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## Corporate Governance in Serbia: The State of Reforms After Five Years

Center for Liberal–Democratic Studies

### Article at a glance

- Five years of corporate governance reforms in Serbia reveal a mixed picture of progress and persistent shortcomings.
- The Center for Liberal-Democratic Studies (CLDS) has been working with the Serbian private sector to gauge the current state of corporate governance and produce concrete reform recommendations.
- Corporate governance reforms can only succeed if they are a part of a larger systemic transformation that builds the institutions of good governance and market economy.

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## Introduction

In 2003, the Center for Liberal-Democratic Studies (CLDS), an independent economic think tank and CIPE partner based in Belgrade, surveyed the state of corporate governance in Serbia and identified key reform priorities.<sup>1</sup> At that time, the predominant form of ownership was socialist, with all the associated inefficiencies and governance issues in the sense of public and corporate governance. Management usually reported to the state or ruling party, or employees, or self-reported, and the private sector had only begun to take root with onset of privatization. Whether public or private, large or small, firms lacked formal structures for ensuring accountability on a daily basis.

Along with indentifying a very poor corporate governance situation, the survey also suggested a way forward. It promoted and advocated extensive reform of Serbia's overall institutional environment – from efforts to establish the rule of law and strengthen institutions (particularly the judiciary) through important amendments to corporate and financial legislation, all the way to changes of regulations in various aspects of economic life (ownership, accounting and audit, competition, anti-corruption activities, and others).

In 2008, CLDS conducted another survey to monitor the progress and to investigate what else could be done in this important area of the country's transition. In the last five years, more state-owned enterprises have been privatized; regulatory innovations have been introduced; new laws on corporate governance and business operations have been passed.

Yet the new survey revealed that firm-level implementation and understanding of these new laws remains incomplete and that larger institutional and governance problems persist, making Serbia's business environment challenging. Just as its predecessor, the 2008 survey also provides concrete reform recommendations to move corporate governance reform in Serbia to the next level – the level that goes beyond just introducing relevant corporate governance laws and structures and instead focuses on following their spirit and

implementing their substance.

Serbia's systemic transition since the dissolution of Yugoslavia has been a long and often challenging process. Building the institutions of market economy is at the core of this transformation, necessary not only to stimulate growth of the private sector but also to improve governance. In that context, constructing a sound system of corporate governance is an important element of reforms, since it is both a precondition for making sound business decisions in a market system and a way to ensure that those decisions occur in a transparent and accountable way.

## The Problem of an Incomplete Transition

As in many other transition countries, the main goal of early economic reforms in Serbia was to change the motivation of corporate operations by replacing state ownership with private ownership. Before the beginning of the true<sup>2</sup> transition in 2000, Serbia nominally boasted many common market economy institutions, such as laws on property and its protection, on companies, on foreign investments, anti-monopoly laws, laws on accounting and auditing, commercial banks, exchanges, customs-free zones, courts, arbitrations, chambers of commerce, trade unions, etc. However, that economic system was not a true market system. The laws were often bad or not applied, and the state retained de facto control of most economic entities.

During the 1990s, serious difficulties hampered the work of Serbian governments both locally and in the international context. The problem of Serbia's cooperation with the Hague Tribunal (after the Balkan conflict) adversely affected the stability of not only the governments and the ruling coalitions in all these years, but also the relations with the international community. Meanwhile, severe political battles were taking place domestically between competing parties fueled by two unresolved problems Serbia inherited after old Yugoslavia broke up. The first was the relationship with Montenegro within the new Yugoslav union, and the second

was the issue of the future status of Kosovo and Metohija. These issues diverted crucial political energy from the economic transition.

Serbia was left with a legacy of not just the decades of communism but also an unfinished and deeply flawed transition. Nominal market institutions introduced during the original round of reforms were not functioning. Therefore, the main challenge of the reforms undertaken after 2000 was not to establish the market from scratch but rather to improve it through stronger incentives for transparency and accountability in privatized enterprises. This is where corporate governance came into play.

## Corporate Governance in Serbia Today

During the last five years, most of the so-called socially owned capital in Serbia was privatized in the commercial sector of the economy, together with the financial and banking sector. Privatization has, undoubtedly, brought about essential changes in corporate governance, since the new private owners have introduced healthier market incentives. Yet the predominant manner in which privatization in Serbia has been accomplished – by sale of 70 percent package of shares to a single investor – has decisively skewed the ownership structure and management model, benefiting the majority owner who has both the ways and means to control the company management firmly. Thus, instead of the conventional principal-agent problem that underlies the need for corporate governance rules in the first place, the principal-principal issue emerged as the predominant one in Serbia – the challenge of protecting a minority owner from expropriation.

According to Serbia's laws, privatization automatically meant a company's transformation into an open joint stock company, meaning that small businesses such as local hairdressing parlors were given the same complex legal form as large companies. This onerous solution was unsustainable in the long-term. In the post-privatization period, further concentration of ownership continued due to insufficient protection of small shareholders, the aspiration of controlling owners to increase their

share package, and the desire of most employees to dispose of their shares since they were not genuine investors.

In 2004, the new Company Law was enacted, harmonizing Serbia's laws with OECD corporate governance principles and EU directives. In 2006, Serbia adopted new laws in the area of finances (on market of securities, takeover, investment funds) that have generally improved the capital market and financial sector as a whole. The Serbian Chamber of Commerce has also attempted, with limited resources, to promote voluntary codes of corporate governance. Following the Western model, these codes are meant to complement statutory regulations with voluntary self-regulation in the interest of investors.

The main reason for continued poor corporate governance performance is the fact that most Serbian firms are joint stock companies not by intention, but by the force of the original privatization law. They do not raise new capital on the market. Instead, they trade in shares primarily aiming at the change of their status – from an open/public joint stock company to a limited liability company, which is much simpler and less costly to operate. When new capital is not raised at the market, the strongest motive for proper corporate behavior and maximum transparency to improve the reputation and rating is not even present.

Corporate governance in Serbia at this point remains in a transitional phase with only partial normalization of ownership and status structure. Shares change hands from employees to proper investors, and owners of most joint stock companies want their status changed to become limited liability companies. These circumstances undoubtedly affect the nature – and cause weaknesses – of corporate governance in Serbia.

## Survey of Corporate Governance

The purpose of the 2008 study was to evaluate changes since 2003 and produce new reform recommendations. This analysis relied on two pillars. First, CLDS gathered empirical data based

on a special survey designed for this study and data on change of ownership structure through publicly available information on market trading. The second pillar comprised the analysis of legislation pertinent to corporate governance. Combined, those two elements led CLDS to formulate specific suggestions on how to improve corporate governance in Serbia.

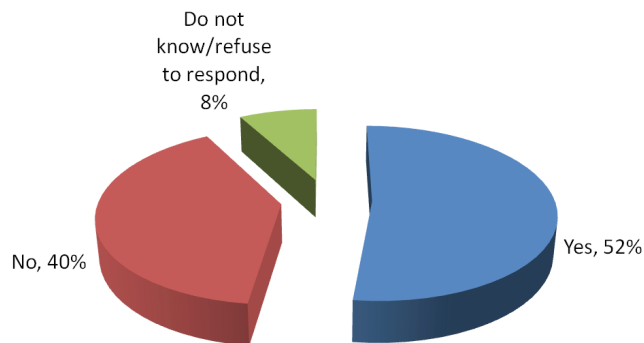
The surveyed sample comprised 214 joint stock companies. CLDS selected only joint stock companies since they primarily encounter corporate governance problems based on separation of ownership from the management. They also account for the predominant part of the Serbian economy not only in terms of turnover, but in absolute number as well, given that all privatized companies in Serbia have been turned into joint stock companies.

Among these 214 companies, 91 belong to the industry sector; 68 to trade; 33 to construction; and 22 to finance. Among them, 62 firms have up to 25 employees; 56 firms between 26 and 100 employees; 43 firms between 101 and 250 employees; and 53 firms employ over 250 staff. Geographically, 60 of the surveyed companies are located in Vojvodina, 77 in Belgrade, and 77 in Central Serbia.

Most of the surveyed companies have become joint stock companies through the privatization process, 68 percent; 17 percent were re-organized from another legal form; and only 15 percent were set up as joint stock companies from the very beginning. These percentages illustrate that this legal form is intentionally selected by only about a third of joint stock companies while for a vast majority (over two thirds) privatization was the decisive factor. They have become joint stock companies by force of law, not economic rationale, a process that has contributed to corporate governance problems.

Concentration of joint stock company ownership in Serbia is an interesting issue, since it is an important determinant of both the problems and the methods for improving corporate governance. Thirteen percent of companies have up to eight owners, and additional 18 percent from nine to 50 owners; 28 percent reported 51 to 500 owners;

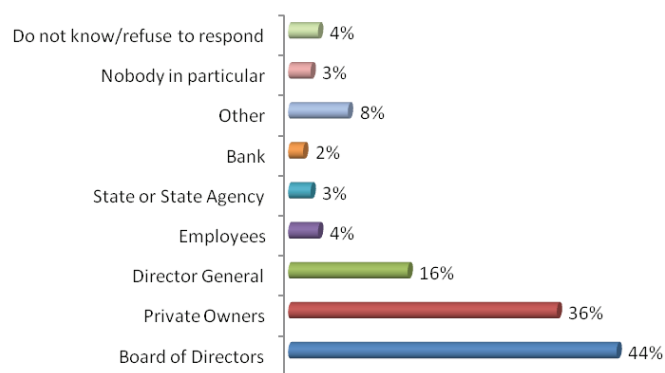
and 31 percent reported over 500 owners. These numbers suggest fairly dispersed ownership. An alternatively formulated question shines a different light, one that properly frames the corporate governance discussion for Serbia: When asked whether they have owners of ordinary shares with over 66.7 percent of the shares survey subjects gave the following answer:



At least 52 percent have owners with over two thirds of shares, or ownership. Naturally, this is a consequence of the privatization mode resorted to in 2001, where one investor purchased 70 percent of socially owned capital. When asked if they have any owners with between 50 and 66.7 percent of ordinary shares, 11 percent of companies confirmed, meaning that 63 percent of joint stock companies in Serbia have a majority owner. This concentration of ownership may be described as high even in comparison with conventionally understood European shareholding model.

For corporate governance it is important whether the managers own shares or not. If they do, they are likely more interested in the company's long-term profitability. If the stake is substantial, however, the management may expropriate the minority shareholders for its own benefit. In Serbia, 28 percent of company managers in the CLDS sample do not own any ordinary shares; in 15 percent of companies, the management owns up to 25 percent shares; only in 14 percent of joint stock companies, the management owns majority shares, meaning that the majority owners have taken over operational management of the company. Of note, 42 percent of respondents did not know or did not want to talk about the percentage of ordinary shares owned by the management.

Distribution of competences, or power, among the bodies of joint stock companies in Serbia generally follows not only the legislation in place, but the one common in countries with mature shareholding systems: predominance of the Board of Directors over the management is quite salient. Nevertheless, such competence distribution does not illustrate sufficiently the true, informal impact of one body on another, such as frequently strong influence of the General Manager, or Director General,<sup>3</sup> on the Board of Directors. The purpose of CLDS survey was to identify the true influence, both formal and behind the scenes. In order to precisely define such influence the following question was asked of the respondents: ‘Which of the parties listed below effectively controls the company, where such control implies actual decision-making relating to most important company matters?’ The responses were distributed as follows (multiple responses were accepted):



Such distribution of responses may, generally, fail to identify primary decision-makers in the companies, since in countries with dispersed ownership structure it is not quite sure who controls the Board of Directors: shareholders or the management. Nevertheless, in Serbia these dilemmas are not present since most owners have no major problems with the management. Managers dominate joint stock companies either directly or through the Board of Directors, and make key decisions in their own interest. Boards of Directors, at least in companies privatized pursuant to the 2001 law (majority) were elected by the only majority owner and, undoubtedly, operate favoring interests of the majority owner.

Limits on the board’s power and control were also reflected in inadequate access to information, which is a prerequisite to successfully running a business. When asked whether Board of Directors members have access to all company information and documentation, in 90 percent of surveyed companies at least one board member said they still do not understand who manages the company. This shows that managers commonly and successfully marginalize their Board of Directors. That it is partly a remnant of the past, self-management era, where the General Manager was the only true power, and partly a realistic balance of power in most Serbian companies in which the General Manager prevails. Many board members also simply fail to understand that they are in charge of company affairs and chose to believe that the Board of Directors is just an advisory body to the General Manager, which they find agreeable since it is an easier job requiring less effort and ability.

Only in 4 percent of companies do the employees still have the true control of the company, suggesting that the era of self-management is definitely left behind. It is present only in the companies privatized pursuant to pre-2001 laws where shares were distributed to employees, making them the main owners and accordingly company managers.

The survey also probed attitudes toward corporate governance. The international corporate governance standard is the one proposed by the OECD. In Serbia, a half of the respondents were familiar with the Principles of OECD Corporate Governance, while 47 percent were not. CLDS also investigated the opinion of respondents on the state of corporate governance in their company, in Serbia as a whole, and regarding legislation pertinent to corporate governance. They graded them as follows, with 1 indicating poor and 5 excellent:

State of corporate governance in own company	3.2
State of corporate governance in Serbian companies	2.8
State of legislation pertinent to corporate governance	2.8

The difference between the evaluated quality of corporate governance in one’s own company and other joint stock companies is quite interesting.

With perfect knowledge, the difference should not be present. Nevertheless, if one assumes that the respondents are more familiar with the situations in their own companies than in the other, the conclusion may be that the state of corporate governance in Serbia is better than it is generally assumed.

The respondents also recognized the following main obstacles in promotion of corporate governance in Serbia: lack of knowledge and information (36 percent of respondents), ineffective corporate legislation (16 percent), and corporate governance information withheld as business secrets (13

percent).

## Remaining Corporate Governance Reform Priorities

In the past seven or eight years of transition, Serbian legislation has been reformed in the direction customary for market economies. Serbia today boasts new economic legislation: beginning with financial regulations, to laws governing registration of companies and bankruptcy, laws governing other fields (taxes, customs duties, banking, insurance, accounting, auditing, etc), as well as a new constitution which provides a modern framework for main economic relations.

However, the quality of economic legislation is inconsistent. Some laws are very well written (such as the Company Law), but there are many other laws that are not at that level (e.g. some laws in the area of finance). Regardless of weaknesses, current economic laws are not the main problem: more important are the shortcomings in their implementation. The weaknesses in the executive power and the judiciary are particularly conspicuous.<sup>4</sup>

As a result, the state of corporate governance in Serbia remains far from commendable and requires continued reforms. A considerable number of enterprises are not yet privatized, particularly in infrastructure, telecommunications, and energy, and those socially owned enterprises or companies with mixed ownership continue to suffer from massive losses. The old socialist mechanisms of governance based on state ownership and strong political interference still prevail in terms of strategic decisions and appointment of CEOs. Despite the normative arrangements on the dominance of boards of directors and shareholders' meetings, the CEO remains the most important decision-maker. Soft budget constraints are also still in place, as is overdependence on state subsidies, absence of bankruptcy proceedings, lack of transparency, and poor accountability for business operations.

The shortcomings of corporate governance in Serbia remain a major problem. Significant

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## The Key Conclusions of the CLDS Survey

- The predominant legal form of companies is an open/public joint stock company, produced by the transitional legal process that transformed former socially owned companies through privatization into open/public joint stock companies, placing 70 percent ownership into one shareholder's hands.
  - This ownership structure makes main problem of corporate governance in Serbia principal-principal problem, not the principal-agent relationship with dispersed ownership, as it is in Anglo-Saxon world and elsewhere. In Serbian joint stock companies there is an undisputable majority shareholder who appoints and controls the management.
  - In Serbia, the main corporate governance body is the Board of Directors, instead of the management.
  - The relationship between the majority and minority owner may be perceived as a bigger problem, since the former has motives and opportunities to expropriate the latter, due to poor legal protections for minority shareholders and a weak judiciary.
  - Conflict of interest among managers of joint stock companies is fairly widespread, with both knowledge and approval of the company bodies and without.
  - Joint stock companies do not make an effort to inform the public and potential investors on own performance, most probably caused by a very low level of interest to raise new capital by the issue of new shares.
  - Managers in Serbia are aware of weaknesses of corporate governance, but less willing to admit it in their own than point out in other companies.
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improvements were expected from the privatisation and the companies' passing from the hands of political party officials to the hands of private owners who would be more motivated to perform well and to improve the operations of their company. However, privatisation was not and is not a cure-all. In and of itself, privatization does not bring about better governance. Without proper rules and mechanisms by which a company can operate when the ownership is separate from control, the opportunities for abuse, mismanagement, and corruption abound just as they did under state ownership. Without better rules and mechanisms, old habits in how companies had been previously run – and mismanaged – are difficult to change.

The most obvious problem of privatized companies in Serbia is the expropriation of minority shareholders by the majority one(s), either through pulling out money from the company or through share dilution. What is more, the economic legislation is not entirely well reformed, which sometimes puts wrong incentives into the legislative framework for corporate operation. The Company Law of 2004 regulating corporate governance in a modern way has been much praised, but it leaves room for further improvement. Moreover, its provisions could not completely change the corporate governance system in Serbia in such a short time, especially if other important laws are still not up to par (e.g., the Law on Securities Market).

CLDS proposed improving the Company Law by removing some of the shortcomings and imprecision recognized in this law over the four years of its application. CLDS suggested complete personal separation of the Board of Directors from the Executive Board,<sup>5</sup> which would be more in line with the underlying philosophy of this piece of legislation. CLDS also believes that greater mutual harmonization of this and other laws (on accounting and audit, securities, etc.) is necessary. The Law on Securities should be corrected in at least two important segments: the first is the issue of poor quality securities originating from privatization, and the second is better organization of the Securities Commission. CLDS also suggests adoption of the

new Takeover Law.

A larger underlying problem is that corporate governance cannot work well when weaknesses persist in the functioning of key government authorities and the judiciary. The institutions in Serbia, even the most important ones, are not sufficiently strong and efficient to perform their proper functions in a market economy: provide a stimulating, well-regulated environment for entrepreneurship and ensure the execution of proper rules of business conduct.

Another line of reform activity in the public sector could focus on strengthening implementation of the law (judiciary) and other rules (Belgrade Stock Exchange and other regulatory agencies). In Serbia, the greatest weaknesses are identified in this area and they prevent the system of corporate governance from functioning properly. For example, the law prohibited the use of insider information long ago, but nobody has ever been sanctioned for doing so, and it is a common knowledge that huge fortunes have been made on the basis of insider information. These and similar cases clearly support the notion that “crime pays,” which is a disincentive to rule of law and socially responsible behavior.

As for the private sector, various programs could be initiated, such as:

- Activation of voluntary codes of corporate governance that have been proven successful in some countries; the current ones may be revitalized, compiled by the Chamber of Commerce, and new may be formulated in proper consultation with joint stock companies; the principle “obey or explain” could be very powerful in this respect, where aberration from the rules stipulated in the code is quite acceptable as an expression of voluntarism and autonomous right of a company but the aberration needs to be explained.
- Establishment of the rating system to measure the quality of corporate governance to try to really measure the level of corporate

governance in certain companies; the rating could become quite influential in the business community, with rating agencies, and among investors.

- Training of owners and managers on corporate governance, where good models and good practices could be explained to those who could then implement them.
- Public advocacy on the need to promote corporate governance and the ways to do so.

## Conclusion

The aim of corporate governance should be to maximize long-term value of the shares by improving the decision-making processes and the performance of joint stock companies through good structure of relationships between investors, managers, and other stakeholders (creditors, clients, and employees). It requires the establishment of rules and incentives that serve the company's best interests, and at the same time respect all duties to other participants.

In Serbia, the normalization of ownership and status structure is a key requirement for further progress of corporate governance. The final transfer of shares from the hands of employees to the hands of investors will end the conflicts between the group of employees that are also shareholders and the controlling owner over issues that are not directly related to operations and should be the prevue of trade unions (negotiating salaries, employment security, etc.). Further, conversion of joint stock companies, particularly the small ones, into limited liability companies will simplify the managerial structure by getting the owner closer to the operational management and narrow down the areas of corporate governance problems.

Upon completion of normalization, the role of capital markets and banks will be greater as a source of new capital. The reputation of joint stock companies will also become increasingly important for those that hold the capital they count on. Many of the remaining joint stock companies will search for additional capital, but other new joint stock

companies will be set up from scratch or when prosperous limited liability companies go public. The importance of good corporate governance will rise in parallel, since it is a major if not the decisive factor of credit worthiness and investment decisions.

Good corporate governance contributes substantially to improved company performance and its image in the outside world. It is not, therefore, primarily an issue of legal obligation or business ethics but the key aspect of protecting the interests of a company and its shareholders. The greatest progress in improving corporate governance may come by the effort of joint stock companies themselves. While corporate governance in Serbia is on a decent level in companies that are owned by foreign reputable companies, there is much room for improvement in locally owned companies. As substantiated by the survey conducted by CLDS, bolstered by anecdotal evidence, many members of company boards of directors have either insufficient knowledge on corporate governance and associated issues, or have no pertinent knowledge whatsoever. Accordingly, no system of company management cannot function well, regardless of the level of compliance with the relevant legislation, if owners and managers do not understand their basic roles.

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## Endnotes

- <sup>1</sup> *Unapređenje korporativnog upravljanja (Improving Corporate Governance)*, CLDS, 2003.
- <sup>2</sup> The original transition in Serbia and in the entire Yugoslavia of that time started in 1990, but it merely resulted in a transformation of defunct socialism into a degenerated market/administrative system. A more in-depth market-oriented transition started only in 2000.
- <sup>3</sup> Director General of the company, elected by the Board of Directors, chairs the Executive Board. Thus, the Executive Board Chairperson is also the company Director General, but the Director General may also be the Company President and Board of Directors Chairperson as well.
- <sup>4</sup> For more details, see *Reforme u Srbiji: dostignuća i izazovi (Reforms in Serbia: Achievements and Challenges)*, CLDS, 2008.
- <sup>5</sup> Any public company has to set up the Executive Board composed of executive managers. The Executive Board members, i.e. executive managers are elected by the Board

of Directors, which may dismiss them at any time, without any limitations whatsoever.

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*Center for Liberal-Democratic Studies (CLDS) is an independent think tank based in Belgrade. CLDS elaborates and publishes public policy proposals and organizes seminars and lectures on topical policy issues as part of its mission to influence the public policy issues in Serbia.*

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