# Post-conflict Privatisation: A Review of Developments in Serbia and Bosnia Herzegovina

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# Acronyms

| | |
|---|---|
| BiH | Bosnia Herzegovina (comprising two entities – FBiH and RS) |
| CIS | Commonwealth of Independent States |
| CMEA | Council for Mutual Economic Assistance |
| DFID | Department for International Development |
| DS | Democratic Party |
| DSS | Democratic Party of Serbia |
| EBRD | European Bank for Reconstruction and Development |
| FBiH | Federation of Bosnia Herzegovina (one of two entities that make up BiH) |
| FRY | Federal Republic of Yugoslavia (became Serbia and Montenegro in 2003) |
| FYROM | Former Yugoslav Republic of Macedonia |
| GDP | Gross Domestic Product |
| GMP | Gross Material Product |
| IFC | International Finance Corporation |
| IFI | International Financial Institution |
| IPF | Investment Privatisation Fund (Czech Republic) |
| IPO | Initial Public Offering |
| KM | Convertible Marka (currency of Bosnia Herzegovina) |
| MAP | Monthly Analyses and Prognoses |
| MEBO | Management and Employee Buy-out |
| NATO | North Atlantic Treaty Organisation |
| OHR | Office of the High Representative |
| PIF | Privatisation Investment Fund |
| POS | Public Offering of Shares |
| PRSP | Poverty Reduction Strategy Programme |
| RS | Republika Srpska (one of two entities that make up BiH) |
| SFRY | Socialist Federal Republic of Yugoslavia |
| SME | Small and Medium Enterprises |
| TVE | Township-Village Enterprises |
| UN | United Nations |

# Exchange Rates

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|---|---|
| **Bosnia Dinar/KM per DM** | | | | | | | | |
| Exchange rate (annual average) | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 |
| **Serbia Dinars per US$** | | | | | | | | |
| Exchange Rate (official end-year) | 4.7 | 5.1 | 5.9 | 10.0 | 11.7 | 63.2 | 67.7 | 59.0 |
| Exchange rate (official annual average) | 1.8 | 5.0 | 5.7 | 9.3 | 11.1 | 33.0 | 66.8 | 64.2 |

*Source*: EBRD Transition Report

# Executive Summary

This paper is concerned with the effects of privatisation in South-East Europe, focusing on the experiences of Bosnia Herzegovina and the Republic of Serbia. The emphasis of the research is on the micro-level effects of privatisation. At the enterprise level, privatisation, which originated in industrialised countries, is intended to lead to greater internal efficiency. The policy is also associated with macroeconomic objectives as privatisation is expected to contribute to improvements in resource allocation, to bring in revenue from sales and to reduce fiscal demands on the state. In the countries of Central and Eastern Europe and the former Soviet Union, much was expected of privatisation which was seen as a cornerstone of economic transition. In this context, privatisation was perceived as the means by which a private sector could be created, and was intended to bring about economic development as state enterprises were transferred to dynamic private agents, thereby creating a property-owning class which would demand the appropriate legal and institutional framework and the rule of law.

Initially the view was that privatisation should be carried out quickly by transferring shares in state enterprises to citizens for a nominal fee in order to create wide-scale share ownership. Subsequently it emerged that, while such methods quickly dissipated state control and achieved (at first) political support, without an effective institutional framework (taken for granted in industrialised economies) they failed to generate an effective system for corporate governance. Ownership was widely dispersed among shareholders who had little capacity to monitor the operation of privatised enterprises. Subsequently, greater credence has been given to a more gradual, case-by-case approach to privatisation. Aside from the effects of privatisation, overall the results from transition policies have been disappointing. While the countries of Central and Eastern Europe have experienced some economic improvements, those of the Commonwealth of Independent States (CIS countries – i.e. those that were part of the former Soviet Union) have seen a major economic decline since the start of transition.

There have been many empirical studies into the effects of ownership change in transition economies, ranging from cross-country studies of thousands of enterprises to detailed case-studies of individual firms. Research generally compares privatised with state-owned enterprises or looks at developments within privatised enterprises over time. Most studies concentrate on financial indicators of performance, but some look in greater detail at the effects of privatisation on the internal workings of the firm (Carlin et al., 2001; Estrin and Angelucci, 2003). Empirical research into the effects of privatisation faces a number of significant challenges which studies have attempted to address by various means. For example, there is a self-selection bias in that the firms that are the first to be privatised are often those that have been performing well before privatisation. Similarly, the direction of causality may be difficult to infer, since while privatisation may appear to have an impact on performance, it may be the underlying performance of the enterprise that determines whether or not it is privatised. The effects of privatisation in transition economies have been mixed. Much of the literature suggests that, of all privatisation options, sale to foreign investors is the preferred option, while transfer of ownership to 'insiders' (managers and employees) emerges as in general the least effective form of privatisation. One important feature to emerge from the research is that the timing of the analysis affects the empirical results as ownership structures and privatisation impacts evolve over time.

The paper looks at the effects of privatisation on a sample of enterprises mainly in the manufacturing sector in Bosnia Herzegovina and the Republic of Serbia. Both of these states were part of the former Socialist Federal Republic of Yugoslavia (SFRY) which had a unique structure of economic organisation based on worker-ownership instead of the centrally planned system that was common in other transition economies. Unlike in many Eastern European countries, enterprises in the former SFRY enjoyed considerable autonomy and

traded with Western economies. SFRY was one of the first transition countries to introduce privatisation based on the sale of shares to 'insiders' in 1989. In the early 1990s the republics of SFRY separated and both Serbia and Bosnia Herzegovina endured several years of devastating conflict. As a result, the transition process has been about far more than adjusting to a market economy. Both Serbia and Bosnia Herzegovina have had to adapt to the redrawing of national boundaries in a way that has meant radical changes to industrial supply chains, markets and employment. Both suffered greatly from the war and, in the late 1990s, were approaching transition from a much weaker economic base than when privatisation had first been introduced ten years earlier.

While there is much shared history, Bosnia Herzegovina and Serbia have had different experiences with privatisation. Bosnia Herzegovina (with extensive input from international advisers) implemented a programme of 'mass privatisation' in the late 1990s which was adopted largely for political reasons and which, while promising much, created dispersed ownership and weak corporate governance, with the value of shares falling substantially. The country has now adopted a revised approach to privatisation, with the aim of selling majority stakes in selected medium-sized and large-scale enterprises to strategic investors. Progress with this new programme has so far been extremely slow. Privatisation is still seen as a policy which has major economic significance and is perceived, particularly by donors and investors, as an indicator of government commitment to reform. In Serbia, a series of laws were passed in the 1990s which were based on insider ownership but, since a change of government in 2000, the approach has been to sell enterprises to strategic investors. The programme made substantial progress in the first three years but the best enterprises have now been sold – raising substantial amounts of revenue – and it is likely that privatisation of the remaining enterprises will be considerably more difficult, as these are less attractive to investors.

The republics of the former Yugoslavia were among the first transition economies to implement privatisation as far back as 1989. However, in Bosnia Herzegovina and Serbia the subsequent conflict meant that little was achieved until after the war, with the introduction of revised privatisation programmes in the late 1990s. This paper is concerned with the post-war privatisation experiences, but the policy has been implemented only relatively recently. Hence it is too soon to identify a definitive privatisation impact, although some conclusions can be drawn. While the results can only provide an indication of preliminary developments, the findings are of interest to policy-makers and donors as privatisation continues to be challenging and is by no means completed. Furthermore, the issues arising from this research have implications for other policy-makers considering reform of the industrial sector in post-conflict economies.

The paper explores the relationship between different privatisation methods and policy outcomes in medium-scale industrial enterprises in Serbia and Bosnia Herzegovina for alternative categories of investor. It also considers the effect on the enterprises surveyed of the years of conflict and the break-up of the SFRY. The research framework draws on the work of Carlin et al. (2001) and Estrin and Angelucci (2003), in that the focus is on internal changes implemented within the firm, and this is supported by a review of performance indicators. A survey was carried out of 40 privatised enterprises (19 in Bosnia Herzegovina and 21 in Serbia) covering more than 23,000 employees (before privatisation). The aim was to limit the survey to the manufacturing sector but this proved too restrictive in Serbia where the privatisation programme had only recently started. The analysis is based on both quantitative and qualitative data. The results were categorised in Bosnia Herzegovina by investor type and privatisation method. In Serbia, all enterprises were privatised by a similar method (tender or auction). Survey responses were analysed according to investor type.

There was a considerable diversity of experience with firms reporting both strong positive and negative effects from privatisation. Overall, the findings indicate that privatisation has so far brought little improvement in the financial performance of enterprises in either state, but this is not unexpected as many of the firms in the survey had only been privatised for one or two years. However, most firms that responded had already achieved significant increases in the volume of production in the short time after privatisation. Furthermore, the majority of firms had implemented internal restructuring measures that could be expected to improve performance in the future.

In contrast with much of the literature on privatisation in transition, the findings did not indicate a substantial difference in outcomes when analysed according to the nature of the investor. In Bosnia Herzegovina over half the firms that responded had been taken over by employees (11 out of 19). The results from sales to this investor group were not substantially different from those to foreign or domestic investors. The category of employee owner was sub-divided according to privatisation method and it emerged (although sample sizes were small by this stage) that more restructuring was introduced in firms that had been transferred to employees by tender than those privatised to employees through vouchers or through direct sales following failed tender attempts.

This implies, then, that insider privatisation can be beneficial but outcomes depend on the capacity and the motivation of the insiders. In effect, tender privatisation, which requires employees to raise finance to buy the firm, can be interpreted as a fairly stringent procedure for screening the more proactive and resourceful enterprise managers. Privatisation by vouchers, which is a less demanding process on the part of the insiders, has resulted in little restructuring. This could be interpreted as an indication that the insiders who became owners by this method are not so suited to enterprise ownership as those who followed the tender route. This would imply that 'insiders' are not a homogenous group. Some workers and/or managers are effective enterprise owners and some are not. The findings are in keeping with other research that indicates that employee buy-outs are more successful where the employees have to pay for the enterprise rather than are given shares for free (Wright et al., 2002).

Privatisation in a country emerging from conflict presents significant challenges. There are reasons outside the scope of the enterprises themselves why it has been and will continue to be difficult to attract investors to parts of South-East Europe. These countries have only existed for a little more than ten years. Incomes are low, political stability is fragile and the institutional framework is still evolving, all of which are deterrents to investors. The diverse experiences of Bosnia Herzegovina and Serbia with privatisation suggest that the policy impact in a post-war context depends on the nature of the economic and political climate as well as the privatisation programme itself. However, both countries are now in the position of trying to find investors for a number of less attractive medium-scale state-owned enterprises. Privatisation policies generally fail to provide a solution for firms that are not easily sold, beyond the belief that privatisation of the better performing firms will contribute to general improvements in the wider economy that will ultimately benefit all.

There is a danger that a narrow focus on ownership change can obscure the wider goal of economic development. A completely 'market-led' approach to privatisation would interpret the failure to secure an investor as an indication of the lack of viability of a business and hence the solution would be to liquidate such an enterprise. However, the absence of an investor may also be a reflection of the wider economic and political climate. With privatisation to a strategic investor as the only policy option, potentially viable enterprises may be forced to close. In the absence of expansion in the rest of the economy, widespread closure of state-owned enterprises could have a high social cost in terms of increasing unemployment and the policy could contribute to social unrest, thereby undermining support for reform and prospects for growth.

The findings from this small survey of enterprises are not statistically robust but they do raise issues that require more detailed investigation. The survey results indicate that there are different kinds of insider owners, some of whom are good for the enterprise and some are not. In view of the policy alternative, either to liquidate enterprises for which no investor is found or to allow them to endure a protracted privatisation process while the prospects of sale decline further, this paper calls for further research into the incentives and constraints facing existing and potential insider owners and whether this can be supported in a revised approach to enterprise reform.

# Chapter 1: Introduction

The aim of this paper is to analyse the impact of privatisation on medium-scale enterprises in Bosnia Herzegovina and the Republic of Serbia. Until the early 1990s, these were part of the Socialist Federal Republic of Yugoslavia (SFRY) and are generally considered to be transition economies, although their background and experiences are different from those of many countries in Central and Eastern Europe. SFRY had a unique system of worker-management from the 1950s to the late 1980s, and this may be a factor in determining privatisation outcomes in the region.

The paper reviews the broad trends in empirical research into the effects of privatisation, taking into account the methodological challenges and the principal findings. A range of privatisation methods have been used in transition economies, leading to diverse outcomes which, the paper suggests, reflect variances in the initial conditions and the underlying approaches adopted by different national governments. Empirical research into privatisation is fraught with methodological difficulties and these are considered in the paper. Issues to be addressed include the question of the counterfactual and the selection bias which are often dealt with only in the interpretation of results. In addition, privatisation theory fails to raise an obvious empirical question. While most research considers the effect of ownership change on enterprise restructuring, it is not immediately clear how restructuring should be measured, and such an approach fails to consider the wider, macro level effects of privatisation.

The paper uses techniques developed by Carlin et al. (2001) and Estrin and Angelucci (2003), in that the emphasis is on internal enterprise indicators of restructuring rather than more traditional financial indicators of performance. This is considered to be the most appropriate path, as privatisation in these countries has been undertaken relatively recently and hence restructuring policies are unlikely to have made an impact on enterprise accounts. The survey results are analysed according to type of owner and privatisation method. The research findings indicate that, while most enterprises had undertaken some kind of internal restructuring measures, their financial indicators did not yet reflect the changes that had been implemented. When the responses are broken down by type of investor, the findings indicate that employee-owned enterprises have also undertaken restructuring. Further analysis suggests that privatisation outcomes can be related to the method by which ownership is transferred to employees, although findings have to be interpreted with caution due to endogeneity, as it may be that the underlying characteristics of the firm determine the method of privatisation.

Privatisation has been implemented in these states only relatively recently. Hence it is too soon to identify a definitive privatisation impact, although some conclusions can be drawn. The framework for the research arose from discussions with economists from the UK donor agency, the Department for International Development (DFID), which has been supporting privatisation in both Serbia and Bosnia Herzegovina. Although the results can only provide an indication of preliminary developments, the findings are of interest to policy-makers and donors as privatisation continues to be challenging and is by no means completed. Furthermore, the issues arising from this research have implications for other policy-makers considering reform of the industrial sector in post-conflict economies.

While these findings have weak statistical significance, there are potentially far-reaching policy implications as, in much of the literature, insider ownership is considered the least successful method of privatisation in terms of the impact on enterprise restructuring. The indications from this research are that privatisation to insiders could be beneficial, and this is an area that could benefit from more detailed research.

The structure of the paper is as follows. Chapter 2 presents a summary of different privatisation approaches adopted in transition economies as well as a review of the main empirical findings. This is followed by a review of recent economic history in South-East Europe, the development of worker-management in SFRY and the implications for privatisation. Chapter 4 sets out the methodology for the research programme and Chapters 5 and 6 present the findings from the research in Bosnia Herzegovina and Serbia respectively before Chapter 7 concludes.

# Chapter 2: Privatisation in Transition Economies: Literature on Country Experiences

## 2.1 Introduction

Over the past twenty years, policy-makers and academics have paid increasing attention to the ownership of resources. Privatisation has become a core economic policy throughout the world and is particularly significant in the countries of Central and Eastern Europe, where it is one of several policies intended to contribute to the transformation of the economy from one which is dominated by the state to one which is led by the private sector. In the transition context, privatisation has been regarded as central to economic transformation through its impact on enterprise performance. In the Czech Republic, according to the Head of the Privatisation Board in 1992, 'privatisation… is not just one of the many items on the economic program. It is the transformation itself…privatisation is the element that distinguishes transformation from reform. That is why privatisation must be conceived of and viewed as an end in itself' (cited in Nellis, 2002: 19).

The results from transition are mixed at best. Since the start of the implementation of reform policies at the beginning of the 1990s, some transition economies have seen a dramatic decline in economic performance. Output has fallen to the extent that, by 1999, only two out of 25 transition countries had output levels higher than in 1989 (Campos and Coricelli, 2002). There has since been some recovery in Central European countries which have seen a kind of U-shaped effect of reform policies, but in the countries of the Commonwealth of Independent States the effect has been described rather as L-shaped (Carlin et al., 2001).

The record of privatisation, which is a key component of transition reforms, is far from clear. While empirical research at the enterprise level has tended to find in favour of privatisation in many industrialised countries (see for example, Megginson and Netter, 2001, Boardman and Vining, 1989), efforts to analyse the empirical impact of privatisation in transition economies have remained inconclusive. The evidence indicates that the outcomes from privatisation vary widely, suggesting that the policy impact depends to a large extent on the context in which it is implemented (Djankov and Murrell, 2002).

This chapter reviews the theoretical arguments for privatisation in the context of transition as well as the difficulties with empirical estimation, before outlining the main findings from empirical research. Transition is an ongoing process of which privatisation is only a component. Thus, some of the citations below refer to privatisation almost in passing, while assessing the wider policy environment and its impact not just on enterprises but on the process of economic transformation. The chapter provides a brief outline of the main developments in the transition literature that relate to ownership change, but there is substantial overlap with the effects of other policies and the economic and political context.

## 2.2 Privatisation theory and practice

At the micro level, privatisation is intended to lead to improvements in enterprise efficiency, and several theoretical propositions support this argument. First, privatisation sharpens the focus of enterprise management because the vague, and sometimes contradictory, objectives of the public sector (such as creating social welfare) are replaced with the single clear goal of profit maximisation. Second, according to property rights theory, private owners are expected to be more efficient monitors of enterprise activity than the state because the private owner of a company accrues profit from the firm and so has a personal financial interest in monitoring enterprise performance. In the public sector, there is less immediate financial incentive for government owners to pay attention to performance. Third, enterprises in the public sector are potentially subject to manipulation by politicians, and decision-making may therefore be affected by political goals to the extent that, for example, appointments may be determined on the basis of political support rather than merit. Fourth, private firms are more agile in that they are unencumbered with the bureaucratic constraints of state ownership and they are therefore more able to respond to information.

At the macro level, a privatised economy is expected to lead to improvements in the use of economic resources, as these are allocated according to market signals rather than a centrally planned model. Furthermore, privatisation can be used to raise political support, and might be expected to improve the fiscal position of the government through the reduced need for state subsidy as well as higher tax payments when enterprises become increasingly profitable and as a result of sale proceeds (although this effect should be neutral, as the revenue from sale is exchanged for future income stream (Adam et al., 1992)). Countries in Central Europe have had further motivation to privatise in order to qualify for accession to the European Union.

In transition economies, privatisation was not just about improving incentives but also about creating a whole new market-oriented economic structure. Under central planning, firms faced an incentive structure where information asymmetries and soft budget constraints resulted in an economic system which encouraged widespread hoarding of productive inputs (Bevan et al., 1999). The traditional industrial structure was one of large dominant firms with high levels of horizontal integration, which limited the effects of competition and reduced entrepreneurship, although the degree of central planning was not the same in all transition economies. Most enterprises in Russia and the CIS countries allocated resources primarily through quantity-based planning. There was no market in the supply of goods, either for final products or intermediates. According to Estrin (2001: 3), 'firms were not autonomous decision-making units; it is better to conceive of them as production units within an economy that was run as a single giant firm.' Firms in these countries were not financially independent and did not have responsibility for sales or pricing, and this legacy was difficult to overcome in the creation of a market economy. Managerial incentives were focused on production targets. There was little competition from foreign producers, as trade relationships were governed by a communist planning arrangement called the Council for Mutual Economic Assistance (CMEA) (Estrin, 2001). Privatisation in this context was also intended to generate a shift in attitudes to risk as well as the development of entrepreneurial skill to bring about pro-active, revenue-enhancing measures in enterprise management (Bevan et al., 1999). There was considerable pressure to privatise quickly at the start of transition. The primary reason for this was political. There was a fear that delaying the speed of transition would reverse the collapse of communism and a belief that capitalism would take root if a class of capitalists was created quickly (Nellis, 2002).

There has been widespread criticism of the theoretical arguments for privatisation,[1] which implicitly assume an institutional context that may not be valid outside industrialised countries. In the context of transition, there are many practical constraints which have prevented privatisation achieving the intended results. The process of implementing privatisation is demanding, and it was not clear that transition governments had sufficient capacity to implement a privatisation programme or that there was enough managerial capacity for the effective market-oriented management of large corporations. State capacity constraints meant that there was effectively a policy choice between problematic privatisation and problematic continued state ownership. The process is made more complicated in countries that have had a system of central planning which has created unclear property rights. While private owners may have a financial interest in the performance of an enterprise, they may not have the ability or the institutional framework to implement effective monitoring. The capacity to implement privatisation in transition economies by conventional methods used in industrialised economies was severely limited by the weak financial sector, low domestic incomes and lack of foreign direct investment on the scale required (Estrin, 2001). Initial public offerings (IPOs) and direct asset sales were difficult because of the absence of any method for valuation, and the level of household savings was far too low for the sale of millions of shares in thousands of enterprises (Andreff, 2003).

### *2.2.1 Privatisation methods*

Only a handful of tools have been used to implement privatisation in transition economies, but the ways that they have been used are indicative of differences in the underlying philosophy as well as practical constraints. In addition, variations in initial conditions have meant that outcomes have varied widely. Kornai (2003) differentiates between two reform strategies adopted. The first emphasises bottom-up organic development and healthy growth of a new private sector (e.g. Hungary), while the second puts greater emphasis on accelerated privatisation and dismantling of the state (e.g. Russia). These two approaches are not mutually exclusive but strategies differ in the emphasis they put on the different components. For example, Poland mainly followed the organic development strategy but with occasional elements of the accelerated privatisation approach. Kornai considers the emphasis on speed of privatisation in the early years of reform to be a false basis on which to measure success, since the policy is concerned with the transformation of society from socialism to capitalism and so should not be evaluated in terms of speed.

In transition economies, most countries implemented some kind of 'mass privatisation', whereby citizens were given nominal assets with sufficient value to purchase the assets to be privatised – usually in the form of privatisation vouchers or certificates. The aim of mass privatisation is to inject sufficient liquidity into the economic system to enable the transfer of state ownership but without causing inflation, by ensuring that the credits cannot be used to finance consumption directly. While the government does not receive revenue from the shares distributed through vouchers, the system can create political support for the scheme (at least, initially). There was a belief among some of the supporters of voucher privatisation that this was a sufficient condition for capitalist development and that, while the institutional structures were important, they would emerge automatically as the large and powerful new group of company owners would put pressure on the

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[1] See, for example, Chang and Singh, 1992; Martin and Parker, 1997; Haque, 1996; Commander and Killick, 1988; Chang and Rowthorn, 1995; Bayliss and Fine, 1998.

government to create an appropriate framework (Nellis, 2002). Unfortunately, this was proved not to be the case. Mass privatisation failed to generate a corporate governance structure which would be associated with restructuring (Andreff, 2003).

Mass privatisation was first introduced in Russia, Czechoslovakia and Romania in 1992 and then in Estonia and Lithuania in 1993. Other countries followed suit (Armenia, Kazakhstan, Kyrgyzstan, Latvia, Slovenia (1994); Poland, Ukraine, Albania, Belarus, Bulgaria (1995)) (Estrin and Stone, 2001). Most countries have used a combination of methods, and mass privatisation may be secondary to other methods such as direct sale to investors or to a buyout by employees and/or management (MEBO). Nellis (2002) provides a list of 26 transition countries and the primary method of privatisation that they have used (Table 2.1). Some of the distinctions are hazy as, for example, Russia and Georgia are listed by Nellis as examples of voucher privatisation but another author puts these countries in the MEBO category because the voucher system was used to transfer ownership to insiders (Vagliasindi and Vagliasindi, 2003). Thus it is not just the method *per se*, but the way in which it is adopted that determines policy outcomes.

Table 2.1 Primary privatisation methods used

| Voucher | Direct sale | Management and/or employee buyout (MEBO) |
|---|---|---|
| Bosnia, Armenia, Moldova, Kazakhstan, Georgia, Lithuania, Kyrgyz Republic, Russia, Czech Republic | Tajikistan, Latvia, Bulgaria, Poland, Estonia, Slovakia, Hungary, | Belarus, Turkmenistan, Albania, Azerbaijan, Ukraine, Uzbekistan, Romania, Macedonia, Croatia, Slovenia |

*Source*: Nellis, 2002

Mass privatisation has taken different forms in different countries. For example, vouchers or certificates could be distributed to all citizens or to specific groups (employees, war veterans, etc.). Shares could be either issued in waves - as in the Czech and Slovak Republics, where a computer system was established which was designed to mimic a general equilibrium market clearing process so that shares were transferred in waves of hundreds of firms simultaneously - or privatised continuously either singly or in groups at a time chosen by management - as in Russia, Ukraine and many CIS countries. Privatisation in waves appears less vulnerable to insider deals (Vagliasindi and Vagliasindi, 2003).

There have been many variations, for example in how much trade in vouchers was permitted and the approach to Privatisation Investment Funds (PIFs). Share ownership by investment funds was supposed to consolidate shareholdings and thereby counter the potential problems of dispersed ownership. Some governments actively encouraged the development of PIFs (Czech Republic) and others made them compulsory (Kazakhstan, Poland, Romania -Vagliasindi and Vagliasindi, 2003). In some countries they were tightly monitored (Poland), while other governments had little control over their development (Czech Republic). In the Czech and Slovak Republics and in Russia, vouchers could be exchanged directly for shares in enterprises but financial intermediaries soon emerged, whereas, in Poland, citizens were given entitlement to shares in PIFs rather than in commercial companies directly. There were also differences in the holding limits of PIFs ranging from a minimum of 33% in Poland to a maximum of 20% in the Czech Republic, Georgia, Lithuania and Slovak Republic (Vagliasindi and Vagliasindi, 2003). Estrin and Stone (2001) have drawn up five different models of mass privatisation, based on the approach adopted by governments to the issuing of shares, the rules regarding trade and the approach to investment funds (see Table 2.2).

Table 2.2 Five models of mass privatisation

| Privatisation model | Shares | Vouchers | PIFs | Countries following this model |
|---|---|---|---|---|
| Russian | Continuous | Bearer and tradable | Encouraged | Belarus |
| Armenian | Continuous | Bearer and tradable | Allowed | Georgia, Kyrgyzstan |
| Lithuanian | Continuous | Non-transferable | Allowed | Estonia, Latvia, Ukraine |
| Czech-Slovak | Waves | Non-transferable | Encouraged | Bulgaria, Moldova, Romania |
| Polish | Waves | - | Compulsory | Kazakhstan, Romania |

*Source*: Estrin and Stone, 2001

Not all countries adopted mass privatisation. The main exception was Hungary which followed what is usually termed a case-by-case approach. Most countries adopted a mixture of mass privatisation and direct sales to investors, but countries differed greatly in the way methods were combined and the specific way in which they were implemented. In Estonia for example, vouchers were used for minority shareholdings while majority stakes were transferred to a strategic investor, thereby ensuring that vouchers were likely to provide some kind of value for the holders (Nellis, 2002).

Voucher schemes were considered to be an equitable way of distributing ownership but they had significant limitations. Whereas privatisation by sale engendered 'natural selection', the transfer of property rights effectively by giveaway maintained the existing structure (Kornai, 2003) and failed to bring in either new people or new finance where enterprises became 'insider-owned'. Table 2.1 indicates that most of the countries where voucher privatisation was the primary method (7 out of 9) were in the former Soviet Union. These countries have suffered a major decline since the start of transition. Furthermore, the countries in Central and Eastern Europe that used vouchers as the primary privatisation method (Czech Republic, Slovakia and Lithuania) reportedly had more problems than those relying on non-voucher methods – Poland, Slovenia, Hungary, Estonia (Nellis, 2002). Voucher privatisation creates a dispersed ownership structure and, where capital markets are thin and share trading is not widespread, there are few possibilities for concentrating ownership. The potential for takeover is limited because of the difficulty of purchasing shares.

Even the equity outcome from mass privatisation has been disappointing, as the returns on the vouchers were much less than expected and substantially less than the huge amounts of wealth acquired by a small elite (Birdsall and Nellis, 2003). In some cases the best enterprises were not privatised by vouchers but went in non-transparent deals to managers and supporters. Birdsall and Nellis list a number of ways in which some dispersed minority shareholders saw the value of their holding collapse as the company was manipulated by the majority stakeholder; for example, assets were 'tunnelled' out of firms which then consisted just of liabilities, or the value of their minority shares fell overnight to zero, or the company was inexplicably de-listed from the stock exchange, or the privatisation fund was transformed without notice into an unsellable status. While the counterfactual may have been equally challenging, these outcomes were in sharp contrast to what was expected of voucher privatisation, which was supposed to be a means whereby state property would be shared equitably among the citizens; political fall-out from this disappointment continues in Russia, the Czech Republic and the former Soviet Union (Birdsall and Nellis, 2003).

### 2.2.2 Country experiences

The results from privatisation have been diverse. This sub-section briefly reviews the experience of the Czech Republic which was heralded in the mid-1990s as the model for privatisation and informed the approach adopted in Bosnia Herzegovina. The experience here is compared with that of Poland and Russia as examples of different approaches to privatisation.

In the Czech Republic, privatisation was introduced in 1991. Every Czech citizen over eighteen could buy a book of vouchers containing 1,000 investment points for a nominal fee of $34 (the equivalent of about one week's wage – Nellis, 2002). Citizens could bid with their coupons to buy shares in any of the firms or they could transfer their coupons to an Investment Privatisation Fund (IPF) which became the owner of a larger and more diversified portfolio (Pohl et al., 1997). 1,600 firms were sold in mass privatisation. About 70% of coupons were turned over to 550 funds which became dominant owners of Czech firms (ibid.). Almost anyone could establish a fund. There were two waves of voucher privatisation (1992-3 and 1993-4). In the first wave, nearly two-thirds of the participating public invested their vouchers in nearly 450 IPFs, with the 14 largest collecting over 78% of the voucher points remitted to the funds (ibid.).

By 1995, about 1,800 firms had been privatised through two waves of voucher privatisation. A further 350 were sold on a trade basis to strategic investors. Dozens of IPFs emerged, some promising returns to investors. Citizens bought vouchers and at the end of the second wave most citizens held shares in investment funds (Nellis, 2002). The largest IPFs were controlled by banks that were still majority state-owned. The government kept stakes of 20-25% of firms which were used for restitution or for sale to strategic investors (Pohl et al., 1997).

In 1995-6, there was a rapid reallocation of shares as new owners including IPFs swapped shares to diversify and/or concentrate portfolios and to ensure conformity with legal requirements which prevented IPFs holding excessive stakes in firms. Each fund was prevented from investing more than 10% of points acquired in the voucher scheme in a single company and from obtaining more than 20% of shares in any company. This reallocation was largely unregulated, with IPFs swapping large blocks of shares. More stable ownership patterns began to emerge in 1996 (Kocenda and Svejnar, 2003). While individual IPFs were legally prevented from holding more than 20% stakes in privatised firms, funds co-operated with each other and the combined holdings in a single firm typically came to a majority stake (Frydman et al., 1997).

Gupta et al. (2001), using data from the Czech Statistical Office on 1,121 firms, find strong evidence that the government privatised first the firms that were more profitable, firms in downstream industries and firms in industries subject to greater demand uncertainty. Firms with higher market share were also more likely to be privatised early on Insider ownership was not widespread in the Czech Republic. The government sent a clear signal that worker buyouts were undesirable forms of privatisation, compared with Russia and the Ukraine where they were more common (Gupta et al., 2001).

Initially, the results from privatisation were encouraging. The size of the private sector grew rapidly and inflation was low. In 1996 the Prime Minister described the voucher privatisation programme as 'rapid and efficient' (Nellis, 2002). World Bank advisers were also impressed with the Czech model, and voucher privatisation became widely promoted and adopted as *the* way to privatise (Ellerman, 2001). However, growth rates plummeted in the second half of the 1990s and did not recover until 2000. Privatisation contributed to the decline. The investment funds were not sufficiently regulated; there were therefore some dubious and illegal transactions that worked in the interests of the fund managers at the expense of minority shareholders and which were damaging for the enterprise. Some of the largest funds were owned by local banks which were still state-owned and which failed to stop lending to poorly performing voucher-privatised firms (Nellis, 2002).

The case of the Czech Republic can be contrasted with that of Poland where there was far greater emphasis on the regulatory framework for privatisation and the operation of investment funds. Unlike other transition economies, Poland considered the investment funds as an 'active restructuring agent', instead of treating them as a temporary interim structure to pool otherwise dispersed ownership (Vagliasindi and Vagliasindi, 2003). Hence these funds were closely regulated. Privatisation was much slower. Only about 512 firms were privatised with mass privatisation.

In contrast to the Czech Republic, the Polish government kept much more control over ownership structure. There was substantial emphasis on the regulatory framework and efforts were made to avoid a dispersed ownership structure. At the same time policy-makers were concerned about the dangers of high levels of individual stakes. The government distributed enterprise shares to 15 investment funds, and the lead fund was only allowed a maximum stake of 33% in any one enterprise; the rest was distributed to other funds, workers and the government (25%) for later sale. The investment funds were managed by highly experienced Western specialists who were selected by international competition. Citizens were given a certificate entitling them to equal ownership in all 15 funds (Pohl et al., 1997). In comparison, in the Czech Republic, there was less regulation and a fear that state intervention would stand in the way of the rapid development of market institutions. Laws regarding the operation of securities markets were fairly lax. In Poland, privatisation was concerned with improving firms' incentives and bringing about restructuring, and there was therefore considerable emphasis on corporate governance. In the Czech Republic, privatisation was seen as a pre-condition for the emergence of a market environment and expected to generate spill-over effects; more emphasis was therefore put on the speed of reform and less on the specific ownership structure (Grosfeld and Hashi, 2003). In Poland, it seems that, apart from the small number of show-case enterprises selected for sale to foreign investors, the best enterprises were acquired by managers through MEBOs (Carlin, 2000).

Despite the very slow pace of privatisation in Poland (Nellis, 2002), the country recorded significant growth and in the mid-1990s enjoyed the highest GDP growth rate in Europe. By late 1999, GDP in Poland was estimated to be 125% of GDP at the end of 1989. This is attributed to the rapid entry and growth of new firms which have been behind the country's transition (Nellis, 2002; Kornai, 2003). Poland also benefited from strong workers' councils which were effective in monitoring managers and preventing large-scale asset-stripping (Nellis, 2002). More recently, slower growth in Poland is attributed to the growing impact of large loss-making state-owned enterprises that have yet to be privatised (Nellis, 2002). The comparative experiences of Poland and the Czech Republic highlight a kind of trade-off that faced policy-makers. The choice was between rapid and yet flawed privatisation and slow privatisation but with flawed continued state ownership.

While privatisation in Central Europe has raised concerns and issues regarding different aspects of its implementation, privatisation in Russia and other countries of the CIS seemed to show little benefit in the 1990s. Between 1992 and 1994, Russia, with help from the World Bank, the EBRD and USAID, implemented a massive privatisation programme. More than 16,500 enterprises were privatised and over 41 million Russian citizens became shareholders either through direct ownership of shares in newly privatised companies or through share ownership in voucher investment funds. About 55% of firms in Russia were sold through management and employee buy-outs (World Bank, 1996a). The focus was on speed. To reward key stakeholders, managers and/or employees became majority shareholders in about two-thirds of firms and these insiders generally failed to restructure the firms. Production failed to recover and few external investors were involved in secondary trading of shares. Stakes acquired with vouchers became worth very little (Nellis, 2002). It was likely that the best enterprises went to insiders because of the lack of information available to outside investors, the weakness of the legal framework for protection of investor rights, and control by insiders over the selection of the method of privatisation (Carlin, 2000). What outsider ownership did exist was so dispersed that it was ineffective. The privatisation programme created a small number of individuals who took over control of most of Russia's major firms.

There was concern about the impact of the Russian privatisation programme, and the results were initially considered to be disappointing, with faith in the voucher system misplaced (Nellis, 2002). However, as mentioned above, it is not possible to know what would have happened otherwise. Indeed, the concerns regarding the 'loans-for-shares' scandal in the mid-1990s - whereby 13 natural resource-based firms were handed to Russian commercial banks which were apparently owned by a group of financial oligarchs connected to the presidency in a manner described as 'totally rigged' (Nellis, 2002) - highlight the fact that alternatives to mass privatisation might have been equally damaging. The above discussion shows that privatisation methods and outcomes have varied widely in transition economies. The limitations of mass privatisation – once seen as the solution to many countries' needs – have become clear, although the absence of a counterfactual calls into question whether alternatives would have been any better in transition economies. Privatisation policies now focus more on direct sales to investors.

## 2.3 Empirical issues

There is a vast body of empirical research into the effects of privatisation. Djankov and Murrell, in their meta-analysis of the empirical literature on transition economies, highlight the diversity of findings from the research, revealing that privatisation can bring about substantial benefits but can also be damaging, depending on methods and circumstances. However, they point to great difficulties in drawing firm conclusions on the privatisation issue. A number of unresolved issues in the empirical estimation of the effects of privatisation are considered below.

### *2.3.1 Bias and interpretation*

Empirical research on the impact of privatisation is potentially flawed because of problems of selection bias. For example, the enterprises selected for research analysis are the ones that have done relatively well since privatisation (or at least have not collapsed). Survey-based research inevitably builds in some kind of bias as the findings are based on the firms that take part in the survey which may have other characteristics in common. They may be the ones that have had the most positive experience from privatisation.

Selection bias also occurs in the privatisation process where the choice of enterprises to be privatised is not random, but their current or prospective performance determines in part whether they are selected; hence the superior performance of privatised firms is a reflection of this rather than of aspects of ownership.[2] Frydman et al. found that firms privatised to insiders had performed better before privatisation than those privatised by other methods (based on research in Poland, Hungary and the Czech Republic). Goud (2002), on the basis of analysis of data from 4,104 firms from 25 transition countries, found that the performance of the firm was related to the probability of its being privatised. Similarly, Gupta et al. (2001) show that government priorities often led to the best firms being privatised first. They point out that, as a result, studies that simply compare the performance of privatised and non-privatised firms without taking the sequencing of privatisation into account will overstate the positive impact of privatisation on performance.

A further bias can be introduced in the measures which are selected for comparison. For example, performance indicators are often those, such as sales revenue and profit, which are of more relevance to a privatised firm than a state-owned firm or a firm awaiting privatisation; the use of these measures to evaluate privatisation may therefore produce biased results. In addition, conclusions from research are sometimes based on questionable assumptions about causality. For example, where firms with more concentrated ownership are found to perform better than those with dispersed ownership, such a result may arise because larger investors are more attracted to such firms because they were already performing well.

### *2.3.2 The counterfactual*

It is very difficult to know what would have happened without privatisation; hence it is difficult to know whether the results following privatisation are the effects of the policy itself or would have happened anyway because of other aspects of the policy environment. Similarly, in the context of transition where many policy parameters are changing simultaneously, it is difficult to pinpoint the effect of ownership change in isolation. Outcomes may be due to many other factors such as liberalisation, firming of budget constraints or product market competition. While some studies attempt to estimate a counterfactual (e.g. Galal et al. (1994) in their analysis of enterprise sales in four middle-income countries), most do not. When it comes to research into transition economies, the counterfactual is rarely even mentioned. This is in part justified because privatisation, as part of the transition process, presents no alternative, apart from different methods of privatisation.

While the counterfactual cannot be known, speculation as to the effects of alternative policies can be used by both supporters and critics of privatisation, as the case of Russia demonstrates. According to Nellis (2002):

> One can make a case that the likely alternative to mass and rapid privatisation to insiders in Russia was not some close approximation of the Polish or Hungarian approaches but rather what one sees in Ukraine: Very slow privatisation of larger firms, rampant and rapacious bureaucratic interference in firms and, in the absence of a powerful set of insider-owners, political stagnation as the various factions fight over the still initial division of the spoils (Nellis, 2002: 42).

[2] Frydman et al. (1997) attempt to overcome the potential self-selection bias in empirical estimations of the impact of privatisation by not only comparing the performance of state-owned and privatised enterprises but also looking at the respective performances before any privatisation, in order to establish if the enterprises privatised were those that were less profitable and whether this could account for subsequent disparities in performance.

According to Ellerman (2001), however, there was a viable alternative in Russia which took the form of a system of enterprise leasing that had been developed earlier under Gorbachev and which had parallels with a successful system in Poland and the Chinese township-village enterprises. The system had reportedly been abolished by the reformers with the approval ('indeed insistence') of Western advisers: 'Thus the reformers and their Western counterparts not only pushed Russia along a disastrous path but deliberately blocked an alternative indigenous path that showed great promise elsewhere' (Ellerman, 2001: 20). These two opposing views highlight the great difficulties that researchers face in considering a counterfactual. Such a process is inevitably based on subjective views rather than hard evidence.

### 2.3.3 What to measure?

Privatisation theory does not lend itself to a single, clearly identifiable economic relationship and there are many complications regarding choices of dependent and independent variables and the possible relationships between these. Studies rarely consider the macro-level impact of privatisation, such as the fiscal effects. In industrialised countries, the emphasis is on measuring changes in productivity following privatisation, and in most applied research this is taken to be labour productivity (Bevan et al., 1999). Many studies simply use profitability as a dependent variable (for example, Boardman and Vining, 1989).

Generally, in transition economies, 'restructuring' (rather than productivity increase) is considered to be the over-arching policy goal in that it indicates the degree to which an enterprise is able to respond to a market environment, but there are different notions of what this concept might mean and how it should be measured. In practice, the proxy for 'restructuring' can be the same as that for 'productivity' in industrialised economies. For example, Pohl et al. (1997) take the following measures of restructuring: profitability; proportion of firms with positive operating cash flow; average operating cash flow as a percent of revenue; growth in labour productivity; growth in total factor productivity; and growth in exports. Alternatively, Frydman et al. (1997) take sales revenue as a proxy for restructuring on the grounds that this best measures proactive responses by enterprise managers to changing circumstances to secure new markets. According to Frydman et al., in the short term profits may be volatile and subject to accounting decisions, especially with regard to costs that bear little relation to long-term performance. They also suggest that revenue is more transparent and captures the essence of entrepreneurial, risk-taking imagination.

In the 1990s, the emphasis of empirical research was on traditional indicators of enterprise performance (productivity and profitability). More recently, researchers have differentiated between different types of enterprise restructuring. For example, Bevan et al. (1999) highlight the distinction between restructuring measures in the short and long run. In the short run, the level of capital employed does not change. Short-run restructuring measures are regarded as those which result in cost reduction, while long-run measures are related to revenue enhancement, such as changes in the internal structure of the organisation and investment in capital. Short-run restructuring behaviour includes measures that affect those components of the input bundle which are variable in the short term, but without influencing the level of capital employed by the firm (ibid.).

Other studies differentiate between *deep* (or 'strategic' or 'revenue-enhancing') restructuring and *defensive* (or cost-cutting) restructuring. The former includes measures such as employment reduction and plant closure, while the latter includes the identification of new markets and improvements to the internal organisational framework with the introduction of such functions as accounting and marketing. It is deep restructuring that is the more substantial indicator of long-term development prospects and so is of greater interest. Studies organised along these lines have been based on enterprise surveys. However, research has found counter-intuitive results from the analysis of different types of restructuring.

Carlin et al. (2001) carried out a survey of a total of 3,300 state and private firms in 25 countries to explore how firms had responded in the transition context. In the course of their analysis they compared restructuring measures implemented by firms with different ownership structures. They expected, in common with earlier studies, to find little difference between state and privatised enterprises when it came to defensive restructuring, as all enterprises were expected to respond to the shock of marketisation but privatised firms were likely to implement a greater degree of strategic (or deep) restructuring. They found (in keeping with expectations) that state-owned firms were less likely than privatised firms to engage in new-product restructuring and that privatised firms were more likely than state firms to have changed suppliers and customer base. But they also found that state firms were just as likely as those privatised to outsiders (and much more likely than those privatised to insiders) to have brought in new management.

The results from analysis of defensive restructuring measures were also surprising. They found that state-owned firms were significantly more likely than privatised firms to have implemented defensive restructuring measures (i.e. to have reduced employment by more than 10%, discontinued at least one product line or closed at least one plant). The results also indicated that soft budget constraints are associated with *more* defensive restructuring. The authors attempt to account for this surprising result by suggesting that the privatised firms had perhaps already undertaken defensive restructuring (Carlin et al. 2001).

Estrin and Angelucci (2003) developed the methodology used by Carlin et al. (2001) to investigate the effects of privatisation in a large sample of Russian firms. They use the following indicators of deep restructuring: introduction of products and services; moves to new markets; improved marketing; energy-saving innovation; quality-raising innovation. They use the following indicators of defensive restructuring: liquidation of unprofitable products; cuts in social provision; shedding excess labour; sale or leasing out of excess equipment; sale or leasing out of real estate. Paradoxically, they find that more 'deep' restructuring was implemented than 'defensive.' While this might be considered a good sign, the authors are more circumspect, given the poor state of Russian industry. They suggest that the high values might reflect optimistic evaluations of their own performance on the part of the respondents.

Alternatively, it might be that the categorisation of 'deep' and 'defensive' has limitations. Under this division, an increase in sales, for example, will be considered a superior result to the production of the same amount of output with a much smaller workforce. While sales growth may reflect greater capacity to operate in market conditions, it may also be the result of shifts in market structure and capacity of consumers. Defensive restructuring measures may indicate weaknesses of the firm or may demonstrate proactive responses to changing circumstances. The same enterprise activity may be either deep or defensive, depending on the circumstances. The distinction is hazy. Plant closure can be a distress signal or can indicate a rational response to the new policy environment. In the transition context where enterprises are extremely diversified, hiving off of different business activities is an important part of enterprise development and not just defensive. A further limitation of this approach is that it presupposes the need for restructuring measures, in that it only considers changes and not existing strategies. Thus a firm that already has a sound internal structure may fail to score highly on restructuring measures, but this may be because they are not required.

### *2.3.4 Data*

The reliability of quantitative data is questionable where enterprises are new to accounting procedures, where accounting systems have changed since privatisation and where there may be a tax incentive to under-report company results. Empirical measurement depends on the accuracy of reporting and historical valuation, which may be imprecise where there is high inflation and there are large changes in relative prices. According to Bevan et al. (1999), levels of effective taxation are significantly below official nominal rates and indicate high degrees of tax evasion and non-compliance, demonstrating the existence of an incentive to under-report certain indicators which might increase the tax liability. This is likely to lead to a bias in the data (especially profits); thus the use of such measures at the level of individual enterprises may generate unreliable performance indicators.

Despite these weaknesses in such data, most studies on privatisation in transition focus on performance which is usually measured by some kind of financial indicator rather than survey-based findings on internal decision-making (Djankov and Murrell, 2002). According to Djankov and Murrell (2002), quantitative variables are considered in the literature to be more reliable than qualitative information, despite the acknowledged difficulties with misreporting and inaccurate accounting. However, there are additional limitations to a strictly quantitative analysis. Such an approach attributes all changes to change of ownership and thus risks wrongly attributing changes in performance to privatisation, when they may be the result of other aspects of operation (such as the external environment). Furthermore, there may be a considerable time-lag before internal restructuring measures affect the firm's performance indicators.

The limitations of purely quantitative analysis are highlighted in the findings from the survey of 437 firms by Estrin and Angelucci (2003), namely, that ownership does not affect traditional measures of economic performance such as profitability or productivity but that there are differences between state and private firms in terms of their restructuring activity. This would not emerge from a purely quantitative analysis. Restructuring measures may not result in immediate improvements in financial performance but they have implications for longer-term growth. All indicators of enterprise performance have limitations, but these may be more pronounced in the transition context. This suggests that the best approach is to consider a variety of alternative indicators. For example, Bevan et al. (1999) suggest a 'twin-track' approach using both quantitative and qualitative information.

## 2.4 Main findings

The wide body of empirical research takes many forms ranging from in-depth analysis of one national privatisation programme (for example, Martin and Parker (1997) on the UK, La Porta and Lopez-de-Silanes (1997) on Mexico or Antal-Mokos (1998) on Hungary) to studies that incorporate large numbers of firms from many countries (Megginson et al., 1994; Boardman and Vining, 1994; Carlin et al., 2001). In addition, there are studies of studies which attempt to synthesise findings from the numerous individual empirical investigations (Shirley and Walsh, 2000; Djankov and Murrell, 2002; Megginson and Netter, 2001).

The majority of studies on privatisation in industrialised and middle-income economies find that privatisation has a positive effect on performance. For example, Shirley and Walsh (2000) examine 52 studies which empirically assess the effects of privatisation. Of these, 32 find the performance of private and privatised firms to be superior, while 15 find that there is no significant relationship between ownership and performance or that the relationship is ambiguous. Only 5 studies conclude that publicly-owned firms perform better than private firms.

Research findings are more mixed from research in transition economies. According to Carlin et al. (2001: 5) 'evidence that privatisation enhances performance has not leapt out of the data'. There are some large-scale cross-country studies which find positive results from privatisation (e.g. Goud, 2002; Pohl et al., 1997), but other research has found considerable variation in the effects of privatisation. Frydman et al. (1997) compared the performance of state and privatised firms before and after privatisation in a study of 506 medium-sized firms in the Czech Republic, Hungary and Poland, drawing a sample from firms employing between 100 and 1,500 people. They found that, from the start, privatised firms outperformed state firms on all performance measures, particularly revenue growth. Carlin et al. (2001), on the other hand, in their study of over 2,245 firms in 25 transition economies with different ownership structures found that, controlling for other factors, there was no significant relationship between privatisation and performance.

Djankov and Murrell (2002) review evidence from over 100 empirical studies in transition economies and find that privatisation improved enterprise performance significantly in Central and Eastern Europe, but for the CIS countries there was no difference between the performance of state-owned and privatised firms. The privatisation effect in these countries is statistically insignificant, and this is a robust result according to their synthesis of studies (Djankov and Murrell, 2002). Notwithstanding the large variation in results from the empirical research, some key parameters appear to have a consistent impact and these are explored below.

### *2.4.1 Ownership structure*

Privatisation results in different ownership structures, depending on the methods used, and these can be expected to affect privatisation outcomes. Owners can be insiders (managers and employees) or outsiders (foreign or domestic investors). Domestic investors can become owners through direct sales agreements, auctions and tenders or can be institutional investors including privatisation investment funds or small-scale individual owners who have invested their vouchers in shares in privatised enterprises. Generally, the best owners are considered to be foreign investors. Next best are domestic outsiders with concentrated (rather than dispersed) shareholdings. Insider ownership is considered to be the least effective form of privatisation, with sales to managers deemed better than sales to employees. Djankov and Murrell (2002) find that privatisation to outsiders has the largest positive effect on enterprise restructuring. They conclude that investment funds, block-holders, foreigners and commercialised state-owned firms performed better than traditional state-owned enterprises, whereas manager-owned firms performed no differently from state firms. They find that privatisation to investment funds is better even than to foreigners. According to their research, privatisation to investment funds is five times as productive as privatisation to insiders, while privatisation to foreigners or block-holders is three times as productive as privatisation to insiders. Privatisation to outsiders is associated with 50% more restructuring than privatisation to insiders, and privatisation to workers is found to be detrimental to enterprise performance while privatisation to managers produced a very slight benefit (Djankov and Murrell, 2002).

Evidence from the Czech Republic finds that foreign-owned firms carry out strategic restructuring and increase profits by increasing sales and speeding up production rather than cutting labour costs, while domestically-owned enterprises carry out more defensive restructuring, reducing both sales and labour costs. This implies that foreign firms are able to cut costs elsewhere (Kocenda and Svejnar, 2003). Carlin (2000) also provides an overview of ownership structures. Foreign investors were regarded as the highest ranked option with the requisite finance and expertise. Then came domestic strategic investors, followed by managers and then workers. However, foreign ownership is not always found to be superior. For example, Frydman et al. (1997) find that, although foreign ownership brings improvements, the impact is not significantly stronger than that of domestic outsiders.

The above arguments suggest that privatisation to domestic outside owners is more effective at inducing reform where these are block shareholders rather than dispersed individual owners. With dispersed ownership a free-rider problem emerges, as there are large costs to enterprise monitoring while the benefits accruing to each individual investor are relatively small (Bevan et al., 1999). The free-rider problem is minimised if ownership is concentrated in the hands of large block shareholders – individuals or investment funds. More concentrated ownership is associated with more effective monitoring of private sector managers (Bevan et al., 1999).

Comparing the outcomes of privatisation in Mongolia and Central Europe, Djankov and Murrell (2002) suggest that the weaker benefits from privatisation in Mongolia are due to the small scale of investors when compared with the block investors in Central Europe. Evidence from the Czech Republic indicates that firms with shares held in large blocks perform better than those with more dispersed ownership, which they interpret as evidence that relatively concentrated ownership generally, and concentrated in investment funds in particular, leads to performance improvements, although the authors caution against reverse causality in that investment funds are only interested in the better performing firms. Furthermore, firms with loans from and ownership ties to banks restructured more, suggesting that these organisations were more effective at monitoring (Pohl et al., 1997). Worker ownership and diffuse ownership are more prevalent in the CIS than in Central Europe, so this could explain why privatisation seems to have been more effective in the latter (Estrin, 2001). Frydman et al. (1997) also find strong performance from firms where privatisation funds are the largest owners and that firms owned by privatisation funds have high employment discipline. They suggest that this might be because, as new institutions, privatisation funds are not encumbered with old inefficient routines and so are better at revitalising privatised companies than other owners such as domestic production companies or banks.

Much of the widespread support for mass privatisation and PIFs was based on the experience of the Czech Republic in the mid-1990s. While it is plausible that less dispersed ownership creates more effective corporate governance, much depends on the governance structure of the shareholders themselves, which will determine their motivation and capacity to monitor firms effectively. Investment funds are run by fund management companies with possibly thousands of shareholders, which will suffer from even greater ownership dispersion, particularly when they are prevented from holding a majority stake in an enterprise (Ellerman, 2001). It became apparent in the Czech system that it matters who the owners are, rather than the level of share concentration *per se*. Concentrated ownership may be a necessary condition for successful enterprise transformation, but it is not sufficient. Owners need a strong regulatory framework in capital and financial markets to promote transparency, to ensure that appropriate procedures are adhered to and to protect minority shareholders (Nellis, 2002). According to Ellerman (2001), the flaws in the design of investment funds should have been seen at the start: ‘How come so many western experts thought that going from perhaps thousands of shareholders in an industrial company to hundreds of thousands of shareholders in a nation-wide investment would "solve" the corporate governance problem rather than considerably aggravate it?’ (Ellerman, 2001: 25).

One of the reasons that outside ownership is to be preferred is that insiders might be reluctant to bring in changes in enterprise management. While it can be difficult to isolate the effect of changes in management as this often coincides with ownership change, there is evidence to suggest that firm performance is negatively correlated with the length of tenure of the general manager of the enterprise (Bevan et al., 1999; Pohl et al., 1997), and management turnover is almost always effective in improving performance (Djankov and Murrell, 2002). There is also evidence to suggest that external ownership has greater impact on management turnover than ownership by insiders. Bevan et al. (1999) cite evidence to show that concentrated share ownership is associated with high rates of turnover of directors and the existence of large block holders increases the probability that managers of poorly performing firms will be replaced. However, Carlin et al. (2001) found (surprisingly) a higher level of managerial turnover in state firms than in privatised firms. They also found that state firms were just as likely as firms privatised to outsiders – and much more likely than in firms privatised to insiders – to bring in new managerial talent from outside the firm.

Takeover by insiders is generally regarded as the least effective form of privatisation and is usually associated with less restructuring than privatisation to outsiders, since insiders are expected to be more concerned with wages at the expense of investment and restructuring and to suffer from difficulties in obtaining finance and to be less likely to shed labour (Bevan et al., 1999). There is some empirical support for this. Frydman et al. (1999) analysed 218 medium-sized manufacturing firms in the Czech Republic, Hungary and Poland and found that only outsider ownership contributed to efficiency gains. They found that firms with outsider owners significantly outperformed those with insider owners on most performance measures and that employees were particularly ineffective owners - less effective than the state. Insider-owned firms shed employment at significantly lower rates than state or other private companies. The researchers conclude that it is better to have state-owned than employee-owned firms. A survey of 452 Russian shops (Barberis et al., 1996) indicated that the presence of new owners and new managers raises the likelihood of enterprise restructuring. The researchers therefore highlight the need for new management rather than changes in the incentive structure as the focus for reform. According to Djankov and Murrell (2002), privatisation to workers has no effect in Eastern Europe and is detrimental in the CIS.

However, not all empirical research supports the position that insiders are associated with less restructuring. For example, Earle and Estrin (1996) found that, in a sample of more than 200 Polish firms, those that were employee-owned performed moderately well. They suggest that this was in part the result of a policy which allowed insiders to buy out firms and borrow from the state to do this. So management and workers will only choose to privatise their firm if it has good enough long- and short-term prospects. Thus causality runs from performance to privatisation. It may be that, with voucher privatisation, insider owners were able to get the pick of the best enterprises, and so these enterprises subsequently have superior performance indicators (Bevan et al., 1999). Other research indicates that privatisation buy-outs can lead to significant restructuring, but their impact depends on the institutional context. Restructuring may be greater where insiders purchase shares rather than acquire them for free (Wright et al., 2002).

Privatisation effects change over time. For example, the rapid and massive privatisation programme undertaken in the Czech Republic was initially regarded as a success in the mid-1990s, but in the late 1990s, as more information became available, the consensus became negative. In Poland, the slow progress of privatisation initially attracted criticism, but when the country started a period of growth and macro stability, the privatisation approach received wider approval. A subsequent reversal of fortunes in the two countries once more raises issues on the relative merits of different privatisation approaches (Birdsall and Nellis, 2003). Similarly, after many years of poor results from mass privatisation, recent research by Bennett and colleagues (2004), which estimates a growth equation for 23 countries from 1990 to 2001, finds that mass (voucher) privatisation has a significant positive effect on growth.

Ownership structures are also changing over time. Grosfeld and Hashi (2003) document an evolving ownership structure in the Czech Republic which has seen extensive consolidation of previously dispersed ownership. Similarly in Poland, many of the firms privatised with vouchers have since sold majority stakes to strategic investors. Thus, it is not necessarily the privatisation method that determines the long-term nature of ownership. Pohl et al. also document the evolving nature of ownership. They found that mass privatisation seemed to result in the same speed of restructuring as other methods. A reason for this is that mass privatisation does not in the end always result in dispersed ownership. For example, evidence from the Czech Republic resulted eventually in consolidated ownership, and in the Czech and Slovak Republics investment funds were transformed into holding companies. Instead of having small minority stakes in many companies, these new holding companies had large majority stakes in just a few companies (Pohl et al., 1997). Estrin and Angelucci (2003) find, in their study of firms privatised in Russia, that there was a major decline in insider and state ownership and an increase in outsider ownership in the post-privatisation period. Out of their sample of 279 firms, nearly 80% were majority-owned by insiders immediately after privatisation, but in 2000 this proportion had fallen to just under 60%. They also find that, within the group of insider ownership, managers have been increasing their stake at the expense of workers.

### *2.4.2 Hard budget constraints*

Much of the empirical research indicates that privatisation is more successful where it results in the imposition of hard budget constraints (including the strength of bankruptcy and liquidation legislation (Estrin, 2001; Bevan et al., 1999)). Privatisation through bankruptcy and liquidation can be regarded as one of the main techniques for changing ownership (Kornai, 2003). Djankov and Murrell (2002) find that the effect of hardened budget constraints is stronger in CIS countries than other transition economies. However, it is difficult to measure the relative 'hardness' of budget constraints, as the direction of causality might mean that it is the poor performance that causes soft budgets rather than the other way round. By definition, a firm that is bailed out has performed badly.

Soft budget constraints take many forms. For example, in Romania and Bulgaria they come via credits from the state-owned banking sector. Informal financial flows tend to undermine exit and hard budgets. But in Hungary the banking sector did not provide such soft budgets. Tax arrears were a source of soft budgets in Poland (according to several studies cited in Djankov and Murrell, 2002). While, in theory, the relative hardness of budgets is a separate policy from ownership, as governments can provide bail-outs to the private sector and state-owned firms can be subject to hard budget constraints, in practice empirical research indicates that privatisation has had the most impact in terms of policies to harden budget constraints (Djankov and Murrell, 2002).

### *2.4.3 Initial conditions and institutions*

There is some evidence to suggest that the method of privatisation used is not the main determinant of privatisation outcomes. Pohl et al. (1997), for example, find no difference in the degree of restructuring according to the method of privatisation. They find little difference in productivity between privatised firms in countries that used mass privatisation methods (Czech and Slovak Republics, Poland) and in other countries that used standard (case-by-case) methods. Carlin (2000) reviews evidence of differences in industrial performance in the Czech Republic, Hungary and Slovenia which upgraded exports much faster than Poland or Russia. Yet the Czech Republic, Hungary and Slovenia used very different dominant privatisation methods, suggesting that other economic characteristics and initial conditions are more important.

Within the broad category of transition economies, there were variations in the extent to which central planning was adopted. In the CIS, central planning was more deeply embedded and lasted for longer than in Central European countries where some countries also had extensive private sectors (Hungary and Poland) and consumer preferences were allowed to guide production decisions to a limited extent, thereby creating more consistency between demand and supply. These countries had made some progress in establishing enterprises as autonomous units with some responsibility for employment, production, sales, exports and even investment decisions. In addition, in these countries some moves had been made towards allowing the entry of small private firms and creating an autonomous financial sector, so the problems in establishing a market economy were less severe where the planning process was decentralised (Estrin, 2001). There were also large variations in the degree to which countries were exposed to international trade competition. Czechoslovakia, Poland, Slovenia and Hungary all exported more than 50% of their exports to Western countries in 1989 (Estrin, 2001).

The impact of transition policies does not seem to be affected by the pre-transition level of reform. Countries that were more reformed, such as Slovenia, Hungary and Poland, as well as some that were relatively less reformed, such as the Czech Republic and some that were part of the Soviet Union such as Estonia and Latvia are among the best performers in transition economies (Estrin, 2001). Estrin attributes these differences to fundamentally different political attitudes towards reform.

Governments in Central and Eastern Europe were led by 'legitimate governments elected on platforms of reform, while the reformers in Russia and many of the CIS governments represented a small but powerful political group advising the president but opposed by much of the parliamentary and civil service structure' (Estrin, 2001: 28). Furthermore, the CIS countries also have a geographical disadvantage in their distance from Western Europe (Estrin, 2001).

The institutional framework seems to have important implications for privatisation outcomes. In particular, effective privatisation requires a strong financial sector which can allow secondary trading, a banking system which can make sound lending decisions, and a robust legal system. Dispersed share ownership requires a means of secondary trading to provide effective enterprise monitoring. For effective secondary markets, there need to be accounting rules with extensive disclosure requirements, regulation of securities markets and sophisticated accounting and banking capacity (Estrin, 2001). In Russia, for example, weak capital markets made it difficult to sell shares and stock. The countries with the most advanced capital market institutions are those that did better from privatisation – the Czech Republic, Hungary, Poland, Slovakia and Slovenia (Estrin, 2001).

Access to finance is crucial for enterprise development, regardless of ownership. Where banks are able to make lending decisions based on enterprise performance, this in itself provides another dimension to corporate governance. However, it is the quality of lending rather than the amount that affects enterprises. Pohl et al. (1997) find that, in the early stages of privatisation, additional bank lending was associated with a decline in productivity, suggesting that banks were financing losses initially. According to Bevan et al. (1999), it is important for enterprises to receive access to credit and to be monitored effectively if they are to engage in restructuring activity and improve long-term performance, particularly in the context of transition where restructuring requires extensive capital investment. However, sound lending is difficult for banks because past performance is not an indicator of future performance and new firms do not have a track record.

While much of the focus of transition policy has been on the changing role of the state and its influence on enterprise activity, there is also a need to consider the way that firms shape the activities of the state. In the post-privatisation context, state capture – whereby firms exert influence on the state and shape the legal and regulatory context to suit their own interests, thereby extracting rents from the productive economy – is a major concern. Hellman et al. (2000) carried out a survey of firms in 22 transition countries. They found higher levels of 'administrative corruption'[3] in the CIS countries than in those of Central and Eastern Europe, although there was considerable variation within and between countries and the high regional average for the CIS was driven by values in the Caucasus countries and Kyrgyzstan. The survey also evaluated the extent of captured economies where public officials had effectively created a private market for what would normally be considered public goods, such as security of property and contract rights as well as rent-seeking opportunities. The findings indicate that the group of 'high capture' economies (in terms of the extent to which firms are affected by corruption in a series of government activities) include both relatively advanced reformers and those

[3]Administrative corruption is the extent to which firms make illicit and non-transparent private payments to public officials in order to alter the implementation of administrative regulations placed by the state on firms' activities.

that are less advanced (Azerbaijan, Kyrgyzstan).[4] The authors suggest that capture might be expected to thrive in a context of partial economic reforms and concentrated political power, since these countries have made progress with liberalisation and privatisation but there has been much less advance with institutional reform, for example to support a proper legal and regulatory framework (Hellman et al., 2000).

The lack of effectiveness of the legal and corporate governance mechanisms, as well as the competitive market environments, are blamed in part for the poor outcomes from worker ownership in CIS countries, as workers have been less effective there in improving performance than in countries with a stronger institutional framework such as Poland (Estrin, 2001). In a weak legal system, new owners of privatised firms may find it more profitable to rob firms and divert assets to other uses than running firms effectively. There is evidence (Johnson, McMillan and Woodruff (2002) and Frye (2001), cited in Djankov and Murrell (2002: 67)) that managers who have faith in the court system extend more credit and make more investment.

### *2.4.4 Market structure*

Competition and privatisation have been regarded as mutually reinforcing, since privatisation policies in isolation could simply lead to the creation of private monopolies (Bevan et al., 1999). While enterprise performance is expected to be affected by the market structure of the industry in which it operates, compared with the literature on Western economies, there is little evidence to indicate that market structure has a strong influence in transition economies (Bevan et al., 1999). Estrin and Angelucci (2003) were unable to identify any impact of competitive pressure on enterprise behaviour, using financial or economic measures of performance. However, they did find that competitive pressures influenced qualitative indicators of managerial activity such as restructuring and investment intentions. Carlin et al. (2001) found that restructuring was associated with the presence of just two or three seriously competing firms.

The liberalisation of trade has encouraged firms in transition economies to look for new markets overseas, but international competitiveness has been constrained by the lower quality of products, although foreign competition is reported to have encouraged improvements in product quality and marketing (Bevan et al., 1999: 15). Competition has also increased with the establishment of greenfield sites by foreign companies, forcing domestic firms to compete or allowing domestic and foreign companies to establish joint ventures (Bevan et al., 1999). Other research differentiates between regions and sources of competition. In Eastern Europe, the gains are reported to come from import competition but are also evident through domestic competition. In the CIS, domestic competition is sometimes found to be insignificant in explaining restructuring and imported competition generally has a negative effect on restructuring, but in Eastern Europe import competition is found to have a strong positive effect on enterprise restructuring. These findings suggest that in the CIS rapid liberalisation deterred domestic restructuring (Djankov and Murrell, 2002).

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[4] The high capture economies were found to be Azerbaijan, Bulgaria, Croatia, Georgia, Kyrgyzstan, Latvia, Moldova, Romania, Russia, Slovakia and Ukraine.

## 2.5 Conclusion

The privatisation literature has evolved since the start of transition. There is less emphasis on enterprise performance in strictly financial terms and greater consideration is attached to the internal workings of enterprises and the mechanisms by which change happens. Typically, studies tend to focus on the micro-level impact of reforms, but, as outlined above, research does consider the relationship between privatisation and other aspects of reform such as hard budget constraints and market structure. However, the focus is on the effects of privatisation on the enterprise and not on others affected, such as the state (through fiscal effects) or consumers (through changes in prices and access).

In transition economies, aside from improving internal enterprise efficiency, privatisation was intended to change attitudes, raise finance and develop capital markets, and contribute to the creation of a private sector. Empirical research generally finds that privatisation has had positive effects on firm performance in middle- and high-income countries, but the results are less clear-cut in transition economies. Privatisation outcomes have varied across enterprises, with some positive effect in Central Europe and largely negative results in CIS countries. Much of the research is inconclusive and studies produce conflicting results. In general, the conclusion is that the initial optimism regarding speedy privatisation has been replaced with a more cautious approach, since the focus on speed meant that issues relating to corporate governance and sequencing were neglected (Andreff, 2003).

The transfer of ownership to enterprise insiders is not considered to be an effective means of privatisation, because employees and managers are expected to have little incentive to introduce change, fail to bring in finance for investment and will be more focused on raising wages at the expense of long-term enterprise development. However, the evidence on this subject is inconclusive. Clearly, insiders play an important role in privatization, and managers are active players in the process. Where privatisation is seen as inevitable, managers can be expected to use what tactics they can to influence the process and final outcome (Antal-Mokos, 1998) Hence, according to Nellis (2002), privatisation policies need to place considerable importance on establishing control over managers, as they are the group best placed to further their interests.

# Chapter 3: Yugoslavia

The Socialist Federal Republic of Yugoslavia (SFRY), made up of six republics - Serbia, Montenegro, Bosnia and Herzegovina, Croatia, Macedonia and Slovenia - existed from 1945 to 1992. Under the leadership of Marshall Tito, a unique economic system was created in the country in the early 1950s known as 'worker-managed market socialism'. Under this system, enterprises were 'socially owned' which, although not legally defined, was a system where workers collectively held ownership rights over their enterprise, in that they were managers and had the right to dispose of assets and the right to residual income, although they were not able to sell their share (Medjad, 2002).

Unlike in other transition economies, output levels were not specified by federal and republican plans, but the firm itself drew up its own plan and was responsible for its own rate of production and for its own sales. Firms entered freely into contracts for the sale of output and the purchase of raw materials. The main indicator of firm performance became not exactly profit but the ability of the firm to cover its costs. Enterprises had more autonomy and the country had more interaction with Western countries and markets than other transition economies. This method of worker-management, which was not centrally controlled but was allowed considerable regional autonomy, was better suited to the region's potential ethnic tensions than a centrally planned economic structure (Rosser and Rosser, 2004). The system has been described as 'half-way between a centrally planned and a modern market economy' (Stojanov, 2003: 266), and this form of industrial organisation contributed to the country's earlier economic success next to the Socialist centrally planned state ownership system (World Bank, 2001). Debates about the economic effects of such a model came after it was established. At the time, the process was *ad hoc* (Rosser and Rosser, 2004).

Initially, prices and investment were set by the government but enterprise autonomy grew and, following a series of further reforms in 1965, the range of decisions undertaken at the enterprise level increased substantially with a view to creating a free-market system of autonomous self-managed firms (Estrin, 1983). Any profits (beyond 90% of contractually set wages) were at the disposal of the workers' council to be used for investment or distributed to the workers. The system was designed to increase efficiency through competition between firms (Zelic, 1997). Firms were not entirely independent, as investment decisions were made with interventions from local government and banks (Rosser and Rosser, 2004) and the state had the right to alter any decision of which it disapproved, but intervention was intended to be the exception rather than the rule (Ward, 1958). The government kept control of some prices. For example, wages were centrally set and depended on the sector in which the firm operated. The land, plant and equipment were usually state-owned and the amount the firm paid to the state was set according to the social plan.

In principle, managers were elected and so were accountable to workers. From 1952, after the original Workers' Council Law was passed, the supreme controlling body of an enterprise was the workers' council, elected by the workers. The council would appoint a management board to include workers and the enterprise director who would be jointly responsible for decisions regarding the organisation of production, purchase of inputs, shop-floor conditions, marketing, financing and wage and salary policy. Although these systems were in place, in practice there might be little scope to control a strong director who disagreed with the council members (Rosser and Rosser, 2004). In practice, over time the large firms became not 'worker'- but 'director'-managed. As firms increased in size and complexity, it became increasingly difficult to allow workers to have an input into management decisions and for lower skilled workers to have any control over technically complex operations. Firms became larger through a series of mergers, which arose in part because of soft budget constraints which meant that indebted enterprises were taken over through a kind of debt-equity conversion. Enterprises grew as parents acquired subsidiaries, further complicating the concept of social ownership (Medjad, 2002). In the mid-1970s new legislation was passed that effectively limited the power of workers (Rosser and Rosser, 2004). The pattern observed in SFRY, whereby greater control was placed in the hands of directors as enterprises expanded, has parallels with the separation of ownership and control observed in large Western companies (Medjad, 2002). Directors also had political connections which undermined the effectiveness of worker involvement (ibid.). Furthermore, in practice, enterprise decision-making was heavily influenced by outsiders such as the Communist Party, trade unions and local government authorities that increasingly strove to establish their independence and duplicated facilities that existed in other republics (Rosser and Rosser, 2004).

There was a tendency for wage dispersion within enterprises within worker-managed Yugoslav firms to be narrower than in capitalist and many other socialist countries (Vodopivec, 1992; Rosser and Rosser, 2004). However, there was evidence of relatively wide income differentials within and between sectors after the 1960s, and of earnings dispersion for a given job across sectors and firms, suggesting that firms were able to choose what level of wages they paid regardless of labour market pressures (Estrin, 1983). Worker-managed economies are also expected to aim at stabilising employment at the enterprise level, meaning that those in employment are secure but that there will not be new opportunities for the unemployed. Initially, employment was stable, but unemployment started to rise gradually after the mid-1960s and escalated in the 1980s (Rosser and Rosser, 2004).

Yugoslavia maintained economic relations with countries in both East and West. It was not a member of the Council for Mutual Economic Assistance like many transition economies, but had a number of trade agreements with the European Economic Community (Uvalic, 2001). The period of worker socialism achieved impressive economic results for post-war Europe which are comparable with other OECD countries. In 1945, Yugoslavia was a 'poverty-stricken, largely pre-industrial, war-damaged economy with a per capita income of only US$100 a year' (Rosser and Rosser, 2004: 403). By 1980, it had achieved respectable middle-income status.[5] The country was managed by a series of five-year plans, and the fifth five-year plan (1971-5) is considered to be a high point for worker-managed socialism in Yugoslavia (Rosser and Rosser, 2004).

One of the supposed limitations of worker management is that it is likely to lead enterprises to under-invest, as workers will have a short time horizon for investment, and will aim to maximise not profit but individual wage income; hence the focus will tend to be on maximising current income at the expense of ploughing profits back into the enterprise. This weakness was particularly significant in large industrial enterprises where there was a need to reinvest a large proportion of revenue (Atkinson, 1973). It was partly for this reason that investment was centrally managed in the 1960s. As there was little incentive for employees to invest in their socially-

[5] In 1981, per capita GNP was $3150 in current prices (World Bank, 1993), following three decades of per capita income growth averaging in excess of 5% p.a.

owned enterprise in order to accumulate capital, what capital was accumulated was mainly due to state intervention (Rosser and Rosser, 2004).

There is evidence of increasing inefficiency in investment as the reported capital-output ratio fell initially in the 1950s and then increased until the late 1980s (Table 3.1). Other evidence of the increasing inefficiency of capital investment is shown in Table 3.2, as the contribution to 'material product' from a fixed value of investment declined from the 1950s, becoming negative in the 1980s.

Table 3.1 Capital-output and labour-output ratios

| | **1953** | **1964** | **1974** | **1979** | **1988** |
|---|---|---|---|---|---|
| Capital-output ratio | 2.36 | 2.00 | 2.37 | 2.52 | 3.23 |
| Labour-output ratio | 0.41 | 0.28 | 0.19 | 0.17 | 0.19 |

*Source*: Egon Žižmond (1992) cited in Rosser and Rosser, 2004: 405.

Table 3.2 Investment efficiency (Dinars at 1972 prices)

| | **1952-60** | **1961-70** | **1971-80** | **1981-90** |
|---|---|---|---|---|
| Increase of material product on 100 dinars of gross economic investments in fixed assets | 38.8 | 26.8 | 21.1 | -3.5 |

*Source*: *Monthly Analyses and Prognoses*, Institute of Economic Sciences, Belgrade, October 2003

There was considerable variation in incomes across the six republics that made up the SFRY. Serbia was the largest, contributing 38% of total Yugoslav Gross Material Product (GMP)[6] and controlling more than a third of the territory with more than 40% of the population, but its GMP per capita was below the federal average. In Slovenia, GMP per capita was twice the Yugoslav average, reaching about $6,500 in 1990 (Fox and Wallich, 1997). In 1990, per capita GMP in Bosnia was about 29% of that of Slovenia (ibid.). Slovenia had a strong base in medium-sized manufacturing compared with Serbia, where enterprises were much larger and competing only within a protected domestic market. Geography had an important impact on regional development. Exporting firms were concentrated in the North, where transport costs to European customers were lower, while heavy industry and agriculture were more dominant in the South and in the more mountainous regions of Montenegro and Bosnia and Herzegovina.

Some republics were more autarkic than others. Table 3.3 shows the allocation in percentage terms of output levels that were traded in 1988. Despite relations with many countries, both the national and republic-level governments wanted to be self-sufficient. The relative openness of different republics is shown in the table. Slovenia was the republic with the highest proportion of output exported outside the country and a high proportion was traded with other republics. Serbia was the most autarkic, exporting considerably less and with the least trade with other republics.

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[6] GMP or "social product" in Yugoslav terminology is the value of 'productive' sectors of the economy, thus excluding 'non-productive sectors such as education, health, defence, banking and other services' (Uvalic, 2001: 6). In most socialist economies, GMP was calculated rather than GDP.

Table 3.3 Exports and trade between republics - % of output (1988)

| | **Bosnia Herzegovina** | **Montenegro** | **Croatia** | **Macedonia** | **Slovenia** | **Serbia** |
|---|---|---|---|---|---|---|
| Trade with other Yugoslav Republics | 19.8 | 26.0 | 19.2 | 23.4 | 22.2 | 14.8 |
| Exports outside of Yugoslavia | 10.7 | 8.4 | 12.1 | 10.1 | 14.9 | 9.0 |
| Internal | 69.5 | 65.6 | 68.7 | 66.5 | 62.9 | 76.2 |

*Source*: Rosser and Rosser (2004)

After Tito's death in 1980, the economic system began to unravel and per capita income fell. National political control went to a rotating collective presidency with little power, and political and economic authority rapidly devolved to the republics. Economic performance deteriorated and interregional tensions mounted. Since the 1960s, the country had had a tendency towards inflation due to soft budget constraints. While bankruptcy was a legal possibility, it was politically unacceptable, so local governments and banks propped up local firms, providing guarantees to such a degree that they were unable to finance them (Tyson, 1977; Rosser and Rosser, 2004). After 1986, inflation escalated rapidly while output declined. There was a wave of strikes in 1987 as workers attempted to make wages keep up with prices. Furthermore, much of the country's expansion had been financed by borrowing which was becoming unsustainable by the late 1980s. Yugoslavia's external debt in 1981 was $21.1 billion, $15.7bn higher than in 1974 (MAP, October 2003). The impossibility of debt servicing became apparent and a series of financial arrangements with the International Monetary Fund was initiated, starting in 1983.

In the late 1980s, the country was in economic crisis, with spiralling inflation. The international financial institutions forced the reformist government to take drastic measures including the freezing of credit to the industrial sector (Medjad, 2002). The federal government introduced some measures to stimulate the shift towards a market economy, and 1989 marked the beginning of Yugoslavia's move towards standard market capitalism. New laws allowed privatisation and foreign investment. The currency (dinar) was linked to the German Deutschemark and inflation was brought down from 1,256% in 1989 to 121.7% in 1990 (Rosser and Rosser, 2004).

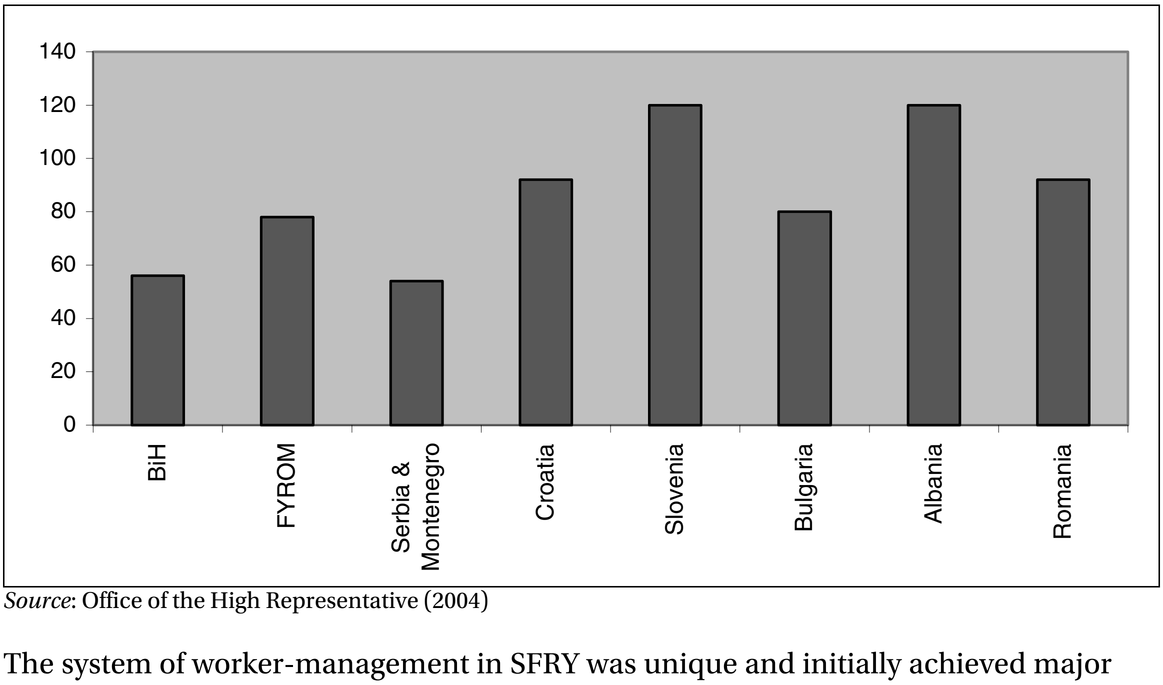
In 1989-90, the Law on Social Capital was passed by the government of Prime Minister Ante Markovic. The objective was to improve corporate governance and efficiency by transferring ownership in a more formal manner to workers by converting a socially-owned enterprise into a joint stock (or limited liability) company. Employees were able to buy shares at a discount on stated value, based on previous annual balance sheets. Shares sold could not be traded on the stock market. Workers could opt for privatisation, in which case they would be entitled to up to 60% of the equity of the new company. Four types of enterprises were to be allowed: Socially-owned, co-operatives, private (owned by individuals, foreigners or civil legal entities) and mixed (any combination of asset ownership of the other three types). Workers voted for conversion in thousands of enterprises, but only a few hundred completed the process, possibly due to the intervention of parent companies (Medjad, 2002).

The process was intended to create a gradual transformation of ownership from 'social' to private by the purchase of shares by employees and pensioners of the specific company, with discounted payments on an instalment basis. In addition, the aim was to establish forms of trading companies with a profit motive in accordance with market economies, and to set up mechanisms for corporate governance (management board, supervisory board, management with the participation of employees) with a view to creating more efficient management (Stojanov, 2002). Furthermore, at the time many enterprises had not paid their workers: 'It is probable that this law was not meant to express any official opinion on the substantive meaning of social ownership for it acknowledges the workers in their capacity of privileged creditors rather than their capacity of residual owner' (Medjad, 2002). The privatisation process in the former SFRY was without precedent, like the system of economic organisation that preceded it.

Until the end of 1990 several hundred enterprises, employing about 23% of the 'socially-owned' capital in the economy, entered the privatisation process (Cerovic and Malovic, 2003). While the law itself was overtaken by the subsequent break-up of Yugoslavia, subsequent privatisation initiatives in each of the Republics were in some way connected to Markovic's Law and there was already a substantial internal shareholding in many firms (Domadenik et al., 2003).

The process of transition and economic development ground to a halt in the early 1990s as conflict escalated across the region. The subsequent devastating wars meant that privatisation was off the policy agenda for many years. In most of the Balkans, the level of industrial output in the late 1990s was about half of the 1989 level (Habib, 2001). Fig. 3.1 shows that in 2002 the output levels of Bosnia Herzegovina and Serbia were far below the level of 1989.

Fig. 3.1: Index of real GDP in 2002, 1989=100




*Source*: Office of the High Representative (2004)

The system of worker-management in SFRY was unique and initially achieved major economic successes. However, it is unclear whether such a system was sustainable. There were a number of major weaknesses. The system was unable to operate in the context of increasingly complex and growing enterprises. In addition, the methods for making investment decisions seem to have been increasingly inefficient. The absence of hard budget constraints was responsible for a series of liquidity crises that became unsustainable by the mid-1980s. Evidently some reform was required and the country was the first transition economy to bring in privatisation under Markovic in 1989.

Until the start of the 1990s, the circumstances of SFRY should have been set for a relatively smooth transition to capitalism. Unlike the countries with high levels of central planning, enterprises in SFRY were relatively autonomous and traded with European countries. Compared with other countries in the region, SFRY had parallels with Poland and Hungary which are considered relatively successful privatisers. The picture was transformed by the war in the 1990s. After this, Bosnia and Serbia became not just economies on a transition path, but countries emerging from conflict with fragile political structures, low incomes and weak institutions. This was a far more difficult context for privatisation than when the concept was first introduced in 1989.

# Chapter 4: Methodology

## 4.1 Introduction

The objective of this research is to gain greater understanding of the way in which enterprises are affected by privatisation, focusing on the experiences of medium-scale enterprises in Bosnia Herzegovina and Serbia. Broadly, the research explores the relationship between policy outcomes at the micro level and the privatisation methods used as well as the type of investor. It also identifies some of the ways in which firms were affected by the regional conflict. This study looks at restructuring from the perspective of changes in internal processes (building on the research by Carlin et al. (2001) and Estrin and Angelucci (2003)) and this is supplemented by a review of key performance indicators. Both quantitative and qualitative indicators are used (the 'twin-track' approach recommended by Bevan et al. (1999)) based on survey questionnaires and interviews. The survey responses are further broken down to determine whether privatisation outcomes are affected by the nature of the new owner and/or the privatisation method. The scale of the research is small, with a target of twenty enterprises in each state. However, the depth of coverage of both the enterprise surveys and the interviews provides information on aspects of privatisation that have so far received little attention in the empirical literature.

The overall approach, then, focuses on survey responses regarding internal restructuring, supplemented with data on performance indicators. This methodology was adopted for a number of reasons. First, the privatisation programmes under examination in these countries have taken place relatively recently and there is evidence to suggest that changes in internal processes will take some time to affect quantitative performance indicators. Estrin and Angelucci (2003) find clear differences between private and state-owned firms in terms of their internal restructuring activity, but not in terms of measures of economic performance such as the profitability or productivity, suggesting that this effect is lagged. Thus a highly quantitative approach was considered inappropriate. Secondly, the aim was to cover a relatively small sample size but to find out in detail what privatisation has meant for the firm in the specific country context. The research findings that are of particular policy relevance are the details of firm responses which would be lost in a method of data analysis that focused on numerical detail and significance of *t*-statistics.

Third, the aim was to consider the effects of the policy environment on privatisation. The policy cannot be considered in isolation from the context in which it is implemented.[7] Hence Bosnia Herzegovina and Serbia have been analysed separately as, despite a shared history, they have been through quite different privatisation strategies in contrasting circumstances. The aim was to look in more detail at the mechanisms of enterprise control after privatisation, with a view to contributing to the bigger picture of systems of corporate governance that are emerging (Carlin, 2000). As a result, the findings presented here take the form of trends and observations rather than rigorous statistics. However, the findings reveal a number of policy issues that could usefully be the focus of more detailed research.

## 4.2 Survey

The research was based on a survey of privatised enterprises in the manufacturing sectors of Bosnia Herzegovina and Serbia, carried out in the first half of 2004. The

[7] See Nellis (2002) for a discussion on this point in relation to Poland.

goal at the outset was to receive responses from twenty firms in each country. Considerably more firms were contacted. As discussed earlier, there is evidence to suggest that privatisation programmes typically result in the best firms being privatised first. This potential selection bias has not been addressed in the research and needs to be borne in mind in the interpretation of the results. Furthermore, while the aim was to select a random sample from a list of privatised enterprises, in practice this process was also subject to bias as some firms declined to participate. More details on the difficulties in survey implementation are set out in Chapters 5 and 6. In addition to analysing responses from completed survey forms, interviews were held with managers of several enterprises (10 in Bosnia and 1 in Serbia). Firms were assured of confidentiality. Hence findings are presented on an aggregate level and individual firms are not identified.

### 4.2.1 Enterprise performance

The quantitative aspect of the research focuses on *changes* in enterprise performance and not on absolute values which can be distorted by differences in accounting practices across enterprises. In addition, Bevan et al. (1999) caution against evaluation of enterprise performance using Western benchmarks, but recommend focusing attention on changes in performance within an enterprise.

Firms were asked to provide data on sales, costs, profits, debt, employment, production volume and capacity utilisation for the year before privatisation, the year after and, where possible, two years after ($t$-1, $t$+1, and $t$+2).[8] Data were converted to constant (2002) prices and, where there were two observations for 'after privatisation', these were averaged to create an 'after' variable. The difference between the 'before' and 'after' values was calculated to create a 'percentage change' variable for each indicator. Thus there is no comparison of absolute values across enterprises. For each indicator, the mean value of percentage change is calculated, along with the maximum, minimum, standard deviation, number of positive and number of negative observations. This gives a picture of the results from the sample which is then compared with developments in the wider economy, and the manufacturing sector in particular, over the same time period in order to determine whether these results can be attributed to ownership change. These indicators were also calculated on a per employee basis to give a general indicator of changes in labour productivity. Firms were also asked to provide information on tax payments and on government support before and after privatisation, but there were few responses to this. However, some enterprises did volunteer information on access to financial resources.

### 4.2.2 Enterprise history and privatisation process

Firms were asked to provide details of the way that the years of conflict and the break-up of national boundaries affected their enterprise. This provides an insight into post-privatisation developments as, for example, firms have been forced to access new suppliers and/or markets after the country was broken up. Enterprises were also asked to provide data on financial performance on the eve of the conflict in 1990 in order to provide a comparator to demonstrate the impact of the conflict, but there was little response to this. In order to understand the impact of Markovic's

[8] Some firms were reluctant to provide this information.

Law, which was different in each republic, enterprises were asked to provide data on ownership structure from 1990 until two years after privatisation.

The privatisation process itself has the potential to affect the enterprise. This is particularly the case when privatisation is protracted or there are difficulties in identifying an investor. Firms were asked about the privatisation process itself in order to determine if this had had an impact on enterprise performance and to indicate if some firms were easier to sell than others. Managers were asked if there had been difficulties in the privatisation process and if the enterprise had been subject to any restructuring in the build-up to privatisation.

### *4.2.3 Internal restructuring*

Researchers have used several indicators of enterprise restructuring to determine the effects of different ownership structures. Carlin et al. (2001) take the following indicators of restructuring: decreases in employment, closure of plant, increases in employment, opening of new plant, new product line, upgrade, change of supplier, change of customer, change of main bank, change of organisational structure, and give responses by proportion of firm type. Estrin and Angelucci (2003) asked firm managers a number of questions about activities, ranging from the introduction of new products and services or quality enhancing innovation to sale or leasing out of real estate and shedding of excess labour.

Broadly, the introduction of new products, suppliers, markets and production processes is associated with proactive management (or deep restructuring). Shedding products, suppliers and markets are considered indicators of defensive restructuring, and no change indicates no restructuring. In the survey, firms were asked to provide information on the following indicators of enterprise restructuring:

- *Production processes*
  Changes in production method; level of production, quality of goods; changes in sources of inputs; the introduction of new products; sale of or investment in assets.
- *Internal structure*
  Introduction of new departments into the enterprise (such as marketing or accounting) since privatisation.
- *Employment practices*
  Number of employees; changes in incentives provided to managers and workers; changes in working conditions.
- *Governance*
  Managerial turnover
- *Impact of privatisation*
  Could the changes have been implemented without ownership change?

### *4.2.4 External environment*

Firms were asked about product market competition in several ways. They were asked to state the number of competitors that their enterprise had (none, one, two to five or more than five). Estrin and Angelucci (2003) use three categories for product market competition, defining competition as high if there are more than 5 competitors. Carlin et al. (2001) find that sales and productivity growth were higher in firms facing between one and three competitors for their main product than in firms that either faced no competition or faced more than three competitors.

Other questions were put to managers that related to product market competition. They were asked if they were exporting, and about prices charged over the period since privatisation, and were also asked to estimate how much the demand for their product would fall if the price increased by 10%. This approach is used by Carlin et al. (2001), who found that firms that reported that demand would fall slightly following an increase in prices were those with higher productivity growth than those that faced high price sensitivity in demand or complete insensitivity of demand. Firms were asked about their sources of finance, their view of the effectiveness of the legal system and whether they would take legal action against a supplier. Finally, firms were asked about the main opportunities and constraints facing their enterprises.

## 4.3 Methodological difficulties

The above discussion demonstrates that the empirical investigation of the effects of privatisation presents major methodological challenges. These have been addressed to varying degrees in this research and their treatment is discussed below. Chapter 2 presents evidence to show that both ownership structures and privatisation effects evolve over time. This research took place fairly soon after privatisation in both countries, and so the evidence presented here is of the immediate effects of privatisation rather than the long-term results. However, both countries are still implementing privatisation programmes, so an assessment of the early impact is of policy relevance.

Studies reviewed by Djankov and Murrell generally confronted the problems of selection bias after data collection and then used *ad hoc* methods to deal with these. They recommend that a study should start with a detailed institutional examination of the process that generated private ownership. This research attempted to address this issue by reporting on the institutional framework for the privatisation process and wider developments with the policy. However, two major sources of bias remain in the analysis. First, the sample only includes firms that have been privatised and, as mentioned above, typically it is the more attractive firms that are the first to be sold. Second, some firms declined to participate in the research. The goal was to create a sampling frame that covered all privatised enterprises in the industrial sector that had more than 200 employees and had been privatised for a year or more, incorporating all regions, sub-sectors and privatisation methods. With this as a starting point, the aim was to select a random stratified sample. However, the responses were not random as some firms opted not to take part in the survey. It may be that the firms that declined to take part share some characteristics giving rise to an additional bias.

Thus the results need to be interpreted with caution. In assessing a counterfactual position, it is difficult to find an appropriate control group. While there are numerous enterprises that have not been privatised, they fall into distinct categories with specific characteristics. Virtually all enterprises in the manufacturing sector are at some stage in the privatisation process. Hence comparing the performance of those that are privatised with those that are not would be misleading, because the ‘waiting for privatisation’ status is effectively an additional ownership category with its own pressures and constraints, and which would fail to indicate what would happen to firms if they did not pursue a privatisation path. There has been some attempt to address the counterfactual, as the quantitative indicators are compared with more general economic trends in order to determine whether the results are consistent with general sector movements. In addition, enterprise managers are asked whether the changes that have been implemented could have taken place without privatisation.

The sample sizes are relatively small in this research, limiting the extent of econometric analysis that can be carried out. Some data sets are even smaller, where enterprises opted not to provide information. Financial data were evidently perceived by some respondents to be sensitive, and there are a number of missing values. Thus the figures presented are not statistically robust. However, they are supplemented with details from enterprises which provide greater depth to the understanding of the effects of privatisation.

The survey relies on the responses of managers and thus are subjective, and the accuracy of the information is not verifiable. Responses may be subject to a tendency to complain which can be an excuse for poor performance. Where possible, subjects are covered in different questions to check for consistency of responses. To some extent, then, the research is about managers' perceptions rather than hard facts. This is particularly pertinent when it comes to questions about, for example, the market share of the enterprise or the legal environment, since it is the perceptions of managers that determine enterprise activity rather than factual information. The financial data are also based on what firms report in the questionnaire form rather than any kind of audited accounts. There may be reasons to either over- or under-represent different aspects of accounting data, so caution should be applied in the interpretation of these.

Some aspects of the survey were not well responded to and have been dropped from further analysis, in particular questions regarding budget constraints. Some data may not be accurate. For example, enterprise managers were asked about the number of workers employed. It is known that during the 1990s a substantial informal economy developed in both countries. Workers were not paid for periods of time (in Serbia) and so developed alternative means of economic survival in the informal economy.

# Chapter 5: Privatisation in Bosnia

## 5.1 Introduction

The state of Bosnia Herzegovina has a unique political structure which was established under the General Framework Agreement for Peace at the end of the war in 1995. The country is composed of two entities, Republika Srpska with 49% of the territory and the Federation of Bosnia Herzegovina (referred to here as the Federation) with 51%. The Federation is made up of ten cantons.[9] There are, then, 13 'governments' (ten cantons, two entities and one Bosnia Herzegovina state). Aspects of policy are carried out at state level (such as banking laws and customs), and federal and cantonal levels (fiscal policy and privatisation). In addition to the state apparatus, there is the Office of the High Representative (OHR). The position of High Representative was created under the Dayton Peace Agreement to oversee the implementation of the civilian aspects of the Agreement. In practice, the OHR has considerable powers and is able to impose or veto legislation and remove public officials from office. Thus the international community has substantial input into the running of the country.

Since 1997, privatisation has been a key policy throughout the country. This chapter reviews recent economic developments with particular emphasis on the manufacturing sector. It then analyses progress with privatisation in the country as a whole, before discussing results from the survey of 19 privatised enterprises. The findings show that there has been great diversity in the way enterprises have been affected by privatisation, depending on the initial conditions, the nature of the investor and the method of privatisation. They indicate that sales of enterprises to managers and employees have been successful where the sale has been through a tender process rather than using vouchers or certificates, thus suggesting that more research into the dynamics of insider ownership could be beneficial.

## 5.2 The economy

The Bosnian economy suffered greatly in the 1991-5 war. Incomes fell drastically and many of the population left. Since the war there have been impressive growth rates as shown in Table 5.1,[10] but because the economy was at such a weak point, absolute income levels remain low and are still far behind pre-war levels. At the start of the war in 1991, per capita GDP was $2,400 (Stojanov, 2002). In 2002, the corresponding figure was only $1,376. Recovery is set to take a long time. One of the goals of the macroeconomic framework of the Mid-Term Development Strategy of the Bosnia Herzegovina 2004 Poverty Reduction Strategy Programme (PRSP) is to reach 70% of the pre-war GDP by the end of 2007.

The high post-war growth rates were achieved mainly through investment in public infrastructure, predominantly financed and sustained by aid flows. Growth has been slowing down more recently as aid has tailed off (World Bank, 2004a). Despite changes in labour legislation introduced in 2000, labour market rigidities remain and have contributed to a situation where wage inflation has exceeded productivity, negatively affecting competitiveness (World Bank, 2004a).

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[9] There is also the Brcko District which under the Brcko Final Arbitration Award in 1999 was given substantial legislative and administrative autonomy.

[10] Some of the national statistics are far from robust, particularly in areas such as employment.

Table 5.1 Selected economic indicators in post-war Bosnia Herzegovina

| Indicator | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|---|
| GDP (% change in real terms) | 20.8 | 86.0 | 37.0 | 15.6 | 9.6 | 5.6 | 4.5 | 3.8 | 3.5 |
| Industrial gross output (% change) | 33.0 | 38.1 | 33.0 | 23.3 | 12.1 | 9.4 | 2.8 | 7.6 | 8.0 |
| Consumer prices (% change, annual average)- Federation | -4.4 | -24.5 | 14.0 | 5.1 | -0.9 | 1.9 | 1.9 | -0.2 | - |
| Consumer prices (% change, annual average)– RS | 12.9 | 16.9 | -7.3 | -14.0 | 14.1 | 14.0 | 7.0 | 1.7 | - |
| Unemployment (% of labour force) | | | | 38.0 | 38.5 | 39.7 | 39.7 | 40.6 | - |
| Private sector share of GDP (%) | - | - | - | 35.0 | 35.0 | 35.0 | 40.0 | 45.0 | - |
| GDP per capita, constant (1995) US$ | 546 | 981 | 1,298 | 1,455 | 1,551 | 1,595 | 1,633 | 1,675 | - |

*Source*: EBRD (2003), *World Development Indicators*, www.worldbank.org/data

Before the 1991-5 war, the industrial sector of the Bosnian economy was dominated by 12 huge companies, including Energoinvest, Unis, Sipad, Famos, Rudi Cajavec, Soda So, Agrokomerc, and UPI, producing for the domestic market in Bosnia and the former Yugoslavia (SFRY), and for foreign markets. Beside these giants, there were many privately owned small and medium enterprises (SMEs), more often small than medium in size. Since the end of the conflict, enterprises have had to contend with devastating war damage as well as the loss of markets and the break-up of larger enterprises. According to the country's 2004 PRSP, some difficulties facing the industrial sector in Bosnia Herzegovina stem from the economic system operating before the conflict. Bosnia Herzegovina's industry was highly dependent on large investments in the military industry for a long time after the Second World War. Before the break-up of the country, more than 55% of the military industry of SFRY had been located in Bosnia Herzegovina. This industry had a secure market in the Yugoslav People's Army, and exported successfully. During the war facilities were destroyed, skilled personnel left and the market collapsed (Bosnia and Herzegovina Council of Ministers et al., 2004).

There is a high level of obsolescence in enterprise equipment because companies were relatively technologically obsolete before the war, and the war then destroyed much of the equipment. Furthermore, with a post-war policy emphasis on privatisation, there has been little support for state enterprises (Stojanov, 2000). In general, the business environment is regarded as not conducive to investment, owing to the complex legal and regulatory environment, the lack of transparency in the administration and a weak and ineffective judicial system. The market is small (3.5 million people). Market institutions are weak and corruption is pervasive. Stojanov (2000) cites a study which looked at the experiences of 50 firms and found that the ruling political parties act as an organised family. Furthermore, non-compliance with the law is widespread at all levels, with cronyism and nepotism dominating the business environment. Such a climate has had knock-on effects on production, since it can be more lucrative to focus on the interplay between trade and politics than to make the effort to produce goods (Stojanov, 2000).

A number of reforms and policies have been put in place to improve the business environment. For example, the OHR established the 'bulldozer committee' in

November 2002, designed to streamline cumbersome bureaucratic processes. Bankruptcy Laws were approved in Republika Srpska in October 2002 and in the Federation in June 2003. Production had been constrained by a weak financial sector, but the system seems to have improved since the privatisation of banks that was carried out through a process of international tenders which has been relatively successful. The banking system which was in crisis before privatisation is now stable, although, despite significant foreign investment, the proceeds have been fairly small (Bosnia and Herzegovina Council of Ministers et al., 2004). According to the EBRD, a sound banking system has taken root in the Federation (EBRD, 2003). In 2003, the domestic banking sector increased its lending to businesses, and as a result the share of loans to businesses in GDP approached the share of loans to households (Bosnia and Herzegovina Council of Ministers et al., 2004).

There are differing views on the state of the manufacturing sector in Bosnia Herzegovina. The World Bank talks of 'stagnating manufacturing activity' (World Bank, 2004a). Meanwhile, according to the government in the country's PRSP, while the industrial sector suffers from numerous constraints (including poor productivity and competitiveness, due to weak infrastructure, underdeveloped financial markets, a weak fiscal system, the low level of technological development, and lagging in business strategy and management quality), the trends are 'encouraging' with 5% growth in both entities. The share of industrial production in GDP is estimated to have risen from about 30% in 1997 to about 38% in 2003 and is expected to rise to 40% over the course of the medium-term PRSP (Bosnia and Herzegovina Council of Ministers et al., 2004).

Table 5.2 provides data on industrial developments in both entities in the period 2000-3. The figures show a heavy decline in industrial production in Republika Srpska, while production has increased in the Federation. Manufacturing employment fell in both entities by around 13% during this period.

Table 5.2 Selected economic performance indicators (2000-3)

| | **2000** | **2001** | **2002** | **2003** |
|---|---|---|---|---|
| **Federation** | | | | |
| Index of industrial production (% increase over previous year) | 8.8 | 12.2 | 9.2 | 4.8 |
| Average no. of employed people | 410,808 | 407,199 | 394,132 | 387,381 |
| - of which manufacturing | 103,830 | 97,848 | 85,592 | 90,397 |
| | | | | |
| **Republika Srpska** | | | | |
| Index of industrial production (% increase over previous year) | | -12.9 | -2.5 | 5.7 |
| Average no. of employed people | 228,291 | 220,791 | 233,718 | 236,438 |
| - of which manufacturing | 71,932 | 67,125 | 66,058 | 63,270 |

*Source*: Federal Office of Statistics; Republika Srpska Institute for Statistics

The data in Table 5.3 also show that, since 2000, manufacturing output has been increasing in the Federation, but suffered a decline in Republika Srpska in 2001. Value added in both entities has been increasing and is higher in the Federation than in Republika Srpska.

Table 5.3 GDP by value added in each entity: Manufacturing[a]

| | 2000 | | 2001 | | 2002 | |
|---|---|---|---|---|---|---|
| | '000KM | % | '000KM | % | '000KM | % |
| **Bosnia Herzegovina Production Account** | | | | | | |
| Output | 4,345,725 | | 4,360,135 | | 4,577,624 | |
| Intermediate Consumption | 3,331,676 | 77 | 3,286,631 | 75 | 3,415,655 | 75 |
| Gross value added | 1,014,049 | 23 | 1,073,504 | 25 | 1,161,969 | 25 |
| | | | | | | |
| **Federation Production Account** | | | | | | |
| Output | 2,915,430 | | 3,222,633 | | 3,420,153 | |
| Intermediate consumption | 2,161,694 | 74 | 2,364,610 | 73 | 2,506,083 | 73 |
| Gross value added manufacturing | 753,736 | 26 | 858,023 | 27 | 914,070 | 27 |
| | | | | | | |
| **Republika Srpska Production Account** | | | | | | |
| Output | 1,382,568 | | 1,102,026 | | 1,111,537 | |
| Intermediate consumption | 1,142,920 | 83 | 898,156 | 82 | 879,985 | 79 |
| Gross value added manufacturing | 239,648 | 17 | 203,870 | 18 | 231,552 | 21 |

*Source*: Bosnia and Herzegovina *Statistical Bulletin*, Agency for Statistics
*Note*: a) The values for the Federation and Republika Srpska do not add up to the total for the country as a whole because the national figures also include Brcko District which is not covered here.

Some sectors have fared better than others, and they face different constraints, aside from the country's operating environment. For example, food processing experiences difficulties because of obsolete plants and shortage of domestic agricultural products. Metal working is in crisis because it is dependent on the military industry. Leather and textile production cannot achieve adequate competitiveness because of the salary levels in Bosnia Herzegovina (compared with South-East Asia). Some sectors are considered strategic, and the government intends to implement policies to stimulate them.[11]

A study of 105 companies in Bosnia Herzegovina by Muris Cicic (2002) found that there was a marked discrepancy between enterprises in the Federation and in Republika Srpska where companies were much smaller with fewer assets and less production, sales, exports and labour force. The research finds that, in terms of profitability, there is little difference between state-owned and private firms, since the majority are still making losses. However, it is the companies with the largest participation of private capital that have the smallest losses.

While industrial growth for the country as a whole remains positive, the rate of growth has slowed in recent years. There are now calls for a major change in the approach to industrial policy, in that the large-scale industries that dominated activity before the war cannot be recreated. According to the country's 2004 PRSP, a radical change in the approach to development is required as it is no longer realistic to focus on the retention of large enterprises (Bosnia and Herzegovina Council of Ministers et al., 2004: 237). The PRSP also highlights the problems caused by the country's slow privatisation which has hindered industrial development through expansion of the technology lag, particularly since the lack of public funds makes it impossible for the state to support scientific and applied research (ibid.).

[11] Wood processing; food processing; textiles; leather goods and footwear; metal-working; tourism; energy; information and communication technologies.

## 5.3 Privatisation in Bosnia Herzegovina

### *5.3.1 Overview*

As in the rest of Yugoslavia, companies in Bosnia Herzegovina were 'socially' – rather than state – owned. As a result of this history and in the context of a fragile political framework, the emphasis of the privatisation programme has been on social and political acceptability rather than economic efficiency. The way Markovic's Law was implemented in Bosnia in 1989 resulted in a small proportion of shares in companies being transferred to employees rather than whole companies (as in Serbia). By 1991 in Bosnia Herzegovina, 585 (5.24%) of socially-owned companies had carried out such transformation with 98,494 (12.87%) of employees (Stojanov, 2002).

After the Markovic legislation, privatisation did not emerge again until 1997 when donors were participating in the post-war reconstruction. The model adopted was broadly that of voucher privatisation, whereby all citizens were given vouchers with which they could buy shares in enterprises. This approach was intended to allow broad participation of all citizens and was based on the Czech model (see Chapter 2). The emphasis was on speed and simplicity as well as political acceptability, at the expense of creating a strong corporate governance structure:

> The quick privatisation of still-functioning but idle assets of state enterprises (trucks, machines, sheds) could be of great help in starting a private sector-led recovery. These assets could be split off and sold through simple mechanisms by the enterprises themselves under, say, municipal supervision similar to what has been tried in Albania, Croatia and Russia. This effort would require moving away from any complicated privatisation schemes such as those that have been implemented in other Republics of the former Yugoslavia. (World Bank, 1996b: 16)

Initially, the process was expected to be completed in a couple of years, but progress was far slower than expected. By early 2001, less than 10% of large-scale enterprises within the Federation had been privatised, while in Republika Srpska the figure was less than 5% (Donais, 2002).

Privatisation in Bosnia Herzegovina as in the other transition economies was intended to be part of a process of transition to a market economy. Expectations were high. Still on the website of the privatisation agency of the Federation, objectives include: contributing to the development of economic reforms and transferring to institutions and mechanisms of the market economy; return of lost markets; introducing Western standards and norms; upgrading of technology and management; capital inflow and revitalisation of the economy (Federation Privatisation Agency website, www.apf.com.ba).

In addition, the process was intended to be a means of settling the large number of claims on the government (e.g. for unpaid wages and pensions, and for damage losses arising from the war) which the government could not possibly meet. Instead, such claims were to be settled through the provision of privatisation certificates:

> No major fiscal resources should be provided for the settlement of claims. A substantial portion of the claims of individuals could be settled by exchanging them for privatisation certificates that can be used along with cash for privatisation transactions....These privatisation certificates

> could later be used, together with cash to purchase publicly-owned assets that could be offered for sale in the near future including housing, agricultural and forest land, enterprises and commercial banks (World Bank, 1996b: 55).

The Bosnia Herzegovina Framework Law on privatisation called for inter-entity co-operation in the privatisation process, but there were differences in the privatisation rules adopted in each entity. In the Federation, the Privatisation Agency was set up legally in 1997 with ten cantonal agencies under its jurisdiction. Most of the privatisation has been implemented at the cantonal level. Each canton has its own privatisation agency to avoid political complications: 'Privatisation too, will have to be organized at the regional level to avoid debates about unfair asset allocation across communities, despite the potential inefficiencies of multiple privatisation agencies' (ibid.: xiv). Because of the adoption of different rules in each entity, companies that were in both entities had to be broken up (according to survey interviews).

In the Federation, vouchers were issued to all citizens who had been aged over 18 in 1992. In 1999 each citizen was given a basic certificate to the value of 1900KM. In addition, some were given certificates in recognition of military service or in lieu of pension entitlements. With these certificates, individuals were able to buy shares in enterprises put up for sale via public offering, or shares in Privatisation Investment Funds (PIFs) or to buy housing (in the Federation). PIFs were established for the collection of certificates to invest in shares or holdings of enterprises which could then exchange the certificates for shares in companies offered for privatisation. The main method of privatisation in the Federation was known as the Public Offering of Shares (POS), where shares were offered to citizens and PIFs. Each PIF was only allowed to use the vouchers invested in it to purchase shares of enterprises during the POS.

There were three waves of public offerings.[12] Each PIF was prevented from investing more than 20% of its capital in any one enterprise and was not allowed to own more than 30% of an enterprise. PIFs needed equity of KM200m. of certificates in order to be registered.[13] Eleven have been registered in the Federation. Initially, the POS was the preferred means of privatisation, but as the limitations of this approach became apparent (weak corporate governance structure and no injection of capital), greater interest was focused on tender privatisation methods (Federation Privatisation Agency) and POS was stopped in November 2002 (www.afp.com.ba).

In the Republika Srpska, the Directorate for Privatisation was established in April 1999. The approach adopted was slightly different from that of the Federation. The term 'voucher' (rather than 'certificate') was used. These did not have a monetary value as they did in the Federation. Also, in the Federation certificates could be used to buy housing, which they could not in Republika Srpska. In Republika Srpska, every citizen, according to law, was entitled to free vouchers. The basic entitlement in Republika Srpska was 20 vouchers, and this was increased depending on such things

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[12] Three groups of enterprises were sold and in each wave there were two rounds. In the first round, applications were received and where this was close to the value of the state capital (i.e. a value based on the balance sheets returned by the firms) and within a range of 80 to 120% of this state capital value, the sale was concluded. If it fell outside this range, the sale was considered not viable and went through to a second round where these criteria did not apply, so even if only 1KM was put up for a sale, it would go through.

[13] Securities Commission Regulation on the format and contents of the Prospectus for the First Share Issue of a Privatisation Fund.

as number of years in employment, length of military service, etc. These vouchers could be exchanged for shares in a company or they could be invested in PIFs. Thirteen PIFS have been registered in the Republika Srpska.

Initially in the Republika Srpska, the privatisation method used was known as 'Voucher Offer', which was similar to the POS. In the first Voucher Offer launched in November 2000, citizens and the thirteen PIFs were offered 55% of the state equity in 830 enterprises. Out of a total of 49 million vouchers issued, over 84% were utilised, of which PIFs collected 57% which were invested in 530 enterprises (OHR, 2001). In addition, the Directorate now uses auctions (or Dutch auctions where the auctioneer lowers the bid price until there is a bid) and tenders for privatisations. With an auction, the Directorate has to advertise it in at least one daily newspaper that is accessible to the whole territory of Republika Srpska at least 30 days before the date when the auction is to be held. Interested parties then submit an application to the Directorate. If no bidders bid at the initial price, the auction is declared unsuccessful. In contrast, a tender sale requires the collection of bids from potential buyers in compliance with tender conditions announced beforehand. There are two types of tenders – fixed conditions tenders where the bidder agrees to implement conditions on employment and investment published by the Directorate for Privatisation in the Public Invitation, and variable conditions tenders. The Directorate issues a public invitation to tender. During the period of the bid submission, interested bidders can visit the site to examine the enterprise in detail (due diligence). Bids are received in sealed envelopes by a specified date (Directorate for Privatisation in Republika Srpska, www.rsprivatizacija.com).

If tender and auction privatisation processes fail to secure an investor for the firm, the privatisation agency can as a last resort implement a process known as 'direct negotiation'. Procedures for direct negotiation are similar to those of tender in that sealed bids are invited. The difference is that, at this stage, there is clearly little interest, and the agency may therefore accept a lower price.

### 5.3.2 Results

Table 5.4 shows how citizens used their certificates and vouchers according to household data collected in 2001 for the country's Living Standard Measurement Survey.[14] The table shows that in the Federation a large proportion of certificates (37%) had not been used by September 2001 (two years after issue). This was substantially higher than the corresponding figure in Republika Srpska. Over half the vouchers issued in Republika Srpska were invested in PIFs, compared with around 22% of certificates in the Federation.

[14] The true picture is slightly more complex, as some vouchers were used in the Federation and some certificates in Republika Srpska, but the overall picture is not changed (LSMS, 2002).

Table 5.4 Distribution of persons who had used vouchers according to nature of transactions, September 2001 (%)

| | Federation | Republika Srpska |
|---|---|---|
| | Certificates | Vouchers |
| Sold | 15.98 | 1.01 |
| Bought apartments | 15.58 | 0.50 |
| Investing in company | 5.22 | 29.14 |
| Investing in funds | 21.99 | 54.74 |
| 'Without transactions' – not used | 37.08 | 13.51 |
| Other | 4.16 | 1.11 |

*Source*: Living Standard Measurement Survey, 2002

Both the Federation and Republika Srpska group enterprises into 'small' and 'large.' In the Federation, 'small' enterprises are those with state capital of less than KM500,000 and fewer than 50 employees. In Republika Srpska, 'small' enterprises are those with state capital of less than KM300,000.[15] Essentially, the privatisation of small and medium-sized enterprises is complete in both entities. In the Federation, the first wave of privatisation was carried out in 1999 and focused on small enterprises. According to the data in Table 5.5, a total of 1,284 firms had been privatised by the end of 2003 in the Federation. However, the firms sold are mainly small.

Table 5.5 Privatisation in Federation of Bosnia Herzegovina (2003) - Numbers of firms privatised

| | 1999-2000 | 2001 | 2002 | 2003 | Total |
|---|---|---|---|---|---|
| **Small privatisation (< KM500,000 and 50 employees)** | | | | | |
| No. of firms | 153 | 46 | 38 | 10 | 247 |
| % of payment by certificates | 62.47 | 62.66 | 31.10 | 76.51 | 60.16 |
| % of payment by cash | 37.53 | 37.34 | 68.90 | 23.49 | 39.84 |
| **Large-scale privatisation through tender** | | | | | |
| No. of firms | 83 | 68 | 99 | 35 | 285 |
| % of payment by certificates | 71.74 | 65.55 | 78.45 | 62.22 | 70.68 |
| % of payment by cash | 28.26 | 34.45 | 21.55 | 37.78 | 29.32 |
| **Public offering of shares** | | | | | |
| No. of firms | 0 | 681 | 71 | 0 | 752 |
| % of payment by certificates | - | 100.00 | 100.00 | - | 100.00 |
| % of payment by cash | - | 0.00 | 0.00 | - | 0.00 |
| **Totals** | | | | | |
| No. of firms | 236 | 795 | 208 | 45 | 1284 |
| % of payment by certificates | 66.99 | 98.74 | 97.09 | 71.31 | 96.10 |
| % of payment by cash | 33.01 | 1.26 | 2.91 | 28.69 | 3.90 |
| | | | | | |
| **Privatisation proceeds (% of GDP)** | **1.3** | **0.7** | **0.1** | **0.0** | **2.1** |

*Source*: Federation Privatisation Agency data; IMF (2004a)

Total proceeds from privatisation to the end of 2003 came to about KM8.9billion (Federation Privatisation Agency). Table 5.5 shows that this accounts for a very small proportion of GDP, reaching a peak of 1.3% in 2000. The table also shows that more

[15] There is considerable emphasis on the value of 'state capital' in privatisations in both Republika Srpska and the Federation. Progress is measured in terms of the amount of state capital privatised. This value was derived from calculations during the pre-war Markovic privatisation.

than 96% of the payments for privatisation in the Federation have been in the form of certificates and the majority of these were exchanged during Public Offering of Shares. However, these are the smallest firms. Much of the data used by the privatisation agencies are in terms of the value of state capital. This relates to valuations of enterprises carried out at the time of Markovic. While the measure might have questionable interpretations (the issue of enterprise value in the privatisation context is often problematic), it can be useful for comparisons. Table 5.6 contrasts the proportion of firms privatised and the proportion of state capital privatised to demonstrate that, while the majority of firms have been privatised (67%), these are small firms of relatively low 'value', as this proportion corresponds to only 37% of state capital.

Table 5.6 Privatisation in Federation of Bosnia (2003)

| | **2003** | **2006 target** |
|---|---|---|
| % firms privatised | 67 | 78 |
| % state capital privatised | 37 | 84 |

*Source*: Federation Privatisation Agency data

For the larger firms sold, there has been more in promised investment than in receipts, and high amounts of employment are promised (Table 5.7). Over KM800million of new investments was contracted, of which KM371m. was foreign investment. Of 50 contracts signed with foreign investors, 18 were with investors from Slovenia and 11 from Croatia. A smaller number of investors have been from Austria, the Czech Republic, Germany and Italy (Federation Privatisation Agency, 2004).

Table 5.7 Results for large firms[a]

| | |
|---|---|
| Price | KM607m. |
| Vouchers | KM178m. |
| Agreed investment | KM800m. |
| Agreed new employment | 41,470 |
| New employment to date | 9,576 |
| Number of employees taken over | 31,894 |

*Source*: Federation Privatisation Agency
*Note*: a) i.e. with state capital of more than KM500,000

In Republika Srpska, 1,100 companies have been offered for sale through similar methods to those in the Federation. In addition to sales by voucher offer, at the end of 2003, 519 enterprises had been privatised in Republika Srpska (Table 5.8). In most companies, about 55% of state capital was exchanged for vouchers, 10% was transferred to the pension fund, 5% to the restitution fund and 30% was kept by the state to be sold by alternative means such as auction or tender. With strategic enterprises, only 20% was offered for sale by vouchers (field-work interviews). In Republika Srpska, in addition to voucher sales the privatisation proceeds included KM133m. in frozen foreign currency savings and KM20m. in cash.

Table 5.8 Republika Srpska firms privatised to 31/12/03

| | No. | % |
|---|---|---|
| **Firms below KM300,000** | | |
| Auction | 103 | 19.8 |
| Direct sale | 34 | 6.5 |
| Tender – fixed conditions | 1 | 0.2 |
| | 138 | 26.5 |
| **Firms above KM300,000** | | |
| Auction | 253 | 48.7 |
| Direct sale | 5 | 0.9 |
| Tender with fixed conditions | 12 | 2.3 |
| Stock market | 71 | 13.7 |
| | 341 | 65.7 |
| **Strategic** | | |
| Tender – with negotiable conditions | 40 | 7.7 |
| | | |
| Total | 519 | |

*Source*: Directorate for Privatisation, Republika Srpska

The basic certificate entitlement was KM1900 in the Federation (in Republika Srpska, vouchers were based on points), and some individuals were given additional certificates in recognition of military service or in lieu of pension entitlements. The value of certificates fell substantially after they were issued, and when they were sold, most received substantially less than the nominal value. Table 5.9 shows the percentage distribution of those provided with certificates according to the nominal value they received and the value at which they were sold. The table shows that 36% of the population received the basic value of KM1900, and most received more than this basic entitlement. However, when the certificates were sold, the value of more than 99% had fallen to below the basic certificate value. They are reportedly still being traded at about 3% of par value.

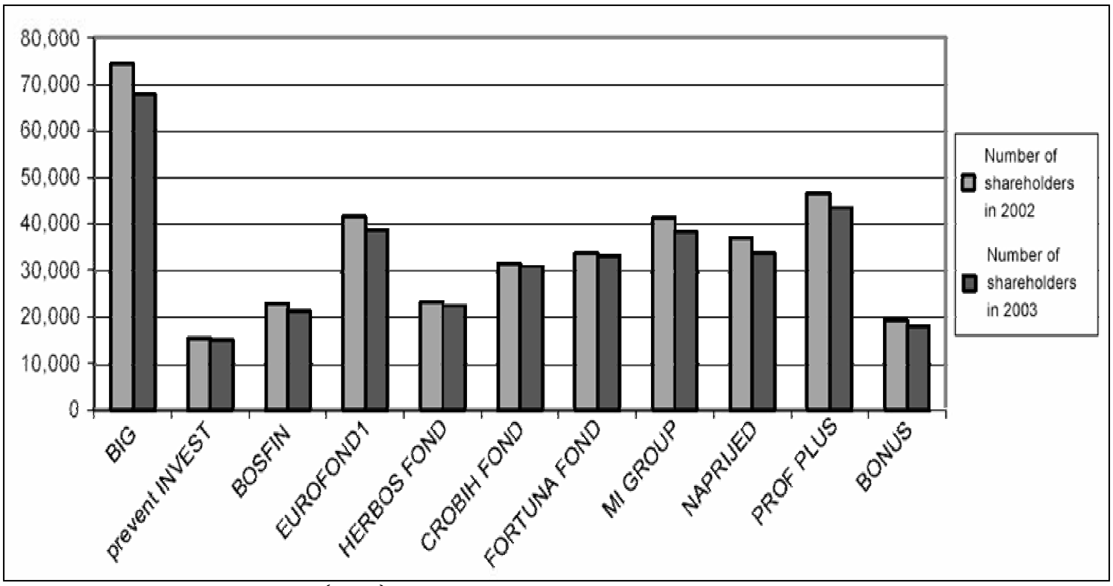
Table 5.9 Percentage distribution of those who had sold their certificates according to the nominal value of the certificates sold and their actual value obtained from the sale

| Value KM | Nominal (% population) | Sold value (% population) |
|---|---|---|
| 1-1,899 | 2.33 | 99.42 |
| 1,900 | 36.73 | 0.00 |
| 1,901-4,999 | 11.79 | 0.58 |
| 5,000-9,999 | 16.24 | 0.00 |
| 10,000-14,999 | 12.08 | 0.00 |
| 15,000+ | 20.83 | 0.00 |

*Source*: Living Standard Measurement Survey in Bosnia Herzegovina (2002)

There are currently 11 PIFs registered with the Securities Commission in the Federation. The expectation was, when PIFs were established, that they would provide a valuable contribution to corporate governance and a source of capital funding for enterprises. Outcomes have been disappointing. The largest PIF, which is called BIG, has nearly 70,000 shareholders. Fig. 5.1 shows the number of shareholders in each PIF in 2002 and 2003. All of the PIFs have fewer shareholders in 2003 than 2002. One of these (MI Group which, according to Fig. 5.1, has around 40,000 shareholders) has shares in more than 150 companies. Thus shareholder control over corporate governance is extremely diffuse.

Fig. 5.1: Number of shareholders in the PIFs in the Federation of Bosnia Herzegovina




*Source*: Securities Commission (2003)

Each PIF is managed by a fund management company. There were three public share offerings. Of the total subscribed initial capital in all of the 11 PIFs (which came to KM4.3bn), almost 100% was used to purchase shares in 463 companies. 96% of the investments of PIFs is 'unmarketable', meaning that they are not traded (Securities Commission, 2003). With such large numbers of shareholders, corporate governance is difficult. According to the Securities Commission, there has been no great interest from shareholders in participating in general meetings. The percentage of voting shares represented at meetings in 2003 was between 0.14% and 13.39%, despite efforts by the Commission to inform and remind shareholders to exercise their rights (ibid.).

The Securities Commission reports that in companies where they are registered shareholders, the funds have been involved to some degree, participating in meetings and appointing their representatives to management boards. However, when it comes to active participation in the management of companies in which they are dominant owners through the introduction of fresh capital investments, company restructuring or finding strategic investors, the results remain 'negligible' (Securities Commission, 2003) There are concerns that, with trading in shares in PIFs, a growing number of shares are being taken over by individuals connected with the fund management company and there could be a danger that the PIFs will be managed in the interests of the minority connected with the fund management company (ibid.).

In general, privatisation with vouchers has not been considered successful in terms of the impact on enterprise restructuring. While the process has transferred ownership to the private sector, ownership is widely dispersed in the hands of unsophisticated and inexperienced shareholders with no capital to invest in enterprises and little expertise or interest in running an enterprise according to conventional notions of corporate governance. The profit motive has (reportedly) been manifested in asset stripping rather than improvements in production processes. The result is described in the 2004 PRSP as the 'the transformation of ownership' rather than a 'real revival of production'. PIFs have had a negative image, and as a result people have neglected to spend a large share of their certificates/vouchers (about KM4bn) in the privatisation process. PIFs are usually minority owners in companies. They were prevented from holding majority stakes in enterprises and this greatly weakened their ability and motivation to exercise due corporate governance. Hence, their ability to contribute to the acceleration of the economy was limited (Bosnia and Herzegovina Council of Ministers et al., 2004). The IMF has called for changes to the rules governing PIFs in Bosnia Herzegovina which limit the share of an individual company that PIFs may own (IMF, 2003: para. 18).

The approach to privatisation has now changed. Public offerings of shares are no longer used. In the main, privatisation is to be carried out by a process of tender and if this fails, by direct negotiations and if this fails, by leasing. Where firms are tendered, certain conditions are set. Buyers have conditions imposed on them in terms of commitments to invest and to maintain or increase employment. If the conditions are not met over a specified period, the agency is entitled to sue the firms (according to interviews with agency staff). The conditions and price depend on the state of the enterprise. For example, it was reported in interviews that one enterprise was sold for a nominal 1KM, while the investor took on substantial debts.

The focus now is on the privatisation of 'strategic' enterprises (i.e. enterprises in which the participation of a strategic investor is sought). There has been considerable debate about which companies should be in this category. In 2000, 108 enterprises were on this list (56 in the Federation and 52 in Republika Srpska). The strategic companies were allocated to different donor agencies including the European Union, the World Bank, the GTZ and USAID. The idea was that potential investors would have professional support from the initial point when they express an interest in participating in the privatisation, right through to the tender and sale process. Since then, by the end of 2003, only 23 of these 108 firms had been sold (19 in the Federation and 4 in Republika Srpska).

### 5.3.3 Privatisation constraints

Massive resources have been invested by the donor community in privatisation, but with little result beyond the sale of small-scale enterprises. The process has been slow and has brought little in terms of economic regeneration. It is difficult to find any support for the privatisation programme in Bosnia and there are many critics. For example, according to Donais (2002: 2): 'What international advisors originally envisaged as an apolitical, rapid and orderly transfer of assets from public to private hands has become a corrupt, ethnicized, and protracted struggle for power, which has done little to stimulate economic growth or promote inter-ethnic reconciliation.'

Privatisation is widely unpopular. Many said, informally in interviews, that voucher privatisation had failed, but as yet there has been no formal evaluation of the process. Arguably, it succeeded in terms of social and political objectives, but failed when measured against the ambitious economic objectives set out above. The process has meant that firms have been taken over by, in some cases, thousands of individuals, and these are unsophisticated shareholders with little understanding of corporate governance issues. Privatisation in this way is unlikely to do much to improve firm performance.

There have been regional variations in privatisation outcomes. In Tuzla Canton, widespread abuse of the voucher system was reported through PIFs which resulted in 'wildly speculative privatisations which brought no new working capital' (OHR, 2004). In the Canton of Zenica-Doboj, PIFs have not been so prominent. Privatisation has been internationally supervised. However, progress has been disappointing. Similarly in the North East of the Federation, privatisation of larger and strategic businesses has not been successful, and it has only been marginally successful in eastern Republika Srpska where privatisation has not brought the expected results. Although cases of successful privatisation exist, by and large the process has been slow and has been characterized by small investments, an insufficient number of new jobs and a lack of new managerial expertise (OHR, 2004).

In Canton 1, OHR (2004) cites some positive examples of newly privatised companies, such as the Bosnia Herzegovina dairy, whose new owner paid off old debts and started to expand the production base. Privatisation in Canton 10, as elsewhere in Bosnia Herzegovina, has not produced the expected benefits. There are still some 30 companies in the Canton which are not privatised. In the Sarajevo region, the premises of Famos, an important state-owned industrial multinational before the war, were successfully being turned into an industrial zone through the privatisation of the company in parts. As many as 90% of businesses operating in the Sarajevo region are privately owned. The rest are either state-owned, of mixed ownership, or registered co-operatives. However, a substantial part of the total corporate assets in Sarajevo is still in the hands of state-owned enterprises (OHR, 2004).

Although voucher privatisation is no longer implemented, revised privatisation policies have yet to have a major impact. There are several factors which, to varying degrees, have constrained the implementation of privatisation policies, and these can be grouped into two main headings: lack of investor interest and lack of political will. Bosnia is perceived as a high-risk environment because of the war, the unusual government framework, the small market size and the low domestic incomes. The business environment is not conducive to investment activity, with lengthy time periods for company registration. In addition, there are constant revisions and recommendations for revisions to the legal framework. The enterprises themselves are not attractive, with high and growing debts, overstaffing, and lack of investment for at least ten years, and most are operating considerably below capacity. The process of privatisation itself is making it harder to sell enterprises because it has been so slow. Debts that were written off to make enterprises more attractive have grown again during the long build-up to privatisation, and have thereby eroded the value of state capital (Bosnia and Herzegovina Council of Ministers et al., 2004).

The slow speed of privatisation is also attributed to the lack of political will and the government's reluctance to sell enterprises to foreign investors. There have been (according to the EBRD (2003)), especially in the Republika Srpska, several high-profile privatisation failures (Banja Luka Brewery, Fruktona fruit juice processing), and these were attributed to 'the rigidity of the existing legislation, the lack of experience of the privatisation agencies and the lack of political willingness to accommodate legitimate requirements coming from potential investors' (EBRD, 2003). Those who benefited under the social ownership system are in no hurry to dismantle the system. According to Stojanov (2000), workers' perceptions of privileges under self-management, such as permanent employment, are deep-rooted, and they continue to claim these as rights. Politics continues to be influential in the privatisation process. The High Representative dismissed the politically appointed head of the Federation Privatisation Agency's management board and USAID temporarily suspended its support for the Federation's privatisation process (Donais, 2002).

### 5.3.4 Revised objectives

In the light of experience, the policy objectives of privatisation have been modified slightly. While vouchers no longer feature in the programme design, if anything, greater emphasis is attached to ownership transfer and the acceleration of the privatisation of strategic enterprises is viewed as '*an absolute prerequisite'* to improving economic development (Bosnia and Herzegovina Council of Ministers et al., 2004). This view is echoed by donors. Privatisation has always been a key feature of the transition programme but now it is acquiring even greater significance as, for donors, the implementation is a signal of political commitment to reform. For example, according to the EBRD, 'the acceleration of privatisation is going to be one of the most important tests to show the commitment of the new entity governments to reform' (EBRD, 2003: 17). For the OHR, 'if the governments of Bosnia Herzegovina seriously intend to achieve greater private-sector participation in the Bosnia Herzegovina economy and higher rates of growth than those achieved in recent years, a more sustained and focused effort to unblock the privatisation process must be undertaken' (OHR, 2004: 5).

The IMF documents major structural imbalances in the country which are related to weak corporate governance and poor progress in privatisation: 'These imbalances are symptomatic of fundamental structural weaknesses. Key amongst these is that enterprise managers face distorted incentive structures: simply put, the bulk of managers in state owned and voucher privatized firms appear not to seek profits for their shareholders.' The economic future of the country depends on increasing corporate profits, and privatisation is seen as key to achieving these:

> Accelerated privatisation of large-scale enterprises and improved corporate governance in voucher privatised firms constitute the bedrock of the reform agenda focused on transferring ownership to competent profit seeking managers as soon as possible. In this context the hiatus in privatisation over the past two years is highly regrettable not least because during the delay your corporate assets have continued to erode. Without strengthened political commitment to privatisation the dividends from other elements of the reform agenda – a strategy for corporate debt reduction, a targeted and affordable social safety net, strong bankruptcy proceedings, removal of portfolio limits on Privatisation Investment Funds (PIFs), the bulldozer and other initiatives to improve the business environment and reforms in government – will be much diminished. (IMF, 2003: para. 6)

Results from the first few years of privatisation were disappointing. The drastic decline in value of the vouchers and certificates undermined efforts by the state to use these to settle outstanding claims. Reports above indicate that the process did little to bring about the transformation of a dynamic market economy. Now the approach has changed and – despite earlier disappointments - expectations from privatisation are even higher. A process of '*accelerated* privatisation' according to the PRSP is expected to bring great benefits including:

- prevention of the erosion of state capital that has been happening during the years of inactivity with privatisation;
- acceleration of economic growth and increased employment;
- increases in the volume of foreign investment;
- acceleration of integration into international markets, creating conditions for increased exports; and

- secure incomes (through generating revenue that the government can use for social expenditure) (Bosnia and Herzegovina Council of Ministers et al., 2004).

The new approach means effectively abandoning mass privatisation and public offering of shares for a case-by-case approach for the privatisation of larger enterprises, although certificates will continue to be used until June 2007. The outstanding stock of these vouchers remains large. Projected privatisation receipts are negative (IMF, 2004a).

## 5.4 Survey

Against this backdrop, a survey was carried out of privatised enterprises to determine how they had been affected by privatisation. The survey took place between February and May 2004 by researchers from the Faculty of Economics in Sarajevo. The aim was to select a sample of 20 enterprises from a list of all privatised firms that fitted the specific criteria of having more than 200 employees and operating in the manufacturing sector. However, the list was not so easy to devise, partly as a result of the decentralised framework and the number of agencies implementing privatisation in the country. The sampling frame was compiled from various sources including a source document from the Federation Privatisation Agency (APF, 2004) a further list from the Agency in Republika Srpska as well as the agency websites and consultancy and World Bank reports.

The final list comprised 83 companies which met the above criteria of more than 200 employees, and having been privatised for more than one year, although at this stage the sector was not clear. From this, the 60 largest firms (in terms of employee numbers) were selected to take part in the survey, 14 from Republika Srpska and 46 from the Federation of Bosnia Herzegovina. Some of these firms were excluded from the survey because they were operating in sectors such as tourism and retailing. Some firms opted not to participate in the survey but a number were very co-operative. Survey forms were completed with a total of 19 firms, 16 of which were in manufacturing, 1 in construction and 2 in transport. These were considered to be comparable sectors. 17 of the firms were in the Federation and 2 in Republika Srpska. Interviews were held with managers of 10 of these firms. The total number of employees during the year before privatisation in the enterprises that took part in the survey was 11,848. Firms were asked to provide details of the external context in which their firm was operating as well as details of enterprise performance and restructuring measures. Responses are analysed in the following sections.

Table 5.10 Details of sample firms by sector

| Sector | Number |
|---|---|
| Production of clothes | 3 |
| Furniture | 3 |
| Transport | 2 |
| Production of leather goods | 2 |
| Other textiles | 2 |
| Food processing | 2 |
| Metal processing | 2 |
| Construction | 1 |
| Soap/detergent production | 1 |
| Electronic equipment | 1 |
| Total | 19 |

## 5.4.1 External environment

Firms were asked about the context in which they were operating. A complete list of survey responses is provided in Annex 2 and is summarised below.

### 5.4.1.1 Product market competition

Companies were asked about the extent of competition in the market in which they were operating. This indicator is based on the perceptions of managers. Most are of the opinion that they were operating in a highly competitive environment, and they perceive the degree of competition to have increased since privatisation. This is in part due to the liberalisation of imports and a more competitive global environment as trade barriers are reduced around the world (most companies are exporters). Firms reported a high degree of unfair competition from goods imported illegally and traded in the 'grey' economy. The effects of competitive pressure are supported by developments in prices. The majority of firms have reduced the prices charged over the period since privatisation, which would indicate that the firms in the sample were not in a strong market position, although Table 5.1 indicates that price inflation was low and slightly negative in 2002 so prices were not increasing in the wider economy. Reasons given for reducing prices included pressure from competition and in some cases improvements in production processes. Reductions in prices suggest that consumers have benefited from the effects of competition. Most of the firms are exporting and some are operating in extremely competitive sectors (most notably textiles) where they are competing with producers from South-East Asia with much lower labour costs. Price increases were mainly due to upward pressure from increases in input prices. Firms were also asked about the average change in prices of inputs for three main products, and some variation was evident. For some this was due to changes in import prices or to changes in world prices of goods such as oil or crops.

### 5.4.1.2 Institutional context

There is evidence that the institutional framework is evolving to support market-focused enterprises with a stronger domestic banking sector and a legal system which respondents indicated that they would use (even if they considered it ineffective). Firms were asked about their ability to raise finance and the nature of their main creditors. The majority reported that domestic banks were their main creditor. Seventeen firms reported raising funds from banks and two from government. One had received a loan from the International Finance Corporation (World Bank) for which it was eligible only if it had private sector status. In interviews, firms expressed the view that the banks were more accessible since bank privatisation. Managers also indicated that in some cases it had been easier to raise finance from suppliers and banks as a private company, because the status of the enterprise had greater credibility in part because creditors were now clear about who had ultimate responsibility for the firm. This is mainly attributed to the fact that evidence of there being a clear owner provides comfort to the lender rather than the situation under social ownership, when it was not clear who had ultimate control. According to one manager interviewed, 'foreign partners did not want to do business with state companies.'

In terms of the credibility of the legal system, 12 firms said that they would use the courts to take legal proceedings against a supplier if contractual terms were not met;

3 said that they would not. Only one firm ranked the legal system as effective; 18 ranked it as ineffective or highly ineffective. The main constraints on business activity cited by firms were the grey economy, high contributions on salaries and poor access to finance.

#### 5.4.1.3 Enterprise performance

Firms provided data on various performance indicators for the year before and two years after privatisation. Local currency data were used in all analyses. Data on costs and revenues were converted to 2002 figures to ensure comparability using the appropriate Consumer Price Index (CPI) from the Transition Report (EBRD, 2003) for each entity. Some firms were only able to provide data for one year after privatisation, and some provided two. These were all converted to 2002 values and, for the post-privatisation values, an average value was created for comparison with the pre-privatisation data. In addition, some additional productivity variables were created on a per employee basis. The percentage change in value of the performance indicators from pre- and post-privatisation was calculated, and it is these percentage values that are the basis for further analysis. By using this approach, the potential distortions that may emerge with comparisons of firms using different accounting systems are less damaging, since the focus is on how costs and revenues have changed rather than on their absolute value. The initial mean and median values of percentage changes from pre- to post-privatisation are shown in Table 5.11. The numbers of positive and negative observations are also listed.

The results were widely dispersed but some general trends can be observed. The mean value of sales and value added have increased but factor costs have also risen on average by more than revenue, giving a small negative value for the average increase in net profit in the survey sample. Debt has also increased, and production rose substantially by more than 86%. Production increased on average by more than sales, suggesting an increase in stock levels (there has been low inflation in the Federation where most of the firms are based – see Table 5.1). However, this result highlights the fragility of the figures in view of the small size of the sample. One would expect parallel movements with sales figures and production figures. The large discrepancy between the values of these indicators in Table 5.11 is due to one outlier that reported large increases in production and a fall in sales.

The average change in employment levels is positive (although small) and more firms reduced employment than increased it. A further 4 firms reported no change in employment levels. Employment is discussed in more detail below. What is striking about these results is that, for many indicators, the sample is more or less equally divided, with about half experiencing increases in values and half decreases, apart from net profit (where most firms experienced a decrease), total debt (where most experienced an increase) and production, where all firms responding reported an increase. In addition to the information provided above, firms were asked about taxation paid. However, only 5 enterprises responded to this question and there was substantial variation in the responses, as 2 reported a large fall in taxes paid, 2 reported little change, and 1 firm reported a large increase in tax payments after privatisation.

Table 5.11 Percentage change in key performance indicators

| Performance indicator | N | Min. | Max. | Mean | Median | No. of positive | No. of negative |
|---|---|---|---|---|---|---|---|
| Sales | 14 | -22.46 | 111.89 | 16.37 | 8.02 | 9 | 5 |
| Raw materials | 14 | -41.25 | 110.13 | 7.60 | 0.31 | 7 | 7 |
| Value-added | 10 | -66.90 | 349.42 | 35.89 | -1.60 | 5 | 5 |
| Indirect costs | 12 | -45.22 | 213.03 | 35.56 | 0.65 | 6 | 6 |
| Labour costs | 14 | -34.53 | 282.74 | 45.72 | 14.99 | 11 | 3 |
| Other costs | 13 | -64.67 | 285.80 | 54.95 | -1.65 | 6 | 7 |
| Net profit | 12 | -172.57 | 464.55 | -1.59 | 42.44 | 3 | 9 |
| Total debt | 13 | -67.33 | 143.75 | 14.78 | 9.41 | 9 | 4 |
| Volume of production | 11 | 1.57 | 743.75 | 86.46 | 9.50 | 11 | 0 |
| Capacity usage | 12 | -13.08 | 75.71 | 12.83 | 6.07 | 8 | 4 |
| Employment | 19 | -33.04 | 60.41 | 3.13 | 0.00 | 6 | 9 |
| Sales per employee | 14 | -0.22 | 1.12 | 0.18 | 0.09 | 10 | 4 |
| Value added per employee | 10 | -0.67 | 5.54 | 0.48 | 0.03 | 5 | 5 |
| Operating profit per employee | 12 | -1.69 | 4.19 | 0.01 | -0.51 | 9 | 3 |
| Production per employee | 11 | -11.52 | 1126.6 | 120.66 | 15.30 | 8 | 3 |
| | | | | | | | |
| **Manufacturing only** | | | | | | | |
| Volume of production | 9 | 2.12 | 743.75 | 105.28 | 25.80 | 9 | 0 |
| Employment (4 enterprises reported no change) | 16 | -33.04 | 60.41 | 5.76 | 0.00 | 6 | 6 |
| | | | | | | | |
| **Federation firms only** | | | | | | | |
| Employment (3 enterprises reported no change) | 17 | -33.04 | 60.41 | 2.34 | -0.89 | 5 | 9 |
| Manufacturing employment (3 enterprises reported no change) | 14 | -33.04 | 60.41 | 5.29 | 0.00 | 5 | 6 |
| Volume of production | 7 | 2.12 | 743.75 | 121.77 | 25.80 | 7 | 0 |

*Source*: Survey data

The next stage was to consider whether these results were substantially different from developments in the rest of the economy. Table 5.12 gives developments in the economy as a whole over a comparable period (2000-3). The table shows that industrial production in the economy has also increased over the same period, but that the economy-wide increase of 23.57% is substantially lower than the increase in production of more than 86% in the survey sample. Over the research timeframe, employment increased slightly on average in the sample by an average of about 3%. For the firms that were only in the manufacturing sector (omitting 3 firms in construction and transport), employment increased by an average of 5.76 employees. These values are not significantly different from the overall employment change in the sector, which increased by about 6% over the same period. However, manufacturing sector employment in the economy fell by nearly 13% in the same period.

Table 5.12 Selected economic indicators (2000-3)

| Indicator | 2000 | 2001 | 2002 | 2003 | Cumulative % change 2000-3 |
|---|---|---|---|---|---|
| GDP change in real terms (%) | 5.6 | 4.5 | 3.8 | 3.5 | +18.55 |
| Employment (Federation only) | 410,808 | 407199 | 394,132 | 387,381 | -5.70 |
| Manufacturing employment (Federation only) | 103,830 | 97,848 | 85,592 | 90,397 | -12.94 |
| Indices of industrial production (Federation only) | 108.8 | 112.2 | 109.2 | 104.8 | +39.70 |

*Source*: Adapted from tables above

The aim was to compare value added in the manufacturing sector in the economy with value added in the survey firms. However, according to the Statistics Agency, the data for the two entities have yet to be amalgamated for the manufacturing sector, due to differences in the treatment of different aspects (www.bhas.ba). Table 5.13 shows the results from one-sample, two-tailed, *t*-tests where the observed result from the sample is compared with the average trend in the wider economy to test for the likelihood that they came from the same population. As most of the sample responses were from the Federation (only 2 were from Republika Srpska), the focus of this analysis is a comparison of developments in the Federation enterprises with developments in the Federation as a whole.

The results show that the only significant result from the quantitative analysis in the research is a change in employment. Employment in manufacturing has declined substantially since 2000. However, the sample results show on average an increase in employment.

Table 5.13 Results from one-sample *t*-tests (see Annex 1)

| Variable | N | Sample mean (Table 5.11) | Economy value (Table 5.12) | *t*-value | Difference significant at 90% confidence level? |
|---|---|---|---|---|---|
| **Employment change – economy (Federation only)** | 17 | 2.34 | -5.70 | 1.617 | Not significant |
| **Employment change - manufacturing (Federation only)** | 16 | 5.29 | -12.94 | 3.006 | Significant |
| **Production volume change (Federation only)** | 9 | 121.77 | 39.70 | 0.816 | Not significant |

*Source*: Survey data

The evidence presented in Table 5.13 lends no support to the hypothesis that output from the privatised enterprises has grown at a significantly faster rate than that of the wider manufacturing sector. However, the evidence indicates that privatised firms have increased employment on average, while the overall employment level in manufacturing has fallen. Manufacturing employment over the period fell by 13% but increased in the sample firms by nearly 6%. This result may have arisen because of falling employment in state manufacturing firms, and because some privatisation deals were made conditional on at least maintaining if not expanding the enterprise employment level.

Firms were classified according to their ownership structure after privatisation. Where no party had a stake of 51% or more, the ownership was classified as ‘no majority investor’ to see if this had an impact on performance. Table 5.14 shows that the situation of no clear investor (with potential difficulties of dispersed ownership) has arisen from voucher and certificate privatisation. Privatisation via tender has transferred ownership to employees, and domestic and foreign investors. Direct negotiations follow failed tender exercises. Employees are able to participate in a tender where they may be competing with other bidders. In some cases, where there were no bids after a tendering exercise, employees put together a bid for direct negotiation in order to ensure the survival of the company. Four enterprises were sold to employees as a last resort following failed tender attempts.

Table 5.14 Sample profile by investor type and privatisation method

| Majority owner | Tender | Voucher/Certificates | Direct negotiations | Total |
|---|---|---|---|---|
| Employees | 5 | 2 | 4 | 11 |
| Bosnian investor | 1 | 0 | 1 | 2 |
| Foreign investor | 2 | 0 | 0 | 2 |
| No majority stakeholder | 0 | 4 | 0 | 4 |
| Total | 8 | 6 | 5 | 19 |

*Source*: Survey data

Table 5.15 shows changes in performance indicators for different types of owners. The data indicate that firms sold to foreign investors had the biggest increase in sales and gross profit, but also suffered the largest mean loss in terms of net profit. Firms sold to employees showed the largest gain in terms of average increase in production.

Table 5.15 shows that only 2 firms in the sample were sold to a Bosnian investor and they both opted not to provide data, apart from on employment which increased by an average of 26% in these firms. Little can be said about the effects of Bosnian or foreign investors or where there were no majority stakeholders, as there are so few enterprises in these groups. Firms sold to employees showed a small increase in sales but a substantial increase in production with an average increase of 132%. Production per employee also increased substantially.

Table 5.15 Percentage change in selected indicators by type of investor

| Majority Owner | | Sales | Total Debt | Production | Capacity Usage | Employment | Sales per employee | Production per employee |
|---|---|---|---|---|---|---|---|---|
| **Employees** | Mean | 5.73 | 6.30 | 132.95 | 8.80 | 2.09 | 0.05 | 188.99 |
| | N | 9 | 8 | 6 | 7 | 11 | 9 | 6 |
| **Bosnian investor** | Mean | | | | | 26.24 | | |
| | N | | | | | 2 | | |
| **Foreign investor** | Mean | 80.60 | 61.65 | 58.20 | 47.47 | 2.55 | 0.77 | 55.14 |
| | N | 2 | 2 | 2 | 2 | 2 | 2 | 2 |
| **No majority stakeholder** | Mean | 5.45 | 6.13 | 12.33 | -0.86 | -5.26 | 0.20 | 27.68 |
| | N | 3 | 3 | 3 | 3 | 4 | 3 | 3 |
| **Total** | Mean | 16.37 | 14.78 | 86.46 | 12.83 | 3.13 | 0.18 | 120.66 |
| | N | 14 | 13 | 11 | 12 | 19 | 14 | 11 |

*Source*: Survey data

Table 5.16 Investor response, debt levels and firm performance before privatisation (KM)

| Lack of Investor? | | Debt per employee | Sales per employee | Value added per employee | Operating profit | Production volume | Capacity utilisation (%) | Production per employee |
|---|---|---|---|---|---|---|---|---|
| **Yes** | Mean | 10,105 | 14,273 | 3,343 | -520,764 | 1,512,812 | 40.67 | 1,726 |
| | N | 5 | 6 | 4 | 4 | 6 | 6 | 6 |
| | SD[a] | 9,314 | 17,150 | 4,335 | 1,132,244 | 3,085,111 | 28.68 | 3,511 |
| **No** | Mean | 17,632 | 29,388 | 9,586 | 931,165 | 3,403,112 | 60.67 | 8,652 |
| | N | 8 | 8 | 6 | 8 | 5 | 6 | 5 |
| | SD | 19,549 | 22,608 | 8,986 | 4,512,173 | 4,688,263 | 16.33 | 11,530 |
| **Total** | Mean | 14,736 | 22,910 | 7,088 | 447,189 | 2,372,040 | 50.67 | 4,874 |
| | N | 13 | 14 | 10 | 12 | 11 | 12 | 11 |
| | SD | 16,321 | 21,181 | 7,843 | 3,717,104 | 3,811,220 | 24.58 | 8,510 |

*Source*: Survey data
*Note*: a) SD = standard deviation

### *5.4.3 Enterprise history and privatisation process*

Companies were asked first about the effects of the war on their enterprise. Results are shown in Annex 3. Firms said that profitable production was impossible during this period. The war caused different divisions of companies to become separated from each other and many workers left and moved to neighbouring countries. Other difficulties reported included problems with communication, slow movement of materials, a slow visa and customs regime and trade restrictions. Firms lost their suppliers and many had to construct completely new markets; for example, some that used to sell to Croatia and Serbia now sell to Western Europe. Employment fell not only because workers left but also because firms selling to Serbia and Croatia lost their markets and had to lay off staff. The most often cited effect was loss of markets as a result of the conflict. Many firms lost large numbers of employees. The average reduction in employees from the 11 firms that responded was 55%.

More than half the firms (10 out of 18) reported difficulty in finding an investor, due to large debts, excess labour and weak domestic markets reducing the attractiveness of the enterprise. Where enterprises were bought by employees, some had considerable difficulty raising the finance for the purchase. Only 3 out of 18 firms reported that there were no problems in the privatisation process. Further investigation was carried out on the firm performance data for the period before privatisation to see if there were any specific characteristics of firms that were easily sold as compared with those that were difficult to sell.

Many enterprises in Bosnia Herzegovina are highly indebted. This is widely believed to be a major factor in the slow progress with privatisation, as enterprises are less attractive to investors (Bosnia and Herzegovina Council of Ministers et al., 2004). The consensus is that privatisation has been delayed because of the indebtedness of enterprises. While this makes intuitive sense, the survey data indicate that the extent of enterprise debt might not be the primary factor in determining the saleability of enterprises. Table 5.16 compares survey responses regarding difficulty in attracting investors with the mean values of debt per employee as well as other performance indicators. While a total of 18 firms responded to this question, not all of these firms provided data on debt levels or other performance indicators for the year before privatisation. Hence, in Table 5.16, the number of observations varies depending on how many firms responded to the request for performance indicators. The table indicates, surprisingly, that the level of debt per employee was about 75% higher for firms that reported no difficulty in finding an investor. However, other performance indicators are more in keeping with expectations. Firms that reported no problems with securing an investor had, on average, considerably superior performance in productivity, profitability and production.

The average value of sales per employee for firms that had no difficulty in finding an investor was more than double that of firms with such problems, and a similar picture emerges with other performance indicators. While there are limitations in the data presented, in particular because of the small numbers of firms involved, the findings suggest that the extent of indebtedness of a firm is not so much of a deterrent to investors as are other indicators of firm performance. These findings also demonstrate the ambiguity of debt as an indicator of firm performance. High debt levels may be a sign of distress or they may be the result of investment. Over 60% of firms have seen an increase in the level of debt since privatisation. While this could be a good sign if it is the result of investment expenditure, for some firms it is a manifestation of poor performance. While it is not clear from the survey whether firms were servicing their debt, information from interviews indicates that high debt levels can be either a positive or a negative indicator of the health of an enterprise. A few firms reported that as private operators they were able to raise credit from sources that had previously been closed to them. However, another firm reported difficulties in collecting monies due, especially from the government. Another indicated that the increase in debt was due to doing business at a loss.

Firms were asked if they experienced any restructuring before privatisation. Some indicated that they had suffered employment reductions, but that this was a result of the war. Others indicated that the actions that had been taken, such as capital investment, etc., were effectively attempts to repair war damage. Some began to separate out different functions and had unbundled companies in the lead up to privatisation, for example, stopping non-industrial activities.

### *5.4.4 Internal restructuring*

Firms were asked to provide details of changes implemented since privatisation. The results are summarised in Annex 4. Results are shown in the table for firms grouped by privatisation method, by ownership structure and, for employee-owned firms, according to privatisation method.

#### 5.4.4.1 Production processes

Most firms reported an increase in production. One firm reported that production had increased because it was now sourcing inputs from Western Europe rather than Serbia and Slovenia, as a result of the war. Another reported that changes in the incentives to workers had increased productivity by 40%. However, it is not valid to attribute all such changes to change of ownership. One firm made it clear that, although it had introduced many changes and increased production, it had been doing this continuously long before privatisation and the company was already successful with strong managerial capacity.

New products were introduced in 13 out of 19 firms. Six firms reported no change in product mix. Some were responding to the demands of a new buyer, while others were responding to the weak demand for their previous product range. Most reported that they were 'responding to the demands of the market'. While no firms reported that they had changed all their suppliers, out of 16 firms that responded, only one reported that there had been no change in the source of inputs. This was a firm privatised with voucher privatisation and owned by a group of PIFs. 15 firms reported some changes in input sources. One indicated that, as a private firm, it had more credibility with suppliers and so was better able to source inputs. 2 firms were involved in relationships in which the customers supplied the input (in textiles, known as a 'lohn' agreement), thus effectively narrowing the input base.

The majority of firms (14 out of 16) reported investment in equipment in 2002 (which was after privatisation for most firms), but it is noticeable that investment was ongoing before privatisation. 9 firms reported investment in equipment in 1997 and the same number in the year of privatisation. Where firms are in difficulties or where enterprises have been bought for the purpose of asset stripping, one can expect sales of assets to take place soon after privatisation. However, in this sample most firms

(12 out of 16) reported that they had sold no capital assets since privatisation. The 4 that had made sales indicated that these had not been of major significance.

Almost all (17 out of 18) firms were exporting both before and after privatisation. Firms were also asked about their main customer base, as privatisation can bring about changes in relationships where companies have been mainly supplying the state, for example where sales have been relatively safe, with the government as a principal customer. The results indicate that few companies had been reliant on the state as a customer. Under social ownership, firms operated on a relatively autonomous basis and many firms had no commercial dealings with the state. All firms responding reported no change in dealings with the state, apart from where customers that had been socially owned were privatised.

The above results indicate that, although results are inconclusive when it comes to enterprise performance, most enterprises have undertaken measures to restructure. For most enterprises, privatisation has allowed managers to respond to market information and to refocus their operations accordingly.

#### 5.4.4.2 Internal structure

Most firms implemented limited changes in management (Annex 5) but responses were varied. 13 out of the 19 firms that responded changed less than 10% of management staff. However, 3 firms changed the management entirely. Most firms (16 out of 19) reported a change in internal organisation after privatisation. This often took the form of a revised managerial structure to reduce layers in decision-making, and a reduction in administrative and an increase in production staff. Just over half the firms reported changes to the incentive structure for both managers and employees. For some, this took the form of setting quotas for production and drawing up performance up contracts with management.

Only 6 firms (out of 19) had introduced new departments since privatisation. 5 of these were marketing departments and one was a department for the development of new products.

#### 5.4.4.3 Employment practices

In general, privatisation is associated initially with a fall in employment followed by a subsequent increase (a U-shape) (see Kocendar and Svenjar, 2003). Not all studies find a fall in employment after privatisation. For example, Frydman et al. (1997) found a positive effect of privatisation on employment, but that insider-owned firms shed labour at a slower rate than state or other private firms.

Annex 6 provides a detailed breakdown of the employment practices of sample enterprises after privatisation, grouped according to privatisation method and ownership structure. 6 firms have increased employment, while 9 have reduced employment and 4 reported no change. The average employment change for the whole sample was an increase of 3.13%. When the responses are broken down by privatisation method, no clear pattern emerges. More than half the firms sold by tender have increased employment, and the average employment change for this privatisation method is an increase of more than 13%, while firms sold by auction have reduced employment more. A similarly surprising picture emerges when the findings are broken down by ownership structure, as more than half the employee-owned firms reduced employment after privatisation. Of the 3 foreign investors, one increased, one reduced and one had not changed employment levels since privatisation, so no clear employment pattern could be observed.

There are a number of possible reasons for the lack of reduction in employment. It may be that the enterprises are not over-staffed and so do not need to lay off employees. Alternatively, the privatisation agency can stipulate that the investor does not reduce employment and it may even require that the investor increases employment, so this could be why there is no observable employment effect. It could also be that the firms with productive potential were the ones that were selected for privatisation. Thus the absence of a decline in employment is the result of bias in the nature of the firms that have achieved privatisation.

There was a high rate of unionisation in all firms, with an average rate of union membership of 93%. Privatisation had not brought about an influx of labour from outside the country, even where firms were taken over by foreign investors. All staff in all firms were 100% Bosnian before and after privatisation.

The above evidence indicates that a large proportion of firms in the survey have undertaken some measures to restructure the enterprise to some degree. Furthermore, there is considerable emphasis on what has been known as deep restructuring; firms have increased their product range and suppliers, have carried out investment and have changed the internal structure of the firm. 6 firms reported that the changes could have been implemented without privatisation (Annex 4), while 12 said that the changes could not have been implemented without privatisation. There was a wide variation in responses to this question, ranging from 'privatisation has saved our company' to 'the management [in place long before privatisation] takes credit for the changes; new shareholders have not shown much interest', 'privatisation has not changed much' and 'privatisation has not resulted in increases and positive trends for our business'. Respondents were asked about the motivation of investors. For some that were taken over by employees, it was to ensure the survival of the company. Enterprise managers were asked about their views of the wider privatisation programme. Responses here ranged from 'catastrophic' to 'our opinion is mainly positive'. Firms cited difficulties in raising finance after privatisation as a weakness in the process, where there is no participation from a strategic investor. A number of respondents were critical of the long delays in implementing privatisation and many were of the opinion that the process was badly planned.

#### 5.4.4.4 Ownership structure and restructuring

Responses were broken down to determine if different types of privatisation method and alternative ownership structures were more conducive to the implementation of internal change and enterprise reform. Such disaggregation made for small sample sizes, but the results are shown in Annex 4. These indicate that more changes are implemented in firms privatised by tender than by other means, although other privatisation methods are shown to be consistent with changes to some degree. When change implementation is broken down by type of investor, it is clear that employee-owned firms are just as able to carry out restructuring as firms owned by foreign and domestic investors. Sample sizes are very small by this stage, but when the employee-owned category is unbundled into different ownership types, there seems to be a discernible pattern in that the employee-owned enterprises that have carried out the least restructuring are those privatised with vouchers or by direct negotiation as a last resort. In addition, firms privatised by vouchers and certificates have replaced a smaller percentage of management (Annex 5).

This finding indicates that there is considerable diversity within the category of 'insider ownership'. This research is consistent with the finding by Wright et al. (2002) that employee-owned firms are more likely to implement restructuring if they pay for their shares. It is not clear exactly why this should be the case. It may be that employees have a greater interest in an enterprise if they have had to part with money to acquire it, which would mean that all enterprises could benefit from being sold to employees. Alternatively, this result might arise because, at least in this case, the firms that take part in the tender process (which is demanding since employees have to raise large amounts of investment capital) are the firms with stronger managerial capacity to start with. The evidence here suggests that some insiders are good owners while others are not, and perhaps what matters for insider ownership is not the privatisation method so much as the quality of the insiders.

## 5.5 Conclusion

The results presented above indicate that privatisation has yet to have a significant impact on enterprise performance measures, but there appears to be some tentative evidence of privatisation-induced restructuring within enterprises. The majority of firms have started to implement internal changes, suggesting that performance improvements will occur in the future. According to the data in Table 5.11, performance indicators are fairly split in terms of the numbers of firms that have experienced positive and negative effects. The one positive feature in the table is that production has increased in all the survey firms that responded. The value of average production increase was substantially higher than that of the industrial sector generally, although this result lacked statistical significance.

The data in Annex 4 indicate that most firms have introduced restructuring measures that might not yet have reached the performance indicators. The findings suggest that more 'deep' than 'defensive' restructuring was implemented. The overall average impact on employment is positive over the privatisation period. The data in Annex 6 show that slightly less than half the enterprises implemented what would be considered the 'defensive' restructuring measure of employment reduction (although when it came to employee-owned firms, the proportion was slightly more than half). However, a substantial majority implemented 'deep' restructuring measures such as introducing new products or seeking new suppliers. This calls into question the division of restructuring measures between deep and defensive. The findings indicate that the privatisation method has an impact on privatisation outcomes, since more restructuring was implemented by firms privatised by tender. However, the causality may also work in reverse. It may be that the firms with most potential and in which there is most interest from investors are sold by tender.

The evidence indicates that employees can be effective enterprise owners. Table 5.15 shows that employee-owners have been as effective as other investors in improving enterprise performance. Annex 4 also indicates that employees can implement deep restructuring measures. This is in contrast with much of the literature outlined in Chapter 2. The breakdown of employee-owners indicates that there is some pattern in the effects of employee-ownership according to privatisation method. Those privatised to employees by tender implemented more restructuring than those privatised by other methods. Such conclusions are borne out by anecdotal evidence collected during interviews with enterprise managers. In interviews, there was a contrast between managers who clearly had strong ideas about how the firm could survive in the current fairly harsh environment as well as ideas and innovations, and managers who had an expectation that their old markets would return eventually. Thus there is considerable diversity in the quality of enterprise management. While employee capacity might be considered to have an impact on privatisation outcomes, the causality may in fact work in reverse and it could be that employees are better placed to acquire the firms that are worth buying.

The survey findings need to be interpreted with caution because of the small sample size and the considerable bias that is incorporated into research of this nature. The firms that did not take part were the ones that could not be contacted or which declined to take part. Some firms did very well from privatisation, while for some the results have been very disappointing. Managers of firms sold to foreign and domestic investors and firms sold to employees through tenders (mainly) believed that privatisation had been essential to the implementation of changes in their company, while results were more mixed from firms privatised though vouchers or by direct negotiations. Some aspects of enterprise activity were not adequately captured in the research. For example, there was little response on taxation payments, so the overall fiscal effect of privatisation cannot be determined. Similarly, enterprises were asked about government support with a view to identifying hard budget constraints, but answers to this question were not always clear, perhaps reflecting shortcomings in the questionnaire. However, the hardness of budget constraints is not likely to be reflected in official government subsidy, but via interactions with suppliers and banks such as slow payments and debts to employees.

Privatisation in Bosnia Herzegovina has been a slow and tortuous process. The shortcomings of the earlier approach have now become clear but, despite immense difficulties in attracting investors into a process which has itself contributed to the decline in the saleability of state enterprises, donors are attaching growing priority to the achievement of privatisation. Many found it difficult to attract an investor, leading to a protracted process of privatisation with no investment and little production. This can in itself be destructive. One manager interviewed, who had endured the war and economic decline with his enterprise, said that nothing had been as bad as the period prior to privatisation, because of the uncertainty which had had a devastating effect on staff morale.

The findings suggest that privatisation can be difficult to achieve in a post-war context, due to low incomes, weak institutional and political systems and, hence, little investor interest. Policy-makers need to be realistic about prospects for foreign direct investment. The evidence from the research indicates that, while being taken over by a foreign investor has undoubtedly been beneficial for the few firms that have managed to achieve this, it is not a viable strategy for most enterprises. The results from this survey are not sufficiently robust to support an argument for an alternative privatisation policy, but they do suggest that there is considerable diversity within the category of 'insider-ownership'. In view of the difficulties encountered in attracting strategic investors into the privatisation programme in Bosnia Herzegovina, more detailed investigation into the nature and impact of employee takeovers might be a suitable agenda for further research.

# Chapter 6: Privatisation in Serbia

## 6.1 Introduction

The Federal Republic of Yugoslavia (FRY) (which became Serbia and Montenegro in 2003) was constituted in Spring 1992. UN sanctions followed immediately (end of May 1992). These included a trade and financial embargo. The economic situation deteriorated. Despite some considerable recovery since the end of the conflict in 1999, the political situation remains fragile. Elections held at the end of 2003 saw a large share of votes going to the ultra-nationalist Serbian Radical Party. The country has implemented a series of privatisation laws since the policy was first introduced under Markovic in 1989. These have been mainly based on insider privatisation until the most recent legislation was introduced in 2001, which is based on sales to strategic investors.

This chapter analyses developments in the most recent phase of privatisation in Serbia. It presents findings from a survey of enterprises carried out in Belgrade in the first half of 2004. Although only tentative conclusions can be drawn at this stage, as privatisation has been implemented in these firms relatively recently, the findings indicate that privatisation has not had an immediate positive impact on enterprise financial performance (due in part to persistent high inflation). However, firms have generally managed to substantially increase production and capacity utilisation since privatisation (although empirical concerns such as causality, endogeneity and the small sample size, discussed above, call into question the degree to which these changes can be attributed to ownership change). In addition, the survey of enterprises indicates that the majority of firms that responded have implemented structural changes within the organisation which can be expected to affect performance positively in the future.

## 6.2 The economy

All former Yugoslav economies experienced a recession at the start of the 1990s, but the FRY (as the country of Serbia and Montenegro was known before 2003) economy experienced the largest decline (Habib, 2001), as the economy suffered the effects of war, the loss of markets due to the break-up of the economy and the impact of UN sanctions. The government brought in some drastic measures to deal with recession; for example, price controls were introduced and a law was passed in 1992 forbidding firms to fire employees. Two years were particularly bad for the country during the 1990s. In 1993, a fall in output of more than 30% was experienced and hyperinflation took hold, with the inflation rate, at one point, measured in billions of percentage points. There was a moderate recovery from 1994 to 1999, but in 1999, the conflict with NATO over Kosovo led to a decline in real GDP of 15% (EBRD, 2002).

Table 6.1 shows how industrial production performed during the 1990s. The table reveals that industrial output in 2000 was less than half the 1990 level. In the manufacturing sector, production in 2000 was just 37% of the level in 1990.

Table 6.1 Indices of industrial production (1990=100)

| | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|
| All industry | 41 | 42 | 45 | 50 | 51 | 40 | 44 |
| Mining | 73 | 77 | 76 | 81 | 82 | 59 | 64 |
| Manufacturing | 34 | 35 | 39 | 44 | 46 | 32 | 37 |

*Source*: Federal Statistical Office, cited in UNECE (2002)

Table 6.2 shows the impact of the economic decline on employment. The figures show that the numbers employed in industry fell by 23% over the period from 1990 to 1997. Table 6.1 indicates that industrial production fell by a much larger proportion (50%) over the same period, suggesting that large numbers of the population were underemployed during this time.

Table 6.2 Numbers employed ('000s)

| | 1990 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|
| Industry | 1,067 | 940 | 916 | 894 | 870 | 852 | 820 |
| Total | 2,707 | 2,536 | 2,464 | 2,413 | 2,379 | 2,367 | 2,332 |

*Source*: Ibid.

During the 1990s, a substantial informal economy began to absorb employment from failing state and social sectors. Many workers were formally listed as working in state and social enterprises, and even received nominal wages and benefits, but were also employed or had small businesses in the grey economy. By 1997, the informal economy was estimated to account for over one-third of total employment, concentrated in trade (28%), agriculture (22%) and the retail and service sector (19%) (World Bank, 2001). Furthermore, there was a loss of confidence in the financial sector, with growing debts. According to the World Bank, 'a complex web of major arrears … built up between the governments, companies, banks and people' (World Bank, 2001: 4). By 2001, it was reported that most enterprises were operating in a range of 5 to 30% of capacity utilisation (ibid.).

In October 2000, Milosevic was ousted following massive peaceful demonstrations. The FRY was reintegrated into the international community. A number of reforms have since been implemented. Policies to improve the business climate by, for example, reducing the bureaucratic process for business registration, have been put in place (World Bank, 2003). In the banking sector, the four largest insolvent banks were put into liquidation in January 2002, several domestic banks received injections of foreign capital and foreign banks started operations. Industrial policy is heavily focused on both privatisation and easing constraints on private sector investment. For example, in order to attract investors, particularly in privatisation, the government is now offering tax holidays, a low rate of corporate tax (14%) and a 10-year tax holiday for €10m. investment and 100 new jobs created, or a 5-year tax holiday for €10,000 investment and 5 new jobs created (Vlahovic, 2003). Similarly, the government is relaxing commitments required from investors to fulfil social obligations (paying severance pay for staff laid off) when taking over an enterprise.

Table 6.3 shows movements in several economic indicators since the mid-1990s. There has been some recovery since the major deterioration of 1999. GDP has improved and inflation has been brought under control. The share of the private sector in GDP increased to 45% in 2002, following the introduction of new privatisation legislation in 2001.

Table 6.3 Selected economic indicators - Serbia

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|
| GDP (% change in real terms) | 7.8 | 10.1 | 1.9 | -15.7 | 5.2 | 5.3 | 3.8 | 2.0 |
| Industrial gross output (% change in real terms) | 7.6 | 9.5 | 4.4 | -24.5 | 11.1 | 0.0 | 1.7 | - |
| Consumer prices (annual average % change) | 94.3 | 21.3 | 29.5 | 37.1 | 60.4 | 91.3 | 21.4 | 12.0 |
| Unemployment (% of labour force, year end) | 25.7 | 25.9 | 26.8 | 27.9 | 28.4 | 27.5 | 28.9 | - |
| Private sector share of GDP (%) | N/A | N/A | N/A | N/A | 40.0 | 40.0 | 45.0 | - |
| GDP per capita, constant (1995) US$ | 1,358 | 1,455 | 1,489 | 1,218 | 1,280 | 1,348 | 1,830 | - |

*Sources:* EBRD (2003); Serbia and Montenegro Federal Statistical Office, Belgrade; *World Development Indicators*

Despite some economic recovery in the wider economy, the industrial sector has faced major difficulties. After the war, like Bosnia Herzegovina, enterprises in Serbia had a greater degree of obsolescence in assets than in comparable countries in Central and Eastern Europe, due to lack of access to markets, technological advances and new equipment. In addition, the 1999 Kosovo crisis resulted in damage to a number of enterprises in important sectors – particularly the oil, metal-working, chemical and metallurgical industries (World Bank, 2001). Enterprises were also highly indebted, due to soft budget constraints in state, socially-owned and mixed firms, as a result of various factors including the lack of incentives to appraise properly and enforce the repayment of bank loans, as well as the growing tolerance of inter-enterprise arrears due to pressures in the real sector (ibid.). According to the EBRD, short-term growth has been constrained by 'the legacy of dilapidated and obsolete infrastructure, lack of working capital, unclear ownership and a depleted level of social capital and institutional development' (EBRD, 2002).

While the industrial sector recorded some initial progress after the war, the volume of production declined in 2003 and employment in manufacturing has fallen by more than 22% (see Table 6.4).

Table 6.4 Selected industrial sector performance indicators - Serbia

| | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| Employment (% change all enterprises) | 2.3 | 3.8 | 1.8 | 4.0 | 4.6 |
| Employed manufacturing ('000) | 707 | 668 | 647 | 594 | 550 |
| Manufacturing physical volume of production (% change over previous year) | -30 | 14 | 1 | 3 | -4 |

*Source*: Serbia and Montenegro Federal Statistical Office, Belgrade

There is high unemployment (see Table 6.3), although this is widely believed to be lower than official figures because of the grey economy. Research carried out by the G17 Institute (Petkovic, 2003) indicates that there are many impediments to enterprise development in Serbia, including lengthy, and not entirely transparent, processes to obtain licences and an extremely complicated system of taxes and corruption: 'Senior civil servants as well as high-ranking managers or those in charge of purchases, without appropriate control, show a proneness to taking a "percentage" of the value of the contract. This applies both to domestic and foreign companies without considerable difference' (Petkovic, 2003: 8). Despite the introduction of pro-reform transition policies, there is reportedly a reluctance on the part of policy-makers to dismantle the structure of social ownership, with a close relationship between the political and economic elites (Uvalic, 2001).

## 6.3 Privatisation in Serbia

### *6.3.1 Privatisation up to 2001*[16]

Unlike Bosnia Herzegovina, where privatisation was not pursued between 1989 and 1997, privatisation efforts continued in Serbia, although the pace during the 1990s was extremely slow. Serbia introduced a Federal privatisation law in 1991 which was similar to the previous (1989) Markovic law. The main privatisation method was that of selling stakes to insiders at preferential rates. However, under the 1991 legislation, the conditions were made more restrictive and limits were imposed on the amount that insiders could buy. In 1994, amendments to the 1991 privatisation law introduced the 'obligatory revaluation of privatised property' which took inflation into account. Previously, under the 1991 legislation, the unpaid portion of shares was re-valued only once a year. As a result, many individuals were able to pay off the full value of unsubscribed shares with 'extremely small amounts of money' (Uvalic, 2001) in a context of high inflation. The 1994 amendment re-valued all subscribed shares and, as a result, many had to renounce their shares as the new price became too high.

In July 1997, the Serbian government adopted the Act on Ownership Transformation, which remained in effect until early 2001. Under this legislation, most firms were to be privatised 'autonomously', using methods which offered favourable conditions to insiders. In the first round of the privatisation process, selected groups (workers, pensioners and insured farmers) were *given* shares. They had the right to receive shares in their enterprise free of charge of a dinar equivalent nominal value of DM400 for each year of employment, but the total amount distributed could not exceed 60% of the enterprise capital. Then, in the second round, the same categories of individuals were allowed to *buy* shares at a 20% discount (plus 1% for each year of employment but not exceeding 60%) over a repayment period of up to 6 years within a limit of the dinar equivalent of DM 6,000 per worker-shareholder. A 10% share was transferred to the Serbian Pension Fund. Proceeds from the sale were distributed between the Development Fund (50%), Pension Fund (25%) and Employment Fund (25%). Remaining shares for which there were no buyers were transferred to the Shareholding Fund which was to offer them for sale on the stock exchange.

All firms planning to start privatisation were obliged to have their social capital valued by mid-1998. Few did this, so the deadline was extended to the end of 1999. As before, this was a voluntary system of privatisation. Social property as an ownership structure continued (Uvalic, 2001). The aim was in part to achieve distributional objectives favouring distribution to those who had contributed to the generation of the capital (through retained earnings), rather than sale to private investors, which would have meant to the small elite who would have been able to afford to participate. The idea was that this model would 'provide for a quick and full privatisation' (Djuricin, 1997). Excluded from the legislation were 75 firms that had been identified as being of 'strategic importance', which were to be privatised according to a special government programme (Uvalic, 2001).

Under the Markovic law during 1989-90, a total of 1,220 socially-owned enterprises (or 33% of the total) entered the property transformation process. The capital structure of these enterprises after transformation was on average 80% private and 20% socially-owned. After the introduction of the more restrictive 1991 legislation,

[16] The details of privatisation legislation from 1989 to 2001 are covered in detail in Uvalic (2001).

there was a slowing down of privatisation. The 1994 revaluation amendments led to a substantial decrease in the relative share of privatised capital which, after the process, was usually less than 10% of the total enterprise capital. Most enterprises that had started the privatisation process saw a substantial increase in the share of non-privatised capital. Many cases were subjected to a long court procedure with no final results (Cerovic, 2003). Following the implementation of the 1994 legislation, only about 4% of socially-owned capital was actually privatised (Djuricin, 1997). This retroactive legislation made firms less willing to embark on the privatisation process (Uvalic, 2001).

As a result, firms did not rush to take part in the 1997 privatisation, as the new legislation did little to re-establish the confidence of potential shareholders. As the process was voluntary, few enterprises decided to start privatisation. By the expiry of the deadline for capital valuation at the end of 1999, only 2,218 firms (30% of the total) had started capital valuation. By the end of 1999, only 344 enterprises (less than 5% of firms eligible for privatisation) had started the process of distributing free shares to workers. Only 202 firms (less than 3%) had started the second round of share offers at a discount. Most of these firms were from Belgrade or Vojvodina. By 20 November 2000, when the 1997 legislation was suspended, a total of 412 enterprises had entered the privatisation process – still less than 6% of the enterprises earmarked for privatisation (Uvalic, 2001).

Around 600 large and another 1,500 medium-sized social sector firms, which were responsible for most of the losses in the Serbian economy, were not privatised. This was largely because the privatisation legislation set financial limits on the amount that could be transferred, so, for large firms, the major part of the capital would be transferred to the privatisation fund and insiders would therefore lose control and decision-making power. Overall, privatisation attempts in the 1990s were not considered successful: 'Overall privatisation has mainly resulted in widespread ownership by insiders who today, given enormous losses of a large part of the economy, most frequently own worthless shares in highly undercapitalised enterprises' (Uvalic, 2001: 6).

In parallel with the stagnation of privatisation, there was an expansion of the state sector and a growth in the entry of new firms. There was a huge increase in the establishment of new firms in the 1990-92 period when the legislation of the former Yugoslavia greatly stimulated private sector development, but firm creation practically stagnated after 1993. Furthermore, there was an expansion of the state sector as certain enterprises that were excluded from the privatisation process were transformed from socially-owned into state-owned or public firms. By the end of 1994, there were 604 public enterprises in the FRY (530 in Serbia). The public sector included a number of very large enterprises in transport, water supply and telecommunications (partly privatised in 1997). Other enterprises were taken over by the state for no clear reason or from political motives (such as the takeover of the Yugoslav opposition media – the main private TV and radio stations and one of the most popular daily newspapers (*Blic*)) (Uvalic, 2001).

Over the period 1990-8, foreign inflows from privatisation amounted to about US$1.1bn, but this was almost entirely due to the sale of a 49% stake in Serbian Telecom to Italian and Greek investors. It has been reported that, after the sale, the performance of the company was less dynamic than before privatisation. This is attributed to the motivation of the government in selling the enterprise; it was interested only in raising revenue to reduce the state budget and enable the payment of long overdue wages and pensions, thereby increasing its short-term political popularity (Uvalic, 2001). The deal was ‘based on negotiations with interested investors’ rather than a tender (Djuricin, 1997). In 2002, the government bought back the 29% stake sold to Telecom Italia for 40% of what had been paid, amid allegations that the privatisation had been improper.[17]

By the end of the 1990s, the introduction of different privatisation processes resulted in an array of ownership structures with complex implications for corporate governance. First, there were private firms, most of which had been recently set up and were, in the majority of cases, owned and managed by a single proprietor (Uvalic, 2001). Second, there were ‘socially-owned’ firms. The FRY was the only republic of all of those in the former Yugoslavia that continued, after the early 1990s, with the concept of ‘social ownership’. The issues associated with this type of ownership were discussed in Chapter 2. The main difficulty arising from social ownership in the FRY in the late 1990s was not worker participation in decision-making, but that it was not clear who was the residual owner of the firm, and there was scope for different interpretations of the concept (see Uvalic, 2001). Property rights are divided among three collective agents: employed workers, the enterprise and the state. No group has full control, and so the incentives for effective corporate governance remain weak. Third, most enterprises that entered privatisation in the 1990s ended up in a category known as ‘mixed ownership’, where ownership is shared between private shareholders and social ownership as few became completely privatised. In most cases, insiders are the dominant shareholders. This leads to a complex system of corporate governance with both wage-earners as shareholders and employed workers also with some kind of ownership rights (ibid.). Fourth, there were co-operatives, and fifth, there were some state firms.

A number of large and successful firms were privatised at this time. Employees bought Apatim Brewery and in 2004 they sold their shares to a strategic investor (Interbrew) at €160 per share, making a substantial profit. Hemopharm is now an international pharmaceutical company which has been buying up firms in the post-2001 privatisation round. Metalac reported in September 2003 that sales rose by 18% compared with the first half of 2002 and, according to the company’s general manager, the 1,200 workers were to receive a 15% wage rise.[18] Others include Sintellon (carpet manufacture) and Imlik Dairy which are still operating effectively. However, while some firms have done well through this insider privatisation, many have not. This method of privatisation fails to bring in either new capital or new management to the enterprise and can result in dispersed ownership. For example, Hemopharm has 10,000 shareholders. It proved difficult during fieldwork to identify a complete list of enterprises privatised before 2001. In interviews, supporters of earlier privatisation methods drew attention to these success stories, while detractors suggested that these were successful enterprises (breweries and pharmaceutical companies are often among the first to be privatised because they are of interest to investors) that could have been much more successful with a different corporate governance structure, and provided further evidence of selection bias in the privatisation process.

By the end of 1997, according to the Federal Statistical Office, there were 73,858 active firms in the FRY (Table 6.5). Of these, the majority (85%) were privately owned, but these were very small. A further 3,400 (4.6%) of firms had what was

[17] ALTUELNO ‘Serbian government buys back the 29% stake in Telekom Serbia from Italy’, 30 December 2002.
[18] AKTUELNO ‘Cookware maker Metalac reports 18% rise in first half sales, strong exports’, 18 March 2003.

known as mixed ownership. 5,256 were still socially-owned, and this grouping included state-owned firms.

Table 6.5 Number of firms with different ownership structures – end 1997

| Ownership category | No. of firms |
|---|---|
| Privately-owned | 62,969 |
| Mixed ownership | 3,400 |
| Socially-owned | 5,256 |
| Cooperative | 2,209 |
| Total | 73,858[a] |

*Source*: Cerovic and Malovic (2003)
*Note*: a) 24 units are not accounted for (Cerovic and Malovic, 2003: 183)

While the majority of firms were privately owned, analysis of the ownership of total capital indicates that the private sector accounts for only a small proportion. Table 6.6 shows that, at the end of 1997, social ownership still accounted for 47% of capital and state ownership for 38%.

Table 6.6 Enterprise ownership in different structures (% shares in capital: book value, end 1997)

| | |
|---|---|
| Private sector | 6 |
| Privatised capital | 9 |
| Socially-owned capital | 47 |
| State capital | 38 |

*Source*: Cerovic and Malovic (2003: 184)

Table 6.7 provides a breakdown of the structure of enterprise ownership and the number of employees in each category in June 2000. The data come from a different source and the timing is later, which accounts for the discrepancies with Table 6.5, but some general trends can be observed. The table shows that the average number of employees in privately owned firms is only 4.14. Mixed ownership firms are largest, with an average of 155 employees. Socially owned firms are also large, with 149 employees. This category probably includes state enterprises (although it was not specified in the source).

Table 6.7 Enterprise and workforce by ownership in Serbia, June 2000

| Ownership category | Number of enterprises | Number of employees | Average employees per enterprise |
|---|---|---|---|
| Privately owned | 50,858 | 210,700 | 4.14 |
| Mixed ownership | 2,839 | 440,400 | 155.12 |
| Socially owned | 4,721 | 704,900 | 149.31 |
| Co-operative | 2,118 | 23,000 | 10.86 |
| Total | 60,536 | 1,379,000 | 22.77 |

*Source*: World Bank (2001) (taken from ZOP Belgrade).
*Notes*: a) The data here are taken from World Bank (2001), which fails to specify the meaning of the different ownership categories. In Table 6.5, the socially owned category includes state ownership. It is assumed that this is also the case in the data provided for this table.
b) This table is taken from a World Bank report. The total given in the source is 60,552 but this is not what the figures add up to. It is not clear from the report why there may be a discrepancy. This paper takes the figures for each category from World Bank (2001) and uses the correct total.

Table 6.7 shows that, by 2000, the majority of enterprises (nearly 84%) were privately owned but these were very small, and this category accounts for only 15% of employees. More than half the employees (51%) were in the socially owned category of enterprise. Thus, ten years after privatisation was first introduced, 'social ownership' (including state ownership) still accounted for most of the economic activity in the FRY at the end of the 1990s. This is echoed by the World Bank (2001) which reports that the country 'embarks on its renewed transition with a still dominant state and socially-owned enterprise sector that is thoroughly accustomed to soft budget constraints and thus inefficiently organised, substantially loss-making and excessively indebted' (World Bank, 2001: 4).

### *6.3.2 Privatisation since 2001*

After the election of the reformist government in October 2000, a new Privatisation Act was adopted in 2001. Unlike previous privatisations, the focus was on selling enterprises to strategic investors. Under this law, privatisation could be initiated by the company, the ministry or the buyer, but it had to be initiated by some party. Privatisation was no longer voluntary. Under the scheme, 70% of shares were to be sold to investors, 15% to employees and 15% to a Privatisation Fund. The model also aimed to complete the privatisations that had been started under earlier privatisation models (Government of the Republic of Serbia, 2003). The approach is based on that of countries regarded as successful privatisers – Latvia, Estonia, Poland, Hungary and the Czech Republic (in the later stages of privatisation) and recently Slovakia – which have used a combination of auction and tender sale methods (www.priv.yu).

The policy has many objectives in Serbia: to create an open economy and ownership structure; to maximise investment in the real economy; to achieve social and political acceptability; to establish a clear ownership structure and mechanisms of corporate administration based on this (www.priv.yu). It is key to recovery of the enterprise sector: 'Privatization and better financial discipline (adoption of the Law on Bankruptcy) will further reduce losses and increase profits' (Government of the Republic of Serbia, 2003: xiv). Privatisation is intended to be part of the strategy to reduce poverty – 'accelerated restructuring and privatization which will revitalize those state/socially-owned enterprises capable of becoming market-oriented and competitive' (ibid.: 4).[19] In addition, it is intended to stimulate foreign investment and thereby increase internal demand, leading to growth and employment (ibid.). There are now plans to speed up the process: 'As many of the fixed costs of privatisation have been borne (institutional and legislative preparation), an acceleration of the privatisation process is expected in the next two years' (ibid.).

This new approach presented a significant psychological shift, demonstrating a decisive departure from earlier privatisations (Cerovic and Malovic, 2003), and reflecting a change in the underlying priorities. Privatisation during the 1990s was focused on distributional goals which took priority over commercial and economic efficiency. Hence shares were distributed to employees. Since 2001, privatisation has been about a quick transition to a market economy, and distributional priorities are secondary. The contrast demonstrates that social priorities can conflict with commercial imperatives, creating a trade-off between social and business objectives. As a result, the privatisation approach in Serbia has been modified to weaken the demands on investors:

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[19] This effectively accounts for any outcome as an enterprise which fails after privatisation was presumably not 'capable'.

> Full privatisation, effected by creating concentrated private ownership, leads to the increase of enterprise efficiency, but very often at the cost of a lot of people losing their jobs. This consequence of privatisation has made government make quite strict demands on the 'social programme' when applying the model for tenders, namely that investors provide for the surplus manpower. It is clear that such a demanding policy has shown negative results in attracting foreign investors, though it represented a good transitional model in terms of reaching a social consensus, so important for Serbia. Therefore the new policy (starting with the recent change of the law on Privatisation), will not be so demanding. (Government of the Republic of Serbia, 2003: 49)

Under the current legislation, enterprises fall into one of three categories. First, the majority (89%) of firms are auctioned. Some have been auctioned several times before being sold. Second, medium to large, more attractive firms are sold by tender, and, third, some companies that cannot be sold fall into the category of restructuring. This can mean statutory and organisational corporate restructuring of companies or parts of companies. In addition, as part of the 2001 privatisation initiative, the Privatisation Share Fund was established in 2002 to assist firms that fell into the 'mixed-ownership' category under earlier privatisation legislation. The Share Fund was formed as part of the latest privatisation strategy to administer the state's shares in enterprises acquired through privatisations during the 1990s, and it was expected to exist for 6 years.[20] The Fund helps to deal with issues of dispersed ownership that have arisen under previous privatisations. For example, Sintellon sold a 68% stake to a strategic investor. The objective of the Share Fund, then, is consolidation of the dispersed ownership structure rather than development of share trading activity. Shares are sold just once, but not traded.

Initially, the government identified 50 enterprises or enterprise groups employing 160,000 employees that should be restructured first (EC, 2003). Enterprises have to be dismantled to identify which 'business units' are viable. Many are massively indebted and need financial restructuring. Some enterprises evolved in the period before 1990 to cover a huge range of activities. Reference was made in one interview to an example of a textile factory that included a football stadium, a hotel, a kindergarten and a museum. After restructuring, enterprises enter the tender or auction process. Few firms have taken this step but it has been done. Zorka (described in one interview as 'a diversified monster') was split up and some parts have come through the privatisation process and been sold. In addition, subsidiaries of Min and Gosa and Elektronska Industrija Nis have gone from restructuring to tender/auction (Vlahovic, 2003). Other enterprises have gone the other way, from tender/auction back to restructuring because of difficulties in selling them. At the time of the research (early 2004), the original list of 50 enterprises in the restructuring process had increased to around 60 (survey interviews). There have been some small liquidations but it is not clear what will happen to the big firms. In the restructuring list are companies like Bor Mining and Zastava car production which have little hope of being sold. In one list of 54 enterprises for restructuring, a total of 460 independent business units had been identified. A new law on bankruptcy was adopted in July 2004 and was due to come into force on 1 February 2005 (www.invest-in-serbia.com).

[20] Over the year to May 2003, the Fund offered for sale packages of shares of different relative size in 133 companies. Sales were achieved in 79 cases. According to MAP (May 2003), demand for shares is 'low and inefficiently structured'. Main buyers of minority stocks are domestic investors from the industrial and trade sectors; the number of foreign investors is 'negligible'.

In general, the privatisation agency has opted to sell first the companies that have the best chance of attracting investors (EBRD, 2002). Table 6.8 shows that, by November 2003, 804 enterprises[21] had been sold. It was expected that by the end of 2004, the privatisation of almost all small and medium-sized enterprises would be completed (IMF, 2004b). Total sales at the end of 2003 came to €1.1bn, with €662m. pledged for investment and €261m. for the 'social programme' (i.e. to support workers who are laid off).

Table 6.8 Total privatisation carried out, 2002/03

| | **No. of firms** | | | | **'000 €** | | |
|---|---|---|---|---|---|---|---|
| **Method** | **Offered** | **Sold** | **% sold** | **Employment** | **Capital** | **Pledged investment** | **Pledged social fund** |
| Tenders | 62 | 27 | 44% | 24,130 | 795,689 | 600,586 | 261,106 |
| Auctions | 884 | 777 | 88% | 66,258 | 283,180 | 61,329 | |
| Total | 946 | 804 | 85% | 90,388 | 1,078,869 | 661,915 | 261,106 |

*Source*: Vlahovic (2003)

Aside from improving corporate governance, the privatisation programme in Serbia is about raising revenue to support the government's fiscal programme. Some considerable success has been achieved in this respect, as a number of large enterprises were sold to foreign investors during 2002 and 2003. Two tobacco farms have been sold, one to Philip Morris and one to BAT. Three cement factories were sold to foreign investors - Lafarge (France), Titan (Greece) and Holcim (Switzerland) - for a total of US$138.1m. Other major tenders that took place during 2003 include Merima (household chemicals) bought by Henkel (Germany) for $14.4m. and Seval aluminium mill bought by Impol (Slovenia) for $7m. In August 2003, it was announced that the Russian oil firm Lukoil had placed the best bid for the Serbian fuel chain Beopetrol, offering €117m. for 79.5% of the socially-owned capital and a further €85m. in investment over five years.[22] Table 6.9 lists the countries that have participated in the Serbian privatisation programme.

Table 6.9 Foreign investment in privatisation (€m.)

| | |
|---|---|
| USA | 393 |
| Russia | 117 |
| Switzerland | 61 |
| France | 59 |
| UK | 57 |
| Greece | 45 |
| Croatia | 29 |
| Netherlands | 27 |
| Macedonia | 16 |
| Austria | 14 |
| Slovenia | 13 |
| Italy | 9 |
| Cyprus | 5 |
| Germany | 4 |
| Others: Slovakia, Israel, Hungary, Ireland | 3 |
| **Total** | **852** |

*Source*: Ibid.

[21] Excludes minority stake holdings sold through the Share Fund.
[22] 'Lukoil offers €117m for Beopetrol fuel chain; pledges to invest €85m', www.invest-in-serbia.com, 25 August 2003.

While there have been a number of significant high-profile privatisations which have brought in substantial revenue, these are the most successful firms and the process looks set to become more difficult, since the firms that remain to be sold are not so attractive or at least are not in sectors where foreign investors are active. The IMF estimates privatisation receipts in 2003 to have been around 4.3% of GDP (Government of the Republic of Serbia, 2003), up from 2.2% in 2002 and zero in 2001. The estimate for 2004 was for privatisation receipts to be equivalent to only 0.7% of GDP, a considerable decline. The country's PRSP was more optimistic, hoping for privatisation receipts of around 2-3% of GDP (ibid.).

At the time of the research (early 2004), it seemed that the treatment of firms that were not easily sold had still to be resolved, and the impression gathered was that no-one was entirely clear about what would happen to them. It was suggested in one interview that a fund might be established to take on enterprises not sold after a certain date. According to Cerovic and Malovic (2003), after the initial surge of privatisation, policy-makers should look differently at what is left over and give firms incentives to design their own privatisation projects. Where firms are not easily sold to investors, they recommend an insider privatisation. More recently, there has been pressure to speed up privatisation as this is considered to be the key to overcoming the financial indiscipline which lies behind long-standing macroeconomic problems, and fast privatisation is intended to create a dynamic private sector (IMF, 2005). The process is particularly challenging when it comes to those large enterprises which are in financial difficulties with high debts, excess labour and obsolete technology. In this respect, according to the IMF it is 'imperative' that the government does not hesitate to initiate bankruptcy procedures in the case of enterprises with financial problems that fail to attract investors (ibid.).

Since a change in government at the end of 2003, the privatisation process has come increasingly into question. The new government has pledged to investigate 80 privatisations carried out by the previous government.[23] Particular interest has been expressed in the sale of 3 sugar companies to MK Komerc, whose owner was a close friend of the late former Serbian Prime Minister, Zoran Djindjic, and a significant financial backer of his DS party. Privatisation is controversial where there has been only one bidder. According to one commentator, protests by trade unions against privatisation played a key role in the election of the radical party. Trade unions held a number of demonstrations during 2003 that 'gained considerable publicity and helped in large part to win votes for both the DSS and the ultra-nationalist Radicals'.[24]

It is extremely important for the government to attract investment through privatisation, as there is no room for increased public spending in GDP and the fiscal sustainability of future spending relies heavily on privatisation proceeds. The fiscal deficit is principally financed from privatisation income projected at 2-3% of GDP. Thus, privatisation proceeds have already been earmarked and are key to achieving growth and poverty reduction targets: 'Not achieving projected revenue from privatisation is a risk to the sustainability of the public spending plan …Foreign direct investments, through tender privatisation, will represent a significant source of fiscal deficit coverage, which will contribute to the establishment of the internal balance in the medium term' (Government of the Republic of Serbia, 2003: 34).

[23] *World Markets Analysis* 28 April 2004, 'New Serbian Government to Review Eighty of Predecessor's Privatisations'.
[24] (ibid.).

## 6.4 Survey

The aim of the research was to explore the impact of privatisation on medium-scale enterprises in Bosnia Herzegovina and Serbia (Montenegro was not included in the survey). This can only be examined in a limited way in Serbia at this stage, as privatisation had only really started about two years before the time of the research. However, the findings provide an indication of the preliminary effects of privatisation. Because privatisation has taken place only recently in the enterprises surveyed, the research lays greater emphasis on qualitative measures of restructuring since it is unlikely that privatisation will have had a major effect on the financial data so soon after implementation. Initially, high costs may be associated with the adjustment to privatisation, since, for example, severance pay is paid to laid-off staff, investment costs are incurred and firms begin to adjust to a new ownership structure, thus leading to a deterioration in financial indicators.

While there was some privatisation activity before 2000, the evidence above indicates that on the whole this process did not result in large-scale private sector ownership. Tables 6.5, 6.6 and 6.7 demonstrate that while most firms were privately owned, they were very small, accounting for little more than 15% of employees (Table 6.7), although some large firms were also sold at this time. The context of privatisation before the 2001 legislation (under Milosevic) was very different from that of the current programme and therefore has little current policy relevance. Hence this research focuses only on firms privatised since 2001.

The aim was to select 20 firms in the manufacturing sector with more than 250 employees that had been privatised since 2001. However, a review of the database of the Privatisation Agency in Serbia revealed that only 26 firms met these criteria, and it would be ambitious to expect as many as 20 responses from such a small sampling frame. Hence the criteria were relaxed to include all firms with more than 200 employees, privatised before February 2003. This gave a total sampling frame of 35 enterprises. All were contacted to take part in the research. A total of 22 responses was received, of which 16 were in the industrial sector. One could not be used owing to the subsequent cancellation of the privatisation. Another turned out to have been privatised far more recently than the rest of the sample. The financial data provided by this firm were not used, but the responses to restructuring within the firm were incorporated in the analysis. Table 6.10 provides a breakdown of the firms that took part in the survey by sector.

Table 6.10 Break down of sample firms by sector

| Sector | No. of firms |
|---|---|
| Sugar production | 3 |
| Construction | 3 |
| Food and drink production | 3 |
| Pharmaceuticals | 2 |
| Restaurants | 2 |
| Retail trade | 2 |
| Textiles | 2 |
| Other manufacturing | 3 |
| Transport | 1 |

The findings are limited by selection bias. It may be that firms that are more successful are more likely to be willing to take part in the research. Furthermore, it has been reported that the most profitable and attractive firms have been the first to be privatised, so the findings from these firms may not be representative of the likely impact on the rest of the stock of state (socially)-owned enterprises.

### 6.4.1 External environment

Firms were asked about the context in which they were operating. A complete list of survey responses is provided in Annex 2 and is summarised below. There were few analysable data on prices charged and prices of inputs, due to the high inflation levels. Some reported that privatisation had made no difference to prices. One company reported that the major changes that took place in terms of prices and sources occurred following the change of government in 2000 when the management was changed. One (pharmaceutical) firm said that prices were still controlled by the government, despite privatisation.

All firms reported that they were operating in a competitive environment. Almost half the firms reported that they had between two and five competitors, which earlier research has found to be the most effective in exerting positive competitive pressure (Carlin et al., 2001). Most reported an increase in competition since privatisation. Debts had increased in 7 out of 12 cases. One firm said that this was because of paying instalments to the government to buy the enterprise. As mentioned earlier, increase in debt can be a positive development where it is incurred in order to finance investment, but for some firms it was a distress signal. One attributed growing debt to low domestic incomes. For another firm, the increase was due to reduction in sales and increases in production costs. Most firms had raised finance from banks. One was now sourcing funds through its new parent company.

Most thought fairly badly of the legal system, with scores ranging from fairly ineffective to very ineffective. However, in at least one case, the perception is that the legal system has improved since privatisation. Lack of access to working capital was a major constraint for some firms. This included the fact that interest rates were high and that banks demanded high collateral for loans. The financial sector was reported to be restrictive, with high rates of interest. Another firm reported difficulties in attracting appropriately skilled staff, and a number of firms complained about unfair competition from the black economy.

### 6.4.2.1 Enterprise performance

Firms provided data on key performance indicators before and after privatisation and a value was calculated for the percentage change in the indicator. Table 6.11 shows the maximum, minimum, mean and median values for the percentage change in selected indicators. The table also lists the numbers of firms with positive and negative values for the percentage change after privatisation.

Table 6.11 Percentage change in key performance indicators - Serbia

| % change | No. | Minimum | Maximum | Mean | Median | No. of positive | No. of negative |
|---|---|---|---|---|---|---|---|
| Sales | 10 | -87.11 | 86.67 | -12.71 | -28.54 | 4 | 9 |
| Raw material costs | 8 | -61.88 | 17.54 | -27.55 | -23.77 | 1 | 7 |
| Value added | 6 | -87.28 | -1.56 | -47.31 | -56.68 | 0 | 6 |
| Labour costs[a] | 14 | -57.46 | 46.96 | -9.19 | -9.73 | 4 | 10 |
| Operating profit | 4 | -405.98 | 33.71 | -112.83 | -39.52 | 1 | 3 |
| Debt | 10 | -32.28 | 509.00 | 84.13 | 19.37 | 8 | 2 |
| Production[b] | 8 | -51.79 | 230.00 | 26.29 | -12.00 | 3 | 5 |
| Capacity utilisation | 9 | -8.82 | 112.50 | 36.30 | 13.33 | 8 | 1 |
| Employment | 20 | -58.16 | 8.56 | -16.05 | -11.47 | 4 | 16 |
| Tax payments | 10 | -80.79 | 415.27 | 39.22 | 35.39 | 3 | 7 |
| | | | | | | | |
| **Productivity** | | | | | | | |
| Revenue per employee | 13 | -87.97 | 139.23 | 11.72 | -13.11 | 6 | 7 |
| Value added per employee | 6 | -88.13 | 50.16 | -31.78 | -48.04 | 1 | 5 |
| Operating profit per employee | 4 | -566.76 | 42.35 | -146.59 | -30.98 | 1 | 3 |
| Production per employee | 8 | -32.15 | 300.25 | 98.63 | 73.60 | 7 | 1 |

*Source*: Survey data

*Notes*: a) Labour costs are restricted to wages in this case as there was poor response on allowances and very high dispersion according to the standard deviation.

b) Production increased by an average of 26% though the average volume of sales fell by 13%. For 5 out of 8 firms the annual average level of production declined in real terms. 6 of the firms that provided sales data did not provide data on production. 5 out of these 6 experienced a decline in sales levels. Meanwhile, one firm provided production data but no information on sales and this firm experienced a large increase in production. Such discrepancies highlight the limitations on inferences from the data.

Table 6.11 indicates that most firms experienced a decline in financial performance indicators in real terms after privatisation. Before adjusting for inflation, most performance indicators increased substantially, but when values are adjusted to take account of fairly high (although declining) inflation rates over the period 2001-3 (see Table 6.3), in most cases they become negative. Table 6.11 shows a positive movement in the two non-financial performance indicators. Production increased by an average of 26% and capacity utilisation by 36.3%. However, in view of the absence of a control group and the empirical issues such as selection bias and causality discussed earlier, these trends cannot be attributed to privatisation.

The survey asked for information on overall tax payments and what are known as sales tax and company tax. A total of ten firms responded. Only 2 firms provided data for pre- and post-privatisation on company tax, so the tax position relates mainly to sales tax, but the analysis relates to the overall tax position in order to provide some kind of understanding of the fiscal impact. Most firms (7 out of 10) reported an increase in tax payments in nominal terms, but when the high inflation rate was taken into account, the change in taxation became negative in real terms for most firms. There was a wide range of responses. A few firms reported very high increases in tax payments. In one case this was because the firm had been effectively moribund before the private sector owners took it over. Thus the average percentage change in taxation is positive, even though the majority of firms experienced a decline in taxation payments in real terms.

The above results were compared with developments in the wider economy over the same period (Table 6.12). The negative mean value for sales in the survey firms contrasts with the positive growth in output in the wider economy. Similarly, the average fall in employment in the sample firms contrasts with the overall increase in employment in the wider economy. However, the manufacturing sector has not fared so well, with a fall in employment and production during the period. A fall in employment after privatisation was expected: 'The direct effect of privatisation is an initial drop in employment in newly privatised enterprises. However, privatisation also creates preconditions for new, sound private investments. Such investments will lead to the creation of new jobs, though this will take some time' (Government of the Republic of Serbia, 2003: 84).

Table 6.12 Cumulative change in selected indicators (2001-3)

| | **2001** | **2002** | **2003** | **Cumulative total % change 2001-3** |
|---|---|---|---|---|
| GDP % change | 5.3 | 3.8 | 2.0 | 11.5 |
| Employment all enterprises % change | 1.8 | 4.0 | 4.6 | 10.7 |
| Employment manufacturing | 647.0 | 594.0 | 550.0 | -14.90 |
| Manufacturing production index | 0.8 | 2.7 | -4.4 | -0.88 |

*Source*: Adapted from tables above

Table 6.13 shows the results of the two-tailed *t*-tests where the value of the sample mean was compared with the test value above. The table provides a summary of results, and more details are provided in Annex 1. Two of the three results shown are statistically insignificant. The third shows a significant fall in employment in privatised firms at a time when employment was increasing in the wider economy. However, the more accurate comparison is with manufacturing employment, as most of the sample firms are in the manufacturing sector. Table 6.13 indicates that the 14.9% fall in manufacturing employment in the economy over the period was close to the average reduction in employment in the sample firms which was 15.77%.

As in Bosnia Herzegovina, the only result that is significant relates to employment; however, the effects in Serbia stem from the large fall in employment in privatised firms compared with employment in the wider economy which increased by more than 10% over the same period. When the contraction in employment is compared with developments in the manufacturing sector the findings from the survey firms are not significant, as employment has fallen in the manufacturing sector generally.

Table 6.13 Results from one-sample *t*-tests

| **Variable** | **No.** | **Sample mean**[a] | **Economy value**[b] | ***t*-value** | **Difference significant at 90% confidence level?** |
|---|---|---|---|---|---|
| Employment change – economy | 20 | -16.05 | 10.70 | -6.561 | Significant |
| Employment change - manufacturing | 15 | -15.77 | -14.90 | -0.164 | Not significant |
| Production volume change – manufacturing only | 6 | 76.66 | -0.88 | 1.776 | Not significant |

*Source*: Survey data
*Notes*: a) from Table 6.11; b) from Table 6.12

The next stage in the analysis was to determine if the results varied according to method of sale and/or type of investor. Tenders are used for the privatisation of larger enterprises, where investors are invited to pre-qualify in order to be invited to submit bids for the enterprise. Auction procedures are used for small and medium-sized enterprises and a standard procedure is applied. Table 6.14 shows that the majority of firms in the sample were sold to Serbian investors. In contrast with Bosnia Herzegovina, few firms in Serbia were sold to employees; in our sample there were only 2 firms out of 21. The results show a negative change in financial indicators (due in large part to the high inflation rates). However, there seems to be a substantial increase in production levels in Serbian investor-owned firms (Table 6.15). Table 6.14 indicates that domestic investors participate more by auction than by tender. Foreign investors participate more by tender, presumably because these are the larger, more significant enterprises.

Table 6.14 Sample - Sale method/Type of investor

| | Employees | Serbian investors | Foreign investors | Total |
|---|---|---|---|---|
| Tender | 1 | 2 | 5 | 8 |
| Auction | 1 | 11 | 1 | 13 |
| Total | 2 | 13 | 6 | 21 |

*Source*: Survey data

Table 6.15 Percentage change in key indicators by type of investor (2001-3)

| | | **Sales** | **Value added** | **Debt** | **Production**[a] | **Employment** |
|---|---|---|---|---|---|---|
| Foreign investors | Mean | -18.57 | -1.56 | 172.58 | -9.25 | -25.24 |
| | N | 4 | 1 | 3 | 2 | 5 |
| Employees | Mean | - | - | 9.18 | - | 3.61 |
| | N | - | - | 1 | - | 2 |
| Serbian investors | Mean | -10.1 | -56.46 | 52.39 | 88.87 | -15.54 |
| | N | 9 | 5 | 6 | 6 | 13 |
| Total | Mean | -12.7 | -47.3 | 84.13 | 64.34 | -16.05 |
| | N | 13 | 6 | 10 | 8 | 20 |

*Note*: a) Includes the entire sample, whereas the analysis of production in Table 6.12 refers only to industrial production and hence the value is slightly different.

The above results indicate that there is no great difference in the performance of firms sold to foreign investors and those sold to domestic investors, although these results are not statistically robust. Both sets of firms suffered a decline in sales and in gross profit on average in real terms, while the decline was higher for Serbian investors where there were only 6 observations. The level of debt for foreign-owned enterprises increased by substantially more than the debts of firms bought by Serbian investors. Serbian-owned firms managed to achieve substantially higher increases in production than foreign-owned firms (but the latter category consisted of only 2 firms). Both sets of firms showed an average reduction in employment after privatisation, whereas the average figure for employment change for the 2 employee-owned firms was positive, which is in keeping with the proposition that insider-owners will be reluctant to reduce employment.

### 6.4.3 Enterprise history and privatisation process

Annex 3 provides details of managers' responses to questions relating to enterprise history, the privatisation process, internal restructuring and the external environment. The majority of firms (15 out of 17) reported a loss of markets as a result of the conflict, and with a fall in demand, employees were laid off, so employee reductions also followed from the war. According to one firm interviewed, there was virtually no activity in the firm over the period 1998-2000 and workers had not been paid for 3 years.

In contrast to experiences in Bosnia Herzegovina, only one firm reported that the privatisation process had been constrained by difficulties in finding an investor. Nearly half the firms (9 out of 19) reported that the privatisation process was not constrained by debts or other factors. Others reported that the high level of indebtedness made finding an investor difficult. One firm reported a high drain of the educated workforce before privatisation and lack of experts in key areas such as marketing and PR. For half the companies (10 out of 20) there was no restructuring before privatisation. 7 firms reported a downsizing in employment before privatisation.

### 6.4.4 Internal restructuring

Survey responses to questions regarding restructuring measures according to different types of investor are set out in Annex 7. Most firms reported an increase in production (12 out of 21) but fewer (9 out of 21) reported a change in production methods. Some of the enterprises that reported no change at the time of the research indicated that future progress was likely. Others said that the pressure from competition and the black market made prospects bleak.

Slightly fewer than half of the firms reported the introduction of new products (compared with 68% of firms in Bosnia Herzegovina), and one firm reported a contraction in its product range in order to cancel the diverse operations that were peripheral to the core business activity. The firm said that the reasons for the change were well known, but it could only be carried out after privatisation. Three-quarters of firms introduced new suppliers and 5 reported no change in suppliers after privatisation. All the firms had kept some kind of continuity with suppliers, reporting that only some had been replaced; this suggests that firms were not tied into onerous purchase agreements under state control but had been relatively autonomous. Some firms reported procedural changes in sourcing inputs, for example as a result of having a parent company owner. One reported that it now had a tender system for input sourcing which had brought down prices. In addition, a few firms (4) reported that a proportion of their sales were to government. Of the 20 firms that responded, 10 were exporting before and 13 were exporting after privatisation, so 3 firms exporting after privatisation had not done so before.

The responses shown in Annex 7 indicate that about half of the firms have implemented some restructuring measures which may not yet have had an impact on the performance indicators in Table 6.11. Slightly more than half (55%) reported a change in internal structure since privatisation (compared with 84% in Bosnia Herzegovina). 9 firms out of 12 had introduced new departments. In one, accounting and planning and analysis departments had been set up to create improvements in cost management. A commercial sector was also introduced to improve efficiency. Another firm said that the introduction of new departments had started but had not been completed. Another restructuring measure was the separation of retailing from production activities and the establishment of a new company with that function. Annex 5 shows the percentage change in managers according to the type of investor. The table indicates that 35% of firms replaced 10% or fewer of enterprise managers. 9 firms replaced between 11% and 50% of managers. Foreign investors changed the highest proportion of managers after privatisation.

Firms were asked for details of investment in equipment, land, buildings and vehicles for the period before and after privatisation, but many respondents declined to put a value on investments and simply indicated whether or not investment had taken place. Most firms (13 out of 18) reported investment in equipment since privatisation and a few firms reported disposals; 4 out of 21 reported disposal of vehicles, and only 2 the disposal of land and buildings. While this does not indicate that firms have invested more or less in the post-privatisation period, it does suggest that new owners are not in the habit of asset stripping. Most firms thought that the quality of their product had improved since privatisation. A few thought it was the same. None thought it had declined. Some outcomes were contradictory to privatisation theory. For example, privatisation is intended to streamline decision-making, thereby reducing bureaucratic procedures, but one firm reported that decisions had to be referred to the overseas-based parent company, thereby slowing decision-making procedures.

Annex 6b shows that employment fell in 16 out of 19 firms, and the employment level in one firm remained the same. Only 3 firms had increased employment since privatisation. All firms sold by tender resulted in reductions in employment. This is what was expected from privatisation, at least in the short term (see above). There are no restrictions on employment reductions after privatisation in Serbia. The mean value for employment reduction for the sample as a whole was –16.05%. As might be expected, of the three ownership types, the mean value of employment change was positive where enterprises were sold to employees (although there were only 2 observations) and negative for sales to Serbian and foreign investors. All 5 of the firms sold to foreign investors had seen a reduction in employment since privatisation compared with 10 out of 13 firms sold to domestic investors.

Many firms reported an increase in staff turnover due to a number of lay-offs soon after privatisation. One firm reported that labour costs remained constant despite lay-offs because of higher wages paid to the staff that remained. All workers were highly unionised. Most firms reported 100% union membership, although in some cases membership rates declined after privatisation. 10 firms reported an increase in training after privatisation. 11 reported no change but among these, even where training was provided by the same resources and to the same groups of workers, some reported training was better, and in some cases this was due to the introduction of new equipment, etc.

The data in Annex 7 indicate that there is no clear difference in the degree to which changes are implemented according to ownership by domestic and foreign investors. About half of each category have implemented changes and half have not. This would suggest that firms have as much to gain from being taken over by a domestic investor as by an international investor.

The managers of only 2 firms expressed the view that the changes implemented could have taken place without privatisation. The rest (nearly 90%, compared with 67% in Bosnia Herzegovina) believed that privatisation had been essential for reforms to be implemented. Some of the comments on this point reflect the expectations of privatisation theory. For example, one firm said that privatisation had been essential because it had previously been very difficult to make decisions, due to the ‘unsettled’ ownership structure. Another commented that there was no leading force either external or internal that was able to push forward the necessary internal reforms. However, it is clear that the legal framework is such that there is no option but to privatise. One firm said that, before privatisation, it had wanted to implement the changes that had been brought in after privatisation but this was not possible owing to the environment in which it operated and its lack of access to finance. Another firm also said that the changes that were required were well known before privatisation but they could only be carried out after privatisation.

Firms were asked about the motivation of investors. Employee-owned firms wanted to maintain ownership in ‘what they had created’. Other investors were seeking profit (unsurprisingly) and some cited export potential. Some firms were already highly successful. Firms generally cited reasons such as profitability and market share or that they were already involved in the production process, so firms were bought by suppliers or customers or competitors. These results indicate that privatisation is likely to be more difficult where firms do not show a strong performance or are not part of a larger supply chain.

## 6.5 Conclusion

The privatisation programme currently adopted in Serbia is very different from earlier attempts to privatise and from the programmes in Bosnia Herzegovina. The emphasis is on attracting investment, and to a large extent this has been achieved in so far as attractive enterprises (such as sugar and tobacco production and breweries) have been sold to foreign investors. However, there are concerns that the privatisation process, post-2001, is targeted at only a relatively small number of profitable enterprises (Cerovic and Malovic, 2003).

The findings presented here indicate that there has been some progress with restructuring in privatised firms, although this has failed as yet to have much impact on enterprise performance. On average, most firms have seen improvements in sales and profits in nominal terms, but these have been eroded by high inflation rates and most indicators have fallen in real terms since privatisation and debt has increased for most firms. The results indicate a substantial positive outcome for production levels which have increased in contrast to a slight decline in the wider economy, but this result was not found to be statistically significant due in part to the small sample sizes. The firms had only recently been through the privatisation process and the impact of changes may take some time to reach performance indicators. The survey found evidence of internal restructuring within firms, that might be expected to have a positive effect on enterprise performance in the future.

While micro-level objectives may take time to be achieved, privatisation in Serbia has made significant macro achievements through the receipts of privatisation proceeds supporting the fiscal position. Compared with Bosnia Herzegovina, few enterprises have been sold to employees in Serbia in the post-2001 privatisation programme. Most have been sold to domestic investors and some to foreign investors. The evidence from this research finds no major differences between sales to domestic and to foreign investors in terms of performance or enterprise restructuring.

The process in Serbia represents a major departure from the earlier programmes and the approach adopted in Bosnia Herzegovina which placed greater emphasis on social outcomes and equity. Currently in Serbia the emphasis is on shifting enterprises to the private sector and supporting investors (rather than, say, employees) in the process. Hence there are few demands on investors and one of the clearest contrasts in post-privatisation performance between the two sets of survey results is the employment outcome. In the survey sample, employment fell on average by 16% in Serbia, while it increased by an average of 3.3% in the sample firms in Bosnia Herzegovina (although these results are not robust and cannot be attributed solely to privatisation). This decline in Serbia was expected and the employment effect of privatisation is expected to take a U-shape. In addition, the employment effects from privatisation are less significant than the lay-offs that have been taking place in firms that are in the process of restructuring. However, the lay-offs that are associated with privatisation are contributing to an already high unemployment rate, and while privatisation may increase internal efficiency, it will be a long time before privatised enterprises will be able to contribute to a recovery in employment.

The overall approach to privatisation is primarily market-led.[25] That is to say that enterprises are sold and if they are not sellable the plan is to close them, making use of the new Bankruptcy Law. The aim now is to complete the privatisation process by the end of 2006 (IMF, 2005). Such a policy is intended to make enterprises more competitive, improve financial discipline and lead to the redeployment of labour and capital to more productive uses. However, in view of the fact that the most attractive enterprises have already been sold, rapid privatisation based on acquisition by a strategic investor may mean that Serbia's new bankruptcy legislation will soon be put to repeated use in the context of the (possibly many) enterprises which will not easily be able to attract investors. Whether this will create a dynamic private sector, as envisaged by the IMF,[26] remains to be seen. Alternatively, such an approach could add to already high unemployment, contributing to social unrest that could undermine rather than advance economic growth.

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[25] Although the government has been slow to deal with politically contentious loss-making enterprises such as Zastava car manufacturing which supports the whole town of Kragujevac.

[26] 'Boldly accelerating privatization is undoubtedly the overriding economic policy challenge facing the Government. This is key to overcoming the financial indiscipline that is the root cause of longstanding macroeconomic problems. More important, with the large structural current account deficit leaving little scope for increasing the low share of investments in GDP, sustained economic growth will require redeploying labor and existing capital to more productive usages. This points to the urgency of creating a dynamic private sector through fast privatisation.' IMF (2005: para. 13).

# Chapter 7: Conclusion

## 7.1 Introduction

Serbia and Bosnia have a considerable shared history in the unique economic organisation of worker-management that was in place from the 1950s to the 1980s. Since then both have suffered greatly from years of conflict, and the recovery process has been slow with both still to achieve 1990 income levels. While there is much in common, the approaches to privatisation that they have adopted have been very different, although in both cases there are extremely high expectations of privatisation. The Bosnian model was based on the methods of mass privatisation used in the Czech Republic and Russia, while the Serbian model of privatisation by means of sale to an investor owes much to the privatisation methods adopted in Hungary and Estonia. Both countries have more or less completed the privatisation of small-scale enterprises. Serbia has managed to sell off a number of more attractive larger enterprises. Mass privatisation is no longer used in Bosnia, and the country has a long list of strategic enterprises which it is attempting to sell directly to investors, but few have been sold.

## 7.2 Main findings

The survey results indicate that there has been great diversity in the impact of privatisation, with some firms reporting that they have been saved by privatisation while others have found that the process has been detrimental. It is not therefore possible to point to clearly identifiable effects from privatisation, but some common themes can be identified. First, privatisation has so far brought about little improvement in terms of financial performance, particularly in Serbia where inflation has been high. Furthermore, privatisation is not associated with a fall in debt levels. In most enterprises surveyed, debts have risen after privatisation. However, most enterprises that responded reported improvements in production volume and capacity utilisation. Second, in terms of internal restructuring most firms reported changes that were consistent with deep restructuring, such as changes in production methods, and the introduction of new suppliers and new products. Most firms also reported investment in equipment, and there were few asset sales. These internal measures can be considered indicative of proactive reform-minded management, suggesting that, on the whole, while there has been little progress with financial performance, most privatised firms are laying the groundwork for future growth and expansion. For the majority of firms, privatisation was regarded as an essential pre-requisite for the introduction of these internal changes.

Third, since privatisation, enterprises have seen contrasting changes in employment levels in Serbia and Bosnia Herzegovina. In the survey sample, average employment levels increased slightly in Bosnia Herzegovina, while they fell by more than 15% in Serbia after privatisation. This contrast may be associated with the different approaches to privatisation, which in Serbia are focused on achieving a sale and therefore accommodate the requirements of investors, while in Bosnia Herzegovina, there has been greater emphasis on curbing social costs. However, the contrast may also reflect wider economic developments.

Fourth, the analysis of restructuring by type of investor fails to support the outcomes expected following the literature review. The results from Serbia show little difference in the extent of restructuring in firms sold to domestic as compared with foreign investors. Similarly, the evidence from Bosnia Herzegovina indicates that insiders are no worse as owners than outside investors. A more detailed breakdown of this group shows that employee takeovers by tender resulted in more extensive enterprise reform than takeovers via voucher privatisation or direct negotiation, although the sample sizes by this stage were very small. These results from Serbia and Bosnia Herzegovina, which are in contrast with other research findings, may reflect the historical legacy of worker-management which meant that enterprises had considerable autonomy before privatisation. In contrast with other transition economies, most firms were already operating in highly competitive environments. Many were exporting and were exposed to market forces under social ownership in the SFRY before the conflict in the 1990s. Finally, the privatisation process itself matters crucially for outcomes. Some of the firms interviewed had found the build-up to privatisation extremely difficult while they were in the limbo state of 'being privatised', and the slow privatisation itself has eroded state capital, making it harder to sell enterprises.

There were some considerable limitations to the research. The findings are subject to selection bias. The employee-owned firms that took part were possibly the more successful. Any firms that were subject to 'tunnelling' and subsequent closure would not have been detected in the research. Many of the enterprises that were interviewed in Bosnia Herzegovina had found the privatisation difficult to achieve, so presumably there are many firms experiencing difficulties that have not managed to complete the process. This was a small-scale survey and so failed to capture adequately all aspects of the privatisation process. In particular, the research failed to understand the effects of hard budget constraints which, according to the literature in Chapter 2, are important determinants of the impact of privatisation. While enterprises reported little formal state support, enterprises could be exposed to soft budgets through informal extensions to debts, and this was not analysed in the research. It was not possible to calculate the full fiscal effect of privatisation for the privatisations examined. Where possible the overall tax implications were considered for Serbia, but there were insufficient data to explore this subject in Bosnia Herzegovina. The research did not attempt to cover wider social issues like the distributional implications of selling majority stakes in successful firms to foreign investors.

There have been variations in the degree to which privatisation has met policy objectives. In Bosnia Herzegovina, privatisation was intended to contribute to the development of the economy. It would seem that this has not been achieved, following years of painfully slow mass privatisation during which enterprises have had little or no investment. More recently, high expectations have been attached to the revised approach to privatisation based on sales to investors, including the acceleration of economic growth. While the above findings find some tentative support for these objectives in that there is some evidence that privatised firms have started to implement internal restructuring measures, the wider picture of very slow privatisation and limited investor interest suggests that privatisation outcomes will again be disappointing. In Serbia, there are also high expectations from privatisation which is intended to revitalise enterprises, bring in foreign investment and increase economic growth. The evidence above indicates that there has been considerable success in Serbia in terms of the fiscal effects of privatisation and there is some indication that firms are restructuring. However, there are concerns that the process will become considerably more difficult to achieve as the less attractive enterprises come up for privatisation.

## 7.3 Post-conflict privatisation: Serbia and Bosnia Herzegovina compared

Bosnia Herzegovina has been privatising enterprises for about seven years. Progress has been extremely slow and despite efforts to accelerate the process, many of the larger enterprises remain in state hands. Serbia, in contrast, began the most recent phase of privatisation four years later and managed to sell a number of high-profile firms to international investors and raise substantial amounts of finance relatively quickly. Thus, in terms of achieving sales, the Serbian programme can be regarded as the more successful. The Bosnian model reflected the complex political settlement of the Dayton Peace programme and so achieved a political and social sustainability, even if this was at the expense of an effective corporate governance structure.

The difficulties experienced in Bosnia Herzegovina, where there has been limited investor interest due in large part to the fragile and fragmented political and economic structure, might be expected when implementing privatisation in a country emerging from conflict. However, Serbia suffered from an even longer period of war as well as economic sanctions and yet privatisation (at least initially) seems to have been implemented more easily than in Bosnia Herzegovina. For over half the respondents in the survey in Bosnia Herzegovina (10 out of 18) the privatisation process was constrained by difficulties in attracting an investor. The corresponding figure for Serbia was just 1 out of 19.

It is the lack of investor interest that is the main obstacle to privatisation in Bosnia Herzegovina, but this (as experience in Serbia indicates) is not necessarily the legacy from conflict. The privatisation programme in Bosnia Herzegovina faces particular difficulties. The original model of mass privatisation, heavily supported by donors, is now largely discredited, and this perception of privatisation is difficult to change despite the shift to an ‘accelerated’ programme with different methods. There has been a confusing array of privatisation agencies which could act as a deterrent to potential investors, and the emphasis of the programme has been on social outcomes, thereby placing considerable demands on buyers of firms in terms of employment and investment levels.

Like Bosnia Herzegovina, there are still political tensions in Serbia but, in contrast, the Serbian privatisation programme was brought in by a reformist government, keen to distance itself from the previous regime, and this introduced a radically changed approach with high-level political support. The scheme was centralised and greater emphasis has been laid on the needs of investors. Furthermore, the enterprises that have been put up for sale in Serbia may be more attractive than those under the accelerated Bosnian programme which have had to endure a protracted privatisation process for several years. However, the indications are that privatisation in Serbia is going to get more difficult as the less attractive enterprises are put up for sale. Many of the enterprises already privatised are those most easily sold in privatisation such as breweries, agricultural plantations and cement distribution.

Mass privatisation is no longer considered a viable policy option in Bosnia Herzegovina or Serbia, which leaves sales to investors by some means or other as the main means by which enterprises can be transferred to the private sector. There are some sectors which are attractive to investors in most circumstances, or rather sectors in which multinational companies are acquisitive. These are usually those with a reasonably secure domestic market or with virtually guaranteed export destinations (such as mineral extraction). Whether these could be run effectively without privatisation depends on many factors, but at least their sale may bring in short-run revenue gains.

Enterprises in other sectors are less attractive to investors, particularly those producing for the domestic market which face import competition, and these constraints are exacerbated in a post-conflict situation. Domestic incomes are low, constraining domestic investor response and limiting market demand. Foreign investors face potentially high risks where the economic and political context may be unstable. While the evidence above indicates that clearly some privatisation can take place soon after conflict, it could be problematic to restrict all enterprise development policy to the basic task of finding investors in the post-war context.

Focusing on ownership change can obscure the wider goal of economic development. A lack of investor interest could be perceived as a form of natural selection whereby only the viable enterprises are sold and those that are not sold are regarded as intrinsically deficient and long-term growth prospects would therefore be enhanced by their closure. However, this view of 'market' forces determining the fate of industrial enterprises ignores the climate in which privatisation is being implemented. There are a number of reasons why investors might be deterred from buying enterprises in Bosnia Herzegovina at present. The country has a fragile political structure as well as heavy influence from the international community, with frequent changes to legislation. In addition, it is still associated with conflict. Narrowing enterprise reform to a process of attracting investors runs a high risk of losing potentially viable businesses because of contextual rather than enterprise-specific factors. Similarly in Serbia, there are indications that the most attractive enterprises have already been sold and that it may become more difficult to attract investors in the privatisation process in the future.

## 7.4 Conclusion

This paper presents findings from two small surveys of privatised enterprises in Bosnia Herzegovina and Serbia. While the responses from the enterprises surveyed point to trends and developments, the results are not sufficiently robust to allow confident policy prescriptions, but they do highlight areas that need further research. Both of these countries are implementing privatisation against a backdrop of conflict which has had a devastating impact on enterprises in the manufacturing sector. Firms were in need of investment at the start, but after the war the situation was far worse, with loss of markets, and loss of suppliers as well as widespread structural damage and huge employment reductions. While Serbia endured a longer period of destruction with NATO sanctions, economic recovery in Bosnia Herzegovina has been impeded by an intricate and fragile political arrangement, which, while providing a peaceful settlement, has created a complex privatisation system with twelve privatisation agencies. The analysis presented in this paper indicates that, in view of the different experiences of Serbia and Bosnia Herzegovina, it is not possible to point to a post-conflict privatisation effect. Rather, outcomes depend on a number of factors including the nature of the programme adopted, the post-war political and institutional framework, the capacity and credibility of the privatisation programme and the wider economic climate.

However, despite the differences in privatisation experiences to date, both Bosnia Herzegovina and Serbia are now facing difficulties in securing investors for a number of medium-scale industrial sector enterprises. A policy of liquidating all such firms runs the risk of increasing unemployment and may eliminate potentially viable enterprises, since lack of investor interest may be a reflection of the wider economic and political climate rather than of the enterprise *per se*. The findings from this survey found that employees had been successful owners in some cases. Further investigation indicated that the performance of employee-owned firms was better where the employees had taken over the enterprise through a tender process than where ownership had been transferred through a process which did not require them to pay for their stake. This suggests that there could be scope for successful employee ownership and, in a context of declining interest from external investors, such an approach could present an alternative to liquidation. While these findings are based on small samples and are not statistically robust, in view of the policy alternatives, they present a suitable agenda for further research.

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# Annex 1: *T*-test Results

A series of one-sample tests were run using SPSS to see if the findings from the survey samples for the value of mean change in selected indicators were compatible with general trends in the economy. The mean change in the sample indicator was compared with the mean change in selected indicators in the wider economy. However, in this approach, like is being compared with like in fairly loose terms. The effect of change in sales for the sample is compared with change in output for the economy. It would be more accurate to compare value-added of the sample with that of the wider economy, but data were not sufficient for either to be calculated with any accuracy. More precise were the comparisons of production change and employment in the sample enterprises and the wider economy. All details from the analysis are set out in the table below:

Table A1 *T*-test results

| | Value to compare with sample | *T* | Df | Sig. (2-tailed) | Mean difference | 90% confidence interval of the difference | |
|---|---|---|---|---|---|---|---|
| | | | | | | Lower | Upper |
| **Bosnia Herzegovina** | | | | | | | |
| **Sales/output** | 18.55 | -0.241 | 13 | 0.813 | -2.18 | -18.21 | 13.85 |
| **Employment change – economy** (Federation only) | -5.70 | 1.340 | 16 | 0.198 | 8.13 | -4.69 | 20.96 |
| **Employment change – manufacturing** (Federation only) | -12.94 | 2.578 | 13 | 0.023 | 18.23 | 2.96 | 33.51 |
| **Production volume** (Federation only) | 39.70 | 0.791 | 6 | 0.459 | 82.07 | -171.90 | 336.05 |
| **Serbia** | | | | | | | |
| **Sales/output** | 11.50 | -1.767 | 12 | 0.103 | -24.21 | -48.63 | 0.20 |
| **Employment change - economy** | 10.70 | -6.561 | 19 | 0.000 | -26.75 | -33.80 | -19.70 |
| **Employment change - manufacturing** | -14.90 | -0.164 | 14 | 0.872 | -0.87 | -10.19 | 8.46 |
| **Production volume** | -0.88 | 1.780 | 5 | 0.136 | 77.54 | -10.44 | 165.52 |

# Annex 2: Survey Responses - External Environment

Table A2 External environment

| | Bosnia Herzegovina | | Serbia | |
|---|---|---|---|---|
| | No. | % | No. | % |
| **How many competitors does your enterprise have?** | **N=19** | | **N=19** | |
| 0 | 2 | 11 | 0 | 0 |
| 1 | 0 | 0 | 0 | 0 |
| 2-5 | 2 | 11 | 9 | 47 |
| More than 5 | 15 | 79 | 10 | 53 |
| **How competitive since privatisation?** | **N=18** | | **N=20** | |
| More | 14 | 78 | 13 | 65 |
| Less | 2 | 11 | 2 | 10 |
| Same | 2 | 11 | 5 | 25 |
| **Since privatisation has the level of debt...** | **N=16** | | **N=12** | |
| Increased | 10 | 62 | 7 | 58 |
| Decreased | 4 | 25 | 5 | 42 |
| Stayed the same? | 2 | 13 | 0 | 0 |
| **Who are main creditors? (Managers ticked more than one box)** | **N=19** | | **N=17** | |
| Suppliers | 9 | - | 12 | - |
| Domestic banks | 15 | - | 7 | - |
| Foreign banks | 2 | - | 2 | - |
| Government | 6 | - | 5 | - |
| Employees | 2 | - | 0 | - |
| **Have you raised finance from...** | **N=20** | | **N=18** | |
| Banks | 17 | 85 | 17 | 94 |
| Government | 2 | 10 | 0 | 0 |
| Other? | 1 | 5 | 1 | 6 |
| **Did you receive any government support before privatisation?** | **N=15** | | **N=16** | |
| Yes | 4 | 26 | 5 | 31 |
| No | 11 | 73 | 11 | 69 |
| **Have you received any government support since privatisation?** | **N=15** | | **N=16** | |
| Yes | 4 | 26 | 4 | 25 |
| No | 11 | 73 | 12 | 75 |
| **Would you take legal action against another party?** | **N=15** | | **N=9** | |
| Yes | 12 | 80 | 8 | 89 |
| No | 3 | 20 | 1 | 11 |
| **How do you rank the legal system?** | **N=19** | | **N=14** | |
| Highly effective | 0 | 0 | 0 | 0 |
| Fairly effective | 0 | 0 | 0 | 0 |
| Effective | 1 | 5 | 3 | 22 |
| Fairly ineffective | 10 | 53 | 9 | 64 |
| Highly ineffective | 8 | 42 | 2 | 14 |
| **What are the main constraints that face your business?** | **N=21** | | **N=21** | |
| The grey economy | 7 | 33 | 4 | 19 |
| Access to finance | 8 | 38 | 3 | 14 |
| High taxes on salaries | 9 | 43 | - | - |
| The legacy of the old system | 4 | 19 | - | - |
| Weak markets | 5 | 24 | 3 | 14 |
| Institutional / regulatory constraints | 2 | 10 | 6 | 29 |
| International image of country | 1 | 5 | - | - |
| Competition | - | - | 2 | 9 |
| Excess labour | - | - | 1 | 5 |

# Annex 3: Survey Responses – Enterprise History and Privatisation Process

Table A3 Enterprise history and privatisation process

| | Bosnia Herzegovina | | Serbia | |
|---|---|---|---|---|
| | **No.** | **%** | **No.** | **%** |
| **Impact of conflict and change in national boundaries** | **N=15** | | **N=17** | |
| Change in structure of enterprise | 7 | 37 | 1 | 6 |
| Loss of markets | 14 | 74 | 15 | 88 |
| Loss of suppliers | 7 | 37 | 2 | 12 |
| Loss of support structure | 3 | 16 | - | - |
| Reduction in employees | 10 | 53 | 4 | 24 |
| **Was the privatisation process constrained by...** | **N=18** | | **N=19** | |
| High debts | 6 | 33 | 4 | 21 |
| Excess labour | 2 | 11 | 5 | 26 |
| Lack of investor | 10 | 56 | 1 | 5 |
| Bureaucratic processes | 6 | 33 | 3 | 16 |
| No constraints? | 3 | 17 | 9 | 47 |
| **Pre-privatisation restructuring?** | **N=19** | | **N=20** | |
| Reduction in employees | 9 | 47 | 7 | 35 |
| Increase in employees | 4 | 21 | 1 | 5 |
| Change in organisational structure | 8 | 42 | 3 | 15 |
| Change in product mix | 6 | 32 | 1 | 5 |
| Capital investment | 5 | 26 | 5 | 25 |
| No restructuring | 2 | 11 | 10 | 50 |
| **Why did new owners buy this enterprise?** | **N=15** | | **N=11** | |
| Future prospects and profits | 5 | 33 | 3 | 27 |
| Already a successful company | 2 | 13 | 2 | 18 |
| To ensure future stability for employment | 8 | 53 | - | - |
| To keep what employees had created | - | - | 2 | 18 |
| Good access to raw material and infrastructure | - | - | 2 | 18 |
| Export potential | - | - | 2 | 18 |

# Annex 4: Survey Responses - Enterprise Internal Restructuring Measures by Privatisation Method and Ownership Structure – Bosnia Herzegovina

Table A4 Enterprise internal restructuring measures by privatisation method and ownership structure – Bosnia Herzegovina

| | Production level (I=Increase D=Decrease S=Same) | | | Change in methods? (Y=Yes N=No) | | Goods quality (B=Better S=Same) | | New products? (Y=Yes N=No) | | New suppliers? (Y=Yes N=No) | | Change in internal structure? (Y=Yes N=No) | | Change in quality accreditation? (Y=Yes N=No) | | Change in managers' incentives? (Y=Yes N=No) | | Change in workers' incentives? (Y=Yes N=No) | | Change in working conditions? (Y=Yes N=No) | | New departments? (Y=Yes N=No) | | Could changes have happened without privatisation? (Y=Yes N=No) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **By privatisation method** | | | | | | | | | | | | | | | | | | | | | | | | | |
| | **I** | **D** | **S** | **Y** | **N** | **B** | **S** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** |
| Tender | 8 | 0 | 0 | 7 | 1 | 6 | 2 | 7 | 1 | 7 | 0 | 7 | 1 | 6 | 2 | 7 | 1 | 7 | 1 | 6 | 2 | 4 | 4 | 1 | 7 |
| Auction/ POS | 3 | 3 | 0 | 2 | 4 | 4 | 2 | 3 | 3 | 4 | 1 | 5 | 1 | 5 | 1 | 0 | 6 | 1 | 5 | 2 | 4 | 2 | 4 | 2 | 3 |
| Direct negotiation | 3 | 0 | 2 | 3 | 2 | 2 | 3 | 3 | 2 | 4 | 0 | 4 | 1 | 1 | 4 | 3 | 2 | 2 | 3 | 1 | 4 | 0 | 5 | 3 | 2 |
| **Total** | **14** | **3** | **2** | **12** | **7** | **12** | **7** | **13** | **6** | **15** | **1** | **16** | **3** | **12** | **7** | **10** | **9** | **10** | **9** | **9** | **10** | **6** | **13** | **6** | **12** |
| **By ownership structure** | | | | | | | | | | | | | | | | | | | | | | | | | |
| | **I** | **D** | **S** | **Y** | **N** | **B** | **S** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** |
| Employees | 8 | 1 | 2 | **6** | 5 | 7 | 4 | 6 | 5 | 9 | 0 | 9 | 2 | 6 | 5 | 7 | 4 | 6 | 5 | 4 | 7 | 2 | 9 | 4 | 6 |
| Bosnian investor | 2 | 0 | 0 | **2** | 0 | 2 | 0 | 2 | 0 | 0 | 0 | 2 | 0 | 1 | 0 | 1 | 1 | 1 | 1 | 1 | 1 | 0 | 2 | 0 | 2 |
| Foreign investor | 2 | 0 | 0 | **2** | 0 | 1 | 1 | 2 | 0 | 3 | 0 | 2 | 0 | 2 | 1 | 2 | 0 | 2 | 0 | 2 | 0 | 2 | 0 | 0 | 2 |
| No majority investor | 2 | 2 | 0 | **2** | 2 | 2 | 2 | 3 | 1 | 3 | 1 | 3 | 1 | 3 | 1 | 0 | 4 | 1 | 3 | 2 | 2 | 2 | 2 | 2 | 2 |
| **Total** | **14** | **3** | **2** | **12** | **7** | **12** | **7** | **13** | **6** | **15** | **1** | **16** | **3** | **12** | **7** | **10** | **9** | **10** | **9** | **9** | **10** | **6** | **13** | **6** | **12** |
| **Privatisation method – employee-owned firms** | | | | | | | | | | | | | | | | | | | | | | | | | |
| | **I** | **D** | **S** | **Y** | **N** | **B** | **S** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** |
| Tender | 5 | 0 | 0 | 4 | 1 | 4 | 1 | 4 | 1 | 5 | 0 | 4 | 1 | 3 | 2 | 5 | 0 | 5 | 0 | 3 | 2 | 2 | 3 | 1 | 4 |
| Auction/ POS | 1 | 1 | 0 | 0 | 2 | 2 | 0 | 0 | 2 | 1 | 0 | 2 | 0 | 2 | 0 | 0 | 2 | 0 | 2 | 0 | 2 | 0 | 2 | 0 | 1 |
| Direct negotiation | 2 | 0 | 2 | 2 | 2 | 1 | 3 | 2 | 2 | 3 | 0 | 3 | 1 | 1 | 3 | 2 | 2 | 1 | 3 | 1 | 3 | 0 | 4 | 3 | 1 |
| **Total** | **8** | **1** | **2** | **6** | **5** | **7** | **4** | **6** | **5** | **9** | **0** | **9** | **2** | **6** | **5** | **7** | **4** | **6** | **5** | **4** | **7** | **2** | **9** | **4** | **6** |

# Annex 5: Survey Responses - Percentage Change in Management

## *Number of firms*

Table A5a Percentage change in management – Bosnia Herzegovina

| | 0 | 1-5 | 6-10 | 11-50 | 51-99 | 100 |
|---|---|---|---|---|---|---|
| **By privatisation method** | | | | | | |
| Tender | 1 | 2 | 0 | 2 | 1 | 2 |
| Auction/POS | 3 | 2 | 0 | 0 | 0 | 1 |
| Direct negotiation | 2 | 2 | 1 | 0 | 0 | 0 |
| **Total** | **6** | **6** | **1** | **2** | **1** | **3** |
| **By ownership structure** | | | | | | |
| Employees | 5 | 3 | 0 | 1 | 0 | 2 |
| Bosnian investor | 0 | 0 | 1 | 0 | 1 | 0 |
| Foreign investor | 0 | 1 | 0 | 1 | 0 | 0 |
| No majority investor | 1 | 2 | 0 | 0 | 0 | 1 |
| **Total** | **6** | **6** | **1** | **2** | **1** | **3** |
| **By privatisation method – employee-owned firms only** | | | | | | |
| Tender | 1 | 1 | 0 | 1 | 0 | 2 |
| Auction/POS | 2 | 0 | 0 | 0 | 0 | 0 |
| Direct negotiation | 2 | 2 | 0 | 0 | 0 | 0 |
| **Total** | **5** | **3** | **0** | **1** | **0** | **2** |

Table A5b Percentage change in management by type of investor - Serbia

| | 0 | 1-5 | 6-10 | 11-50 | 51-99 | 100 |
|---|---|---|---|---|---|---|
| Employees | 1 | - | - | 1 | - | - |
| Serbian investor | 1 | 2 | 2 | 7 | 0 | 1 |
| Foreign investor | 1 | - | - | 1 | 3 | - |
| **Total** | **3** | **2** | **2** | **9** | **3** | **1** |

# Annex 6: Survey Responses – Employment Changes

## *Number of firms*

Table A6a Employment changes - Bosnia Herzegovina

| | N | Average change in employment (%) | Number of firms increasing employment | Number of firms reducing employment | Number of firms with no change |
|---|---|---|---|---|---|
| **By privatisation method** | | | | | |
| Tender | 8 | 13.44 | 4 | 3 | 1 |
| Auction/POS | 6 | -8.72 | 1 | 3 | 2 |
| Direct negotiation | 5 | 0.85 | 1 | 3 | 1 |
| **Average/Total** | **19** | **3.13** | **6** | **9** | **4** |
| **By ownership structure** | | | | | |
| Employees | 11 | 2.08 | 3 | 6 | 2 |
| Bosnian investor | 1 | 60.41 | 1 | - | - |
| Foreign investor | 3 | -0.94 | 1 | 1 | 1 |
| No majority investor | 4 | -5.26 | 1 | 2 | 1 |
| **Total** | **19** | **3.13** | **6** | **9** | **4** |
| **By privatisation method – employee-owned firms only** | | | | | |
| Tender | 5 | 8.40 | 2 | 3 | 0 |
| Auction/POS | 2 | -15.63 | 0 | 1 | 1 |
| Direct negotiation | 4 | 3.05 | 1 | 2 | 1 |
| **Average/Total** | **11** | **2.09** | **3** | **6** | **2** |

Table A6b Employment changes by type of investor - Serbia

| | N | Average change in employment (%) | Number of firms increasing employment | Number of firms reducing employment | Number of firms with no change |
|---|---|---|---|---|---|
| Employees | 2 | 3.61 | 1 | 1 | 0 |
| Serbian investor | 12 | -15.54 | 2 | 10 | 1 |
| Foreign investor | 5 | -25.24 | 0 | 5 | 0 |
| **Average/Total** | **19** | **-16.05** | **3** | **16** | **1** |

# Annex 7: Survey Responses - Enterprise Internal Restructuring Measures by Type of Investor –Serbia

*Number of firms*

Table A4 Enterprise internal restructuring measures by privatisation method and ownership structure – Bosnia Herzegovina

| | **Production level (I=Increase D=Decrease S=Same)** | | | **Change in methods? (Y=Yes N=No)** | | **Goods quality (B=Better S=Same)** | | **New products? (Y=Yes N=No)** | | **New suppliers? (Y=Yes N=No)** | | **Change in internal structure? (Y=Yes N=No)** | | **Change in quality accreditation? (Y=Yes N=No)** | | **Change in managers' incentives? (Y=Yes N=No)** | | **Change in workers' incentives? (Y=Yes N=No)** | | **Change in working conditions? (Y=Yes N=No)** | | **New departments? (Y=Yes N=No)** | | **Could changes have happened without privatisation? (Y=Yes N=No)** | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **By type of investor** | | | | | | | | | | | | | | | | | | | | | | | | | |
| | **I** | **D** | **S** | **Y** | **N** | **B** | **S** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** | **Y** | **N** |
| Employees | 0 | 2 | 0 | 0 | 2 | 0 | 1 | 0 | 1 | 0 | 1 | 1 | 1 | 0 | 0 | 0 | 2 | 0 | 2 | 0 | 2 | 1 | 1 | 1 | 1 |
| Serbian investor | 9 | 0 | 4 | 5 | 8 | 8 | 3 | 7 | 6 | 11 | 2 | 7 | 6 | 2 | 8 | 8 | 5 | 6 | 6 | 6 | 7 | 6 | 7 | 1 | 10 |
| Foreign investor | 3 | 1 | 2 | 4 | 2 | 3 | 3 | 2 | 4 | 4 | 2 | 3 | 2 | 2 | 4 | 4 | 2 | 3 | 3 | 3 | 3 | 2 | 4 | 0 | 5 |
| **Total** | **12** | **3** | **6** | **9** | **12** | **11** | **7** | **9** | **11** | **15** | **5** | **11** | **9** | **4** | **12** | **12** | **9** | **9** | **11** | **9** | **12** | **9** | **12** | **2** | **16** |