legal entities by means of establishment and implementation of a management contract. Such a contract is signed by the owner of the infrastructure enterprise (the state) and the private individuals or legal entities that take over the management of the public enterprise. By means of this, the private sector is practically introduced into the public enterprise, even though only in the aspect of management. By means of the management contract for a public enterprise, the

new, private management assumes the obligation to achieve certain target, precisely defined results. In addition, pursuant to this contract, in its capacity as the owner of the public enterprise, the state assumes the obligation to provide the private management with full freedom of action; also, the method by which the state is to reward the private management for completion of the contractual (target) results. Usually, contracts of this type are signed for a period of three to five years. The main idea behind this model of privatization is to create incentives, in this case exclusively in the area of management, for economic efficiency under conditions where there is no private ownership of the capital of the infrastructure enterprises.

Strictly speaking, the management contract is not a model of privatization infrastructure industries, but is rather a model of private sector participation in such activities. In other words, this method does not lead to the privatization of state owned equity capital in public enterprises. For the above reason, this method cannot be used as the primary, but only as an auxiliary method of privatization in the area of infrastructure.

Contracting-out services

Contracting-out services is the next model for privatization of infrastructure industries in Serbia. Namely, public enterprises in Serbia are frequently organized in a manner that allows them to carry out a great number of auxiliary activities in addition to their core activities in the area of infrastructure. For example, this is true for all activities related to facility maintenance, support for the performance of the core activity, as well as services provided for the employees of the given enterprise. Quite frequently, the number of people employed in such auxiliary activities is greater than the number of people employed in the performance of the main, infrastructure industries of public enterprises. There is no technological or organizational need whatsoever for these auxiliary activities to be carried out within the public enterprise.

Accordingly, it is desirable to separate certain auxiliary activities (services) from the operation of the public enterprise and perform them outside of that enterprise, pursuant to a service contract. The contract is to be signed between the public enterprise and the private enterprise (or the individual) that provides such services. Among the auxiliary activities are all of the functions that do not have the characteristics of infrastructure-related core activities and subsequently can be provided, without any limitations, on the basis of market criteria. In this manner, the auxiliary activities are carried out in an entirely different regime than the main activities. Since the former are of a definitely competitive nature, all interested individuals and legal entities can compete for the performance of such activities; therefore, the service contract is to be signed with those who offer the best terms.

The above model for the privatization of the infrastructure may be only an auxiliary one. Only a small portion of the capital in public infrastructure enterprises can be privatized based on this model.

Lease

This model for the privatization of infrastructure activities means the leasing of a facility within the system of the infrastructure to be operated by a private company. This means, for

example, that all the fixed assets (facilities), for example, of the entire water supply system are still owned by the state but are leased, pursuant to an agreement, to a private water-supply enterprise for a precisely determined period of time, which is most frequently between six and ten years, even though the lease may last longer.

Usually, such a solution is achieved based on a competitive bidding among several private companies competing for getting the lease agreement, i.e., for the right to use a given facility, by means of which they also obtain the right to carry out the infrastructure-related activities within a given area, which goes along with the right to charge the users fees for the provision of infrastructure services. Based on the results of the bidding, the lease agreement also regulates the fee payable by the private enterprise for the right to use the state-owned fixed assets and for the right (as a rule, exclusive) to provide the given infrastructure services in the given area and, quite often, the price that such an enterprise may charge the customers. The fee for the lease of a facility is a very important category of this model of privatization. It must be higher than or equal to the amount of depreciation of the leased facility, since this is the only way to maintain its fixed assets (capital), i.e. to ensure the preservation of the facility in the state in which it was initially leased.

Concession

Concession is a very popular method for privatization of infrastructure industries, which has been frequently applied over the past decade. Concession means an arrangement according to which the state (concessor) cedes to the concession holder (the private enterprise) certain assets (facilities) for use, which also includes granting the right to carry out infrastructure-related activities based on these assets, as well as the right to charge the final users for services provided. The obligations of the concession holder toward the state are to invest additional capital and improve the fixed assets, which, after the expiration of the concession agreement, are to be returned to the state, as well as to pay a concession fee to the state. During the term of the concession, the concession holder, i.e., the private enterprise, operates and earns profits, by which it covers its investment. Usually, the term of a concession agreement is longer than the term of a lease agreement and can be even up to 30 years. This is understandable in light of the fact that it is necessary to provide sufficient time for the concession holder to return all of its investment, which cannot be expected under a shorter term of the agreement.

At the beginning of operation of the concession, the concession holder establishes a new, private concession enterprise, which for the term of the concession agreement operates on the basis of the fixed assets subject to the concession. As a rule, after expiration of the concession, the concession enterprise is dissolved (suspended), since all of the facilities are transferred into public, or state ownership.

A particular type of concession are BOT (Build-Operate-Transfer) arrangements. Under such an arrangement, there are no initial fixed assets (facilities), but the fixed assets occur through the investment of the private legal entity (private enterprise) that has entered into such an arrangement.

Privatization of the equity capital

This model for the privatization of infrastructure industries is based on the privatization of the state capital of an existing public enterprise, which means also the privatization of all facilities intended for the performance of the given infrastructure industries.

It has been proven empirically that private ownership leads to the formation of very effective incentives for economic efficiency – private enterprises are inherently more efficient than public enterprises in the area of infrastructure industries as in any other area. The interest of the private owner lies in the maximization of profits, which, at a given price and quality of infrastructure services, is achieved by minimizing expenses. This enables the economically efficient operation of private infrastructure enterprises. In addition, a private owner has a vital interest in the preservation of the property (facilities) of the infrastructure enterprise in order to be able to gain (maximize) profits in the future as well. Finally, it is in the best interest of a private owner to invest capital into further development of infrastructure industries that he operates in order to maximize his future profits, by means of which the problem of attracting new capital for the funding of infrastructure development is solved.

This model of privatization may be applied in two versions. The first version is to establish majority or full private ownership of the capital of the public enterprise; the second is to establish a minority private ownership. Implementation of the second version is less likely and, in that case, it is usually necessary to establish a majority governance right of the private owner.

Successful implementation of this model of privatization means the establishment of efficient economic regulations for the operation of privatized infrastructure enterprises, which means the establishment of specific regulatory institutions and which usually requires a long period of time, particularly in light of the efficiency of such institutions. From a short-term point of view, the lack of appropriate regulatory institutions may be resolved by establishing contractual regulation, even though this is only a temporary, transitional solution on the path to establishing a true institutional system of regulations for private infrastructure enterprises, which, as a rule, have a monopolistic position on the market.

The goals of privatization of the infrastructure in Serbia constitute criteria for the evaluation of the above models for privatization of these activities, i.e., for privatization of infrastructure enterprises. The criterion of applicability of a certain model in light of the particular circumstances in Serbia is added to the above criteria.

Table 3. Evaluation of the Models for the Privatization of the Infrastructure

Privatization Model	Economic Efficiency	New Investments	Transfer of Know-how	Applicability
Governance contract	*	–	*	Yes
Service agreement	*	–	–	Yes
Leasing of Facilities	**	–	**	Conditional
Concession	**	*	**	Yes
Privatization of corporate capital	**	**	**	Yes

- No effect
 * Moderate effect
 ** Significant effect

The privatization of the equity capital is the only relevant model for privatization of the infrastructure; therefore, full consideration will be further given to this model.

Methods for Privatization of the Infrastructure

In general, privatization of the infrastructure, i.e., of public enterprises, may be implemented through the application of several substantially different modifications of the sale as a primary method of privatization, as follows:

- Initial public offering of shares (IPO);
- Sale to institutional investors;
- Sale to financial investors;
- Sale to strategic investors;
- Sale to domestic investors.

Due to their inherent shortcomings, the other methods of privatization (vouchers and internal shareholding) will not be further discussed.

Initial public offering

Unlike the voucher or internal model of privatization, the IPO can, at least principally speaking, bring about great privatization revenues, i.e., a great amount of new capital. Some of the largest privatizations of infrastructure enterprises in the Western world (similar to their privatization in Great Britain carried out during the 1980s) were implemented exactly in this manner. However, this method of privatization requires a highly developed and efficient capital market and a significant demand for capital, and the privatization procedure itself, including the preparation of public enterprises for entering the stock market, is very complicated. Since the capital market in Serbia, cannot be considered as a developed and efficient one, this method is practically inapplicable.

In addition, the public sale of shares most often leads to a great dispersion of shares among small investors, which, as in the case of vouchers, does not create a structure of ownership favorable to the establishment of efficient corporate governance, implementation of reforms

of the infrastructure, and restructuring of the enterprises in the area of the infrastructure. Also, as in the case of privatization through vouchers, there is no transfer of know-how during the public sale of shares.

Sale to Institutional Investors

The sale of public enterprises to foreign institutional investors and, above all, to international financial institutions having at their disposal large amounts of capital removes the problems related to the underdeveloped capital market and dispersed ownership. However, institutional investors are not inclined to purchase a large portion of shares (capital) in public enterprises, much less purchase such enterprises in their entirety. In addition, institutional investors, by nature, cannot carry out the restructuring of enterprises in the area of infrastructure. They are mostly interested in the purchase of a small portion of the stock of infrastructure enterprises (never more than 10% of the total capital), by which the process of privatization may be accelerated as a result of the reduction of the risk for the next potential investors. Of course, as in the case of all methods of privatization previously discussed, no conditions for the transfer of state-of-the-art know-how are achieved.

Sale to Financial Investors

Privatization of the infrastructure by the sale of enterprises to foreign financial investors (which also have at their disposal large amounts of capital) is similar in some of its characteristics to privatization by the application of the previous method. The difference is in the fact that financial investors are ready to purchase the majority of shares or the enterprise as a whole. However, financial investors are not particularly interested in infrastructure. In other words, the term of investment return in this area is quite long, there is a significant regulatory risk, and the liquidity of investment is quite low. So, financial investors are primarily interested in those areas where the term of return on investment is shorter, there is no regulatory risk, the liquidity of investment is high, and the possibilities for speculative profits from capital transactions are very big.

In addition, financial investors are not interested in the restructuring of the infrastructure enterprises that they may purchase, because such a restructuring is a long-lasting process and also because they do not have the specific know-how related to the area of infrastructure that would be needed for the successful implementation of such a restructuring. The lack of specific know-how is the reason why this method for the privatization of the infrastructure does not enable the transfer of state-of-the-art know-how.

Sale to Strategic Investors

All of the problems pointed out so far and related to the infrastructure privatization methods discussed above can be resolved by the application of the method of sale of public enterprises to strategic investors – large and experienced foreign or multinational companies in the area of infrastructure. The fact that such companies have at their disposal large amounts of capital solves the problems related to the insufficient amount of privatization revenues, as well as the problems related to the influx of new capital intended for investment into the development of the infrastructure. Foreign or multinational infrastructure companies are naturally vitally interested in infrastructure, which means that they are ready and able to conceptualize and carry out a process of radical restructuring of

infrastructure enterprises after their privatization and after the establishment of efficient corporate governance. Strategic investors do not lack know-how in the area of technology, marketing, finances, or internal organization of the infrastructure enterprise, and by purchasing a domestic public enterprise, they gain an incentive for the transfer of all of this know-how, which means an increase in the economic efficiency of the infrastructure and its accelerated development.

The sale to strategic investors is a method that is relatively easy to apply and does not require complicated institutional preconditions. It does not need a developed and efficient capital market. What it needs is solid legislation in the area of foreign direct investments.

Based on all the above, privatization by the sale of public enterprises to strategic investors is, generally speaking, a superior method for the privatization of the infrastructure; therefore, it should be applied wherever possible.

Sale to Domestic Investors

Caution with respect to the implementation of direct foreign investments in the infrastructure of Serbia requires the review of another possible method of privatization as well – the sale of infrastructure enterprises to domestic investors. This model is substantially less satisfactory as compared to the sale to strategic investors with respect of all criteria for the evaluation of privatization methods. Only in the case of privatization of small infrastructure enterprises can privatization by a sale to domestic investors ensure the appropriate inflow of fresh capital.

Therefore, the possibility for the application of this privatization method should be limited exclusively to small public enterprises, primarily in the area of the local public utilities (municipal infrastructure), i.e., enterprises in which strategic investors would not be interested.

The evaluation of the methods discussed above, based on previously formulated criteria (the goals of infrastructure privatization in Serbia), is presented in the following table:

Table 4.

Evaluation of the Methods of Infrastructure Privatization

Privatization Method	Economic Efficiency	New Investments	Transfer of Know-how	Applicability
Public sale of shares	*	–	–	No
Institutional investor	*	*	–	Yes
Financial Investor	*	*	–	Yes
Strategic investor	**	**	**	Yes
Domestic investor	**	*	–	Yes

- No effect
- * Moderate effect
- ** Significant effect

Techniques of Infrastructure Privatization

Since some of the above methods of privatization can be applied in different ways, the application of a privatization methods itself is related to certain techniques.

The first difference appears in the case of a conventional sale, and capital increase. Namely, the sale of state owned capital in a public enterprise does not lead to a change in the value of the corporate capital, but only to a change in the ownership of this capital or a portion thereof, while the entire privatization revenue belongs to the previous owner of this capital, the state.

In the case of capital increase, the structure of ownership of the existing equity capital is not changed; instead, the total capital of the enterprise is increased, as a result of which the structure of ownership of the total corporate capital is changed. In other words, the sum of the privatization revenue in the case of capital increase constitutes an inflow of fresh capital directly into the public enterprise, which creates possibilities for funding the development of this enterprise, i.e., development of the infrastructure. It is necessary to reach a political compromise between the two solutions discussed above, where capital increase is more satisfactory from the point of view of the development of infrastructure.

Another difference in the application of privatization methods lies in the possibility for the application of a direct negotiation (private sale) or a tender sale of the public enterprise. The private sale means closed (private) negotiations between the seller (the state) and the buyer. As a result of its non-transparency, in most cases this is not a good technique for the privatization of infrastructure enterprises. Due to the lack of competition at the end of the demand for capital, potential buyers do not have an incentive to offer the best possible terms (from the point of view of the buyer) which they are willing to accept; therefore, in addition to its other shortcomings, this privatization technique leads to a decrease in privatization revenues and opens possibilities for the entry of investors of poor quality.

Contrary to the above, the tender sale is very transparent, the announced terms are valid for all the bidders, and there is competition at the end of demand, which leads to the maximization of privatization revenues and to the choice of a quality investor. These advantages indicate the superiority of the technique of tender sale as compared to the technique of direct agreement; therefore, this privatization technique should be prevalent in the case of the privatization of infrastructure enterprises.

Policy of Infrastructure Privatization

The policy of infrastructure privatization ought to be based on three basic elements: partial (necessary) restructuring of public enterprises prior to their privatization, definition of the development goals that should be achieved by means of the privatization, and reform of the price policy, which in many cases means a significant increase in the existing prices of infrastructure services.

In the area of telecommunications, it is necessary to revise the privatization agreement signed by JP PTT Communications of Serbia and the strategic investors STET and OTE, which envisions a legal monopoly of Telecom Serbia over all telecommunication services within the fixed network until mid-2004. Such a revision must be only the initial step towards establishing conditions for the entry of new private providers for both fixed and mobile telecommunications. This also means establishing a non-biased system of regulation of the industry. Possibly, the first new private investment (entry) will be in the area of mobile telecommunications (a third 2G provider). If the appropriate institutional conditions are created, one can even expect the entry of new providers into the existing fixed telecommunications network. In addition, it is necessary to examine the possibility for further privatization of the national provider (Telecom Serbia) by the introduction of new strategic investors and a decrease of the existing state ownership (51%) of the capital of this enterprise.

Prior to its privatization, the power industry must undergo a process of partial rehabilitation and a thorough restructuring of the EPS. The restructuring must be based on vertical separation, i.e., separation of the area of power generation, transmission and distribution of electric power. In the area of generation, it is necessary to carry out a horizontal separation, i.e., establishment of several independent enterprises for the power generation. Possibly, open-cast coal mines should be integrated with the generation units (enterprises) using their coal. Then, it will be easier to privatize such enterprises. The transmission ought to be covered by a single enterprise for the entire territory of Serbia, owned by the State for the time being in order to enable the integrated governance of the electric power system. The distribution system would be divided into several regional and local monopolies and privatized while providing a strict economic regulation. Underground coal mines and many auxiliary activities should be separated from the EPS. Privatization of such mines is very unlikely; however, privatization of the auxiliary activities can be carried out in a manner similar to the privatization of all other competitive activities. The reform of price policy, i.e., a significant price increase is a necessary precondition for the privatization of the power industry.

The transmission of natural gas has to be prepared for privatization by its full separation from the oil industry. In other words, a separate enterprise for the transmission of natural gas that has no connections with the oil industry whatsoever has to be established. The profitability of the gas business would facilitate its successful and relatively quick privatization. As long as the monopoly of natural gas transmission is preserved, the privatized enterprise would have to assume certain strictly defined obligations regarding the further development of gas industry in Serbia and the development of this industry on the entire territory of the Republic. In addition to covering the major cities in the Republic, a primary goal of this development would be the establishment of a ring-type network and the creation of alternative points of gas supply from abroad, which would enable the country to rely on a greater number of suppliers. In addition, the appropriate solutions (possibly a concession in the form of a BOT or a BOO arrangement) for the further development of low-pressure distributive networks should be examined. The gas distribution must be entirely separated (vertical separation) from the gas transmission.

Enterprises in the area of water supply should be significantly restructured prior to their privatization, primarily by separating the great number of auxiliary activities from the water-supply enterprises. In addition, prior to beginning privatization, it is necessary to change the

current price policy drastically, i.e., to enable a significant increase in the price of water. It is highly possible that the process of privatization in the area of water supply would begin with privatization of the largest and potentially most profitable enterprises, and it is highly unlikely that the water supply enterprises in smaller towns would be privatized. Therefore, it is necessary to examine the possibility for regional integration of water supply enterprises for the purpose of their enlargement.

The first steps of the restructuring of the railroads should be based on the vertical separation of infrastructure facilities and the railroad operations. These activities should be carried out by independent enterprises that regulate their relations through contracts. Then the next step could be horizontal separation, i.e., establishment of a number of operators in passenger and cargo transportation, which would create the conditions for competition of the operators. The question is whether it is possible to create such competition on the relatively small domestic market. It is highly possible that the conditions for efficient privatization of this industry will not be established for a while yet. However, this does not mean that a great number of auxiliary activities that have to be separated from the existing railroad enterprise will not be privatized.

Privatization of the roads (highways) facilities should be based on the privatization of road maintenance enterprises and establishment of competition for the performance of these services by contracting-out the jobs. A state agency should manage all of the work related to the organization of road maintenance, while the contractors should be private enterprises. It is necessary to enable direct private investments into the further development of the road network through specific concession or BOT arrangements.

Privatization of the local public utilities should be preceded by the restructuring of utility enterprises, their specialization, and introduction of competition wherever feasible. It is very likely that it would be impossible to introduce competition in the area of district heating, which means that the privatization of this activity would be based on privatization of the existing monopoly. In all other local public utility industries, it is possible to establish competition by means of the specific competitive contracting-out and franchising. In this way, the problem of economic regulation of the privatized monopoly can be avoided.

Regulation of the Privatized Infrastructure

Effective economic regulation is a key factor for the success of privatization of natural monopolies, such as the infrastructure. The task of economic regulation is to ensure the maximization of social welfare, which is achieved by means of simultaneous protection of consumers and producers. Consumers would have to pay such prices for infrastructure services that they would pay in the hypothetical case of the existence of a free and perfect market of such services. Producers would have to earn such profits that correspond to the cost of capital. In order for economic regulation to perform this complicated task, it is necessary to find good institutional solutions for the performance of this job.

The first question related to the topic of institutional solutions of economic regulation is who should be in charge of economic regulation. Here, there are two main solutions:

- An independent or autonomous regulatory agency;
- The appropriate ministry or government authority.

Previous experience undoubtedly demonstrates that the establishment of a regulatory agency separated from the ministry or government authority is a far better solution. This enables the strict division of jurisdiction, powers and responsibilities for economic regulation and reduces to a minimum the possibilities for the conflicts of interests, which would be fatal for an efficient economic regulation. Even though in literature this type of agency is frequently called “independent,” it is more accurate to call it “autonomous” because, strictly speaking, independence does not include the accountability of such an agency before any other authority. Creating such an agency also includes the strict separation of operational and regulatory functions – an entity involved in the operation of a certain area of infrastructure should not regulate it. The opposite is also true – an entity involved in the regulation of a given area of infrastructure should not be involved in its operation. The strict separation of the operational and regulatory functions prevents any conflicts of interest, which is the most significant factor of a bad and biased economic regulation.

According to the above, an Autonomous Regulatory Agency for the Economic Regulation of the Infrastructure should be established in Serbia. The founder of this agency may be the Cabinet or the Parliament. The founder ought to approve the term of the agency and to appoint the executives of this agency, i.e., the people who will be making the executive decisions of the agency.

It is of key importance that the regulatory agency is provided with autonomy in its work. It is particularly important that all activities of the regulatory agency are strictly separated from political or partisan activities. This can be achieved through a precise term, which is to be assigned to the regulatory agency possibly in the form of a separate law and related sub-legislative documents. It is very important to ensure that the agency is accountable for its work but such accountability should not imply the introduction of daily or partisan policies into the work of the agency. One of the means to ensure this is to make the term of the members of the board who make executive decisions longer than the term of the Cabinet in order to avoid staff changes in the agency that are the result of political or staff changes in the Cabinet.

The work of the regulatory agency should be specified in all details, which should be done by means of sub-legislative documents of the Cabinet as well as bylaws of the agency itself. These documents ought to specify the method in which the authorities of the agency, as well as its accountability to the founder are to be implemented. The procedure for making regulatory decisions should be formalized as much as possible in order to reduce to a minimum the possibility for making arbitrary decisions in the procedure itself. In addition to accountability to its founder, the regulatory agency should be accountable to the public as well. Therefore, it is necessary that the above document provide for the public nature of the work of the regulatory agency, or for the specification of those activities in which the regulatory agency is to have the obligation to act in a public manner. For example, this includes the obligation for a public hearing, during which all interested parties will have the opportunity to express their positions regarding a specific regulatory issue or regulatory decision.

The examination of the abundant international experience in the area offers three main methods of economic regulation:

- Rate of return regulation;
- Price capping;
- Profit sharing.

Rate of return is the oldest method of economic regulation. This method is based on the premise that the monopolist should earn profit exclusively at the amount of the price of the added capital. The regulatory agency verifies the financial results of the operation of the monopolist (particularly its costs of operation), estimates the price of the capital it adds and, based on this, determines the price of its product, which leads to the equalization of the profit rate and the cost of the capital. The main shortcomings of this method are related to the production efficiency, the high cost of regulation as well as the complexity of its application. In order to apply this method, it is necessary to have well-experienced regulatory agencies as well as an abundance of regulatory know-how. Therefore, this method is not satisfactory in cases of privatization of natural monopolies, since no regulatory institutions have been established and gained the appropriate experience yet. All the shortcomings of the method of profit rate control make it an inferior method of economic infrastructure regulation in Serbia.

The price capping was introduced as a method of economic regulation about 20 years ago. By the application of this method, the prices of the monopolist are determined in advance for a period of several years and may be adjusted exclusively by means of a retail price index, which means that only their nominal amount, and not their real amount, can be adjusted. The application of this method allows for the increase and decrease of prices in their real amount during a period determined in advance. The main advantages of this method are in the area of production efficiency, its simplicity and easiness of application, the low regulatory costs and the reduction of some components of regulatory risk. Its disadvantages lie in the area of allocation efficiency and the other components of regulatory risk. This method is very suitable for the case of privatization of natural monopolies, in light of the fact that it is easily applicable even without experienced regulatory institutions. Considering the advantages of this method of regulation, we can say that it is a method of regulation superior to rate of return control.

The method of profit sharing as a method of economic regulation is a combination of the first two methods and has occurred during the past ten years or so as an attempt to combine the good characteristics of the two previous methods. The application of this method is very complicated and, as such, practically impossible in Serbia; therefore, it should be excluded from our further discussion.

Considering all of the characteristics of the infrastructure in Serbia, particularly the extremely high production inefficiency, the establishment of price capping is the only suitable method of economic regulation of the infrastructure.

IV PRIVATIZATION OF THE BANKING SECTOR

Introduction: Specifics of the Privatization of Financial Industries

Financial industries (commercial banking, insurance, investment banking) are different from the industries in the real sector by two features that are very important for their privatization.

The first feature is the structure of the balance sheet, in which borrowed sources dominate in the liabilities and loans dominate in the assets. A bank's capital is not, as in the case of an industrial or trading company, intended primarily for the funding of permanent assets; instead, it is intended for maintaining the financial institution's solvency because such activities are highly risk sensitive. Therefore, it is not a uncommon case when banks' net capital has a negative value. Under such circumstances, privatization is highly unlikely, even when advantageous.

The second important feature of the financial sector in Yugoslavia is the fact that it had been formally privatized by means of conversion of the banks and insurance companies from their previous forms of socially owned entities into joint-stock companies. The actual state of affairs is the following: private capital constitutes only 18% of total banking capital. The remainder is comprised of socially owned capital (more than 80%) and state capital (2%). The manner in which this "privatization" was carried out and its consequences make real privatization much more difficult.

For the above reasons, on the following pages, particular consideration will be given to the analysis of the effects of the formal privatization in the banking sector. Therefore, the main concept of privatization is different from the concept of privatization in the real sector.

The Effects of Formal Privatization on Bank Operations

Formal Privatization and Bank Efficiency

The reform of the banking sector carried out in the early 1990s introduced two important new innovations into the regulation of this area: the first was a formal privatization, and the second was the introduction of the Bazel prudential standards. The later course of events brought these two mechanisms into a strong contradiction, and an attempt was made to eliminate this contradiction by means of the mitigation of prudential standards related to bank operations. The attempt failed: the banking system continued to further drown into an even deeper crisis of insolvency. One of the main reasons for this was the ownership status of the banks.

Formal privatization led to the phenomenon where most Yugoslav banks (except those that had predominantly private ownership) contained in the definition of their status the controversy between the non-ownership nature of socially owned capital and the corporate legal form of the banks. This controversy can be described in the following manner: the owners of the banks would have to be interested in obtaining income from their ownership (dividends) as well as in capital gains; as privileged debtor of the banks, they were primarily interested in debtor's profits from the loans they had obtained from the bank. (This profit measured by the negative real difference between the value of the loan paid back and the

value of the loan received). However, the mayor bank owners, along with the Government and the Central Bank, maintained an interest rate policy of negative interest rates, which allowed borrowers to appropriate high debtor's profits. In this manner, the "debt model of banking" came into existence. Such an interest rate policy makes impossible the normal formation and maintenance of a structural equilibrium in the banks' balances. When this is combined with a directive (through discretionary political decisions) allocation of loans, the result is a quick devastation of the bank's assets and an accumulation of non-performing loans on its balance sheet. As a result of the increase in non-performing loans, there is a decrease in the value of the bank's capital, which increases the wealth of owners who are indebted to the bank and decreases the wealth of owners who are not indebted to the bank. As a result, owners who were indebted to the bank strove towards a debtor's profit greater than the value of the shares, which was decreasing. Political lobbying for additional loans had become a common method of acquiring additional funds.

Therefore, the interest of owners to appropriate as high debtor's profits as possible has been predominant in the practice of most banks so far, which has led to the destruction of a great number of banks.

The combination of repressive regulation of interest rates and the status organization of the banks as debt service institutions inevitably ends with the transfer of loss from the corporate sector to the banking sector. For this reason, an enormous amount of non-performing loans has accumulated in banks that were subjected to the effects of these two factors. In this respect, the Yugoslav banking system is, almost certainly unique in the world. The value of the capital of such banks is far below zero.

True privatization of the banks is a necessary condition for the normalization of the banks' activity. The main arguments on behalf of this statement are as follows:

1. Formal privatization is the main reason for a growth of high-risk bank assets (unrecoverable loans) that is faster than the growth of the bank itself (the increase in its balance sheet amount).
2. Under the circumstances of formal privatization, a bank's growth is determined by informal regulation or allocation of loans by means of a political decree.
3. The greatest growth for the past period was registered in banks with the lowest loan payments.
4. This mechanism accelerates the process of deterioration of the performance of the entire banking sector because the largest amounts of deposits from large socially owned and state enterprises and liquidity loans from the Central Bank are directed towards banks that use them inefficiently. In this manner, indirectly, the growth of predominantly private banks is restricted as well.

Mechanism of Additional Capitalization of Formally Privatized Banks

Formally, privatized banks tend to increase loans at a rate faster than the growth rate of their total assets. For the above reasons, such banks need accelerated additional capitalization. They have frequently sought and obtained the approval of the National

Securities Commission for a public sale of new issues of their shares. (If, under such circumstances, there were a regular system of control of the reliability of financial reports and the prospectus of the issue, such banks would not have been able to use the mechanism of public offering.) The first obstacle for such behavior should have been the supervisory function of the Central Bank. Namely, in order for such a bank to keep its license, it would need increasing values of net capital and reserves for the compensation of potential losses. The National Bank of Yugoslavia has not carried out this supervisory function efficiently. The result has been a mass production of an increasing number of bank shares with a decreasing value. In this manner, an important instrument of the financial market and an important instrument of privatization, i.e., shares, has been compromised.

In actuality, the banks were not acquiring additional capital on the open market through public offerings. It was not possible to acquire additional capital in this manner because the value of the shares of the banks was not known. Such banks acquired additional capital by means of compulsion. The approval of loans was conditioned on the purchase of a certain number of the bank's shares. This mechanism acts in a compensatory manner with respect to the process of deterioration of the bank's assets. In this manner, the intensity of the acquisition of additional capital is limited by the degree of the banks' credit potential and by the degree of the "retention quota," of the portion of the approved loan kept by the bank. For this reason, even banks with predominantly private ownership used this mechanism. In addition, the capital-diluting effect of every new issue of shares was almost never taken into consideration. Subsequently, during periods when the majority of the credit potential was mostly determined by a directive allocation of deposits, banks with the greatest portion of unrecoverable loans in their assets had the greatest chances of additional capitalization. In this manner, additional investments into the banking sector were directed toward banks where they were used least efficiently.

Therefore, formal privatization restricts normal investment in the area of banking. The acquisition of additional capital is determined by the same institutional arrangement that causes the increase in unrecoverable investments. This fact is one of the reasons why there is a great number of midget private and quasi-private banks in Yugoslavia. Formal privatization leads to the finishing of a *circulus viciosus* that inhibit of development the healthy portion of the banking sector.

A way out of the *circulus viciosus* of formal privatization can be found in two possible ways:

- **The first one is a gradual change of the structure of ownership** by means of the regular circulation of shares that have already been issued on the stock market. The first condition for implementation of this strategy is the normalization of the behavior of owners in the banks (privatization of the owners) and activation of standard owner control in them. The second condition for implementation of this strategy is the positive and known value of bank shares on the market. Therefore, a significant improvement in the banks' performance and a normal dividend policy can lead to the formation of an autonomous mechanism for additional capitalization;
- **The second one is a radical, singular change in the structure of ownership and governance of the bank.**

Restructuring and Privatization of the Banks

Regulatory Reform and Classification of the Banks

The restructuring of the financial sector should begin with regulatory reform. The anticipated consequences of regulatory reform for the future course of the privatization in the financial sector are as follows:

1. Designation of banks that may continue unrestricted operations. This group of banks is capable of accepting private investments (by which the structure of their ownership is normalized) and deposits (by which their accelerated growth is made possible). Therefore, the regulatory reform will favor this group of banks.
2. Formulation of the conditions by which new banks may enter into the market is a necessarily. Regulatory reform must favor the entry of banks with a high rating and a low level of risk. It is desirable to introduce such banks into the Yugoslav market within a short period of time. In general, this can be done by establishing new banks with foreign ownership or purchasing some of the banks of the first group. For this purpose, it is desirable to revoke from the national legislation the principle of reciprocity. The establishment of new banks and their expansion, with the strict respect for prudential norms in the case of institutions and for ethical norms in the case of managers, is highly desirable.
3. The next step is classification of all banks into three groups. The designation of the banks should be made through the regulatory reform and a special (diagnostic) audit of their operation.

The choice between the main strategies for the change of the structure of ownership (evolution on the open market or radical strategy including nationalization and accelerated privatization) is determined by the amount of a given bank's net capital and the CAR (capital adequacy ratio).

Change in Structure of Ownership of Healthy Banks

Banks with a positive value of their net capital and a value of the capital adequacy ratio within the norm may change their structure of ownership autonomously and in an evolutionary manner. The duration of this process should depend on the duration of the process of privatization of their main owners.

The regulatory reform and special audit will designate a group of banks that meet all requirements necessary for the continuation of their operation. The anticipated consequences of the special audit and the new prudential norms with respect to this group of banks are as follows:

1. Changes in the net capital expected as a result of amending methods of risk evaluation and calculation of the net capital. In most cases, these changes will register as a reduction in the net capital due to an increase bad loans sum in their assets and insufficient reserves (provisions) for potential losses. A predictable consequence of this procedure will be the

necessity for additional capitalization of such banks. The majority of such banks will be able to accept additional capital and additional deposits from domestic and foreign markets;

2. Mergers and acquisitions of small banks that do not have the capacities to acquire additional capital within a short period of time. This mechanism is known in countries in transition as a consequence of the strengthening of prudential norms;

3. Listing of such banks on the secondary capital market and, subsequently, a normal change of their structure of ownership. The market determination of the value of the shares of such banks may lead to a quick dissolution of the relation dominant owner equal dominant debtor. For this reason, it is desirable to encourage such banks in the listing of their shares on the stock market. At the beginning, their number will be relatively small, but will gradually increase with the normalization of their activity.

Privatization of Insolvent Banks

Banks with a negative net capital are divided into two groups:

1. The operating permits will be taken away from banks with negative values of their net capital and capital adequacy ratio and with low budgetary costs of liquidation. The future fate of such banks will depend on the behavior of their current and future owners. They may be liquidated, merged with or acquired by bigger and healthier banks. Liquidation will take place in instances where the merger or acquisition of the bank (with its assets and liabilities) with or by another bank is not cost-effective. In this manner, a portion of the banking system will be privatized by a bankruptcy procedure and liquidation. If it is estimated that the bank is capable of continuing operation, its owners should carry out additional capitalization up to a level required by the norms of the Central Bank for re-issuance of its license. Domestic as well as foreign investors may invest into the capital of banks within this group.

2. The second group of insolvent banks differs from the first group by the high level of budgetary bankruptcy costs, which constitute liabilities the state would have to assume. Such banks should be restructured, temporarily nationalized and privatized within a previously set period of time. The key criterion for the designation of this group of banks is the level of budgetary expenses that would be incurred in the event of their bankruptcy. They have in their liabilities large amounts of debt to foreign creditors that is guaranteed by the state and the Central Bank. In the event of a bankruptcy, the total debt would be transferred to the taxpayers. The servicing of such high debts would, in the long term, origin a great budget burden for the economy and the citizens. (It is necessary to remind that a portion of the banks' liability based on foreign currency savings has already been transferred to the taxpayers.)

The main limitation for the application of this concept lies in the fact that the major portion of bad loans is concentrated in this group of banks, whose balance constitutes 60-70% of the balance of the entire sector. Also important is the fact that the portion of bad loans in the total amount of asset is among banks within this group far above a level that allows for their autonomous restructuring, be it in the form of additional capitalization on the open market or in the form of an acquisition by another bank. Therefore, this group of banks can be restructured only by means of a strong external intervention. The alternative is bankruptcy and liquidation.

Temporary Nationalization

Temporary nationalization of banks should be done simultaneously with the acquisition of additional capital. The key criterion for the efficiency of this strategy is the minimization of the state's budget expenses. In the event of a deep insolvency of the bank, a special audit would adjust the current condition of its capital downward. In order to be able to continue operation, such banks would have to acquire additional capital. The purpose of the acquisition of additional capital would be to **ensure**, within a new system of supervision, a **minimum positive value of the capital of the nationalized bank**, achieved within a certain period of time. In the event that the special audit determines that the losses are greater than the bank's capital, all previous rights of the bank's owners are to be suspended. In the event of a positive value of the bank's capital, the ownership rights of the previous shareholders are to be minimized. In this case, the state Agency for Bank Recovery is to become the owner of the controlling block or of the total stock of shares.

The purpose of this procedure is to enable the following:

- a) Temporary removal of the riskiest asset components in the bank's balance sheet by writing them off to the level of the capital;
- b) Accelerated recapitalization;
- c) Rational use of the budget funds allotted for this purpose. This principle is especially important for the conditions in Yugoslavia. Additional capitalization is to be carried out rationally for the purpose of minimizing fiscal expenses. In the first step, state investment is to be brought to a level that permits nationalization of the bank and a minimum positive value of the capital adequacy ratio. If it is possible to sell such a bank within a short period of time, then this should be preferable, regardless of the price offered. In this manner, later additional investments in such a bank can be avoided. If it is not possible to sell such a bank within a short period of time, the restructuring should continue, but to a level that is cost-effective for the state. The ratio between the invested funds and the anticipated price that may be obtained at the sale of such a bank should be used as a criterion for cost effectiveness. In order to minimize state expenses, it is necessary to limit the time for restructuring. In this manner, the procedure would necessarily end with the sale of the bank and the return of the invested funds to the budget.

Some possible techniques of additional capitalization of banks taken over by the state Agency for Bank Recovery are as follows:

1. Direct purchase of bank shares following the special audit and cancellation of the existing ownership rights. This procedure needs a relatively large amount of liquid funds. The potential source for funding this transaction is the EFSAL of the World Bank. If this arrangement with the World Bank is not ensured, it is unlikely that this technique can be widely applied during the first years of the restructuring process. In addition to additional capitalization, this technique enables the radical improvement of the bank's liquidity and restarts its credit activity. A key problem that may occur after such a transaction is the moral hazard in the sense that was previously described (non-commercial crediting of enterprises and banks according to political decisions). A broader application of this technique can be

expected at the later stage of the implementation of the program or in the event of the activation of foreign sources of funding for the purposes of restructuring and of domestic sources originating from the privatization of public and state capital.

2. The second way is additional capitalization through conversion of a portion of the dinar and foreign currency deposits of the bank into capital. During the initial phases of re-capitalization, while there is still a significant shortage of liquid funds, this technique can be used for a quick takeover of ownership control over this group of banks. A suitable segment of the foreign currency liabilities for conversion of this type are the so-called non-allocated foreign currency liabilities guaranteed by the state or foreign currency liabilities the final user of which is the bank itself. Such liabilities would be assumed by the state and, for the same amount, the Agency would become the owner of the bank's stock.

3. When the first and second method do not bring about significant amounts of capital for the takeover, a third method would be applied, which consists in individual arrangements for the purchase of those shares of the bank which are in control of high-risk debtors of the bank. This type of intervention would be carried out in two steps: the first step would involve the purchase of the high-risk loans of the bank in enterprise X, while the second would be the exchange of this credit for shares of bank A that are in the control of the enterprise X. In this manner, simultaneously with the additional capitalization, the bank's assets would be cleared of high-risk loans. A limitation of this solution is that it requires additional liquid funds.

A due diligence study is to be prepared with respect to each insolvent large bank that the Agency is to take control over. Such a study should identify the key weaknesses, the main strategy for restructuring and the necessary resources for bank intervention. If there were a possibility for the quick sale of the bank, such a study would be used as the basis to formulate the negotiation strategy with the strategic investor.

The main function of the Agency is the restructuring of the group of banks, where a market procedure (merger, acquisition, liquidation) is not attractive because it would cause socially intolerable costs. It can be predicted that this groups of banks would have to undergo two groups of changes. The first group is related to the transformation of ownership, and the second includes the following major changes in all banks:

- (a) Significant modernization of the management functions, including the treasury function, risk management and the modernization of the total banking product,
- (b) Restructuring and additional training of the management and employees,
- (c) Restructuring and reduction of non-interest expenses,
- (d) Modernization and development of information technology,
- (e) Additional training of employees,
- (f) More efficient control of credit activities, and
- (g) Changes in top management.

Privatization of Restructured Banks

In order to avoid the permanent nationalization of a major part of the banking sector, the restructuring procedure would necessarily end within the previously set period of 3-5 years with the sale of the bank. The arguments on behalf of this idea are as follows. The postponement of privatization of the banks was the cause of great damage in all countries in transition. The budget costs of continuous re-capitalization of the banks (measured in percentages of the GNP) are extremely high and vary from 6 to 54% of GNP. The main reasons for deferred privatization of the banking industry after its restructuring are as follows: a renewal of unrecoverable loans, insufficient structural preparedness of the banks for privatization and political indecisiveness. The idea that if the banks are not quickly privatized the result will be a new degeneration of the credit function of the banks (soft credit) and a renewal of bad debt is true with regard to all countries in transition. In other words, the structure of ownership dominated by the state does not allow for the complete commercialization of the credit function. For this reason, it is **necessary to strongly link the process of re-capitalization with the process of privatization**. The goal is to maximize the bank's value at the moment of privatization and reduce the possibility for any future intervention. Privatization is the only real option for a definite interruption of the tendencies for the renewal of bad debt.

A singular state resource intervention leads to short-term improvements in the balance sheet of banks, but does not stop the renewal of unrecoverable loans. Therefore, postponement of privatization makes the banks unattractive for potential strategic investors and increases the costs of restructuring. The strategic evaluation of the duration and the price of the process of "preparation" for privatization by means of additional capitalization, internal restructuring and modernization of the procedures is crucial for every bank within this group. Typical is the case of Hungary, where, after a series of expensive additional capitalization procedures and negative experiences with the privatization of financially and organizationally unmanageable banks, a strategy for the preliminary preparation of the banks for privatization was accepted. Therefore, a certain degree of restructuring of the banks is desirable and even necessary prior to beginning the privatization procedure. This is particularly the case when there is an expectation of a substantial influx of foreign strategic investors. The privatization experience of large banks in the Czech Republic and Poland confirm this thesis. After this experience it became clear that as long as a strategic investor is counted on, a certain restructuring of the banks is necessary in order to make them sufficiently attractive to be purchased. Of course, in the case of a country with a high current and future budget deficit, the most suitable, though highly unlikely, alternative is the sale of the bank before it has been restructured.

Prior to the sale, the banks would have to undergo drastic procedures for to cleanse their credit portfolio and reduce their labor overhead and operating expenses; only after that can they be sold to strategic investors. In this manner, in most countries in transition, high revenues were earned for the state, political control over the banks disappeared, and the banks were re-capitalized and obtained new owners interested in capital gains rather than in debtor's profits. Most importantly, this type of privatization enabled the introduction of intense competition into the banking sector, which had a positive effect on the faster development of the banking sector on a market basis.

Anticipated Consequences of Bank Privatization and Choice of Privatization Method

The most important result of bank privatization has to be the commercialization of the basic functions of banking. If it is not achieved, a non-market credit allocation is predictable. This finding is confirmed by the experience of the countries of the Visegrad Group even nowadays, at the advanced stage of transition. This puts the banks at the focus of the process of an efficient transition because ensuring disciplined banks is the only way of disciplining the enterprises as well.

Another important consequence is the renewed confidence of the government, the household and the corporate sector in the financial institutions, particularly the banks. This phenomenon would bring benefits for all groups of subjects: greater tax revenues through the increased level of business for the state, returns from deposits and consumer credits for the household and an increased credit supply for the corporate sector.

The third group of consequences is related to modernization of banking activity. The Yugoslav banking system offers to its clients a very narrow register of products and services. Privatization and the entry of large first-class banks into the national market have to bring about a radical increase in the quality and quantity of services provided.

Three main methods for the privatization of financial institutions are used under the circumstances of transition. They are:

- a) Initial public offering (IPO),
- b) Sale to a strategic investor, and
- c) Combination of a sale and free distribution.

Sale through an IPO implicates the previous establishment of the price. The a priori formation of the price hides the risk of undervaluing or overvaluing the shares. If the price is formed based on a tender, this risk is reduced. A condition for reduction of this risk is regulatory reform, which would reduce the existing high systemic risks and increase the demand by the potential buyers at the tender.

The problem of the price arises also in relation to privatization by means of a sale to a strategic investor. The political costs of this method are even higher than in the case of the IPO. However, the sale to a strategic investor has a significant advantage in that it does not depend on the level of development of the national capital market. In other words, underdeveloped and shallow capital markets are not able to absorb large issues of shares and ensure their liquidity.

Experience shows that when foreign strategic investors were more substantially involved in the privatization of banks, the results obtained were far better (Hungary) than in the case of implementation of a mass privatization program (the Czech Republic). The sale of banks to strategic investors has an additional benefit as well – the quick and radical restructuring of the banks through the transfer of relevant knowledge and skills. This, in turn, improves the level of competition in the banking sector.

The key disadvantage of the method of sale to a strategic investor lies in its slowness. This may cause the occurrence of a moral hazard in banks that have already been restructured and, subsequently, may increase the budget expenses for their restructuring. Therefore, most successful seem to be the “electric” programs that combine an IPO (wherever possible) with the sale to strategic investors. Such was the experience of Poland: when some of the banks were sold to strategic investors and some were sold by means of an initial public offering.

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